



San Diego County Water Authority

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June 15, 2016

Randy Record and
Members of the Board of Directors
Metropolitan Water District of Southern California
P.O. Box 54153
Los Angeles, CA 90054-0153

VIA EMAIL TO ALL MWD BOARD MEMBERS

RE: June Board Meeting Board Memo 8-2: Draft Appendix A

Dear Chairman Record and Members of the Board:

This letter responds to Gary Breaux's June 14, 2016 letter and provides comments on the redline Board Distribution Draft Appendix A dated 5/31/16 (Draft Appendix A).

I. Gary Breaux's June 14, 2016 Letter - "Narrowing Down Board Approval"

We submitted a letter dated June 11, 2016 (Attachment 1) regarding the Board's deliberation of June Board Memo 8-2 and specifically, our opposition to MWD staff's new procedure for "how best to involve [the MWD] Board in the process" of reviewing disclosures made in offering statements. At the time of our review of Board Memo 8-2, MWD staff had already withdrawn Board Memo 8-3 (authorizing issuance of up to \$175 million of subordinate water revenue bonds), so that to our knowledge, there was no bond sale pending.

On Monday, June 13, at the Finance and Insurance Committee meeting, MWD's Chief Financial Officer, Gary Breaux, "mentioned" that staff was planning to use the updated disclosures in the Draft Appendix A in connection with the remarketing of bonds "this month" -- a fact that should have been made explicitly clear in Board Memo 8-2. In a letter delivered to the Board yesterday morning (Attachment 2), Mr. Breaux also informed us for the first time that staff planned to print a preliminary official statement using the Draft Appendix A tomorrow, Thursday, June 15, thus providing one day for our review and comment.

Board Memo 8-2, the revised "Metropolitan Water District Disclosure Procedures" and Mr. Breaux's letter are collectively, unclear exactly what "interim" updates will be provided to the Board, and provide no explanation why "narrowing down board approval" of MWD's disclosures to two times a year is necessary or even advisable. We believe such a "narrowing" of the Board's role and oversight is highly inappropriate at the very time questions are being raised about the disclosures MWD is making. As stated in our June 11 letter, we may disagree over what disclosures are required, but it is essential to the process that we have an opportunity as MWD Board members to express our concerns to staff, MWD's professional advisors and our fellow Board members.

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

Mr. Breaux's statement that "Metropolitan's financial and operating information remains fundamentally the same for many months at a time," is untrue. As we have more time available, we will provide an analysis demonstrating that this statement is untrue and that, to the contrary, MWD's financial and operating condition has actually been quite volatile over the past several years.

Mr. Breaux also explains the proposed change in MWD's procedure narrowing Board review as being based on the fact that MWD is a frequent issuer. That might be appropriate if MWD's Appendix A included relatively few changes each time MWD goes to market, but that has certainly not been the case. Numerous changes have been made to each and every draft Appendix A over the past few years, and we have provided comments on each and every one of them. The current Draft Appendix A, as an example, includes 1,009 insertions, 976 deletions and thousands of word changes, many of which are not self-explanatory.

We won't repeat all of the concerns expressed in our June 11 letter; suffice it to say that we have requested and will rely upon the General Counsel's assurance at yesterday's Board meeting that all future proposed changes to Appendix A disclosures will continue to be provided to us for review prior to preparation of any preliminary official statement or sale, or remarketing of bonds. We make this standing request as members of the MWD Board of Directors in order to meet the responsibilities we believe all public officials have in connection with the sale of municipal bonds.

II. General Comments on Draft Appendix A

We incorporate by reference all of the comments and objections contained in our October 12, 2015 letter to the Board (Attachment 3) RE Board Item 8-2: Approve and authorize the execution and distribution of Remarketing Statements in connection with the remarketing [of bonds] (including its incorporation of prior comments and objections). As noted therein, we have raised several substantive issues that have not been addressed by MWD in prior drafts of Appendix A. These include, but are not limited to, MWD's continued commingling of the Water Authority's deposit of disputed funds under the Exchange Agreement with other unrestricted funds, and misstatement of material facts that have been judicially determined in the rate litigation. For example, MWD's continued "disclosure" reporting revenues paid for the transportation of water as a MWD "water sale," thus inflating this key indicator of MWD's financial position and suggesting that MWD sales are not being permanently reduced, as they actually are. As another example, MWD reports that the decision in the rate litigation is on appeal, but does not disclose that there are other appellate cases that are inconsistent with MWD's arguments on appeal, including its contention that Proposition 26 does not apply to wholesale water suppliers.¹ This is material because MWD has stated that any change to its existing rate structure could "destabilize" MWD's rate structure and water sales.²

¹ For example, MWD is well aware of the decision in *Newhall County Water District v. Castaic Lake Water Agency*, 197 Cal. Rptr. 3d 429 (Cal. Ct. App. 2016), because it made an unsuccessful effort to have the decision depublished (Attachment 4).

² See, for example, MWD's argument at pages 14-15 and 79 of its First Pretrial Brief (Attachment 5): "A piecemeal attack on individual rate components that fails to consider all of the factors MWD's Board must consider in allocating costs and setting rates **threatens to destabilize MWD's entire rate structure**. This in

III. Specific Comments on Draft Appendix A

A-6-7 and A-22: Colorado River. Staff has failed to include any discussion of ongoing Colorado River shortage sharing proposals it is engaged in that could result in lower Colorado River water deliveries to MWD. Staff reported at the June Board meeting on the extent of California water losses that could be sustained, but indicated that it has not yet calculated any offsetting benefits.

A-8-9: Integrated Resources Plan (IRP) and Breakdown of MWD Governance. MWD staff has deleted reference to the second phase of the IRP process, in which the Board of Directors would review policy issues, along with the reference to the first phase as being limited to a "technical update." Staff is reinventing history with these edits. Staff should disclose that the MWD Board did not deliberate any policy issues associated with the 2015 IRP Update prior to its adoption, including its failure to examine or consider the impacts of MWD staff's decision to assume for IRP planning purposes only 20,000 acre-feet of planned local water supply development, when the actual number is more than 10 times that -- 205,000 acre-feet -- of local projects that are currently in the full design phase with funds appropriated or at the advanced planning stage with completed certified environmental review.

We believe this breakdown in the process of MWD board governance -- which is also demonstrated, for example, by the absence of a current Long Range Finance Plan, is a material circumstance that should be disclosed to MWD investors. At a minimum, these edits in this section should not be made because they are deleting language that more accurately describes what happened with regard to the planned -- and now, apparently abandoned -- two-phase process for development of the IRP.³

Staff is also deleting, without explanation, reference to the "core resource strategy, uncertainty buffers and foundational actions" contained in the 2015 IRP Update. Please explain.

A-10-15: State Water Project. MWD staff's proposed edits delete discussion of the Delta Stewardship Council and its role under the Sacramento San Joaquin Delta Reform Act to develop a comprehensive management plan for the Delta. The existing Appendix A reported pending litigation, but the proposed edits fail to include discussion of the outcome of the decision, requiring, among other things, that MWD and other state water contractors demonstrate a quantifiable

turn threatens the continued administration of the LRP, CCP and SDP programs because without a stable rate structure, MWD cannot ensure the continued availability of funds necessary to administer these programs and honor its contractual commitments under the programs" (page 79).

³ MWD staff has been clear in any case that it is basing spending decisions on the 2015 IRP Update, with or without Board oversight or policy review of such questions as analysis of the true demand for MWD water. See the Water Authority's January 10, 2016 letter RE Board Memo 8-3: Adopt the 2015 Integrated Water Resources Plan Update - REQUEST TO DEFER BOARD ACTION ADOPTING 2015 IRP UPDATE, OR, IN THE ALTERNATIVE, OPPOSE (Attachment 6).

reduction of the demand for Delta water.⁴ This decision and its impacts on MWD, its State Water Project supplies and plans to implement the California WaterFix must be disclosed to potential investors.

A-33-35: Local Water Supplies. MWD inappropriately discusses local water supply development in the context of its IRP in order to avoid discussing "the rest of the story," that this local water supply development -- which has become cost-effective as the cost of MWD water has increased -- will permanently reduce demand for MWD water. MWD staff finally acknowledged at the June board meeting its awareness that its "current business model of paying [MWD member agencies] incentives and agencies "rolling off" is not sustainable."⁵

A-37 and A-42-43: Water Treatment. MWD's discussion in Appendix A about water treatment does not "match" the discussion of this issue during MWD's recent rate-setting process in which it was initially claimed that MWD has a legal obligation to serve treated water and needs to recover stranded costs. Later, in response to questions contradicting this claim, MWD's legal counsel admitted MWD does not have a legal obligation to serve treated water. MWD has failed to discuss the facts and circumstances that led to its recommendation to implement a fixed water treatment charge, based on reduced demand for MWD treated water; or, the fact that the Board was unable to reach agreement how to recover these stranded costs *ex post facto*. The treated water stranded cost issue may be viewed as the "canary in the coal mine" that foretells potential stranded assets on the supply side as well, if long term planning and financial issues are not meaningfully addressed by the Board and implemented through a revised 2015 IRP Update and Long Range Finance Plan or other planning process.

A-40: Cost of Service. The label titled "Cost of Service" is inappropriate as used to describe the elements of MWD's Capital Investment Plan. This confuses MWD's obligation to set its rates according to cost of service requirements of the common law, California statutes and the state Constitution.

A-43-44: Major Projects of CIP. MWD staff reports hundreds of millions of dollars of CIP cost increases relating to the Colorado River Aqueduct facilities and distribution system. Please provide the data supporting these reported cost increases and when it was previously reported to the Board of Directors.

A-44: Tax Revenues. MWD is deleting the entire paragraph explaining the limitations on its taxing authority; this is misleading. The paragraph should be left in as is, or updated as appropriate.

A-46: Water Sales Including Wheeling Revenues. MWD's revenues from wheeling should be reported separately from its "water sales." Combining these numbers disguises the extent to which MWD

⁴ "Ruling on Submitted Matter: Petitions for Writ of Mandate, Bifurcated Proceeding on Statutory Challenges (*Delta Stewardship Council Cases*, CJP No. 4758, (2016)).

⁵ See Item #7a, Integrated Resources Planning Committee, IRP Board Retreat Follow-up, Slide 8: Key Themes - MWD History and the Laguna Declaration, bullet four: "Current business model of paying incentives and agencies "rolling off" is not sustainable" (Attachment 7).

sales are reduced by member agencies that purchase water from third party sources such as the Water Authority has done.

A-48-51: Litigation Challenging Rate Structure. As noted earlier, MWD's discussion of the rate litigation should account for case law that does not support MWD's contentions on appeal, including its contention that Proposition 26 does not apply to wholesale water suppliers. See discussion and footnote 1.

MWD's description of its accounting for the disputed funds deposited by the Water Authority under the Exchange Agreement should be revised to include disclosure that the newly created "Exchange Agreement Set-Aside Fund" is in a category of "funds" that is not identified in Section 5200 of MWD's Administrative Code. Instead, staff reported yesterday that this is a "Board Directed Fund," another term which is not disclosed or described anywhere in the Administrative Code or Appendix A.⁶

It is apparent from MWD's accounting of fund balances (see pages A-54-55 discussion of MWD's financial reserve policy) that the funds paid by the Water Authority as disputed amounts under the Exchange Agreement are not being held by MWD as a security deposit, but rather, are being commingled with other unrestricted reserves the MWD board may spend in its discretion. This treatment is not only a breach of the Exchange Agreement, but contrary to statements MWD's counsel has made to the Court in the rate litigation that these funds are being held for the intended purpose of securing payment to the Water Authority if it prevails on appeal. The Water Authority's disputed funds are doing "double duty" by being available to meet MWD's minimum unrestricted reserve level at the same time they are supposed to be securing payment to the Water Authority. But the same funds can't be used at the same time for both purposes without either dipping below minimum reserves or failing to maintain the security deposit MWD is contractually required to maintain. MWD either breached its contractual obligation to the Water Authority or its representations to bond holders when it used \$104 million from its unrestricted reserves to pay for the PVID land purchase. See Attachment 3 for a complete discussion of this issue.

We object generally to the continued practice of editing Appendix A to comport with MWD's evolving litigation strategies rather than reporting and disclosing facts that are material to potential investors.

A-51: Member Agency Purchase Orders. MWD's two-tier purchase orders are completely disconnected from the cost of service and do nothing to provide any meaningful level of financial stability for MWD. There is no reason to reference them except to create the misleading impression that they accomplish one or the other of these purposes.⁷ MWD's current two-year budget assumes zero water sales at the Tier Two level.

⁶ MWD staff also reported yesterday that MWD's "Water Management Fund" - referred to at pages A-55 and A-81-82, footnotes (g) and (p) of Draft Appendix A, is a "Board Directed Fund," which is why it also is not included as a "fund" identified in Section 5200 of MWD's Administrative Code.

⁷ See, for example, November 17, 2014 letter RE Board Memo 8-1: Approve the proposed terms for Purchase Orders, etc. (Attachment 8).

A-52: Classes of Water Service. Unlike other outdated text, MWD continues to report "classes of water service," even though two out of the three rates have been eliminated. Cost of service law requires MWD to establish classes of customers based on their patterns of usage, not classes of water service.

A-54-55: Financial Reserve Policy. The fact that MWD is unwilling to "set aside" the Water Authority's disputed amounts, as it is contractually required to do, may reasonably be viewed as an indication that it is financially unable to do so. MWD has already had to borrow money through a commercial line of credit in order to replace funds it spent from the security deposit.

A-57: Preferential Rights. Thank you for adding language disclosing this aspect of the outcome of the trial court decision in the rate litigation.

A-57-58: California Ballot Initiatives. MWD's edits regarding Proposition 26 are inconsistent with existing law and are litigation-driven to support its argument -- rejected by the trial court -- and appellate decisions that the MWD board is the relevant "electorate" for purposes of Proposition 26.

A-75: Projected Costs of MWD for State Water Project Water. What accounts for the substantial increases in the minimum operations, maintenance, power and replacement costs? When was this reported to the MWD Board? Please explain.

A-78-82: Historical Projected Revenues and Expenses. In recent years, MWD has not even attempted to accurately project its revenues and expenses, instead following an admitted strategy to arbitrarily collect and then decide later how to spend hundreds of millions of dollars outside of its budget and rate-setting process. Over the past five years alone, MWD collected – and has now spent – more than \$850 million outside of its budget process, shifting money from fund to fund as necessary, including funds that are not even identified in its Administrative Code, such as the Water Management Fund. MWD's turf removal program and the unplanned purchase of the land described at page A-82, paragraph (p) as a "Pay-As-You-Go expenditure for fiscal year 2015-16" typify this erratic behavior. Since this money was spent, MWD has been forced to take out commercial lines of credit in order to maintain its required reserves. MWD's Long Range Finance Plan is now more than ten years old, because the MWD Board is unwilling to make any commitments to pay MWD's future costs, or grapple with the challenges of an agency spending billions of dollars with no one on the hook to pay for it.

A-82-84: Management's Discussion of Historical and Projected Revenues and Expenses. Statements by management, like its IRP, fail to disclose material factors influencing the future demand for MWD water, rate increases that will be necessary to pay MWD's costs with a diminishing sales base, and the impacts of MWD's recent very large unplanned expenditures (turf removal, PVID land acquisition and acquisition of Delta islands). MWD lacks an IRP resource plan that has buy-in from the member agencies that prefer the present model in which no agency is asked to commit to pay MWD any of its costs before they are invested. This problem was identified by MWD's own Blue Ribbon Task Force more than 20-years ago but MWD has yet to address it in a meaningful way, for example, the

Board's recent inability or unwillingness to adopt a fixed water treatment charge. This exercise will only become more difficult as MWD continues to spend large amounts of money under the present governance model imposing rates that have already been declared illegal.

We appreciate your consideration and timely response to each of these issues and to receiving reasonable notice in the future of MWD's plans to revise the disclosures contained in Appendix A and sell bonds to the public.

Sincerely,



Michael T. Hogan
Director



Keith Lewinger
Director



Fern Steiner
Director



Yen C. Tu
Director

Attachments:

- 1) Water Authority Board Members' June 11, 2016 letter RE Board Memo 8-2: Approve and Authorize Appendix A for use in the issuance and remarketing of Metropolitan's bonds - REQUEST TO TABLE OR IN THE ALTERNATIVE, OPPOSE;
- 2) Gary Breaux's June 14, 2016 letter responding to June 11 letter;
- 3) Water Authority Board Members' October 12, 2015 letter to the Board RE Board Item 8-2: Approve and authorize the execution and distribution of Remarketing Statements in connection with the remarketing [of bonds];
- 4) MWD's March 21, 2016 letter to the California Supreme Court requesting depublication of the Newhall opinion and Supreme Court order denying that request;
- 5) Respondent/Defendant MWD's First Pretrial Brief in the rate litigation (cover page and pages 14-15 and 78);
- 6) Water Authority Board Members' January 10, 2016 letter RE Board Memo 8-3: Adopt the 2015 Integrated Water Resources Plan Update - REQUEST TO DEFER BOARD ACTION ADOPTING 2015 IRP UPDATE, OR, IN THE ALTERNATIVE, OPPOSE;
- 7) See MWD PowerPoint presentation Item #7a, June 14, 2016 Integrated Resources Planning Committee, IRP Board Retreat Follow-up, Slide 8: Key Themes - MWD History and the Laguna Declaration; and
- 8) Water Authority Board Members' November 17, 2014 letter RE Board Memo 8-1: Approve the proposed terms for Purchase Orders.



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June 11, 2016

Randy Record and

Members of the Board of Directors

Metropolitan Water District of Southern California

P.O. Box 54153

Los Angeles, CA 90065-0153

RE: Board Memo 8-2: Approve and Authorize Appendix A for use in the issuance and remarketing of Metropolitan's bonds - **REQUEST TO TABLE OR IN ALTERNATIVE, OPPOSE**

Dear Chairman Record and Members of the Board:

Since Board Memo 8-3, authorizing the issuance of up to \$175 million of Subordinate Water Revenue Bonds, has been pulled from this month's board agenda, this letter will address only Board Memo 8-2, relating to proposed changes in MWD's procedures for board review of bond offering statements in connection with sale of municipal bonds. We will provide detailed comments on the *Board Distribution 5/31/16 Draft Appendix A*, prior to the proposed bond sale being brought back to the Board of Directors for approval. We request that board action approving the "biannual" generic Appendix A attached to Board Memo 8-2 be tabled pending the proposed financing being brought back to the Board.

Board Memo 8-2 describes a *material change* in MWD's longstanding practice of providing a draft Appendix A for board review *each time bonds are proposed to be sold, or remarketed*, prior to finalizing bond offering statements that include Appendix A. According to Board Memo 8-2, MWD staff now plans to limit the Board to a "biannual" review of Appendix A.ⁱ

Copies of the "updated" Disclosure Procedures dated June 1, 2016 and the prior, undated procedures are included as Attachments 1 and 2 to this letter, respectively, so that the Board may see the proposed changes, in particular, the addition of a new paragraph 2, "Preparation of Disclosure Documents related to Debt."ⁱⁱ We OPPOSE this new policy and procedure; in fact, we believe federal law relating to the individual fiduciary responsibilities every MWD Board member has in connection with the sale of MWD bonds cannot be "trumped" by a MWD Board vote, let alone a new procedure developed by staff.

Our staff has provided us with a helpful article we are also taking the liberty of attaching for the

MEMBER AGENCIES

Carlsbad
Municipal Water District

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OTHER REPRESENTATIVE

County of San Diego

Chairman Record and Members of the Board

June 11, 2016

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benefit of our fellow MWD Board members, *Disclosure Obligations of Municipal Issuers: The SEC Enforcement Perspective*.ⁱⁱⁱ Among other things, the article notes:

- The SEC will hold public officials personally accountable and seek enforcement sanctions when it determines that an issuer has failed to disclose material information in violation of the federal securities laws.
- While it is important for a municipal issuer to demonstrate that it has written policies and procedures designed to ensure that material information is disclosed, compliance with such a disclosure checklist is not "the goal unto itself." Rather, it is essential that there are substantive discussions relating to the larger issues facing the agency including disclosure of "bad news."
- While it is important to retain qualified professional advisors, the SEC requires that public officials read and understand the representations being made in offering statements before they vote to approve them.

In short, we believe the changes staff has made to MWD's disclosure procedures are moving in the wrong direction; rather than enhancing review, the changes would reduce the opportunities for, and level of Board review associated with the issuance and sale of bonds.^{iv} We recommend that the staff bring back a complete report on MWD's disclosure procedures, including recommendations by its professional advisors, so that the Board can weigh in on what the process should be before it is finalized.

The Water Authority has expressed a number of concerns about the disclosures in MWD's Draft Appendix A for many years. That alone is a good reason to enhance, not diminish the MWD Board's review. It is important that we express our concerns, and it is important for the rest of the MWD Board to be aware of those concerns, whether or not individual board members agree that additional or different disclosures should be made. Recent SEC actions and other news involving the Westlands Water District also suggest that greater, rather than lesser Board oversight is not only beneficial, but essential.

We appreciate your consideration of these issues and look forward to the discussion at next week's board meeting. We hope the Board will table this item and have a full discussion; if not, we must OPPOSE the action for the reasons stated above.

Sincerely,



Michael T. Hogan
Director



Keith Lewinger
Director



Fern Steiner
Director



Yen C. Tu
Director

Chairman Record and Members of the Board

June 11, 2016

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Attachments:

1. MWD "Disclosure Procedures" dated June 1, 2016
2. MWD "Disclosure Procedures" undated
3. Disclosure Obligations of Municipal Issuers: The SEC Enforcement Perspective, May 2008, prepared by K&L|Gates

ⁱ Attachment 1 and Board Memo 8-2 say different things about what updates staff would provide to the board between biannual updates. The Disclosure Procedures (Attachment 1), which presumably are provided to the SEC and investors, states that "interim" updates will be provided to the Board, described as being those that are needed to "capture key shifts in Metropolitan's financial cycle" (page 2, paragraph 2(b)). Board Memo 8-2 states that "material updates" will be provided for bond sales occurring between the proposed biannual reviews. Without trying to interpret what the language means in either context, we believe the only correct approach is to provide the entire Draft Appendix A to directors as staff has historically done.

ⁱⁱ Staff is also recommending changes relating to the voluntary disclosure of bank loans (Attachment 1, paragraph 6 compared to Attachment 2, paragraph 5), for which an explanation should be provided.

ⁱⁱⁱ There is a wealth of information available about the SEC's continuing focus on the municipal securities market; however, this 2008 article provides an excellent overview of the issues and remains current.

^{iv} No matter what the outcome of the board vote on Board Memo 8-2, the Water Authority's representatives request that staff continue to provide copies of the Draft Appendix A prior to each and every proposed bond sale and remarketing.



THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
INCLUDING
COMPLIANCE WITH SEC RULE 15c2-12
Dated: June 1, 2016

Metropolitan is committed to providing comprehensive and timely disclosure of its financial condition and relevant events to its members, bondholders and other participants in financial transactions, the rating agencies and the municipal finance industry. To that end, and to assure continuing compliance with SEC Rule 15c2-12, Metropolitan has formally assembled disclosure procedures in this document. The purpose of these Disclosure Procedures is to set forth internal processes, procedures and controls for the preparation of Disclosure Documents. Notwithstanding the foregoing, failure to comply with these Disclosure Procedures shall not create any presumption that Metropolitan's disclosure is inadequate. Further, the failure to comply with these Disclosure Procedures shall not affect the authorization or the validity or enforceability of any bonds, notes or other indebtedness that are otherwise issued by Metropolitan in accordance with law.

1. External Communications. The Deputy General Manager for External Affairs is responsible for speaking with the media on behalf of Metropolitan. All communications on financial matters shall be coordinated with the Office of the Chief Financial Officer.
2. Preparation of Disclosure Documents related to Debt. Public debt issuances generally involve the preparation of two offering documents (e.g., official statements), one in preliminary form and one in final form. In some instances, only one offering document in final form is prepared for a debt issuance. Metropolitan may be required to supplement or amend the offering statement at any time between the time of posting of the preliminary offering document until 25 days after the "end of the underwriting period" (usually the closing date for the bond issuance). In addition, offering documents are periodically prepared for remarketings of outstanding debt.

The standard for accuracy in disclosure documents is that there shall be no untrue statement of material fact and no omission of a statement necessary to make the statements made, in light of the circumstances under which they were made, not misleading. All participants in the process should keep this standard in mind at all times when preparing or reviewing any Disclosure Document. References in these Disclosure Policies to accuracy or material accuracy refer to this standard. Any questions about this standard should be directed to the Office of the General Counsel.

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
INCLUDING
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- (a) Offering Statements – Bond Counsel prepares the preliminary\final offering statement; the General Counsel and the CFO’s Office prepare Appendix A (see (b) below); the Controller’s Office provides the most recent Auditors Report and Basic Financial Statements (typically found in Appendix B) and the CFOs office oversees the preparation of The Selected Demographic and Economic Information for Metropolitan’s Service Area (typically found in Appendix E). Co-Bond counsel, underwriters, underwriter’s counsel and Metropolitan’s financial advisor review the documents, provide comments and sign off, before posting to EMMA.
- (b) Appendix A – Appendix A is updated biannually, unless additional updates are needed, to capture key shifts in Metropolitan’s financial cycle, for example following the close of the fiscal year and after closure of the semi-annual accounting period. The General Counsel prepares Appendix A with assistance from the CFOs Office, who prepares the financial sections. Finance, Water Resource Management, Water System Operations, Engineering Services and Human Resources staffs provide information and updates to the Office of the General Counsel to update Appendix A. Metropolitan’s Office of the General Auditor reviews and agrees tables, statistics and financial data. Bond counsel, underwriters, underwriters counsel and Metropolitan’s financial advisor review Appendix A and provide comments. Before posting to EMMA, a draft of Appendix A is provided to senior officers and group managers, with oversight and responsibility for areas discussed in Appendix A, for review and signoff and to the Board for review and approval. Interim updates to Appendix A between biannual updates are provided to the Board for review and comment and to those senior officers and group managers with responsibility for the updates, for signoff. In addition, underwriters, underwriters counsel and bond counsel must sign off before posting to EMMA.
3. Annual Report Procedures. Metropolitan’s Continuing Disclosure Undertakings (CDU) require filing of annual financial information reports with respect to each fiscal year of Metropolitan by no later than 180 days after the end of the respective fiscal year (or no later than **December 27** each year), to the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access system (EMMA). Both Water Revenue Bonds and General Obligation Bonds are subject to filing requirements.

Annual financial information reports are prepared under the supervision of the Office of the Chief Financial Officer. The Legal Department prepares the draft report for review and completion by the Office of the Chief Financial Officer. Financial statements are provided by the Controller. The financial information required by the CDUs to be included in the annual financial information reports is on file with the Office of the Chief Financial Officer (ATTACHMENT A), along with the sources for such information.

4. Amendments to CDU. If an amendment changes the type of financial information or operating data provided in the CDU, the first annual financial information provided thereafter shall include

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
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a narrative explanation of the reasons for the amendment and the impact of the change. (see CDU §4.2c) If amendment changes accounting principles followed in preparing financial statements, the annual financial information for the year in which the change is made shall present a comparison between the financial statements or information prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles. Such comparison shall include a qualitative and quantitative discussion of the differences in the accounting principles and the impact of the change in accounting principles on the presentation of the financial information. Notice of such amendment shall be posted on EMMA. (see CDU §4.2d)

5. Event Notice Requirements. Metropolitan will provide, or cause to be provided, to EMMA, notice for all listed events, as required by CDUs (see table below). For bonds issued **on or after December 1, 2010**, notices must be filed within ten business days of occurrence. For bonds issued **before December 1, 2010**, notices must be filed “in a timely manner.” Metropolitan will strive to provide notice within ten business days of occurrence, regardless of the date of issuance of the bonds.

The Office of the Chief Financial Officer is responsible for monitoring these events and providing event notices, as required. Event notices are prepared under the supervision of the Office of the Chief Financial Officer. The Legal Department prepares the draft report for review by the Office of the Chief Financial Officer.

For events that must be only be disclosed if material, a materiality determination will be made by the Office of the Chief Financial Officer, with advice from the executive officer(s) with oversight and management authority for the subject matter, and with advice and concurrence by the Legal Department (which may consult outside bond counsel).

The table below shows the events that require notice filings and the sources for such information. *Notice of the types of events in italics below are not required for bonds issued before December 1, 2010, but may be provided.*

Event	Materiality Determination Required?
Principal and interest payment delinquencies	n/a
Non-payment related defaults, if material	n/a
Unscheduled draws on debt service reserves reflecting financial difficulty	n/a
Unscheduled draws on credit enhancements reflecting financial difficulty	n/a
Substitution of credit or liquidity providers, or their failure to perform	n/a
Adverse tax opinions, the issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701 TEB) or other material notices of determination with respect to the tax status of the security or other material events affecting the tax status of the security	n/a (for adverse tax opinions and the issuance by the IRS of proposed or final determination of taxability)
Modifications to rights of security holders, if material	

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
INCLUDING
COMPLIANCE WITH SEC RULE 15c2-12

Event	Responsibility for Determining Materiality
Bond calls, if material, and tender offers	n/a (for tender offers)
Defeasances	n/a
Release, substitution, or sale of property securing repayment of the securities, if material	yes
Rating changes	n/a
<i>Bankruptcy, insolvency, receivership or similar event of Metropolitan</i>	n/a
<i>The consummation of a merger, consolidation, or acquisition involving Metropolitan or the sale of all or substantially all of the assets of Metropolitan, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material</i>	yes
<i>Appointment of a successor or additional trustee or the change of name of a trustee, if material</i>	yes
Failure to provide in a timely manner notice to provide required annual financial information by the date specified in the CDU	n/a

6. Voluntary Disclosure of Bank Loans.

With the happening of the following events, Metropolitan will assess and decide upon a course of action including those listed below.

Event:

- Revolving credit agreements
- Bank loans for the purpose of paying purchase price, principal of or interest on water revenue bonds
- Draws
- Substitution of lender or replacement of agreement
- Material amendments
- Extension or renewal
- Expiration, suspension or termination

Action:

- Posting of an event notice to EMMA, either to all outstanding bonds, or to those affected
- Posting of redacted document or notice by Metropolitan to Financial Information-Financial Reports page of Metropolitan's Website or EMMA
- Posting of redacted document or notice by banks to EMMA
- Posting of an updated disclosure to EMMA disclosing the named event

The Office of the Chief Financial Officer is responsible for monitoring these events and providing event notices and updated disclosure, as required. Metropolitan's Legal Department prepares draft notices for review by the Office of the Chief Financial Officer, in consultation with bond counsel, as required.

7. [RESERVED]

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
INCLUDING
COMPLIANCE WITH SEC RULE 15c2-12

8. Web Posting Procedures. The following documents are posted on Metropolitan’s Finance web page, as soon as is practicable after publishing, and updated as more recent information becomes available.

Document/Information	Responsibility for Preparing and Posting
Latest Official Statement—Water Revenue Bonds	Office of the Chief Financial Officer (CFO)
Latest Official Statement—General Obligation Bonds	Office of the CFO
Annual audited financial statements	Office of the Controller
Quarterly financial statements	Office of the Controller
CAFR	
Budget	Budget and Rates Section
Water rates	Budget and Rates Section
Monthly Treasurer’s report	Treasury and Debt Management Section
Quarterly swap report	Treasury and Debt Management Section

9. Request for Documents. Requests for copies of Finance documents are routed through the Office of the Chief Financial Officer and must be coordinated with the Legal Department for compliance with the Public Records Act.

ATTACHMENT A

<u>Financial Information to be Included in Annual Financial Information Reports</u> <u>(as required under CDUs)</u>	
<u>Required Document/Information</u>	<u>Source of Information</u>
Draft CDU Report	CDUs Rev Bonds: S:\FINANCE FOLDERS\Disclosure\2010 filing Rev bonds.docx GO Bonds: S:\FINANCE FOLDERS\Disclosure\2010 filing GO bonds.docx
List of outstanding bonds subject to CDU	App A, Treasurer or Controller
<p>Annual Financial Information:</p> <p>WATER REVENUE BONDS</p> <ul style="list-style-type: none"> • the table under “OPERATING REVENUES, DEBT SERVICE AND INVESTMENT PORTFOLIO – Debt Service Requirements” in the forepart of the OS; • under “METROPOLITAN’S WATER SUPPLY” in App. A, the table “Metropolitan’s Water Storage Capacity and Water in Storage”; • under “METROPOLITAN REVENUES” in App. A, the tables “Summary of Receipts by Source”, “Summary of Water Sold and Water Sales”, “Summary of Water Rates”, and “Ten Largest Water Customers”; the water standby charge for the fiscal year; revenues for the fiscal year resulting from wheeling and exchange transactions; and the total power revenues for the fiscal year; • under “METROPOLITAN REVENUES – Investment of Moneys in Funds and Accounts” in Appendix A to the Official Statement, the total market value of all Metropolitan funds, earnings on investments and the minimum month-end balance of Metropolitan’s investment portfolio; • under “METROPOLITAN EXPENDITURES” in App. A, the table “Summary of Expenditures”; outstanding indebtedness (including revenue bonds, subordinate revenue obligations, variable rate and swap obligations, other revenue obligations and general obligation bonds), the payment obligation under the State Water Contract, a description of other long term commitments, and the information described under the sub-caption “Defined Benefit Pension Plan”; • under “HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A, historical revenues and expenses for the then immediately past fiscal year, as presented in the table “Historical and Projected Revenues and Expenses”; • under “MANAGEMENT’S DISCUSSION OF HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A to the Official Statement, the percentage of operation and maintenance expenses to total costs; • under “POWER SOURCES AND COSTS” in App. A to the Official Statement, the expenses for electric power, for so long as such information shall be deemed to be material by Metropolitan; • and (B) the information regarding amendments to this Undertaking required pursuant to Sections 4.2(c) and (d) of this Undertaking. Annual Financial Information shall include Audited Financial Statements, if available, or Unaudited Financial Statements. 	<p>Rev. Bond Official Statement and App A, containing information for applicable fiscal year</p> <p>If no OS has been issued since prior July 1, expand report to provide the required information (see Annual Information supplement for GO Bonds listed below)</p>

List of financial information required by Metropolitan’s Continuing Disclosure Undertakings to be included in annual financial information reports.
Filed with the Office of the Chief Financial Officer – June 1, 2016

ATTACHMENT A

<u>Financial Information to be Included in Annual Financial Information Reports</u> <u>(as required under CDUs)</u>	
<u>Required Document/Information</u>	<u>Source of Information</u>
<p><u>Annual Financial Information:</u></p> <p>GENERAL OBLIGATION BONDS</p> <ul style="list-style-type: none"> • under “METROPOLITAN TAX REVENUES” in the forepart of the OS, the tables entitled “Summary of Property Tax Levies”, “Summary of Assessed Valuations and Tax Rates”, “Assessed Valuation Within Metropolitan’s Service Area (By Counties)” and “Debt Service Requirements for General Obligation Bonds”; • under “METROPOLITAN REVENUES” in App. A, the tables entitled “Summary of Receipts by Source”, “Summary of Water Sold and Water Sales”, “Summary of Water Rates”, and “Ten Largest Water Customers”; the water standby charge for the fiscal year; revenues for the fiscal year resulting from wheeling and exchange transactions; the total power revenues for the fiscal year; and the unrestricted reserve balances available to Metropolitan for the fiscal year; • under “METROPOLITAN REVENUES – Investment of Moneys in Funds and Accounts” in Appendix A to the Official Statement, the total market value of all Metropolitan funds, earnings on investments and the minimum month-end balance of Metropolitan’s investment portfolio • under “METROPOLITAN EXPENDITURES” in App. A, the table entitled “Summary of Expenditures”; outstanding indebtedness (including revenue bonds, subordinate revenue obligations, variable rate and swap obligations, other revenue obligations and general obligation bonds), the payment obligation under the State Water Contract, a description of other long term commitments, and the information described under the sub-caption “Defined Benefit Pension Plan”; • under “HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A, historical revenues and expenses for the then immediately past fiscal year, as presented in the table entitled “Historical and Projected Revenues and Expenses”; • under “MANAGEMENT’S DISCUSSION OF HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A, the percentage of operation and maintenance expenses to total costs; • under “POWER SOURCES AND COSTS” in App. A, the expenses for electric power, for so long as such information shall be deemed to be material by Metropolitan 	<p>GO Bond Official Statement and App A, containing information for applicable fiscal year</p> <p>If no GO Bond OS has been issued since prior July 1, use Rev. Bond Official Statement and App A, containing information for applicable fiscal year, and statistical tables from CAFR See S:\FINANCE FOLDERS\Disclosure\2008 filing GO bonds.docx, and S:\FINANCE FOLDERS\Disclosure\2008 filing GO bonds\2008 Annual Financial Info Supp GO.docx</p> <p>If no OS has been issued since prior July 1, expand report to provide the required information</p>
<p>ANY AMENDMENT TO CDU</p> <p>If amendment changes the type of financial information or operating data, include a narrative explanation of the reasons for the amendment and the impact of the change. (see CDU §4.2c)</p> <p>If amendment changes accounting principles, present a comparison between the financial statements or information prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles (see CDU §4.2d)</p>	<p>Legal—determine if CDU has been amended</p> <p>Controller, Auditor—provide notice of any changes in accounting principles</p>
<p>ANNUAL FINANCIAL STATEMENTS</p> <p>Audited financial statements must be filed, if available. If not, unaudited annual financial statements must be filed with the annual report and audited statements must be filed when available</p>	<p>Controller</p>

List of financial information required by Metropolitan’s Continuing Disclosure Undertakings to be included in annual financial information reports.
Filed with the Office of the Chief Financial Officer – June 1, 2016



THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
FOR
COMPLIANCE WITH SEC RULE 15c2-12

Metropolitan is committed to providing comprehensive and timely disclosure of its financial condition and relevant events to its members, bondholders and other participants in financial transactions, the rating agencies and the municipal finance industry. To that end, and to assure continuing compliance with SEC Rule 15c2-12, Metropolitan has formally assembled disclosure procedures in the following document.

1. External Communications. The Deputy General Manager for External Affairs is responsible for speaking with the media on behalf of Metropolitan. All communications on financial matters shall be coordinated with the Office of the Chief Financial Officer.
2. Annual Report Procedures. Metropolitan's Continuing Disclosure Undertakings (CDU) require filing of annual financial information reports with respect to each fiscal year of Metropolitan by no later than 180 days after the end of the respective fiscal year (or no later than **December 27** each year), to the Municipal Securities Rulemaking Board's Electronic Municipal Market Access system (EMMA). Both Water Revenue Bonds and General Obligation Bonds are subject to filing requirements.

Annual financial information reports are prepared under the supervision of the Office of the Chief Financial Officer. The Legal Department prepares the draft report for review and completion by the Office of the Chief Financial Officer. Financial statements are provided by the Controller. The financial information required by the CDUs to be included in the annual financial information reports is on file with the Office of the Chief Financial Officer, along with the sources for such information.

3. Event Notice Requirements. Metropolitan will provide, or cause to be provided, to EMMA, notice for all listed events, as required by CDUs (see table below). For bonds issued **on or after December 1, 2010**, notices must be filed within ten business days of occurrence. For bonds issued **before December 1, 2010**, notices must be filed "in a timely manner." Metropolitan will strive to provide notice within ten business days of occurrence, regardless of the date of issuance of the bonds.

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
FOR
COMPLIANCE WITH SEC RULE 15c2-12

The Office of the Chief Financial Officer is responsible for monitoring these events and providing event notices, as required. Event notices are prepared under the supervision of the Office of the Chief Financial Officer. The Legal Department prepares the draft report for review by the Office of the Chief Financial Officer.

For events that must be only be disclosed if material, a materiality determination will be made by the Office of the Chief Financial Officer, with advice from the executive officer(s) with oversight and management authority for the subject matter, and with advice and concurrence by the Legal Department (which may consult outside bond counsel).

The table below shows the events that require notice filings and the sources for such information. *Notice of the types of events in italics below are not required for bonds issued before December 1, 2010, but may be provided.*

Event	Materiality Determination Required?
Principal and interest payment delinquencies	n/a
Non-payment related defaults, if material	n/a
Unscheduled draws on debt service reserves reflecting financial difficulty	n/a
Unscheduled draws on credit enhancements reflecting financial difficulty	n/a
Substitution of credit or liquidity providers, or their failure to perform	n/a
Adverse tax opinions, the issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701 TEB) or other material notices of determination with respect to the tax status of the security or other material events affecting the tax status of the security	n/a (for adverse tax opinions and the issuance by the IRS of proposed or final determination of taxability)
Modifications to rights of security holders, if material	

Event	Responsibility for Determining Materiality
Bond calls, if material, and tender offers	n/a (for tender offers)
Defeasances	n/a
Release, substitution, or sale of property securing repayment of the securities, if material	yes
Rating changes	n/a
<i>Bankruptcy, insolvency, receivership or similar event of Metropolitan</i>	n/a
<i>The consummation of a merger, consolidation, or acquisition involving Metropolitan or the sale of all or substantially all of the assets of Metropolitan, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material</i>	yes
<i>Appointment of a successor or additional trustee or the change of name of a trustee, if material</i>	yes
Failure to provide in a timely manner notice to provide required annual financial information by the date specified in the CDU	n/a

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
FOR
COMPLIANCE WITH SEC RULE 15c2-12

4. Amendments to CDU. If an amendment changes the type of financial information or operating data provided in the CDU, the first annual financial information provided thereafter shall include a narrative explanation of the reasons for the amendment and the impact of the change. (see CDU §4.2c) If amendment changes accounting principles followed in preparing financial statements, the annual financial information for the year in which the change is made shall present a comparison between the financial statements or information prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles. Such comparison shall include a qualitative and quantitative discussion of the differences in the accounting principles and the impact of the change in accounting principles on the presentation of the financial information. Notice of such amendment shall be posted on EMMA. (see CDU §4.2d)
5. Voluntary Disclosure of Bank Loans. Metropolitan will voluntarily post redacted copies of its revolving credit agreement(s) and any other bank loans for the purpose of paying the purchase price, principal of or interest on water revenue bonds on EMMA. In addition, Metropolitan will voluntarily provide notice of the following events with respect to such agreement(s) and loans:
- Draws
 - Substitution of lender or replacement of agreement
 - Material amendments
 - Extension or renewal
 - Expiration, suspension or termination

The Office of the Chief Financial Officer is responsible for monitoring these events and providing event notices, as required. Event notices are prepared under the supervision of the Office of the Chief Financial Officer. The Legal Department prepares the draft notice for review by the Office of the Chief Financial Officer.

6. Web Posting Procedures. The following documents are posted on Metropolitan's Finance web page, as soon as is practicable after publishing, and updated as more recent information becomes available.

Document/Information	Responsibility for Monitoring	Responsibility for Posting
Latest Official Statement—Water Revenue Bonds	Office of the Chief Financial Officer	Office of the CFO
Latest Official Statement—General Obligation Bonds	Financial Officer (CFO)	Office of the CFO
Annual audited financial statements	Office of the CFO	Office of the CFO
Quarterly financial statements	Office of the CFO	Office of the CFO
CAFR	Office of the CFO	Office of the CFO
Budget	Office of the CFO	Office of the CFO

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA
DISCLOSURE PROCEDURES
FOR
COMPLIANCE WITH SEC RULE 15c2-12

Document/Information	Responsibility for Monitoring	Responsibility for Posting
Water rates	Office of the CFO	Office of the CFO
Monthly Treasurer's report	Treasurer	Treasurer
Monthly swap report	Office of the CFO	Office of the CFO

7. Request for Documents. Requests for copies of Finance documents are routed through the Office of the Chief Financial Officer and must be coordinated with the Legal Department for compliance with the Public Records Act.

<u>Financial Information to be Included in Annual Financial Information Reports</u> <u>(as required under CDUs)</u>	
<u>Required Document/Information</u>	<u>Source of Information</u>
Draft CDU Report	CDUs Rev Bonds: S:\FINANCE FOLDERS\Disclosure\2010 filing Rev bonds.docx GO Bonds: S:\FINANCE FOLDERS\Disclosure\2010 filing GO bonds.docx
List of outstanding bonds subject to CDU	App A, Treasurer or Controller
<p>Annual Financial Information:</p> <p>WATER REVENUE BONDS</p> <ul style="list-style-type: none"> • the table under “OPERATING REVENUES, DEBT SERVICE AND INVESTMENT PORTFOLIO – Debt Service Requirements” in the forepart of the OS; • under “METROPOLITAN’S WATER SUPPLY” in App. A, the table “Metropolitan’s Water Storage Capacity and Water in Storage”; • under “METROPOLITAN REVENUES” in App. A, the tables “Summary of Receipts by Source”, “Summary of Water Sold and Water Sales”, “Summary of Water Rates”, and “Ten Largest Water Customers”; the water standby charge for the fiscal year; revenues for the fiscal year resulting from wheeling and exchange transactions; and the total power revenues for the fiscal year; • under “METROPOLITAN REVENUES – Investment of Moneys in Funds and Accounts” in Appendix A to the Official Statement, the total market value of all Metropolitan funds, earnings on investments and the minimum month-end balance of Metropolitan’s investment portfolio; • under “METROPOLITAN EXPENDITURES” in App. A, the table “Summary of Expenditures”; outstanding indebtedness (including revenue bonds, subordinate revenue obligations, variable rate and swap obligations, other revenue obligations and general obligation bonds), the payment obligation under the State Water Contract, a description of other long term commitments, and the information described under the sub-caption “Defined Benefit Pension Plan”; • under “HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A, historical revenues and expenses for the then immediately past fiscal year, as presented in the table “Historical and Projected Revenues and Expenses”; • under “MANAGEMENT’S DISCUSSION OF HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A to the Official Statement, the percentage of operation and maintenance expenses to total costs; • under “POWER SOURCES AND COSTS” in App. A to the Official Statement, the expenses for electric power, for so long as such information shall be deemed to be material by Metropolitan; • and (B) the information regarding amendments to this Undertaking required pursuant to Sections 4.2(c) and (d) of this Undertaking. Annual Financial Information shall include Audited Financial Statements, if available, or Unaudited Financial Statements. 	<p>Rev. Bond Official Statement and App A, containing information for applicable fiscal year</p> <p>If no OS has been issued since prior July 1, expand report to provide the required information (see Annual Information supplement for GO Bonds listed below)</p>

List of financial information required by Metropolitan’s Continuing Disclosure Undertakings
to be included in annual financial information reports.
Filed with the Office of the Chief Financial Officer – December 14, 2015

<u>Financial Information to be Included in Annual Financial Information Reports</u> <u>(as required under CDUs)</u>	
<u>Required Document/Information</u>	<u>Source of Information</u>
<p><u>Annual Financial Information:</u></p> <p>GENERAL OBLIGATION BONDS</p> <ul style="list-style-type: none"> • under “METROPOLITAN TAX REVENUES” in the forepart of the OS, the tables entitled “Summary of Property Tax Levies”, “Summary of Assessed Valuations and Tax Rates”, “Assessed Valuation Within Metropolitan’s Service Area (By Counties)” and “Debt Service Requirements for General Obligation Bonds”; • under “METROPOLITAN REVENUES” in App. A, the tables entitled “Summary of Receipts by Source”, “Summary of Water Sold and Water Sales”, “Summary of Water Rates”, and “Ten Largest Water Customers”; the water standby charge for the fiscal year; revenues for the fiscal year resulting from wheeling and exchange transactions; the total power revenues for the fiscal year; and the unrestricted reserve balances available to Metropolitan for the fiscal year; • under “METROPOLITAN REVENUES – Investment of Moneys in Funds and Accounts” in Appendix A to the Official Statement, the total market value of all Metropolitan funds, earnings on investments and the minimum month-end balance of Metropolitan’s investment portfolio • under “METROPOLITAN EXPENDITURES” in App. A, the table entitled “Summary of Expenditures”; outstanding indebtedness (including revenue bonds, subordinate revenue obligations, variable rate and swap obligations, other revenue obligations and general obligation bonds), the payment obligation under the State Water Contract, a description of other long term commitments, and the information described under the sub-caption “Defined Benefit Pension Plan”; • under “HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A, historical revenues and expenses for the then immediately past fiscal year, as presented in the table entitled “Historical and Projected Revenues and Expenses”; • under “MANAGEMENT’S DISCUSSION OF HISTORICAL AND PROJECTED REVENUES AND EXPENSES” in App. A, the percentage of operation and maintenance expenses to total costs; • under “POWER SOURCES AND COSTS” in App. A, the expenses for electric power, for so long as such information shall be deemed to be material by Metropolitan 	<p>GO Bond Official Statement and App A, containing information for applicable fiscal year</p> <p>If no GO Bond OS has been issued since prior July 1, use Rev. Bond Official Statement and App A, containing information for applicable fiscal year, and statistical tables from CAFR See S:\FINANCE FOLDERS\Disclosure\2008 filing GO bonds.docx, and S:\FINANCE FOLDERS\Disclosure\2008 filing GO bonds\2008 Annual Financial Info Supp GO.docx</p> <p>If no OS has been issued since prior July 1, expand report to provide the required information</p>
<p>ANY AMENDMENT TO CDU</p> <p>If amendment changes the type of financial information or operating data, include a narrative explanation of the reasons for the amendment and the impact of the change. (see CDU §4.2c)</p> <p>If amendment changes accounting principles, present a comparison between the financial statements or information prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles (see CDU §4.2d)</p>	<p>Legal—determine if CDU has been amended</p> <p>Controller, Auditor—provide notice of any changes in accounting principles</p>
<p>ANNUAL FINANCIAL STATEMENTS</p> <p>Audited financial statements must be filed, if available. If not, unaudited annual financial statements must be filed with the annual report and audited statements must be filed when available</p>	<p>Controller</p>

List of financial information required by Metropolitan’s Continuing Disclosure Undertakings
to be included in annual financial information reports.
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DISCLOSURE OBLIGATIONS OF MUNICIPAL ISSUERS: THE SEC ENFORCEMENT PERSPECTIVE

The Securities and Exchange Commission's Division of Enforcement is scrutinizing the municipal marketplace to a degree not seen since the mid-1990's. With \$2.5 trillion of municipal securities outstanding – two-thirds held directly or indirectly by individual investors – SEC Chairman Christopher Cox has identified “ferreting out fraud in the municipal bond market and punishing its perpetrators” as an enforcement priority for 2008.¹ Municipal securities are the focus of one of four “working groups” recently formed within the SEC's Enforcement Division to coordinate investigative efforts nationwide.²

One key component of the SEC's renewed focus on municipal securities is the disclosure obligations of municipal issuers. In a White Paper submitted in July 2007 to the leaders of the Senate Banking Committee and the House Committee on Financial Services, the SEC staff noted its concern over “continued disclosure weaknesses” in municipal securities offerings notwithstanding the SEC's past public statements and enforcement actions.³ The SEC's recent action seeking antifraud injunctions and financial penalties against five former San Diego city officials for failing to disclose the city's under funding of pension liabilities and its growing financial crisis relating to pension and retiree health benefits⁴ illustrates that the SEC is prepared to hold individuals personally accountable and seek tough enforcement sanctions when the agency determines that state and local issuers have failed to disclose material information in violation of the federal securities laws.

This article discusses the disclosure obligations of municipal issuers from the perspective of SEC enforcement practice. Part I reviews the statutory bases in the federal securities laws for SEC enforcement actions against municipal issuers and officials. Because the SEC does not have regulatory jurisdiction over municipal securities, the focus of enforcement investigations is always on potential antifraud violations. Part II reviews developments in the SEC's enforcement program against municipal issuers and officials from the mid-1990's to the present. Part III describes the current environment of heightened scrutiny and the SEC's continuing concerns with certain disclosure practices of municipal issuers. Part IV suggests practical steps that issuers can follow to help minimize the possibility that they will

- 1 Christopher Cox, Chairman, U.S. SEC, “The SEC Agenda for 2008: Remarks to the ‘SEC Speaks in 2008’ Program of the Practicing Law Institute” (Feb. 8, 2008), *available at* <http://www.sec.gov/news/speech/2008/spch020808cc.htm>.
- 2 The other three are built around sub-prime lending, options backdating, and hedge funds. Linda Chatman Thomsen, Director, Division of Enforcement, U.S. SEC, “Regulatory Keynote Address — Outlook From the SEC,” Second Annual Capital Markets Summit, U.S. Chamber of Commerce (Mar. 26, 2008), *available at* <http://www.sec.gov/news/speech/2008/spch032608lct.htm>. (“Thomsen Speech; Outlook From the SEC”)
- 3 “Disclosure and Accounting Practices in the Municipal Securities Market” at 1, 10, *available at* <http://www.sec.gov/news/press/2007/2007-148.htm> (“SEC White Paper”).
- 4 *SEC v. Michael T. Uberuaga, et al.*, Civil Action No. 08 CV 0625 DMS (LSP) (S.D. Cal.) (filed April 7, 2008), SEC Litigation Release No. 20522, *available at* <http://www.sec.gov/litigation/litreleases/2008/lr20522.htm>.

become subject to an enforcement investigation or that the SEC will find any violations should an investigation of the issuer's disclosures be undertaken.

With respect to corporate issuers, the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")⁵ mandated disclosure controls for SEC periodic reports, including requirements for so-called disclosure controls and procedures, internal control over financial reporting, and officer certifications. As will be seen below, it appears that the SEC is increasingly looking to elements of the Sarbanes-Oxley model as a framework for evaluating disclosure practices among municipal issuers. Thus, in any future enforcement investigation, it will be imperative for a municipal issuer to be able to demonstrate to the SEC staff that the issuer implemented written policies and procedures that were appropriate to the issuer and were reasonably designed to ensure that material information concerning the issuer and its securities was accumulated, processed, summarized, and reported in a timely fashion in offering documents, continuing disclosures and other public statements that could affect investors.

I. Background: Applicable Law

In contrast with corporate issuers, the SEC's regulatory authority over disclosures by issuers of municipal securities is circumscribed by statute.⁶ Because municipal securities are "exempt" securities under both the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), they are not subject to the Securities Act registration requirements, and issuers of municipal securities are not subject to the Exchange Act periodic reporting requirements that are applicable to public companies.⁷

However, the SEC's authority reaches to municipal issuers and their officials through the operation of the antifraud provisions of the federal securities laws – Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. The antifraud provisions prohibit "any person," including issuers of municipal securities, from making a false or misleading statement of material fact, or omitting to state material

facts that are necessary to make statements made not misleading, in connection with the offer, purchase, or sale of any security.⁸ A fact is deemed to be material for purposes of the federal securities laws if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.⁹

Thus, in any enforcement investigation involving an offering of municipal securities, the stakes are immediately elevated for the issuer and its personnel. Unlike investigations of disclosures by public companies, or relating to regulated entities such as brokers, dealers, and investment advisers, the SEC's limited authority over municipal issuers means that any potential enforcement action necessarily will sound in fraud. There is no other statutory or regulatory basis on which an action can be brought and, therefore, a potential settlement reached.

Within this limitation, however, an important distinction is made between fraud actions based on negligent conduct and those based on scienter. Under Sections 17(a)(2) and (3) of the Securities Act, which prohibit material misstatements or omissions and fraudulent transactions, practices, or courses of business in the offer or sale of securities, the SEC need only prove that a defendant or respondent acted negligently.¹⁰ However, Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 require the SEC to show that the defendant or respondent acted with scienter,¹¹ defined as "a mental state embracing intent to deceive, manipulate, or defraud."¹² The courts generally permit scienter to be proven by evidence of conduct that was reckless in the face of a known danger of misleading.¹³ Thus, depending on the facts

5 Pub. L. No. 107-202 (2002).

6 "Municipal securities" include all bonds, notes, and other debt securities issued by state and local governments and their respective agencies and instrumentalities. SEC White Paper at 1.

7 SEC White Paper at 3.

8 Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, SEC Release Nos. 33-7049, 34-33741, 1994 SEC LEXIS 700 at *9 (March 9, 1994) ("1994 Interpretive Release").

9 *E.g.*, *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1987).

10 *Aaron v. SEC*, 446 U.S. 680, 685, n.5 (1980).

11 *Aaron v. SEC*, 446 U.S. at 701-702.

12 *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

13 Recklessness is generally defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so 'obvious that the actor must have been aware of it.'" *E.g.*, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir.

and circumstances of the particular case, the SEC can pursue an enforcement action against a municipal issuer or its officials based on a theory of either negligent,¹⁴ reckless,¹⁵ or intentional misstatements or omissions.

Further, in any enforcement investigation, the SEC's scrutiny will not be limited to representations in the official statement or preliminary official statement for an offering. Whenever an issuer of municipal securities "releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions."¹⁶ Thus, for example, the SEC's actions against the City of San Diego and the former city officials cited misleading disclosures not only in official statements and preliminary official statements, but also in the city's continuing disclosures filed with nationally recognized municipal securities information repositories pursuant to Rule 15c2-12 under the Exchange Act, and in presentations to credit rating agencies.¹⁷

II. SEC Pronouncements and Enforcement Actions Relating to Municipal Disclosures

Reforms in the municipal securities market became a focus of SEC rule making, interpretive guidance, and enforcement activity during the 1990's under former Chairman Arthur Levitt, Jr. The SEC's 1994 Statement Regarding Disclosure Obligations of Municipal Securities Issuers and Others cited continuing concerns with the adequacy of disclosure

both in primary offerings of municipal securities and in the secondary market.¹⁸ Among the areas where the SEC determined that improvement was needed was the disclosure in primary offerings of financial and operating information concerning issuers, including known conditions that could significantly affect an issuer's financial condition in the future.¹⁹

The SEC has repeatedly made clear that the obligation to ensure adequate disclosure rests primarily with the municipal issuer itself and its officials, notwithstanding the participation of outside professionals such as underwriters, bond counsel, and issuer's counsel in an offering.²⁰ As the Director of the SEC's Enforcement Division recently stated, "[T]he buck stops with municipalities and their officials."²¹

For example, following the 1994 bankruptcy of Orange County, California as a result of substantial losses in the county's investment pools – the largest municipal bankruptcy in history – the SEC issued a Report of Investigation under Section 21(a) of the Exchange Act that prominently criticized the individual members of the county's board of supervisors for failing to ensure that bond offering documents disclosed increasing budgetary pressures and the county's dependence on interest income from the investment pools. Although the supervisors believed they could rely on the financial advisers, bond counsel, and underwriters that assisted with the offerings, the SEC took the supervisors to task because they "never questioned the professionals regarding the disclosure in the Official Statements, despite their knowledge of facts calling into question the County's ability to repay the securities."²² The

1990) (*quoting Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

14 *E.g.*, *In re The Massachusetts Turnpike Authority and James J. Kerasiotes*, SEC Release No. 33-8260, 2003 SEC LEXIS 1792 (July 31, 2003); *In re Dauphin County General Authority*, SEC Release No. 33-8415, 2004 SEC LEXIS 886 (Apr. 26, 2004).

15 *E.g.*, *In re The City of Miami, Florida*, SEC Release Nos. 33-8213, 34-47552, 2003 SEC LEXIS 676 (Mar. 21, 2003); *In re City of San Diego, California*, SEC Release Nos. 33-8751, 34-54745, 2006 SEC LEXIS 2608 (Nov. 14, 2006); *SEC v. Michael T. Uberuaga, et al.*, *supra*. In the case of individuals, the SEC can also pursue secondary theories of liability; i.e., that the individual "caused" or "aided and abetted" the issuer's primary violations.

16 1994 Interpretive Release at *50.

17 *City of San Diego, California, supra*; *SEC v. Michael T. Uberuaga, et al.*

18 1994 Interpretive Release at *12-*13.

19 1994 Interpretive Release at *31-*34.

20 *E.g.*, *Municipal Securities Disclosure*, SEC Release No. 34-26985, 1989 SEC LEXIS 1173 at *71 n. 84 (June 28, 1989).

21 Linda Chatman Thomsen, Director, Division of Enforcement, U.S. SEC, "Lessons Learned from San Diego," AICPA National Conference on Current SEC and PCAOB Developments (Dec. 11, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch121107lct.htm> ("Thomsen Speech; Lessons Learned from San Diego").

22 Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors, SEC Release No. 34-36761, 1996 SEC LEXIS 132 at *22 (Jan. 24, 1996).

SEC's report concluded with a clear warning to public officials:

In addition to the responsibilities imposed on issuers of municipal securities, the antifraud provisions of the federal securities laws impose responsibilities on a public official who authorizes the offer and sale of securities. A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.

... Based on the Supervisors' significant knowledge relating to the County's finances, they should have understood the materiality of that information to the County's ability to repay the municipal securities. The Supervisors therefore had a duty to take steps appropriate under the circumstances to assure accurate disclosure was made to investors regarding this material information. The Supervisors, however, failed to take appropriate steps. For example, while the Supervisors believed that they could rely on the County's officials, employees or other agents with respect to these offerings, they never questioned these officials, employees or other agents regarding the disclosure of this information; nor did they become familiar with the disclosure regarding the County's financial condition. Had they taken such or similar steps, it should have been apparent to each Supervisor, in light of his or her knowledge, that the disclosure regarding the County's financial condition may have been materially false or misleading.

Consequently, the Supervisors failed to assure appropriate disclosure of these matters by authorizing and approving the dissemination of misleading disclosure documents. This failure denied investors the fair and accurate disclosure required under the federal securities laws.²³

A so-called "Section 21(a) Report" is not an SEC enforcement action and does not impose any sanctions.²⁴ The SEC on occasion issues a Section 21(a) Report under circumstances where the Commission wants to publicize its views concerning certain conduct, but, because novel legal issues are involved or for other reasons, determines in its discretion not to pursue an enforcement action. However, Section 21(a) Reports are exceedingly rare; only eight have been issued since 1996. Far more typically, the SEC's response to violations is to file an enforcement action (either an administrative proceeding at the agency or a civil injunctive action in federal court).²⁵ Thus, the Orange County Section 21(a) Report was a "shot across the bow" for municipal officials, and should not be interpreted as suggesting that similar conduct in other cases will also receive the benefit of Section 21(a) treatment. To the contrary, the recent enforcement action against San Diego's former officials illustrates the seriousness with which the SEC is likely treat evidence of disclosure violations by municipal officials in the future.

In enforcement actions subsequent to the Orange County Report, the SEC has returned time and again to the theme that municipalities and their officials are responsible for the content of disclosures in connection with offerings of municipal securities. For example, in administrative orders entered against the City of Miami, Florida and the former City Manager related to

²³ *Id.* at *29-*31.

²⁴ Section 21(a) of the Exchange Act authorizes the SEC, in its discretion, to conduct investigations and to "publish information concerning any ... violations,..." 15 U.S.C. §78u(a)(1).

²⁵ In enforcement actions filed in connection with the Orange County matter, the SEC charged the former county Treasurer, the Assistant Treasurer, the county, and the board of supervisors as a body with violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 for various disclosure failures in bond offerings relating to the risks of the county's investment pools and the county's reliance on the pools.

several bond offerings, the SEC found that the city and the official committed fraud by failing to disclose that the city's financial condition was deteriorating and that the city might not be able to meet its operating expenses and debt service requirements. In support of its finding of scienter, the SEC emphasized that "Miami's officials ignored the City's disclosure responsibilities":

...[I]n the face of obvious indicators to the contrary, Miami was at least reckless in misstating that its FY 1995 budget was balanced, down playing its cash flow crisis, failing to disclose that Miami needed to issue debt to resolve its crisis, and misrepresenting that there were no material changes in its financial condition. Miami's officials ignored the City's disclosure responsibilities. [The former City Manager] admitted that he was not familiar with Miami's disclosure requirements and dismissed the importance of the bond offering documents....²⁶

The SEC gave short shrift to the city's effort to pass the blame for disclosure failures to the outside professionals who worked on city bond offerings:

Miami further asserts that the City relied on Deloitte, and other professionals who participated in the bond offerings, to advise the City on its disclosure in the Official Statements. Primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon the municipality. A city does not discharge this obligation by the employment of independent public accountants or other professionals. As we have repeatedly emphasized, issuers of municipal securities "are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure."²⁷ Municipal issuers have an affirmative obligation to know the contents of their securities disclosure documents, including their financial statements.²⁷

In an order against the Dauphin County General Authority, the SEC emphasized that the Authority's reliance on a bevy of professional advisers did not absolve the Authority from liability under the federal

securities laws when an official statement that the Authority authorized was found to be materially misleading.²⁸ The Authority issued unsecured bonds to finance the purchase of an office building. Lease and parking revenues from the building provided the sole source of funds to repay the bonds. Although the Authority knew at the time it authorized the preliminary official statement that the tenant that provided more than 60 percent of the building's revenues had determined to vacate the building, this fact was not specifically disclosed. Instead, the official statement merely included general cautionary language to the effect that the leases would expire before the bonds matured, and there was no commitment from the tenants to renew them. In a later enforcement action against the bonds' underwriter, the D.C. Circuit Court of Appeals likened this disclosure to "someone who warns his hiking companion to walk slowly because there *might* be a ditch ahead when he *knows* with near certainty that the Grand Canyon lies one foot away."²⁹

The SEC's order recognized that the Authority retained a financial adviser, bond counsel, and underwriter to assist with the offering, and that the Authority "trusted its professional advisors...to use their professional knowledge and expertise in ensuring that ... all documents, including the Official Statement, were complete, accurate, and contained all necessary disclosures."³⁰ The SEC further acknowledged that none of the advisors discussed with the Authority the need to disclose the departure of the building's major tenant. Notwithstanding these circumstances, the SEC found that the Authority violated the negligence-based antifraud provisions of the Securities Act (Sections 17(a)(2) and (3)) because "[i]ssuers of municipal securities are primarily responsible for the content of their disclosure documents."³¹

The SEC specifically criticized the members of the Authority for not reading the preliminary official statement before they voted to approve it. Even though the case was settled on a non-scienter basis, the SEC

²⁶ *In re The City of Miami, Florida*, SEC Release Nos. 33-8213, 34-47552, 2003 SEC LEXIS 676 at *35 (Mar. 21, 2003) (citations omitted).

²⁷ *Id.* at *36.

²⁸ *In re Dauphin County General Authority*, SEC Release No. 33-8415, 2004 SEC LEXIS 886 (Apr. 26, 2004).

²⁹ *Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 640 (D.C. Cir. 2008).

³⁰ *Dauphin County General Authority*, 2004 SEC LEXIS 886 at *4.

³¹ *Id.* at 9.

cautioned that “Executing offering documents without first reading the documents to ascertain whether they were accurate may be reckless.”³²

The SEC’s view that municipal issuers may not abdicate their responsibility for offering disclosures to outside professionals was also at the core of the SEC’s order finding that the Neshannock Township School District violated the antifraud provisions by failing to disclose the actual use of proceeds and the consequent risk to the tax-exempt status of certain notes that the school district issued.³³ Under governing IRS regulations, the notes’ tax exemption depended on the school district meeting certain strict criteria concerning commitment of the note proceeds to capital improvement projects. Although these criteria were not satisfied (and the proceeds were not in fact used for such projects) the school district decided to proceed with the offering after discussions with the underwriter and bond counsel. Later, the school district had to enter into a settlement with the IRS to preserve the tax exemption for investors.

The SEC found that the school district’s misleading disclosures were made recklessly in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.³⁴ Further, as if to underscore the primary responsibility of issuers for disclosures, after a trial, the SEC only held the bond counsel who rendered the tax-exemption opinion liable for negligent violations (i.e., Sections 17(a)(2) and (3) of the Securities Act).³⁵

In connection with the offering, a school district official executed a “non-arbitrage” certificate drafted by the bond counsel that inaccurately represented that the IRS criteria were met. The official testified at the bond counsel’s trial that she signed the certificate “pretty

much having no idea what it meant.”³⁶ Chairman Cox has pointed to this official, as well as to the examples of the former Miami City Manager and the Dauphin County Authority, to drive home the point that “Too many municipal issuers – and in particular the members of their governing bodies – remain inadequately involved in disclosure.”³⁷

As noted above, in 2006 the SEC found that the City of San Diego violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 by failing to disclose in bond offering documents, in continuing disclosures, and in presentations to rating agencies that the city had been intentionally under funding its pension obligations, faced a near-term dramatic increase in unfunded pension liabilities and retire health benefits, and would have severe difficulties paying its obligations in the future. The Director of the SEC’s Enforcement Division has warned that “San Diego may not be unlike many other American cities, and accordingly there is some concern that San Diego may be a harbinger of things to come as other cities wrestle with their own burgeoning financial obligations.”³⁸

The SEC’s administrative order against the City of San Diego signified an important new approach to cases involving municipal issuers. As part of the settlement, the SEC required that the city retain an independent consultant to evaluate and make recommendations concerning the city’s policies, procedures, and internal controls relating to disclosures, the hiring of employees and outside experts for disclosure functions, and the implementation of training programs regarding disclosure obligations. The city is required to comply with the independent consultant’s recommendations or to adopt alternative measures designed to achieve the same objectives.³⁹

Such so-called “remedial undertakings” have been an integral part of SEC enforcement practice for

32 *Id.*

33 *In re Neshannock Township School District*, SEC Release Nos. 33-8411, 34-49600, 2004 SEC LEXIS 861 (April 22, 2004).

34 *Neshannock Township School District*, 2004 SEC LEXIS 861 at *9.

35 *In re Ira Weiss*, SEC Release Nos. 33-8641, 34-52875, 2005 SEC LEXIS 3107 (Dec. 2, 2005), *pet. for review denied*, 468 F.3d 849 (D.C. Cir. 2006). In a separate settlement, the SEC also found that the underwriter violated Sections 17(a), Section 10(b), and Rule 10b-5, and aided and abetted and caused the school district’s violations. *In re Ira Weiss and Andrew Shupe II*, SEC Release Nos. 33-8459 and 34-50235, 2004 SEC LEXIS 1839 (Aug. 24, 2004).

36 *In re Ira Weiss*, 2005 SEC LEXIS 3107 at *35.

37 Christopher Cox, Chairman, U.S. SEC, “Integrity in the Municipal Market” Town Hall, Los Angeles Biltmore Hotel (July 18, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch071807cc.htm> (“Cox Speech: Integrity in the Municipal Market”).

38 Thomsen Speech; Outlook From the SEC, *supra*.

39 *In re City of San Diego, California*, SEC Release Nos. 33-8751, 34-54745, 2006 SEC LEXIS 2608 at *49 (Nov. 14, 2006).

many years in cases against regulated entities and public companies. As the name suggests, remedial undertakings are intended to remediate the causes or consequences of securities violations, and are limited only by the creativity of the enforcement staff. Often, as is illustrated by the San Diego case, undertakings require an entity to implement expensive, time consuming, and burdensome process reviews and reforms under the oversight of an independent third party expert whose fees are paid by the entity.

In actions against municipal issuers, the SEC has traditionally limited itself to issuing administrative cease-and-desist orders against future violations. The settlement with the City of San Diego marked the first time that the SEC has ordered remedial undertakings in an action against a municipality,⁴⁰ and suggests that the SEC is now prepared to seek costly enforcement remedies developed in other contexts in order to address disclosure violations in actions against municipal issuers.⁴¹ The best way for issuers to avoid such requirements is to proactively take steps to ensure that they have implemented appropriate disclosure controls and that their disclosures are fully compliant with the requirements of the federal securities laws.

III. Heightened Scrutiny and the SEC's Current Concerns; the Staff White Paper

The lesson the SEC has drawn from cases such as those against the City of Miami, the Dauphin County General Authority, the Neshannock Township School District, and the City of San Diego is that the “broader problem” is “the lack of disclosure controls, policies, and procedures for municipal issuers.”⁴² Thus, the SEC’s White Paper expressed the staff’s concerns that “regardless of size, issuers of municipal securities may lack policies and procedures adequate to ensure accurate and full disclosure in their offering documents and are not legally required to certify the accuracy

of their disclosures.”⁴³ The staff’s perspective on disclosures by municipal issuers has clearly been informed by its experience since 2002 under Section 302 of Sarbanes-Oxley and related SEC rules, which require that public companies maintain and regularly evaluate so-called “disclosure controls and procedures,” and that their principal executive and principal financial officers personally certify periodic reports filed with the SEC.⁴⁴

The staff’s White Paper concludes that the lack of such disclosure controls is a key reason for deficiencies in municipal disclosures:

Unlike in the corporate context, in which there are requirements for disclosure controls, evidence obtained in many enforcement actions suggests that issuer officials who vote to approve the use of disclosure documents often assume the accuracy of disclosure documents and approve them with little or no review. Furthermore, the staff has observed that issuer representatives often have limited involvement in the preparation of disclosure documents.⁴⁵

Thus, in a move reminiscent of the Sarbanes-Oxley model, the SEC’s White Paper proposed legislation “Ensuring that issuers of municipal securities establish policies and procedures for disclosure appropriate to the particular issuer.”⁴⁶

The White Paper also concluded that, despite “explicit” guidance provided in the Orange County Section 21(a) Report concerning the responsibility of municipal officials for disclosure in securities offerings, “this problem remains.”⁴⁷ Exacerbating the situation, outside professionals who assist in offerings frequently disclaim responsibility for disclosures or do not have full knowledge of the issuer’s circumstances:

In contrast to corporate securities offerings in which the issuer and its counsel prepare a company’s disclosure documents and filings, with input from the underwriter and its counsel,

⁴⁰ Thomsen Speech; Lessons Learned from San Diego, *supra*.

⁴¹ However, financial penalties against municipal issuers do not appear to be in the offing. Apart from the obvious issues regarding sovereignty that penalties would raise, Chairman Cox has recognized that a municipal issuer has no money of its own, and that any penalty would be paid by citizens through tax dollars. Cox Speech: Integrity in the Municipal Market, *supra*.

⁴² Cox Speech: Integrity in the Municipal Market, *supra*.

⁴³ *Id.* at 9.

⁴⁴ See Section 302 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-202 (2002); Exchange Act Rules 13a-14, 13a-15, 15d-14, and 15d-15, 17 CFR §§240.13a-14, 13a-15, 15d-14, and 15d-15.

⁴⁵ SEC White Paper at 9.

⁴⁶ *d.* at 11.

⁴⁷ *Id.* at 10.

the offering documents for negotiated offerings of municipal securities are typically prepared by the underwriter and underwriter's counsel, who do not have an intimate knowledge of the issuer's affairs. In fact, issuers often are not represented by counsel with respect to the preparation of disclosure documents. The issuer's counsel, bond counsel, and other professionals who work on an offering are often hired on a transaction-by-transaction basis and therefore may lack the depth of factual knowledge derived from an ongoing relationship with an issuer. Often issuer's counsel is only occasionally engaged in municipal securities offerings and is heavily dependent on others about disclosure matters. Bond counsel often limit their practices exclusively to municipal securities and may lack the depth of knowledge of the federal securities laws obtained from representing clients in registration, periodic reporting, and other matters before the Commission. Furthermore, underwriters of municipal securities often disclaim responsibility for statements made in offering documents, which would not be permitted in a corporate bond offering.⁴⁸

For these reasons, the SEC's White Paper also proposed legislation to clarify the legal responsibilities of issuer officials and outside participants in offerings of municipal securities.

IV. Practical Guidance for Issuers of Municipal Securities

Against the backdrop of potential scrutiny from the SEC enforcement staff, there are at least three reasons why municipal issuers should consider reviewing their disclosure processes and making improvements in any deficient areas. First and foremost, enhanced disclosure controls may help ensure compliance with the federal securities laws and therefore minimize the chances that any questions might arise that could result in an SEC enforcement investigation. Second, in the event that an issuer's disclosures do become the subject of an investigation, the fact that the disclosures were subject to detailed controls and a comprehensive review process may help blunt any allegation that the issuer acted recklessly or negligently. Third, the SEC has traditionally viewed the presence of an effective compliance program as a mitigating factor in exercising its prosecutorial discretion as to whether to bring an

⁴⁸ *Id.* at 9-10 (footnotes omitted).

enforcement action against an entity and, if so, what sanctions to pursue. For example, in a recent case involving insider trading by a state agency that managed state pension funds, the SEC decided not to seek either a permanent injunction or a cease-and-desist order against future violations in part because, subsequent to the violations occurring, the agency engaged securities counsel and implemented a compliance program that counsel designed and recommended. Instead of commencing an enforcement action, the SEC issued a Section 21(a) Report (which, notably, criticized the agency for not having adequate policies and procedures in the first instance to ensure that the violations did not occur.)⁴⁹ Conversely, the lack of an effective compliance program may be viewed negatively in the agency's enforcement determinations.

There are a number of steps that municipal issuers should consider taking to help ensure that their disclosures comply with the requirements of the federal securities laws. First, as discussed above, the SEC now appears to view adherence to a suitable set of written disclosure policies and procedures as virtually a "must" for municipal issuers as it has been for public companies at least since the passage of Sarbanes-Oxley. Other helpful steps may include instituting formal and regular training for municipal employees in disclosure obligations; retaining disclosure counsel or issuer's counsel experienced in the federal securities laws as well as knowledgeable about the issuer; and taking steps to ensure the quality and reliability of audits of financial statements.

Each of these steps is discussed briefly below. However, this discussion is not meant to suggest that all such measures are required for all issuers. Even the SEC accepts that disclosure policies and procedures should be "appropriate for the particular issuer," and

⁴⁹ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama, SEC Release No. 34-57446, 2008 SEC LEXIS 513 (Mar. 6, 2008). *See also* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Release No. 34-44969, 2001 SEC LEXIS 2210 (Oct. 23, 2001) (noting that a company's adoption of internal controls and procedures designed to prevent a recurrence of misconduct in the future is a factor that the SEC will consider in determining whether and how much to credit a company in an enforcement matter).

may assume greater importance depending on the size and complexity of the issuer, and the frequency with which the issuer accesses the municipal securities marketplace.⁵⁰ Thus the following discussion is intended only to suggest the range and types of preventative measures that may assist municipal issuers in meeting their disclosure obligations laws, and thus avert, or at least successfully address, any inquiries from the SEC Enforcement Division.

Disclosure Policies and Procedures

As discussed above, SEC rules promulgated pursuant to Section 302 of Sarbanes-Oxley require SEC reporting companies to maintain, and management to periodically evaluate the effectiveness of, the company's "disclosure controls and procedures." Disclosure controls and procedures are defined as:

controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Exchange] Act is recorded, processed, summarized, and reported, within the time periods specified in the Commission's rules and forms. Disclosure Controls and Procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the [Exchange] Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.⁵¹

A closely related concept under Section 404 of Sarbanes-Oxley and SEC rules is the requirement that management evaluate the effectiveness of the company's "internal control over financial reporting." While "disclosure controls and procedures" and "internal control over financial reporting" are distinct concepts under the federal securities laws, the SEC has stated that disclosure controls and procedures include those components of internal control over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit

preparation of financial statements in accordance with generally accepted accounting principles.⁵² Thus, disclosure controls and procedures include controls and procedures relating to both non-financial disclosures and financial reporting.

Although municipal issuers are exempt from SEC reporting requirements, the SEC's definition of disclosure controls and procedures provides a useful starting point for municipal issuers in designing their own controls. For example, the City of San Diego borrowed conceptually from the Exchange Act rules relating to disclosure controls and procedures when it adopted new "Securities Disclosure" provisions in the city's Administrative Code. These provisions require city officials, among other things, to implement written disclosure controls and procedures designed to ensure:

"(1) that information material to the City's proposed and outstanding securities is accumulated and communicated to senior City officials, including the City Manager, City Auditor and Comptroller, City Treasurer, City Attorney, and the City Council, as appropriate, to allow timely decisions regarding disclosure;

(2) that such information is recorded, processed, and summarized in a timely manner to enable the requisite senior City officials to certify the accuracy of disclosures made in connection with City financings;

(3) compliance with all applicable federal and state securities laws, including the disclosure of all material information with respect to the City's proposed and outstanding securities; and,

(4) the preservation of an audit trail regarding information reviewed or prepared in connection with such disclosures."⁵³

The SEC has stated that it will not require reporting companies to implement any particular types of disclosure controls and procedures. Instead, the SEC leaves it to each company to develop a process that is

⁵⁰ SEC White Paper at 11; Cox Speech: Integrity in the Municipal Market, *supra*.

⁵¹ Exchange Act Rules 13a-15(e) and 15d-15(e), 17 CFR §§240.13a-15(e), 15d-15(e).

⁵² Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release Nos. 33-8238, 34-47986, IC-26068, 2003 SEC LEXIS 1380 at *62 (June 5, 2003).

⁵³ San Diego Municipal Code, Article 2, §22.4105 (added Oct. 11, 2004).

consistent with its business and internal management and supervisory practices.⁵⁴ However, corporate issuers have commonly incorporated into their disclosure controls and procedures a number of features that municipal issuers should consider. These include:

- A written statement of policy and procedure that sets forth the steps to be followed in the preparation and review of disclosure documents and clearly delineates the responsibilities of various persons and parts of the organization at each step;
- A process employing formalized and documented communications such as meetings, interviews of relevant personnel, or disclosure questionnaires that are intended to elicit or update material information from various parts of the organization and to identify potential disclosure questions or concerns;
- A committee or group comprised of senior personnel with relevant area or subject matter responsibilities (typically referred to in the corporate context as the “disclosure committee”), including in-house counsel (and assisted by outside counsel), charged with the responsibility to make determinations regarding disclosures, to carefully review disclosure documents to ensure that all appropriate disclosures are made, and to periodically evaluate the effectiveness of the issuer’s disclosure controls and procedures;⁵⁵
- “Sub-certifications” provided by officials with area or subject matter responsibilities to the senior officers attesting that the officials believe that the disclosure documents do not misrepresent any material facts or contain any material omissions with regard to their areas of responsibility; and
- A person or persons designated to coordinate the entire process.

The Director of the SEC’s Enforcement Division has cautioned municipal issuers that as they undertake such processes, they should also “keep the big picture in mind,” and not let the completion of a disclosure

⁵⁴ Certification of Disclosure in Companies’ Quarterly and Annual Reports, SEC Release Nos. 33-8124, 34-46427, IC-25722, 2002 SEC LEXIS 2240 at *30 (Aug. 28, 2002).

⁵⁵ The formation of a disclosure committee to consider materiality issues and make disclosure determinations is the only measure that the SEC has specifically recommended. *Id.*

checklist “become the goal unto itself.”⁵⁶ For example, she has advised that members of an issuer’s disclosure team have “brainstorming sessions” devoted to the larger issues facing the municipality, identify the financial problems and issues that the municipality is struggling with, conduct their own due diligence on these issues, and make sure to disclose “bad news.”⁵⁷

Training

Training of municipal personnel with regard to disclosure obligations goes hand-in-glove with the need to maintain appropriate disclosure controls and procedures. In any investigation of possible securities violations by officers or employees of an entity, the SEC enforcement staff routinely focuses on whether the entity provided adequate compliance training. Training should encompass disclosure and financial reporting requirements applicable to municipal issues under the federal securities laws and generally accepted accounting principles established by the Government Accounting Standards Board, as well as specific training on the roles and responsibilities of individuals in the disclosure process.⁵⁸

Further, senior personnel – including the issuer’s elected officials – should be included in the training.⁵⁹ The SEC made clear in the Orange County Section 21(a) Report, and reiterated in the staff’s White Paper last year, that elected officials risk personal liability if they approve an offering without taking steps to ensure the disclosure of negative material information of which they are aware.

Retention of Knowledgeable Counsel

In many cases, reliance on counsel can provide important evidence of good faith to rebut any charge that the issuer acted recklessly.⁶⁰ However, counsel should be experienced regarding disclosure obligations under the federal securities laws, and should be knowledgeable concerning the operations, finances, and risks facing the issuer. In the SEC’s settlement with the City of San Diego, one of the city’s remedial actions that the SEC credited was the hiring of new disclosure counsel for all future offerings, who would

⁵⁶ Thomsen Speech; Lessons Learned from San Diego, *supra*.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ See *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004).

have a better and more continuous knowledge of the city's financial affairs.⁶¹ Conversely, the staff's White Paper criticized instances where issuer's counsel lacks in-depth factual knowledge about an issuer because counsel is hired on a transaction-by-transaction basis.⁶²

Audit Issues

The SEC has criticized the practice of some municipal issuers of including audited financial statements in disclosure documents without obtaining the consent of the auditor – and, in some cases, without disclosing that consent was not obtained.⁶³ In granting consent, an auditor is required to review other information included in the disclosure document and to consider whether that information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.⁶⁴ Thus, the fact that audited financial

statements were included without the consent of the auditor may be material to investors.

The SEC has also cautioned municipal issuers to make sure that their independent auditors have the requisite technical skills, experience, and resources to conduct competent and rigorous audits. The Director of the Enforcement Division has pointed to the SEC's 2007 suit against San Diego's auditors – which included charges that the auditors did not have sufficient auditing proficiency, were not knowledgeable about the city, failed to obtain sufficient competent evidential matter, and failed to exercise due professional care – as a lesson for municipal issuers. Auditors should be hired based on their ability to do the job, and not based on factors such as political connections, going with the lowest bid, or the desire to give business to local firms.⁶⁵

Finally, municipal issuers may want to consider establishing an Audit Committee, along the lines of the corporate model, to provide specific oversight to accounting, auditing, and financial reporting processes. San Diego's decision to establish an Audit Committee was one of the voluntary remedial undertakings that the SEC credited in its settlement with the city.⁶⁶

61 *City of San Diego, California*, 2006 SEC LEXIS 2608 at *48.

62 SEC White Paper at 9.

63 SEC White Paper at 8; Cox Speech: Integrity in the Municipal Market, *supra*.

64 See Statement of Auditing Standards No. 8, *Other Information in Documents Containing Audited Financial Statements*; see also "Recommended Practice: Auditor Association with Financial Statements Included in Offering Statements or Posted on Web Sites," Government Finance Officers Association (2005 and 2006).

65 Thomsen Speech; Lessons Learned from San Diego, *supra*.

66 *City of San Diego, California*, 2006 SEC LEXIS 2608 at *48; see also San Diego Municipal Code, Article 2, Division 43

V. Conclusion

In public statements and enforcement orders over the past dozen years, the SEC has repeatedly stressed that issuers of municipal securities are primarily responsible for the content of their disclosures. Where disclosures violate the antifraud provisions of the federal securities laws, the SEC may seek tough sanctions against responsible individuals as well as try to impose costly and burdensome undertakings on municipalities such as requiring the retention of an independent consultant to review and make improvements to the municipality's disclosure processes. To promote compliance with disclosure obligations and minimize the risks of future SEC investigations, municipal issuers should consider taking proactive steps to review their disclosure processes and improve upon any deficiencies. Issuers should consider implementing disclosure controls and procedures, retaining counsel knowledgeable about the municipality's finances and risks, and adopting measures to ensuring the rigor and reliability of independent audits of their financial statements.

(added May 2, 2007).

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THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

VIA EMAIL

June 14, 2016

Director Michael T. Hogan
Director Keith Lewinger
Director Fern Steiner
Director Yen C. Tu
San Diego County Water Authority
4677 Overland Avenue
San Diego, CA 92123

Dear Directors:

Your letter dated June 11, 2016 regarding Board Letter 8-2

We received your letter regarding Board Letter 8-2 which expressed your concern regarding the change to Metropolitan's disclosure procedures and we would like to provide some explanation concerning that change to address your concern.

Board Letter 8-2 asks for board approval of the attached Appendix A and authorization for its use in the issuance and remarketing of Metropolitan's bonds. Board Letter 8-2 also advises the Board of updated Metropolitan procedures with regard to Appendix A.

We appreciate your provision of information regarding MWD's disclosure obligations. Metropolitan is familiar with its responsibilities under the Federal antifraud laws and the SEC's guidance concerning those responsibilities and has worked closely with outside counsel to ensure complete compliance with all requirements.

Metropolitan continually evaluates its policies and procedures to comply with the Federal antifraud laws and current guidance from the SEC concerning the responsibilities of issuers of municipal securities. The presentation of Appendix A at a formal Board meeting reflects how seriously Metropolitan and its staff take its responsibilities under the Federal antifraud laws.

The SEC's recent guidance has urged issuers to adopt reasonable policies and procedures to ensure that they provide investors with accurate and complete disclosure. Metropolitan has heeded this guidance by ensuring that any disclosure it provides investors follows policies and procedures that ensure that any such disclosure reflects an information-gathering process that takes into consideration where key information resides within the organization and a review

SDCWA Directors
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June 14, 2016

process that takes into consideration who the key subject matter experts are within the organization and how it should appropriately vet disclosure. The SEC has not provided guidance concerning how often or the context of when issuers (especially frequent issuers) should present their disclosure document to their boards. The SEC has never suggested or required that the boards of issuers need to formally approve disclosure through their formal board meeting process. It is left to issuers to determine both how often and the appropriate level of involvement of board members in the preparation of an issuer's disclosure given its own facts and circumstances.

In formulating its policies and procedures, Metropolitan has given significant consideration as to how best to involve its Board in the process so that involvement reflects a reasonable process given the overall disclosure process of Metropolitan. For infrequent issuers, it is common for disclosure to be approved by their boards with every transaction. With frequent issuers (like Metropolitan), it is common for an issuer to provide their board with a copy of the disclosure before an offering but do so outside of the formal board approval process so that members of the board can review and provide comments. Practices can vary. For many years, Metropolitan's process was to provide a copy of its disclosure to Board members outside of the formal board meeting process. A few years ago, Metropolitan changed this process to provide formal board participation and approval in connection with each offering. Recently, in considering the whole of Metropolitan's policies and procedures, Metropolitan staff, in conjunction with outside counsel, determined that a bifurcated process would be best.

The bifurcated process involves the following: First, at least twice a year, staff will present the Board with the entire Appendix A for formal approval. Second, interim updates to Appendix A between the Board's semi-annual approval and before Appendix A is used in an offering, will be provided to the Board for review and comment. However a vote of the Board would not be required for the Board's review and comment upon the interim updates. The thought behind this is that, from an investor's perspective, the essential credit information concerning Metropolitan's financial and operating information remains fundamentally the same for many months at a time. By narrowing down board approval to two times a year, it allows for a more-focused review by all participants at the times of the year when Metropolitan's disclosure is expected to materially change. We have made this change with very careful consideration of the SEC's recent guidance in the municipal securities market.

One additional point of clarification is important too. Board Letter 8-2 did not relate to the Board's approval of a bond transaction and instead was intended, in implementation of the revised procedure, as an opportunity for the Board to review and provide comments to Metropolitan's disclosure to investors through a formal board meeting. I mentioned at the June 13th Finance & Insurance Committee meeting that we plan to use the updated disclosure in connection with a bond refunding this week. Specifically, Metropolitan is planning to use the updated Appendix A on Thursday, June 16 when it is planning to print a preliminary official statement with respect to a refunding bond transaction of approximately \$280 million of Metropolitan's outstanding Water Revenue Bonds for an anticipated debt savings of \$90 million. As has been the case since 1993, Metropolitan will approve this specific refunding through an

SDCWA Directors
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June 14, 2016

Ad Hoc Committee process pursuant to the Fourth Supplemental Resolution to its Master Senior Resolution. Accordingly, Metropolitan is not seeking specific Board approval for this refunding.

Your letter states that SDCWA has comments to the Appendix A provided by Board Letter 8-2, but you are not providing them at this time. Since we are planning to print a preliminary official statement using this Appendix A, we would like to receive and review your comments as soon as possible so that we can take them into consideration before the preliminary official statement is published this Thursday. We appreciate any input and contributions you can make regarding the disclosure.

Sincerely,

A handwritten signature in black ink, appearing to read "Gary Breaux". The signature is stylized with a large initial "G" and a long horizontal stroke.

Gary Breaux
Assistant General Manager/Chief Financial Officer

cc: MWD Board Members
J. Kightlinger
M. Scully



San Diego County Water Authority

4677 Overland Avenue • San Diego, California 92123-1233
 (858) 522-6600 FAX (858) 522-6568 www.sdcwa.org

October 12, 2015

Randy Record and
 Members of the Board of Directors
 Metropolitan Water District of Southern California
 P.O. Box 54153
 Los Angeles, CA 90054-0153

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

RE: Board Item 8-2: Approve and authorize the execution and distribution of Remarketing Statements in connection with the remarketing of the Water Revenue Refunding Bonds, 2011 Series A1 and A3 and 2009 Series A2 - **OPPOSE**

Dear Chair Record and Members of the Board:

The Water Authority's MWD Delegates have reviewed Board memo 8-2, including the redline copy of Appendix A dated October 1, 2015 ("Appendix A" or "Draft"), and determined we cannot support staff's recommendation to authorize the execution and distribution of the Official Statement in connection with the remarketing of bonds. As we have made clear in the past, we support staff's general financial management objective to reduce debt cost but do not believe the bond disclosures fairly present the facts, as described below, or MWD's current and projected water supply conditions, financial position or risks.

I. General Comments

We incorporate by reference all of the comments and objections contained in our delegation's past letters relating to MWD's authorization, execution and distribution of Official Statements in connection with the issuance of bonds. While MWD has from time to time made certain changes in response to the Water Authority's comments, these letters raise several substantive issues that have not been addressed by MWD in prior drafts of Appendix A, are part of the MWD Administrative Record in connection with the respective actions taken by the board and are incorporated herein by reference, along with copies of any MWD responses.

A number of specific questions and comments are noted below. Broadly speaking, there are two new principal areas in which the current draft Appendix A fails to disclose or accurately describe material facts:

- (1) the status of MWD's unrestricted reserves as related to the deposit it has represented to the Superior Court that it maintains and is required to

A public agency providing a safe and reliable water supply to the San Diego region

Chair Record and Members of the Board

October 12, 2015

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maintain as security for payment of the Water Authority's judgment and accrued interest in the rate litigation (MWD has represented to the Court that it is holding this money in a "separate account" and yet it appears to be commingled with unrestricted reserves); and

(2) material facts that have been judicially determined in the rate litigation, but which MWD continues to misrepresent in various parts of Appendix A. While we recognize that MWD intends to appeal the judgment of the Court, that does not mean that it is not also required to disclose and accurately present to the MWD Board of Directors and potential investors the Court's factual findings and orders as they relate to MWD's contentions in the litigation and included in Appendix A.

Copies of the Courts Statements of Decision dated April 24, 2014 and August 28, 2015, and its Order Granting San Diego's Motion for Prejudgment Interest dated October 9, 2015, are attached (Attachments 1-3, respectively). MWD management has a responsibility to inform the MWD Board of Directors about the findings and orders the Court has made, and the MWD Board of Directors has a responsibility to be informed about the Court's findings and orders in connection with its review of the Draft Appendix A. This is necessary in order to provide complete and accurate disclosure regarding the bonds being offered and their security and source of payment to potential investors. We also request that MWD's management provide this letter and Attachments to MWD's bond counsel team, financial advisor and underwriters.

II. MWD is either in breach of its contractual obligation under the Exchange Agreement to maintain a cash deposit sufficient to secure payment of the Water Authority's judgment and accrued interest; or, it is not in compliance with minimum reserve requirements under its Financial Reserve Policy.

Attachment 4 to this letter provides a graphic representation of the status of MWD's Unrestricted Reserves beginning at July 1, 2015 through the end of September 2015 (all data derived from MWD's Draft Appendix A). If MWD's Unrestricted Funds are reduced by the Water Authority's security deposit -- reflected in Attachment 4 at the \$209.8 million amount MWD informed the Court it is holding as a security depositⁱ -- then it appears that MWD has failed to meet its minimum reserve requirements since the end of July 2015. This would also mean that, on September 22, 2015, MWD did not have sufficient cash available to make the \$44.4 million unbudgeted payment to the Southern Nevada Water Authority without either breaching its contractual obligation to the Water Authority or spending cash that was required by MWD's Financial Reserve Policy to be held in reserve.

III. Several representations in Draft Appendix A are inconsistent with material facts that have been judicially determined against MWD in the rate litigation.

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In addition to failing to accurately describe the Court's findings and orders in the rate litigation per se, MWD is continuing to present certain matters as "fact" in Appendix A that were contested in the rate litigation with respect to which MWD did not prevail. As one important example, MWD continues in Appendix A to report revenues paid for wheeling, i.e., for the transportation of third party water, as MWD "water sales revenues" (A-50). Contrary to arguments made by MWD at trial that San Diego was purchasing MWD water under the Exchange Agreement, the Court specifically found that San Diego does not pay MWD's supply rates (August 28, 2015 Statement of Decision at page 3, footnote 8) and **is not purchasing MWD water under the Exchange Agreement** (August 28, 2015 Statement of Decision at page 28, line 13 and generally, Section IV-B, Preferential Rights at pages 25-29). There is no factual or legal basis for MWD to describe wheeling revenues as its "water sales" and no reason to require potential bond investors to "read the fine print" in the footnotes in order to conclude that MWD's "water sales" revenues are in fact, **not** all MWD water sales revenues. MWD's Summary of Receipts by Source (A-50) substantially overstates MWD's water sales because MWD's water sales were at least 180,000 AF less than stated by MWD (i.e., the amount of water the Water Authority actually purchased from third parties) -- and also fails to disclose that MWD receives revenues from the wheeling services it provides.

IV. Comments on Draft Appendix A

A-6: Metropolitan's Water Supply. MWD is changing the statement that "hydrologic conditions can have a significant impact on MWD's 'water supply'" to the statement that, "hydrologic conditions can have a significant impact on MWD's 'two principal imported water supply sources.'" What water supply sources has MWD acquired since its last Official Statement in June 2015 that are not State Water Project or Colorado River supplies, necessitating this change?

A-7: Drought Response Actions. Staff's suggested edits to the Draft Appendix A state that implementation of MWD's Water Supply Allocation Plan at a Level 3 Regional Shortage Level is anticipated to reduce supplies delivered by MWD to its member agencies in fiscal year 2015-16 to approximately 1.6 million acre-feet (AF). By contrast, language in the Official Statement of last June - now being deleted - states that, "[o]n April 14, 2015, the Board declared the implementation of the Water Supply Allocation Plan at a Level 3 Regional Shortage Level, effective July 1, 2015 through June 30, 2016. Implementation of the Water Supply Allocation Plan at a Level 3 Regional Shortage Level is anticipated to reduce supplies delivered by MWD to MWD's member agencies by 15 percent and water sales to approximately 1.8 million AF." Even though the June disclosure noted the Governor's Order to reduce water use by 25 percent, it stated that member agencies' diminished local supplies will cause MWD's demands to be at 1.8 million AF. Now, in the space of less than four months, MWD has reduced its estimated water sales by 200,000 acre-feet (AF), even though there are no changed factual circumstances identified in the new Draft. Further, MWD staff

Chair Record and Members of the Board

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reported last month that water sales could be as low as 1.5 million AF. Please explain the basis of the new projections and what if anything has changed since June 2015 to account for this substantial reduction in MWD's estimated water sales in fiscal year 2015-16, and, why the new Draft does not disclose the reported potential for water sales to be as low as 1.5 million AF.

Similarly, the storage reserve level as of December 31, 2015 is described in the Draft Appendix A as 1.36 million AF. While this is consistent with reports under MWD's Water Surplus and Drought Management Plan, it is not consistent with forecasted sales of 1.6 million AF, which is lower than a Level 3 water supply allocation. If sales are down, there should be more water in storage. Please explain this apparent discrepancy.

A-9: Integrated Resources Plan. The last paragraph on page A-9 states that the second phase of the IRP is development of "implementation" policy after the conclusion of the "technical" update. Unless staff believes that the Board will be limited in its deliberation of the IRP to policies related to "implementation" of the IRP, we suggest deleting the word "implementation."

A-11: Water Transfers and Exchanges. Why has staff deleted the word, "acquisition"? Given MWD's recent proposed and consummated land acquisitions in Palos Verde and the Delta, deletion of this word is not warranted. Please explain.

A-11: Seawater Desalination. The section on seawater desalination is a sub-paragraph under Integrated Resources Plan Strategy, which is a sub-paragraph of the section describing "Metropolitan's Water Supply," which begins at page A-6. The Water Authority's seawater desalination project is not a MWD Water Supply and the Water Authority does not receive "financial incentives" from MWD for the project, as suggested. The reference to the Water Authority's project should be deleted here and included instead in sections of the Draft that report member agency local projects (Regional Water Resources, for example, like the Los Angeles Aqueduct) and reduced demand for MWD water (MWD Revenues (A-40) and Management's Discussion of Historical and Projected Revenues and Expenses (A-71)).

A-11-A-16: State Water Project. We found the proposed edits regarding Bay Delta Conservation Plan (BDCP) collectively, confusing. On the one hand, the Draft is amended to add language stating that the "basic, underlying purpose of the BDCP is to restore and protect Delta water supply, water quality and ecosystem health within a stable regulatory environment" (A-14), but then makes other edits changing statements that the BDCP is "being developed" that way to a statement that that is the BDCP as it was "originally conceived" (A-15). The Draft goes on to disclose that 50-year permits as originally conceived were not possible; but, it does not close the loop on how the need for a stable regulatory environment will be achieved. Please explain or suggest edits to address this concern.

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A-18: Colorado River Aqueduct. The proposed edits suggest that it was a severe drought and reduced Colorado River storage that "ended" the availability of surplus water deliveries to MWD and "resulted" in California being limited to 4.4 million AF since 2003. These edits should not be made because they do not accurately describe the circumstances or the factual and legal record why California is limited to 4.4 million AF or why MWD no longer has access to surplus water on the Colorado River. There have been absolutely no changes since the last Official Statement of June 2015 that would explain the need for these edits at this time.

A-21: Quantification Settlement Agreement. However artfully described in the Draft Appendix A, MWD cannot credibly deny or change the fact that its projected sales are reduced by 180,000 AF and that San Diego is buying this water from IID, not MWD. The statement that MWD "expects to be able to annually divert 850,000 AF of Colorado River water -- without disclosing that 180,000 AF of that water belongs to the Water Authority -- is misleading, especially as the same sentence goes on to refer to water "from other water augmentation programs [MWD] develops." The section also refers prospective investors to "METROPOLITAN REVENUES--Principal Customers," where MWD continues the charade that its wheeling revenues represent the purchase and sale of MWD water (see page A-50 and section III above). This is misleading by design.

A-22: Sale of Water by the Imperial Irrigation District to San Diego County Water Authority. The sentence at the bottom of page A-22 that -- "[i]n consideration for the conserved water made available to MWD by SDCWA, a lower rate is paid by SDCWA for the exchange water delivered by MWD" -- should be deleted. At a minimum, MWD must disclose that MWD's legal theory and argument that the Water Authority is purchasing MWD water under the Exchange Agreement was expressly rejected by Judge Karnow in his Statement of Decision. See discussion at Section III above. Further, the proposed edits to delete reference to the volume of water MWD is wheeling for the Water Authority under the Exchange Agreement is unnecessary. In fact, this information should be provided.

A-24: Interim Surplus Guidelines. What is the reason for the proposed deletion stating that, "[t]he Interim Surplus Guidelines contain a series of benchmarks for reductions in agricultural use of Colorado River water within California by set dates"?

A-51: Water Sales Revenues. As noted above, MWD fails to disclose that it receives wheeling revenues from the Water Authority. MWD is obligated to disclose the findings and decision by the Superior Court in the rate case, whether or not it intends to appeal. MWD should also disclose here or elsewhere in the draft Appendix A that, since 2012, it has collected \$824,000,000 more from MWD ratepayers than needed to pay its actual budgeted expenses, of which \$743,000,000 exceeded the maximum reserve limits and that this amount may be subject to future claims. Finally, the statement that "MWD uses its financial resources and budgetary tools to manage the financial impact of the variability in revenues

Chair Record and Members of the Board

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due to fluctuations in annual water sales," is patently untrue. This very month, the MWD Board of Directors is being asked by staff to issue \$500 million in bonds, because MWD has now spent not only 100 percent of its budgeted revenues, but also the additional \$824,000,000 it over-collected from MWD ratepayers without any cost of service analysis.

A-52: Rate Structure. MWD should disclose in this section on its rate structure (rather than requiring investors to wade through several cross-references) that its rates have been determined to violate the common law, California statutory law and the California Constitution.

A-53: Litigation Challenging Rate Structure. We have several objections regarding disclosures related to the litigation challenging MWD's rate structure. In addition to the general concerns expressed at section II above:

MWD states that, "the Court granted MWD's motion for summary adjudication of the cause of action alleging illegality of the 'rate structure integrity' provision in conservation and local resources incentive agreements, dismissing this claim in the first lawsuit." What MWD fails to disclose is that the claim was dismissed on the basis of the Water Authority's supposed lack of standing to challenge the RSI provision; and, that the Court otherwise found the rate structure integrity provision to be unreasonable and inappropriate.

As noted in prior letters, the statement that the "Court found that SDCWA failed to prove its 'dry-year peaking' claim that MWD's rates do not adequately account for variations in member agency purchases" is inaccurate. What the Court stated was that, "the record does not tell us that all these charges are sufficient to account for all of the costs of providing what I have called contingency capacity" (April 24, 2014 Statement of Decision at page 64).

A-55: Litigation Challenging Rate Structure. What is MWD's intention and the reason for the proposed edit changing the reference to the "Exchange Agreement" to the "exchange agreement"?

Given the Court's ruling on October 9, MWD now must also disclose the Order Granting San Diego's Request for Prejudgment Interest; and, add this amount to the deposit it is holding as security under the Exchange Agreement.

A-55: Member Agency Purchase Orders. The Water Authority has previously expressed its opposition and concerns regarding the illusory contracts described as "Member Agency Purchase Orders;" those concerns and all past communications with MWD on this subject are incorporated herein by reference. There is no cost of service basis for these purported agreements including but not limited to the fact that MWD does not even set a Tier 2 Water Supply Rate as described.

Chair Record and Members of the Board

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A-58: Financial Reserve Policy. See the Water Authority's letter of this date RE Board Item 8-2: Approve and authorize the execution and distribution of Remarketing Statements in connection with the remarketing of the Water Revenue Refunding Bonds, 2011 Series A1 and A3 and 2009 Series A2 - **OPPOSE** and Section III above, incorporated herein by reference.

Further, MWD has represented to the Court in the rate litigation that it has established a "separate account" as a "security deposit" to cover the payment of the judgment and interest awarded to the Water Authority. It does not appear from any of the disclosures in the Draft Appendix A that this account exists; rather, it is money that is commingled with MWD's Unrestricted Reserves, which must be maintained to satisfy MWD's minimum reserve requirements and which are potentially subject to being spent or otherwise used by the MWD Board of Directors. As noted in section II above, there isn't enough cash available in order to satisfy the Water Authority's judgment and interest, while at the same time, meeting MWD's minimum reserve requirements.

As a detail, MWD has not corrected its prior reference to holding \$188 million - rather than \$209.8 million - in the last paragraph on page A-58.

Regarding the Board's approval of \$44.4 million to pay Southern Nevada Water Authority from unrestricted reserves, it does not appear that sufficient funds were available in unrestricted reserves to make this payment without either breaching MWD's contractual obligation to the Water Authority or falling below minimum reserve levels.

A-60: Ten Largest Water Customers. The numbers reflected in this schedule need to be corrected to show that the Water Authority is not purchasing MWD water when it pays MWD for the transportation of water under the Exchange Agreement.

A-60: Preferential Rights. The Draft must be amended to disclose the Court's findings and orders in the rate litigation, which are omitted.

A-61: California Ballot Initiatives. The Draft must be amended to disclose the Court's findings and orders in the rate litigation, which are omitted.

A-77: Water System Revenue Bond Amendment. Why is the language in the paragraph above the projected costs for State Water Project water being deleted? Is an updated explanation not required?

A-83: Historical and Projected Revenues and Expenses. MWD's "water sales" need to be corrected for the reasons discussed in this letter and Statements of Decision by Judge Karnow in the rate cases.

Chair Record and Members of the Board

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A-85: Management's Discussion of Historical and Projected Revenues and Expenses. The statements contained in this section of the Appendix A suffer from the same deficiencies as noted above, particularly with regard to a "budget" process that is designed to collect more revenues than budgeted expenses in seven out of ten years; MWD's adoption of programs and spending measures that have resulted in the unbudgeted spending of hundreds of millions of dollars, with no cost-of-service justification; and MWD's failure to maintain a separate account as a security deposit to secure payment of the judgment and interest owed to the Water Authority, as represented to the Superior Court.

Thank you for your consideration of and response to address these questions and issues.

Sincerely,



Michael T. Hogan
Director



Keith Lewinger
Director



Fern Steiner
Director



Yen C. Tu
Director

Attachment:

1. Statement of Decision Rate Setting Challenges dated April 24, 2014
2. Statement of Decision dated August 28, 2015
3. Order Granting San Diego's Motion for Prejudgment Interest dated October 9, 2015
4. MWD's unrestricted reserves monthly balances beginning at July 1, 2015 through the end of September 2015 (as reported in draft Appendix A)

ⁱ MWD is suggesting certain edits to the Draft Appendix A to be consistent with the argument it made to the Court (at A-55), claiming that it was holding in its financial reserves a "deposit" equivalent to the amount of money that the Court awarded as damages on August 28, plus the amount of "interest" MWD claimed had accrued on the "deposit." But there was no "deposit" and there was no "interest" earned thereon, as MWD argued to the Court. Instead, MWD has commingled the funds it was required to hold as security deposit in its financial reserves. Although MWD is now claiming that it has since August 31 been holding \$209.8 million in its financial reserves to comply with its obligations under the Exchange Agreement, it does not appear to have been mathematically possible for it to do so without using cash that was at the same time required to be held by MWD in accordance with the Financial Reserve Policy described a A-58 of Appendix A.



FILED
San Francisco County Superior Court

APR 24 2014

CLERK OF THE COURT

BY: [Signature]
Deputy Clerk

SUPERIOR COURT OF CALIFORNIA

COUNTY OF SAN FRANCISCO

SAN DIEGO COUNTY WATER
AUTHORITY,

Plaintiff/Petitioner,

vs.

METROPOLITAN WATER DIST. OF
SOUTHERN CALIFORNIA, et al.

Defendants/Respondents.

Case No. CPF-10-510830

Case No. CPF-12-512466

STATEMENT OF DECISION ON RATE
SETTING CHALLENGES

San Diego County Water Authority (San Diego) challenges the legality of four rates set by Metropolitan Water District of Southern California (Met).

San Diego alleges three defects. First, San Diego argues that Met improperly allocates the bulk of Met's costs under its contract with the California Department of Water Resources' State Water Project to the System Access Rate and the System Power Rate. Second, San Diego contends that Met illegally treats all of its costs for conservation and local water supply development programs as transportation costs by recovering them through the Water Stewardship Rate, which Met charges as a transportation rate. The asserted result of these

misallocations is that parties who use Met's wheeling services pay an inflated rate for that service.

Third, San Diego asserts that, while Met incurs significant costs to accommodate the practice by some member agencies of "rolling on" to Met's system and buying more water in dry years, and "rolling off" of Met's system and substantially reducing their purchases from Met in average years (dry-year peaking), Met's rates fail to assign those costs to the member agencies that cause the dry-year peaking costs to be incurred or that benefit from the availability of dry-year peaking supplies.

I find for San Diego on the first two issues and for Met on the third.

Procedural History

San Diego filed suit challenging Met's 2011 and 2012 rates on June 11, 2010 (the 2010 case).¹ The operative Third Amended Complaint in the 2010 case includes six causes of action: the Rate Challenges (Causes of Action # 1-3); breach of contract (Cause of Action #4); declaratory relief as to RSI (Cause of Action # 5); and declaratory relief as to preferential rights (Cause of Action #6). Within the Rate Challenges, San Diego asserts that Met's 2011 and 2012 rates violate numerous constitutional and statutory provisions, namely: Article XIII A of the California Constitution (Proposition 13) and its implementing statute, Government Code § 50076; the Wheeling Statute, Water Code § 1810 *et seq.*; Government Code § 54999.7(a);

¹ San Diego and Met have driven this litigation, but they are not the only parties. Imperial Irrigation District answered the 2010 Complaint, the Third Amended Complaint in the 2010 action, and the 2012 Complaint alleging that some or all of Met's actions violated Water Code §§ 1810-1814. The Utility Consumers' Action Network also answered the 2010 complaint seeking invalidation of the rates, but not the operative Third Amended Complaint in that action or the 2012 complaint. The City of Glendale, Municipal Water District of Orange County, City of Torrance, Las Virgenes Municipal Water District, West Basin Municipal Water District, Foothill Municipal Water District, and City of Los Angeles all answered the 2010 Complaint, the operative Third Amended Complaint in that action, and the 2012 Complaint siding with Met. Three Valleys Municipal Water District answered the 2010 and 2012 Complaints siding with Met, but not the Third Amended Complaint in the 2010 action. Western Municipal Water District and Eastern Municipal Water District answered the 2012 Complaint, siding with Met.

Government Code § 66013; section 134 of the Metropolitan Water District Act; and California common law.

On June 8, 2012, after Met approved rates for calendar years 2013 and 2014 that relied on many of the same cost allocations and ratemaking determinations, San Diego filed a second lawsuit (the 2012 case). The 2012 case includes four causes of action: rate challenges to the 2013 and 2014 rates (Causes of Action # 1-3) and another claim for breach of contract (Cause of Action # 4). Within the 2012 rate challenges, San Diego alleges that Met's 2013 and 2014 rates violate the same common law, constitutional and statutory provisions as in the 2010 case, as well as Article XIII C § 1 of the California Constitution (Proposition 26).

On September 20, 2013, the parties filed cross-motions for summary adjudication. San Diego moved for summary adjudication on the RSI cause of action. Met moved for summary adjudication on the RSI cause of action, the preferential rights cause of action, and both breach of contract causes of action. By order dated December 4, 2013, I denied San Diego's motion for summary adjudication on RSI, granted Met's motion for summary adjudication on RSI, and denied Met's other motions for summary adjudication.

I bifurcated the breach of contract causes of action and set them for trial at a date following resolution of the rate challenges. The parties agreed to postpone the preferential rights claim as well; it will be heard at the same time as the breach of contract claims. The rate challenges were set for trial on December 17, 2013.

The trial for the rate challenges in the 2010 case and the 2012 case commenced on December 17, 2013, and was completed, except for closing arguments, on December 23. The parties filed post-trial briefs on January 17, 2014; closing arguments were heard on January 23, 2014.

I issued a tentative determination and proposed statement of decision February 25, 2014.

I provided the parties additional time for objections, which were filed March 27.

This statement of decision follows.

Factual Background

1. The Parties

Met was established in 1928 by the Metropolitan Water District Act. Stats. 1969, ch. 209 as amended; Water Code Append. §§ 109-134. Met acts as a supplemental wholesale water supplier to 26 cities and water districts throughout Southern California (Met's member agencies). San Diego is one of Met's member agencies, and has been since 1946. Met's member agencies govern Met through their representatives on Met's Board of Directors. Water Code Append. §§ 109-50, 109-51, 109-55. Each member agency has proportional representation on the Board of Directors, and is entitled to at least one seat on the Board, plus an additional seat for every full 3% of the total assessed value of the property within the member agency's service area that is taxable for district purposes. *Id.* at §§ 51-52.

Member agencies are not obligated to buy water from Met. If member agencies have access to local sources of water, they may freely opt out fully or partially from Met's services. JTX-2 (AR2012-016429) at AR2012-016440; *Metropolitan Wat. Dist. of S. Cal. v. Imperial Irrigation Dist.*, 80 Cal.App.4th 1403, 1417 (2000) (*MWD*).

But (with the exception of Los Angeles) member agencies currently have no way to receive imported water supplies except through Met's facilities. If a member agency such as San Diego purchases imported water on its own, it must as a practical matter move the water through

Met's facilities. The use of a water conveyance facility by someone other than the owner or operator is referred to as "wheeling." Met provides wheeling services to its member agencies.

2. Water Networks

Met "imports water from two principal sources, the State Water Project in Northern California, via the California Aqueduct, and the Colorado River, via the Colorado River Aqueduct."² Met takes delivery of its Colorado River water at Lake Havasu. Met transports its Colorado River water through the Colorado River Aqueduct, which Met owns and operates. Met takes delivery of State Water Project (SWP) water at four delivery points near the northern and eastern boundaries of Met's service area, including two large reservoirs, Castaic Lake and Lake Perris. SWP water is delivered to Met by the Department of Water Resources (DWR) via the California Aqueduct, which is part of the SWP. Met does not own or operate the SWP, nor does Met transport SWP water from Northern California to the terminal reservoirs at Castaic Lake and Lake Perris.³

Once the SWP water is received by Met, Met sometimes blends that water with water from the Colorado River, delivering blended water to its member agencies including San Diego. Met's distribution system transports water across a large part of the State, delivers water in six counties, and serves an area home to 19 million residents.⁴ Member agencies, in turn, deliver water to their customers.

² JTX-2* (AR2012-016429) at AR2012-016440. "*" indicates that a document is present only in the 2012 administrative record. "***" indicates that a document is not in any administrative record. All documents in the 2010 administrative record are also in the 2012 administrative record.

² DTX-090 at AR2012-000001 (capitalization omitted).

³ PTX-237A** (Resps. to RFA Nos. 44-47).

⁴ DTX-109* at AR2012-016583.

3. Met's Contract with DWR

Met has a contract with DWR entitled "Contract Between [Met] and [DWR] for a Water Supply and Selected Related Agreements."⁵ Pursuant to this contract, DWR makes SWP water available to Met at delivery structures established in accordance with the contract.⁶ Met is obligated to make all payments under the contract even if it refuses to accept delivery of water made available to it. *Id.* at AR2012-000048 (Art. 9).

The contract distinguishes between the cost to *supply* SWP water to Met, and the cost to *transport* SWP water to Met.⁷ The cost to transport the SWP water to Met includes a capital cost component; a minimum operation, maintenance, power, and replacement component; and a variable operation, maintenance, power, and replacement component.⁸

The DWR contract gives Met the right to use the SWP transportation facilities to transport water that does not come from SWP facilities.⁹ The contract also gives Met the right to use SWP facilities for "interim storage" of non-project water, for later transportation to Met and its member agencies.¹⁰ Met pays no facilities charge to transport or store non-project water because Met pays for these rights by way of its transportation charge under the DWR Contract. DTX-055 at AR2012-000153 (Art. 55(b)-(c)); DTX-087 at AR2012-011307 ("contractor[s] that participate[] in the repayment for a reach [have] already paid costs of using that reach for conveyance of water supplies in the Transportation Charge invoice under its Statement of

⁵ DTX-090 at AR2012-000001 (capitalization omitted).

⁶ DTX-055 at AR2012-000048-49 (Arts. 9 (Obligation to Deliver Water Made Available), 10 (delivery structures)).

⁷ DTX-055 at AR2012-000065 (Art. 22 (a), defining Delta Water Charge), 000071-72 (Art. 23, defining Transportation Charge).

⁸ DTX-055 at 000071 (Art. 23, defining Transportation Charge), 000074 (Art. 24(a), defining Capital Cost Component), 000083 (Art. 25(a), defining Minimum Operation, Maintenance, Power, and Replacement Component), 000086-87 (Art. 26(a), defining Variable Operation, Maintenance, Power, and Replacement Component).

⁹ DTX-055 at AR2012-000153 (Art. 55(a)).

¹⁰ *Id.*; see also DTX-087 at AR2012-011307; DTX-109* at AR2012-016588. These documents refer to Met's use of the SWP to transport non-project water to full-service users.

Charges”); DTX-109* at AR2012-016588 (“This [non-project water] conveyance service is provided because the state water contractor has paid for the capital and operations and maintenance costs associated with the capacity in the California Aqueduct that is used”).

4. Met’s Rates and Charges

a. Rate-Setting

Until 2003, Met charged its member agencies a single, bundled water rate without any separate supply or transportation components.¹¹ In 1998, Met began the process of designing and implementing unbundled water rates and charges, to reflect the different services Met provides in order to more transparently recover its costs.¹²

Every year, or more recently, every two years, Met’s Board votes on particular rates adopted under that rate structure. In each budget and rate-setting cycle, Met looks at the services it expects to provide and estimates the costs it expects to incur to provide those services. As part of this process, Met evaluates its budget and the required rates necessary to support that budget.¹³

For each rate-setting since the unbundling, Met has presented each Board member with a final letter setting forth the details of the proposed rate options and a staff recommendation, as well as a multi-step cost of service (COS) analysis demonstrating how Met assigns certain expenses to related operation functions.¹⁴

In Step 1 of the COS process, Met determines its revenue requirements for the given fiscal year.¹⁵ This prospective process is necessarily inexact because Met must estimate both the services it plans to provide and their cost.¹⁶

¹¹ DTX-045 at AR2012-006471, 006496.

¹² DTX-132* at AR2012-006462_01; DTX-034 at AR2012-005545-46.

¹³ DTX-090 at AR2010-011443; DTX-110* at AR2012-016594.

¹⁴ DTX-090 at AR2010-0011443; DTX-110* at AR2012-016594.

¹⁵ DTX-090 at AR2010-011467, 011472-011474 (Schedule 1 at AR2010-011474 sets forth the revenue requirements by budget line item); DTX-110* at AR2012-016674, 016679-016680.

¹⁶ *Id.*

In Step 2 of the COS process, Met functionalizes its costs according to the nature of the service to which the costs correspond.¹⁷ These services are: supply, transportation (conveyance and aqueduct and distribution), storage, and demand management.¹⁸

Transportation-related costs associated with bringing water to Met's service area—mainly costs associated with the Colorado River Aqueduct and the SWP transportation facilities—are functionalized as conveyance and aqueduct costs. *Id.* Transportation-related costs associated with Met's internal distribution system are functionalized as distribution costs. *Id.* Costs associated with investments in developing local water resources are functionalized as demand management costs. *Id.*

In Step 3 of the COS process, Met categorizes its functionalized costs based on their causes and behavioral characteristics, including identifying which costs are incurred to meet average demands versus peak demands, and which costs are incurred to provide “standby” service.¹⁹ The relevant classification categories include: fixed demand costs, fixed commodity costs, fixed standby costs, and variable commodity costs.²⁰ Demand costs are “incurred to meet peak demands” and include only the “direct capital financing costs” necessary to build additional physical capacity in Met's system.²¹ Commodity costs are generally associated with average system demands. Fixed commodity costs include fixed operations and maintenance and capital financing costs that are not related to accommodating peak demands or standby service. Variable commodity costs include costs of chemicals, most power costs, and other cost components that vary depending on the volume of water supplied. Standby service relates to

¹⁷ DTX-090 at AR2010-011472, 011474-011482 (Schedule 4 at 011481 sets out the revenue requirements by their service function; DTX-110* at AR2012-016679, 016681-016687.

¹⁸ DTX-090 at AR2010-011474-011475; DTX-110* at AR2012-016681-016682.

¹⁹ DTX-090 at AR2010-011472, 011483-011489; DTX-110* at AR2012-016679, 016688-016694.

²⁰ DTX-090 at AR2010-011483 (Schedule 7 at 011488 sets out the service revenue requirements by classification category); DTX-110* at AR2012-016688.

²¹ DTX-090 at AR2010-011483, 011488; DTX-110* at AR2012-016688, 016693.

MWD's ability to ensure system reliabilities during emergencies such as earthquakes or major facility outages. The two principal components of Met's standby service costs are emergency storage within its own system and the standby capacity within the SWP conveyance system.²²

In Step 4 of the COS process, Met breaks its operation functions down into corresponding rate design elements, which, in Met's rate structure are volumetric rates (*i.e.*, rates charged per acre-foot²³ of water Met delivers to the member agencies), and fixed charges (*i.e.*, charges which do not vary with sales in the current year).²⁴ Among the unbundled volumetric rates in Met's rate structure are the Supply Rates (Tiers 1 and 2) and the Transportation Rates.²⁵ Met's fixed charges included a Readiness-to-Serve Charge and a Capacity Charge.²⁶

b. Water Rate Versus Wheeling Rate

Met's full-service water rate, charged when Met sells a member agency water, includes supply rates (Tier 1 and Tier 2), the System Access Rate, the System Power Rate, and the Water Stewardship Rate. These are all volumetric charges. Met's Wheeling Rate includes the System Access Rate, the Water Stewardship Rate, and the incremental cost of power necessary to move the water. MWD Admin. Code §§ 4119, 4405(b). All member agencies are charged the same rates. These components are described below.

i. Supply Rates

Met's Supply Rates recover costs incurred to maintain and develop water supplies needed to meet the member agencies' demands.²⁷ These costs include capital financing, operating,

²² *Id.*

²³ An acre-foot of water covers one acre one foot deep.

²⁴ DTX-090 at AR2010-011472, 011490 (Schedule 8 at 011490 sets out Met's classified service functions by rate design element); DTX-110* at AR2012-016695.

²⁵ DTX-090 at AR2010-011490-011500; DTX-110* at AR2012-016695-016700.

²⁶ *Id.*

²⁷ DTX-090 at AR2010-011474-011475, 011499-011500; DTX-110* at AR2012-016681, 016700.

maintenance and overhead costs for storage in Met's reservoirs.²⁸ These costs are generally recovered through the Tier 1 Supply Rate. However, if purchases in a calendar year by a member agency that executed a purchase order exceed 90% of its base firm demand (an amount based on the member agency's past annual firm demands), that member agency must pay a higher Tier 2 Supply Rate.²⁹ If a member agency did not execute a purchase order, the member agency must pay the higher Tier 2 Supply Rate for any amount exceeding 60% of its base firm demand.³⁰

ii. System Access Rate

The System Access Rate generates revenues to recover the capital, operating, maintenance, and overhead costs associated with the transportation facilities (*e.g.*, aqueducts and pipelines) necessary to deliver water to meet member agencies' average annual demands.³¹ Revenues from the SAR recover the costs of paying for distribution facilities (Met's facilities within its service area) and conveyance facilities (costs associated with the SWP facilities and Colorado River Aqueduct).³² The System Access Rate also includes regulatory storage costs, which are associated with maintaining additional distribution capacity and help meet peak demands.³³

²⁸ *Id.*

²⁹ DTX-045 at AR2012-006535-006536; DTX-090 at AR2010-011499; DTX-110* at AR2012-016700.

³⁰ *Id.*

³¹ DTX-045 at AR2012-006518; DTX-090 at AR2010-011492; DTX-110* at AR2012-016697.

³² DTX-045 at AR2012-006518.

³³ DTX-090 at AR2010-011473, 011475, 011484-011485, 011488, 011490-011492; DTX-110* at AR2012-016680, 016682, 016695-016697.

iii. System Power Rate

The System Power Rate generates revenues to recover the costs of power necessary to pump water through the SWP and Colorado River facilities to Met, and through Met's facilities to the member agencies.³⁴

Met allocates transportation costs associated with the SWP to the System Access Rate and the System Power Rate the same way it allocates those costs associated with the Colorado River Aqueduct.³⁵

iv. Water Stewardship Rate

The Water Stewardship Rate recovers the costs of funding demand management programs (local water resource development programs, water conservation programs, and seawater desalination programs).³⁶ These demand management programs, discussed in more detail below, are designed to encourage the development of local water supplies and the conservation of water.

c. Readiness-to-Serve Charge

Met's Readiness-to-Serve Charge recovers, among other things, SWP-related conveyance costs associated with peak demand (*i.e.*, capital financing costs), as well as emergency storage and peak-related storage costs (*i.e.*, storage which provides operational flexibility in meeting peak demands and flow requirements), and costs incurred to stand by and provide services during times of emergency or outage of facilities.³⁷ Each member agency's Readiness-to-Serve

³⁴ DTX-045 at AR2012-006520; DTX-090 at AR2010-011492; DTX-110* at AR2012-016697.

³⁵ DTX-090 at AR2010-011488, 011490; DTX-110* at AR2012-016693, 016695.

³⁶ DTX-045 at AR2012-006519; DTX-090 at AR2010-011492; DTX-110* at AR2012-016697.

³⁷ DTX-090 at AR2010-011484-011485, 011488, 011490, and 011494-011495; DTX-110* at AR2012-016688-016689, 016693, 016695, and 016698-016699.

Charge is based on that agency's ten-year rolling average of past total consumption, *i.e.*, all firm deliveries including water transfers and exchanges that use Met capacity.³⁸

d. Capacity Charge

The Capacity Charge is intended to pay for the cost of peaking capacity on Met's system, while providing an incentive for local agencies to decrease their use of Met's system to meet peak day demands.³⁹ Each member agency's Capacity Charge is based on that agency's maximum summer day demand placed on the system between May 1 and September 30 for a three-calendar year period.⁴⁰

e. Treatment Surcharge

The treatment surcharge is a uniform system-wide volumetric rate charged to for treated water.⁴¹

5. Demand Management Programs

Met's demand management programs fall under the rubric of the Local Resources Program, which provides incentives for recycled water and groundwater recovery facilities; the Seawater Desalination Program, which provides incentives for member agencies to develop facilities to desalinate seawater; and the Conservation Credits Program, which encourages the installation of water-efficient devices.⁴²

Met's demand management programs, are designed to, and do, reduce demand for water. *See* DTX-045 at AR2012-006519 ("Investments in conservation and recycling decrease the

³⁸ DTX-090 at AR2010-011495; DTX-110* at AR2012-016699.

³⁹ DTX-090 at AR2010-011492-011493; DTX-110* at AR2012-016697-016698.

⁴⁰ DTX-090 at AR2010-011492; DTX-110* at AR2012-016697.

⁴¹ DTX-045 at AR2012-006520.

⁴² *See, e.g.*, DTX-027 at AR2012-002868-002873; JTX-2* (AR2012-016429) at AR2012-016496, 016519.

region's overall dependence on imported water supplies"); 12/20/2013 Tr.** at 588:24-589:1⁴³ ("That's ultimately what [Met is] paying for is for a reduction in demand for imported water from [Met's] system." (Upadhyay testimony)); DTX-027 at AR2012-002870 (the first key goal of Met's Local Resources Program is to "avoid or defer Met capital expenditures"); 12/20/2013 Tr.** at 578:22-580:11 (Upadhyay testimony stating that Met adopted the Local Resources Program principles and they remain in effect today); DTX-518** at MWD2010-00466049 (Board identifying regional benefits associated with the Local Resources Program, including reduction in capital investments due to deferral and downsizing of regional infrastructure and reduction in operating costs for distribution of imported supplies); 12/20/2013 Tr.** at 580:17-581:21 (Upadhyay testimony that Met adopted the Local Resources Program as described in DTX-518); DTX-527** at MWD2010-00469807 (the first key goal of Met's Seawater Desalination Program is to "avoid or defer MWD capital expenditures"); 12/20/2013 Tr.** at 583:16-585:1 (Upadhyay testimony stating that Met's Seawater Desalination Program results in similar benefits to the Local Resources Program, including its key goals, and Met's Board adoption of the Program).

There are various estimates of the demand for water alleviated by these programs. *See* JTX-2* (AR2012-016429) at 016519 (Met's 2010 IRP estimates that 1,037,000 acre-feet of water will be conserved annually in southern California by 2025 due to Met's Conservation Credits Program). On an annual basis Met is required to report to the Legislature the effect its demand management programs have on decreasing demands on Met's system. *See, e.g.*, DTX-454** (Senate Bill 60 Report for fiscal year 2011/12); 12/20/2013 Tr. at 601:5-18 (Upadhyay testimony). These reports note the number of acre-feet of water Met was able to avoid

⁴³ As explained in note 3, "*" indicates that a document is present only in the 2012 administrative record. "***" indicates that a document is not in any administrative record. All documents in the 2010 administrative record are also in the 2012 administrative record.

transporting to its member agencies in a particular year as a result of its demand management programs. DTX-454** at MWD2010-00310322; 12/20/2013 Tr.** at 601:19-603:15 (Upadhyay testimony). Met calculates the effect demand management programs have by comparing the actual demand in a given year to the amount of reduced demand quantified in its SB-60 Reports. 12/20/2013 Tr.** at 601:19-603:15 (Upadhyay testimony). For example, in fiscal year 2011/12, Met estimated it would have had to transport over 20% more water through its system without its demand management programs. *Id.*; *see also id.* at 603:16-605:19 (Upadhyay testimony explaining that the 20% figure is conservative because the Conservation Credits Program actually reduces demand more than is reflected in the SB-60 Reports).

Met states that these decreases in demand avoid some capital expenditures,⁴⁴ including some transportation-related capital expenditures. *See, e.g.*, DTX-090 at AR2010-011511 (“Investments in demand side management programs like conservation, water recycling and groundwater recovery . . . help defer the need for additional conveyance, distribution, and storage facilities.”).

For example, in 1996, Met conducted a study to determine its future demand scenarios and corresponding infrastructure requirements.⁴⁵ Met evaluated two scenarios: a “base case,” under which no demand management programs were in place, and a “preferred case,” under which demand management program were in place.⁴⁶ Met compared the base and preferred cases and determined that demand management programs would decrease demand, thereby reducing the amount of water passing through Met’s system. Met believes that this equated to \$2

⁴⁴ DTX-020 at AR2012-001655-001657; 12/20/2013 Tr.** at 605:20-606:8 (Upadhyay testimony).

⁴⁵ DTX-018**, DTX-019 at AR2012-001406-001519; DTX-020 at AR2012-001520-001657.

⁴⁶ DTX-018** at MWD2010-00465826-00465828, 00465831-00465836; 12/20/2013 Tr.** at 566:13-567:24 (Upadhyay testimony).

billion savings in capital infrastructure costs.⁴⁷ It is unclear the extent to which the demand management programs contemplated in the preferred case exist.

Met also explored how its anticipated capital expenses relate to demand on Met's system in its 1996 Integrated Resources Plan ("IRP").⁴⁸ In the 1996 IRP, Met performed a sensitivity analysis to assess whether changes in future demands would impact the need for additional or expanded distribution facilities.⁴⁹ The IRP concludes that a 5% increase/decrease of demand had a correlative effect on when Met would need to incur capital infrastructure costs.⁵⁰ For example, Met determined that with a 5% decrease in demand, it could defer building the San Diego Pipeline No. 6 and the Central Pool Augmentation Project, both of which are distribution facilities.⁵¹ Met contends that it has in fact been able to defer both of these projects because demand management programs have decreased demand on Met's system.⁵²

6. Dry-Year Peaking

Met is a supplemental supplier of water. Thus annual demand for Met water can vary for a variety of reasons. *See JTX-2** (AR2012-016429) at AR2012-016473 ("[Met's] primary purpose is to provide a supplemental supply of imported water to its member public agencies. . . . The demand for supplemental supplies is dependent on water use at the retail consumer level and the amount of locally supplied water. Consumer demand and locally supplied water vary from year to year, resulting in variability in water sales").

According to San Diego, "dry-year peaking" refers to annual variations in use of Met water as a result of drought conditions. A reference to this is found in in Met's 1996 Integrated

⁴⁷ DTX-018** at MWD2010-00465836; 12/20/2013 Tr.** at 568:22-569:12 (Upadhyay testimony).

⁴⁸ DTX-020 at AR2012-001520-001657.

⁴⁹ DTX-020 at AR2012-001655-001657; 12/20/2013 Tr.** at 571:25-572:10 (Upadhyay testimony).

⁵⁰ DTX-020 at AR2012-001655-001657; 12/20/2013 Tr.** at 571:25-573:16 (Upadhyay testimony).

⁵¹ DTX-020 at AR2012-001655-001657; 12/20/2013 Tr.** at 573:6-16 (Upadhyay testimony).

⁵² 12/20/2013 Tr.** at 573:17-574:3 (Upadhyay testimony).

Resources Plan (IRP), which spelled out the storage, conveyance, and water supply development costs that Met must incur to satisfy “dry year water demands.”⁵³ This IRP explained that “because demands and supplies can vary substantially from year to year due to weather and hydrology,” and “because Metropolitan’s supplies are the swing supply for the region as a whole, this variation in demand alone translates into a \pm 14 percent change in Metropolitan’s water sales,” much of which is attributed to the fact that “below-normal runoff in the Owens Valley increases [Los Angeles’s] need for Metropolitan’s deliveries.”⁵⁴

Raftelis’s 1999 cost-of-service report, commissioned by Met, also refers to dry-year peaking and the disparity among member agencies in their peaking behavior, caused by the fact that “agencies with local resources” use Met as their “swing supply.”⁵⁵

According to San Diego, some member agencies increase their reliance on Met water by a greater magnitude than other agencies during dry years. San Diego’s experts calculated each member agency’s average annual variations in purchases over the last ten years (including the ratios of highest annual water use to average annual water) and San Diego submitted this information to Met’s Board for its consideration during the 2012 rate-setting cycle.⁵⁶ San Diego’s experts concluded that MWD’s largest customers (*i.e.*, those that purchase over 100,000 acre-feet of water per year, accounting for more than 70% of MWD’s total water deliveries) had ratios between 1.07 and 1.32. *Id.* (San Diego’s ratio was 1.11, Los Angeles Department of Water and Power’s ratio was 1.31).

⁵³ AR2010-001406 at 001450, 001452, 001466, 001491, 001493, 001509-10, 001591.

⁵⁴ AR2010-001406 at 001486-88 (charting LA’s dry-year peaking); *see also* AR2012-16429 at 16523* (detailing Los Angeles’s practice of rolling onto Met’s system in dry years and rolling off again in dry years).

⁵⁵ AR2012-16288_2114 at 2189-92*.

⁵⁶ DTX-108* at AR2012-016177.

Basic Evidentiary Standards and Burdens

The basic evidentiary standards and burdens applicable to the claims asserted here were discussed in the November 5, 2013 pretrial order. While the determinations made there were subject to revision, Pre-Trial Rulings at 9, the parties have provided no new argument and so I reiterate them here.

1. Default Rules

The general principles governing review of a quasi-legislative action on a writ of mandate under C.C.P. § 1085 are discussed in *American Coatings Assn., Inc. v. South Coast Air Quality Dist.*, 54 Cal.4th 446, 460 (2012). The rules are: (1) the standard of review is arbitrary and capricious, (2) petitioner usually bears the burden of proof,⁵⁷ and (3) the court considers only the administrative record before the agency at the time of its decision. An administrative agency's rate-making is a form of quasi-legislative action. *20th Century Ins. Co. v. Garamendi*, 8 Cal.4th 216, 277 (1994); *Brydon v. East Bay Mun. Util. Dist.*, 24 Cal.App.4th 178, 196 (1994) (water rate structure is quasi-legislative). Rates are presumed reasonable, fair, and lawful, *Hansen v. City of San Buenaventura*, 42 Cal.3d 1172, 1180 (1986) and petitioners have the burden of showing otherwise. *Id.*; *San Diego Cnty. Water Auth. v. Metro. Water Dist. of S. California*, 117 Cal.App.4th 13, 23 n.4 (2004).

Evidence outside the administrative record is not usually admissible. *Western States Petroleum Ass'n v. Superior Court*, 9 Cal.4th 559, 565, 576 (1995). *Western States* did recognize a narrow exception: Extra-record evidence is admissible in traditional mandamus proceedings if it existed before the agency made its decision and it was not possible in the exercise of reasonable diligence to present it to the agency before the decision was made. *Id.* at

⁵⁷ Evid. C. § 500. The burden of producing evidence is usually, but not always, on the party which has the burden of proof. Evid. C. § 550 (b).

578. Other exceptions might exist, but extra-record evidence cannot be used to contradict the administrative record. *Id.* at 578-79.

2. Proposition 26 (California Constitution Article XIII C)

California Constitution Article XIII C § 1(e) provides,

The local government bears the burden of proving by a preponderance of the evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a pay or bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity.

This is similar to that enacted by Proposition 218 and found in article XIII D § 4(f), which states:

In any legal action contesting the validity of any assessment, the burden shall be on the agency to demonstrate that the property or properties in question receive a special benefit over and above the benefits conferred on the public at large and that the amount of any contested assessment is proportional to, and no greater than, the benefits conferred on the property or properties in question.

Proposition 218 probably requires independent review. *Silicon Valley Taxpayers Ass'n, Inc. v. Santa Clara County Open Space Authority*, 44 Cal.4th 431 (2008).⁵⁸ Proposition 26 specifies the “burden of proving by a preponderance of the evidence” that the charge is not a tax, whereas Proposition 218 uses only the general term “burden.” By clarifying the burden, Proposition 26 may more strongly suggest that independent or *de novo* review is required. After Proposition 218, “an assessment’s validity, including the substantive requirements, is now a constitutional question,” and agencies may not exercise discretion to violate the constitution.

⁵⁸ *Silicon Valley* held the Proposition did not specify the burden, and so considered extrinsic evidence of voter intent. *Id.* at 445. The Court found that Proposition 218 was intended to overturn cases that held a deferential view of local government assessments was required. *Id.* at 445-46. And the Court concluded that the primary basis for deferential review, judicial deference to legislative acts, did not apply under Proposition 218, a constitutional amendment designed to limit local power, because Proposition 218 makes an assessment’s validity a constitutional question. *Id.* at 447-48. Neither party here discusses the extrinsic evidence of voter intent as to Proposition 26.

Silicon Valley, 44 Cal.4th at 448. This too suggests *de novo* review. See also *Griffith v. City of Santa Cruz*, 207 Cal.App.4th 982, 990 (2012) (reviewing trial court's denial of petition for writ of mandate pursuant to Propositions 218 and 26 *de novo* because it involved a facial constitutional challenge to an ordinance as written); *Greene v. Marin Cnty. Flood Control & Water Conservation Dist.*, 49 Cal.4th 277, 298 (2010) (reciting *Silicon Valley*). Moreover, the statutory language suggests that Met bears the burden of proving that its charge is not a tax under *any* of the seven exceptions.

As to the scope of the evidence to be considered, given the default rule that the scope of review is limited to the administrative record (with certain exceptions) and the failure of Proposition 26 to clearly modify this standard, I will here follow *Western States* and look only to the administrative record.

3. Proposition 13 and Government Code §§ 50075-50077

Whether a statute imposes a tax or a fee for the purposes of Proposition 13 is a question of law to be decided on an independent review of the facts. See *Cal. Farm Bureau Federation v. State Wat. Resources Control Bd.*, 51 Cal.4th 421, 436 (2011).

The following burden-shifting framework applies: (1) San Diego bears the burden of establishing a *prima facie* case showing that the fee is invalid; and (2) if San Diego's evidence is sufficient, Met then bears the burden of production to show that the challenged components of its rates bear a fair or reasonable relationship to the costs of the service Met provides. San Diego bears the burden of proof, and Met's burden is one of production only. See *Cal. Farm Bureau*, 51 Cal.4th at 436-37. For the same reasons discussed with respect to Proposition 26, I will look solely to the administrative record.

4. Wheeling Statutes

The wheeling statutes provide that no “public agency may deny a bona fide transferor of water the use of a water conveyance facility which has unused capacity, for the period of time for which that capacity is available, if fair compensation is paid for that use, subject to [enumerated exceptions].” Wat. Code § 1810. “‘Fair compensation’ means the reasonable charges incurred by the owner of the conveyance system, including capital, operation, maintenance, and replacement costs, increased costs from any necessitated purchase of supplemental power, and including reasonable credit for any offsetting benefits for the use of the conveyance system.” Wat. Code § 1811(c).

Section 1813 provides,

In making the determinations required by this article, the respective public agency shall act in a reasonable manner consistent with the requirements of the law to facilitate the voluntary sale, lease, or exchange of water and shall support its determinations by written findings. In any judicial action challenging any determination made under this article the court shall consider all relevant evidence, and the court shall give due consideration to the purposes and policies of this article. In any such case the court shall sustain the determination of the public agency if it finds that the determination is supported by substantial evidence.

In *Metropolitan Water Dist. of Southern Cal. v. Imperial Irr. Dist.*, 80 Cal.App.4th 1403, 1423, 1426-33 (2000), the Court found the wheeling statutes do not always preclude the consideration of system-wide costs in a wheeling rate calculation, and in so doing the Court afforded no deference to Met’s position. Accordingly, I should review *de novo* whether the statute applies or bars the inclusion of any component in a rate. But to the extent I must to review Met’s factual “fair compensation” determination, the statute requires me to do so under the substantial evidence standard.

The statutory language does not address the burden of proof, nor is there authority on point. San Diego argued in pre-trial briefing that *Beaumont Investors v. Beaumont-Cherry Valley*

Water District, 165 Cal.App.3d 227 (1985) places the burden of proof on the water district to prove that its charges are fairly allocated and do not exceed the reasonable cost of service. But, if anything, *Beaumont* shifts only the burden of production. *Homebuilders Ass'n of Tulare/Kings Cnty., Inc. v. City of Lemoore*, 185 Cal.App.4th 554, 563 (2010) (*Beaumont* conflated the burden of production and the burden of proof, the agency in *Beaumont* failed to meet its burden of production).

Finally, the statute requires me to consider all relevant evidence. *See* Wat. Code § 1813.

5. Government Code § 54999.7(a) and 66013

Met maintains that these statutes do not apply in this case as a matter of law. *See* Met Closing Brief, 26-29 (arguing that (1) § 66013 does not apply because it provides a basis for challenging capacity charges, not water rates generally; and (2) § 54999.7 does not apply to a water wholesaler like Met, or where all customers are public agencies, or where rates are not imposed). The applicability of the statutes is a legal matter, and no deference is afforded to Met. I resolve those legal issues below.

To the extent San Diego alleges Met acted unreasonably by including certain components in its water rates, this may raise factual questions, challenging Met's quasi-legislative actions. As to such issues, I afford deference to Met. I apply the default rule that San Diego bears the burden of proof and the default rule that I am confined to the administrative record.

6. The Met Act

San Diego argues that Met violated its enabling statute, the Met Act, by including in its wheeling rate costs that are unrelated to wheeling. At issue is Water Code Appendix § 109-134, which requires Met to set rates that are "uniform for like classes of service throughout the district."

“[T]he judiciary, although taking ultimate responsibility for the construction of the statute, accords great weight and respect to the administrative construction.” *San Diego Cnty. Wat. Authority v. Metropolitan Wat. Dist. of Southern Cal.*, 117 Cal.App.4th 13, 22-23 (2004). The Court further noted that substantial deference must be given to Met’s determination of its rate design and that rates established by a lawful rate-fixing body are presumed reasonable, fair, and lawful. *Id.* at 23 n.4. Accordingly, here I should give substantial deference to Met’s rate design, presume that Met’s rates are reasonable, and accord great weight to Met’s statutory construction while independently taking ultimate responsibility for construction of the statute. *Yamaha Corp. of America v. State Bd. of Education*, 19 Cal.4th 1, 11 n.4 (1998) (court has final responsibility for the interpretation of the law).

To the extent a burden of proof applies, consistent with the presumption that Met’s rates are reasonable the following burden-shifting scheme applies: (1) the plaintiff has the initial burden to establish that rates are different for different classes of like entities; (2) upon that showing, the defendant must make a showing that the rates were fixed by a lawful rate-fixing body, giving rise to an assumption of fact is required to be made that the rates fixed are reasonable, fair, and lawful; and (3) the plaintiff has the ultimate burden to show that the rates fixed are unreasonable. *Elliott v. City of Pacific Grove*, 54 Cal.App.3d 53, 60 (1975). In *Elliott*, the Court stated in dicta that the burden-shifting scheme proposed by defendants should apply in a rate-setting case. *See also Hansen*, 42 Cal.3d at 1180 (citing *Elliott* for the propositions that rates established by a lawful rate-fixing body are presumed reasonable and that, thus, plaintiffs bear the burden of showing that the rates fixed are unreasonable). Absent a showing that evidence is admissible pursuant to an exception under *Western States*, I should consider only the administrative record.

7. Common Law

A county, for example, can sue to enjoin rates that discriminate without a reasonable and proper basis. *Cnty. of Inyo v. Pub. Utilities Com.*, 26 Cal.3d 154, 159 (1980) (citing *Elliott*, 54 Cal.App.3d at 59). “A showing that rates are discriminatory is in itself insufficient to fulfill a complainant’s burden of proof [citation]; a showing, however, that such discrimination rests solely on the nonresident status of the customer, and not on the cost of service or some other reasonable basis, will prove the rate invalid.” *Cnty. of Inyo*, 26 Cal.3d at 159 n.4. With respect to the common law theory, I should give Met deference. Even when appellate opinions have not applied the writ of mandate standard to rates, they follow the “substantial deference” standard and presume rates’ reasonableness. *See San Diego*, 117 Cal.App.4th at 23 n.4. The burden-shifting procedure described above should apply to the common law theory for the same reasons it should apply under the Met Act. As with the Met Act claim, I should confine myself to the administrative record, absent San Diego’s showing that an exception to *Western States* applies.

Key Cases

1. Wheeling Cases

“State law mandates that the owner of a water conveyance system with unused capacity allow others to use the facility to transport water. The use of a water conveyance facility by someone other than the owner or operator to transport water is referred to as ‘wheeling.’ In return for wheeling, the water conveyance system owner is entitled to ‘fair compensation.’” *Metropolitan Wat. Dist. of S. Cal. v. Imperial Irrigation Dist.*, 80 Cal.App.4th 1403, 1407 (2000) (*MWD*).

With respect to wheeling, the parties focus on two cases decided less than a month apart. *See MWD*, 80 Cal.App.4th 1403; *San Luis Coastal Unified School Dist. v. City of Morro Bay*, 81 Cal.App.4th 1044 (2000).

In *MWD*, Met sought validation of its wheeling rates. *MWD*, 80 Cal.App.4th at 1408. Then, as now, Met's wheeling rate was based on the amount of water transported without regard to the source of water, the facilities used, or the distance traveled. *Id.* at 1419. The rate was based on the same "transmission-related costs" that Met included in the rates it charged for the water it sold to member agencies. *Id.* The transmission-related charges compensated Met for its capital investment and system-wide costs. *Id.* These costs included: debt service, operations and maintenance expenses, and take-or-pay contract costs associated with aqueducts and pipelines that deliver water from the supply sources to storage facilities, treatment plants and customer service connection points; SWP costs identified as transportation (both capital and maintenance); the costs of operating and maintaining the Colorado River Aqueduct and in-basin systems; the costs of planning and constructing transmission facilities, the costs of operating and maintaining regulating reservoirs; and 50% of Met's "Water Management Program branches' expenses." *Id.* at 1419-20. The transmission costs were discounted for wheeling transactions to take into account the fact that wheeling can only occur when unused capacity is available. *Id.* at 1420. The wheeling rate only applied to member agencies. *Id.*

Met explained that it factored system-wide costs into its wheeling rate to maintain its operational and financial integrity and to avoid adverse impact upon rates and charges of other member agencies. *Id.* Specifically, Met argued that if water sales to member agencies were displaced by wheeling transactions and Met was unable to charge wheelers for its capital investments and system-wide costs, then Met would have to scale back its conservation and

recycling programs or shift costs to other member agencies or taxpayers. *Id.* at 1420-21. Met was concerned that wheeling transactions by member agencies would put at risk its investment in facilities, its capital improvements, its water management programs, and its ability to meet its SWP costs. *Id.* at 1421. In short, Met argued that if a member agency purchasing water from Met paid for the fixed, unavoidable costs of the system, then member agencies using the same system for wheeling must contribute to Met's fixed costs on an equivalent basis. In Met's view, this prevents the water-purchasing agencies from subsidizing part of the wheeling transactions by bearing the full costs of Met's system. *Id.*

The trial court bifurcated trial. *Id.* at 1422. In the first phase, the trial court addressed two legal questions: (1) whether Met may include all of its system-wide costs in calculating its wheeling rates rather than only costs relating to particular facilities; and (2) whether Met may set "postage stamp" rates in advance without regard to any particular wheeling transaction. *Id.* The trial court resolved those legal questions against Met, obviating the need for the second phase of trial. *Id.*

The Court of Appeal reversed. First, the Court held that "neither the plain language of the Wheeling Statutes nor the legislative history supports a conclusion *as a matter of law* that system-wide costs cannot under any circumstances be included in a wheeling rate calculation." *Id.* at 1427. In so doing, the Court left it to the trial court to determine whether the system-wide costs included in Met's wheeling rate are proper. *Id.* at 1433. The Court began its analysis by noting that the Legislature did not use language consistent with the theory that only point-to-point costs may be recovered. *Id.* at 1428. Next, the Court reasoned that the fair compensation to which a water conveyance system owner is entitled for wheeling water includes reasonable capital, maintenance, and operation costs occasioned, caused, or brought about by the use of the

conveyance system. *Id.* at 1431. The Court stated that this includes charges the owner become subject to or liable for in using the conveyance system to wheel water when it has unused capacity. *Id.* The Court rejected San Diego's argument that it would be illogical to pass on Met's past costs to present users, concluding that where present wheelers are member agencies the wheeler did have a role in developing Met's present infrastructure, which is utilized in wheeling water. *Id.* Moreover, the Court noted that the bill enacting the Wheeling Statutes was revised to expand the definition of "fair compensation" to embrace capital as well as maintenance costs, omit narrowing references to marginal costs, and to give water conveyance system owners control over the fair compensation determination. *Id.* at 1432. The Court stated that these revisions came in response to criticism that, among other things, fair compensation should not be less than the use charge to long term contractors served by the facility and that the bill could interfere with water conveyance system owners' ability to meet contract payments if wheelers undercut prices and stole away customers. *Id.*

Second, the Court held that Met is not required to determine its wheeling rate on a case-by-case basis, but may set its wheeling rate ahead of time. *Id.* at 1433. Third, the Court declined to address several other challenges to Met's wheeling rate (that the rate was so high that it discouraged wheeling, that Met improperly included system-wide replacement costs), stating that the trial court would address those issues in the first instance on remand. *Id.* at 1435-36.

Morro Bay was decided shortly after *MWD*. In *Morro Bay*, a county agreed to provide a school district seven acre-feet of water annually in exchange for annual payments. *Morro Bay*, 81 Cal.App.4th at 1046. The county was required to transport the water to the Morro Bay city limits, but to bring the water to the schools it had to be carried through facilities belonging to Morro Bay. *Id.* *Morro Bay* denied the school district's wheeling proposal. *Id.* at 1047. In

relevant part, Morro Bay argued that Water Code § 1810(d) prevented the school district from requiring it to transport the water because, if Morro Bay lost the school district as a customer, it would have to increase the rates it charged its remaining customers. *Id.* at 1050. The Court rejected the argument. *Id.* It stated that neither Morro Bay nor its water customers had any right to make the school district purchase any particular amount of water. *Id.* The Court also rejected the notion that loss of income from a customer is the sort of injury to a legal user of water the Legislature had in mind. *Id.*

2. Proposition 218 and Proposition 26 Cases

In *City of Palmdale v. Palmdale Water District*, 198 Cal.App.4th 926, (2011), the Court held that a water district failed to satisfy its burden to establish that its new water rate structure complied with Proposition 218. *Palmdale*, 198 Cal.App.4th at 928.⁵⁹ The water district had retained Raftelis to provide a rate study and recommend a new rate structure. *Id.* Raftelis advised the water district regarding two options for determining fixed revenues, a “cost of service” option and a “percentage of fixed cost” option. *Id.* at 929. Among the advantages of the cost of service option was: “Defensible – Prop 218.” *Id.* Among the advantages of the other options was: “rate stability.” *Id.* The water district ultimately approved a rate structure that included a fixed monthly service charge based on the size of the customer’s meter and a per unit commodity charge for the amount of water used, with the amount depending on the customer’s adherence to the allocated water budget. *Id.* at 930. The customer paid a higher commodity charge per unit of water above the budgeted allotment, but the incremental rate increase depends on the customer’s class. *Id.* For example, irrigation users are charged disproportionate rates,

⁵⁹ Because it is imposed for the property-related service of water delivery, the district’s water rate, as well as its fixed monthly charges, were fees or charges within the meaning of article XIII D. *Palmdale*, 198 Cal.App.4th at 934.

reaching the highest Tier 5 rates upon use of 130% of their budgeted allocation, as compared to other users who do not reach Tier 5 until reaching either 175% or 190% of their allocation, depending on their classification. *Id.* at 937. The water district made no showing that there was a corresponding disparity in the cost of providing water to these customers at such levels. *Id.* The Court noted that the water district did not choose the option that Raftelis stated was defensible under Proposition 218. *Id.* Based on the foregoing, the Court concluded that the water district failed to carry its burden to demonstrate that its rates complied with Proposition 218. *Id.*

Griffith v. City of Santa Cruz, 207 Cal.App.4th 982 (2012) (*Griffith I*) involved a city ordinance subjecting residential rental dwelling units that are not occupied by the owner of the property to annual inspection by city staff. *Griffith I*, 207 Cal.App.4th at 988. The ordinance also provided for fees for annual registration, self-certification, inspection, and re-inspection in amounts to be established by resolution of the city council. *Id.* The city council subsequently set each fee. *Id.* In relevant part, plaintiff challenged the fees as illegal taxes enacted in violation of Proposition 218 and Proposition 26. *Id.* at 989-90. First, the Court noted that Proposition 218 is inapplicable to rental inspection fees. *Id.* at 995.

Second, the Court turned to Proposition 26. The Court stated that Proposition 26 exempts from its definition of “tax,” to which its requirements apply, “[a] charge imposed for the reasonable regulatory costs to a local government for issuing licenses and permits, performing investigations, inspections, and audits, enforcing agricultural marketing orders, and the administrative enforcement of adjudication thereof.” *Id.* at 996. To show a fee is an regulatory fee and not a special tax, the government should prove (1) the estimated costs of the service or regulatory activity, and (2) the basis for determining the manner in which the costs are

apportioned, so that charges allocated to a payer bear a fair or reasonable relationship to the payer's burdens or benefits from the regulatory activity. *Id.* Further, the Court noted that the question of proportionality is not measured on an individual basis, but instead is measured collectively. *Id.* at 997. Permissible fees must be related to the overall cost of the governmental regulation, they need not be finely calibrated to the precise benefit each individual fee payer might derive. *Id.* What a fee cannot do is exceed the reasonable cost of regulation with the generated surplus used for general revenue collection. *Id.*

Against this backdrop, the Court held that the city carried its burden of proof by showing that the fees were valid regulatory fees. *Id.* The Court noted that (1) the city provided a declaration to the effect that the costs of administering the ordinance would be equal to or greater than the fees levied on rental property owners; and (2) the fee schedule was on its face reasonably related to the payer's burden on the inspection program (self-certifications cost less than inspections, which in turn cost less than re-inspections necessitated by property conditions).

Griffith v. Pajaro Valley Wat. Management Agency, 220 Cal.App.4th 586 (2013) (*Griffith II*) upheld a water agency's ordinance against a Proposition 218 challenge. *Griffith II*, 220 Cal.App.4th at 589-90. The water agency was created to deal with saltwater intrusion. *Id.* at 590. The Pajaro Valley Groundwater Basin supplies most of the water used in Pajaro Valley. *Id.* Especially near the coast, saltwater seeps into the groundwater basin when the water table drops below sea level. *Id.* The water level drops below sea level when water is extracted faster than it is replenished by natural sources. *Id.* To prevent saltwater intrusion, the water agency's strategy was to use recycled wastewater, supplemental wells, captured storm runoff, and a coastal distribution system to reduce the amount of water taken from the groundwater basin. *Id.* The cost of this process was borne by all users on the theory that even those taking water from inland

wells benefit from the delivery of water to coastal users as that reduces the amount of groundwater the coastal users will extract from their own wells, keeping the water in all the wells from becoming too salty. *Id.* at 590-91. The water agency recovered this cost through an augmentation charge. *Id.* at 591.

The *Griffith II* Court rejected a series of substantive challenges to the augmentation charge. *Id.* at 597-602. First, the Court held that groundwater augmentation charges necessarily included debt service to construct facilities to capture, store, and distribute supplemental water. *Id.* at 598. Second, the Court held that the costs of purchasing, capturing, storing, and distributing supplemental water necessarily included general expenses to administer those functions. *Id.*

Third, the Court rejected the argument that the charge to an individual property owner was disproportionate because only coastal landowners received services, not that property owner. *Id.* at 600-01. The Court rejected this premise, because the water agency was managing water resources in the public interest for the benefit of all water users. *Id.* at 600. The Court further explained that proportionality is measured collectively, considering all rate-payers. *Id.* at 601. Moreover, apportionment is not a determination that lends itself to precise calculation. *Id.* The Court concluded that grouping similar users together for the same augmentation rate and charging users according to usage was a reasonable way to apportion the cost of service, whether or not other reasonable alternatives existed. *Id.* Accordingly, the Court also rejected the argument it was improper to take the costs of chargeable activities, deduct expected revenues from other sources, and apportion the revenue requirement among users. *Id.* at 600-01.

Key Documents

The parties have focused their attention on several documents in the voluminous administrative record. I summarized them here.

1. 1969 Brown and Caldwell

In a 1969 Water Pricing Policy Study, Brown and Caldwell broke down all costs of the Met system into four functional cost groups.⁶⁰ In that study, Brown and Caldwell defined Met's supply system: "The supply system includes all facilities involved in the function of making water available to the initial regulating reservoirs of the MWD distribution system. This includes the Colorado River Aqueduct up to the inlet works of Lake Mathews, the proposed Bolsa Island desalination plant and its treated water transmission system, and the SWP facilities excluding the terminal reservoirs of that system. In sum, this category includes the facilities whose function is the delivery of water from the sources of supply to the MWD distribution system but whose operation is essentially unrelated to the problems in meeting short term fluctuations in demand of the individual customer agencies of MWD." Brown and Caldwell defined Met's distribution system as all Met facilities that convey water from supply works to the member agencies. Thus, Brown and Caldwell included those SWP costs arising from construction and operation of terminal storage reservoirs. In accompanying tables, the bulk of Met's SWP transportation charge was attributed to supply, while a smaller portion was attributed to fixed distribution costs. *Id.* at 1745-46.

⁶⁰ AR2012_016288_1723 at 1744*.

2. 1993 Raftelis Textbook

The 2012 administrative record includes an excerpt on classifying “O&M”⁶¹ costs taken from a 1993 textbook written by George A. Raftelis. DTX-134* at AR2012-5282, 5284. The text discusses allocation of water service costs to customers. *Id.* at 5291. It states that this usually takes place in two steps: (1) allocation of costs to functional cost of service categories; and (2) reallocation of functional costs to classification of customers. The text identifies several functional cost of service components, including, among others: (1) “Source of supply: operating and capital costs associated with the source of water supply (reservoir construction and maintenance costs, water right purchases, supply development costs, conservation costs, etc.);” (2) “Pumping and conveyance: costs associated with pumping raw water from the source of supply and transferring it through a piping network for treatment[;]” (3) “Transmission: costs associated with transporting water from the point of treatment through a major trunk to major locations within the service area[;]” and (4) “Distribution: costs associated with smaller local service distribution mains transporting water to specific locations within the service area; water storage costs are normally considered a part of distribution costs.” *Id.* at 5291-92 (emphasis omitted). The text notes that if a utility effectively integrates the NARUC chart of accounts, identification of cost by functional category is provided by the accounting system. *Id.* at 5292. If the accounting system does not provide such a breakdown, it is necessary to develop allocations using appropriate bases.

3. Resource Management International, Inc. (RMI) Reports

In October 1995, RMI provided a report outlining its recommendations regarding how a cost of service and rate alternatives study for Met should be conducted. DTX-013, AR2012-

⁶¹ This appears to mean Operation and Maintenance. See DTX-013 at AR2012-001111 (defining “O&M” as operation and maintenance expenses).

001106. In the October 1995 report, RMI explained that operating expenses should be functionalized into a number of major utility functions, including, among others: (1) “Supply Function – Costs of operating and maintaining water supply facilities, such as dams and associated reservoirs, wells, and desalination plants, and costs of purchasing water from wholesale water suppliers[;]” (2) “Transmission Function – Costs of operating and maintaining aqueducts to move water from sources of supply to major centers of demand[;]” and (3) “Distribution Function – Costs of operating and maintaining distribution pipelines which deliver water from the major aqueducts to storage facilities, to treatment plants, and to customer service connection points.” *Id.* at 001112 (emphasis omitted).

In May 1996, RMI provided a cost of service study to Met. DTX-133* at AR2012-001796. This report included, among others, the following categories: (1) “Source of Supply – Source of supply costs include the costs of operating and maintaining water source facilities, such as [same examples as listed in October 1995 report][;]” (2) “Transmission Function – Transmission costs consist of [same definition as in October 1995 report][;]” and (3) “Distribution function – Distribution costs consist of [same definition as in October 1995 report].” *Id.* at 1874 (emphasis omitted). The report stated that conservation, groundwater recovery, local projects, and wastewater reclamation were supply costs. *Id.*

In the May 1996 report, RMI treated the SWP Delta Water Charges as source of supply costs, but treated SWP transportation charges as transmission/distribution costs. *Id.* at 1876-77, 1904. The basis for the distinction was the nature of the expense as the SWP bills are categorized and the capital charges for transmission facilities and the operations and maintenance charges for transmission facilities are transmission-related. *Id.* at 1876. RMI treated Water Management Programs as source of supply costs. *Id.* at 1905.

In December 1995, RMI issued a report identifying approaches for pricing water wheeling services. DTX-136 at AR2012-001223. RMI stated that Met's volumetric rate design, coupled with its fixed expenditures (predominantly flowing from what RMI referred to as SWP Supply costs, including costs for the SWP to transport the water),⁶² created a risk that Met would either have to increase its rates charged in water sales or suffer revenue under-collection if wheeling transfers supplanted Met water sales. *Id.* at 001225, 001231, 001233, 001233 n.4, 001234-35, 001245-46, 001254. However, RMI understood that a rate increase to member agencies was barred by the "hold harmless" requirement. *Id.* at 001234, 001254. (This requirement is also referred to as part of the San Pedro principles, and is discussed in more detail below.)

RMI discussed four alternatives. Three merit discussion. The first option was a wheeling rate that removed only SWP incremental power and fish program charges from the water rates, retaining all of the other rate elements from the firm sales rate. *Id.* at 001244. RMI recommended that option, acknowledging that it would likely be an extremely high rate and accordingly be considered highly unsatisfactory, because it would remove any economic incentive to wheel water. *Id.* at 001254. The second option was to remove all avoided supply costs, including all SWP and Colorado River supply costs, from the rate. *Id.* at 001245. RMI expressed concern that this rate could displace Met sales, forcing Met to increase its firm sales rate and violating the "hold harmless" principle. *Id.* at 001251. It also noted that non-member agencies might object to this rate because they would be forced to contribute to recovery of Met's fixed costs. *Id.* at 001252. The third option was a wheeling rate based on incremental costs. *Id.* at 001247. RMI stated that this would disregard the costs of building and operating

⁶² The report notes that Met still needed to classify its costs. DTX-136 at AR2012-001227. Obviously, this report predated the May 1996 report, discussed above.

the integrated delivery systems Met utilizes to transport water to the customer. *Id.* RMI also expressed concern that this option would lead to a substantial displacement of Met sales. *Id.* at 001252. As is clear from the discussion of Met's wheeling rate above, Met did not take any of these options.

In the report, RMI also discussed SWP wheeling charges, noting that its charge for wheeling water from the from the Delta to Met's delivery point at Castaic Lake could limit Met's wheeling rates. *Id.* at 001237. However, RMI posited that such a constraint could be avoided if Met wheeled the water on the California Aqueduct under its contract with the SWP, because all fixed charges are covered by Met's annual payment to the SWP it would be expected that member agencies receiving on-behalf wheeling service would be charged only variable SWP power charges.

4. 1996 Integrated Resources Plan

The 1996 Integrated Resources Plan (IRP) is comprised of two volumes, a long-term resources plan and an overview study of Met's system.⁶³

The IRP addressed the impact of increasing demand for water in Southern California. In that context, the IRP discussed water conservation as impacting water demand and as a supply option much like any other traditional supply project. *See* DTX-019 at AR 2012-001448. In the IRP, conservation was defined as long-term programs that require investments in structural programs such as ultra-low-flush toilets, low-flow showerheads, or water efficient landscape irrigation technology – coupled with ongoing public education and information. *Id.* Water recycling was also described as a valuable source of water supply. *Id.* at 001452. Ocean desalination was also described as an abundant source of water supply, although a cost prohibitive one. *Id.* at 001456.

⁶³ *See* DTX-019 at AR2012-001406; DTX-020 at AR2012-001520.

The IRP also noted that local management programs reduce the need for additional investment in regional infrastructure. *Id.* at 001491. The IRP stated that changes in water demand can be attributed to weather, structural changes in retail demand, or local supply development. *Id.* The IRP set out guidelines for water management programs and conservation programs, explaining, among other things, that (1) the regional benefits of local water management programs should be measured by reduction in capital investments due to deferral of or down-sizing of regional infrastructure, reduction in O&M expenditures for treatment and distribution of imported water, and reduction in expenditures associated with developing alternative regional supplies; (2) local water management programs must increase regional supplies and provide measurable regional benefits; and (3) the regional benefits of conservation programs should be measured by the same factors, and in addition by environmental benefits from reduced demand on the ecosystem. *Id.* at 001515-16. The IRP included a sensitivity analysis, which discussed the sensitivity of Met's rates to the level of demand on Met's system going forward. DTX-019 at AR2012-001502. For example, the IRP identifies several projects that could be delayed or avoided with a 5% decrease in retail demand. *See* DTX-020 at AR2012-01656.

The IRP also discussed Met's storage, which it divided into "Emergency Storage," "Seasonal or Regulatory Storage," and "Carryover or Drought Storage." *Id.* at 001466. Emergency storage is to be used if a catastrophic event disables a vital conveyance system. *Id.* Seasonal or regulatory storage is designed to balance seasonal demand, ensuring that summer season demand is met. *Id.* Carryover or drought storage is water stored beyond a single year for use in droughts. *Id.* The IRP projected demand under wet, normal, and dry conditions. *See* DTX-020 at AR2012-001566. It also breaks down dry year peak demands of the Met member

agencies. *Id.* at 001572-74; *see also id.* at 001595, 001602, 001610 (charts of projected dry year peak demands in various regions).

5. Resolution 8520

On January 14, 1997, Met's Board issued Resolution 8520. DTX-680 at AR2012-002446, 002451. In Resolution 8520, Met adopted its "postage stamp" wheeling rate. *Id.* at 002448. That is, it adopted a uniform rate per acre-foot of water for wheeling transactions regardless of the facilities used in the transaction or the distance moved. *Id.*

The document begins with a series of "whereas" clauses, including the following statements: (1) Met has a contract with the State of California that requires Met, on a take or pay basis, to pay a proportionate share of the costs of constructing and operating the SWP, including facilities for conserving, storing, and transporting water to Met's service area; (2) under its contract with the State of California, Met has an entitlement to water and associated transportation thereof by the SWP and the right to use SWP transportation facilities for its own purposes, subject to certain conditions; and (3) Met's conveyance system and its rights to use the SWP conveyance system are, together, the conveyance system. *Id.* at 002446.

The Board allocated its transmission costs to reflect the capital, operation, maintenance, and replacement costs incurred by Met to convey water to its conveyance system, including Met's rights in the SWP system, and because it found that including those costs in Met's wheeling rate is necessary to insure recovery of fair compensation for the use of that conveyance system. *Id.* at 002449. Further, the Board found that allocating unavoidable costs attributable to Met's supply, power, storage and customer related functions because including those unavoidable costs in the wheeling rate is necessary in order to protect Met's member agencies

from financial injury by avoiding the shifting of those costs from a wheeling party to Met's other member agencies. *Id.*

Attachment 1 to Resolution 8520 is an October 1996 technical report on the proposed wheeling charge. *Id.* at 002452. The purpose of the report is to describe Met's proposed charge for wheeling, which is defined as provision of transportation-only service for water owned by others rather than the traditional bundled delivery of water owned by Met. *Id.* The report notes that Met has entered into long-term contracts, constructed major capital facilities, issued bonds to finance construction or purchase facilities, and has implemented water management programs to develop, store, transmit, and treat water throughout its service area. *Id.* Further, it notes that one basis for using a postage stamp rate is system integration. *Id.* at 002455. Because the system is integrated, it notes, charges for Met water service should reflect the cost of the whole system, and members using the system to wheel water should pay for the cost of the whole system. *Id.* Moreover, the report lists Met's major facilities and programs as including the SWP, the Colorado River Aqueduct, pumping plants, reservoirs, water treatment facilities, a system of pipelines and control structures, associated facilities for the transportation, storage and delivery of water, as well as water conservation projects and financial assistance for water recycling and groundwater recovery facilities. *Id.* System integration is demonstrated by the blending of water and the ability to compensate for outages by deliveries from other sources. *Id.* at 002455-56.

The report goes on to discuss the proper wheeling rate for member agencies. *Id.* at 002458. The report disaggregates costs into categories for "transmission," "storage," "supply," "power," and "treatment." *Id.* at 002460. At Schedule A, the report charts the allocation of SWP costs and Water Management Program costs between the five categories, above. *Id.* at 002472.

Transmission includes debt service, operations and maintenance expenses, take-or-pay contract costs associated with aqueducts and pipelines that deliver water from supply sources to storage facilities, and treatment plants and customer service connection points. *Id.* at 002460. Transmission includes SWP costs identified as transportation, the costs of operating and maintaining the Colorado River Aqueduct, the costs of planning and constructing transmission facilities, and the costs of operating and maintaining regulating reservoirs. *Id.* Costs functionalized to transmission include the SWP transportation expenses and 50% of the incentives and program costs for the Water Management Programs. *Id.* at 002464.

Supply costs include the costs of operating and maintaining water source facilities such as dams to control river flows, reservoirs to capture runoff, wells, desalination plants, and transfers to procure additional water supplies. *Id.* at 002460. Costs functionalized as supply include 50% of Water Management Programs branches and the Delta Water Charge charged by the SWP. *Id.* at 002462.

6. 2002 Final Report on Rates and Charges and Cost of Service Reports

In its 2002 Final Report on Rates and Charges, Met described and evaluated what remains its current rate structure. In the cost of service process, Met (1) developed its revenue requirements; (2) functionalized its costs; (3) classified its costs; and (4) allocated its costs to rate design elements. DTX-045 at AR2012-006493. In functionalizing its costs, it defined the terms “supply” and “conveyance and aqueduct.” *Id.* at 006496-97. The supply function includes SWP costs that relate to maintaining and developing supplies – the Delta Water Charge and the cost of storage and transfer programs. *Id.* at 006496. The conveyance and aqueduct function includes capital, operations, maintenance, and overhead costs for SWP facilities that convey water to Met’s internal distribution system as well as the SWP variable power costs, which are

categorized in a separate subcategory. *Id.* The report explains that conveyance and aqueduct costs have been separated from source of supply costs to allow a more detailed level of analysis to be performed during the evaluation of rate design alternatives. *Id.* at 006497. The SWP conveyance and aqueduct revenue requirement outpaced the SWP source of supply revenue requirement. *Id.* at 006504.

In the report, Met identified benefits of the Water Stewardship Rate and System Access Rate. The Water Stewardship Rate reduces dependence on imported supplies, increases water supply reliability, reduces and defers system capacity expansion costs, and creates space availability to complete water transfers. *Id.* 006519. The report included a frequently asked questions section. There, Met justified charging all users, including third party wheelers, the Water Stewardship Rate on the basis that all users would benefit from paying a lower System Access Rate because conservation and local resources projects would lead to a deferral and reduction of facility expansion costs. *Id.* at 006775. The report says the System Access Rate ensures that member agencies will pay the same cost for access to Met's system whether they purchase water from Met or another supply source. *Id.* at 006518.

The 2010 and 2012 cost of service studies, which retain the rate structure identified in the 2002 report, identify drought storage as a distinct storage cost that is recovered through supply rates.⁶⁴

7. 2010 Raftelis Study

In 2010, Raftelis Financial Consultants, Inc. reviewed Met's fiscal year 2010/11 cost of service and rate setting process. *See* DTX-088 at AR2012-011309. The review states that functionalizing SWP costs in accordance with the SWP invoice is appropriate because the invoices from the SWP are detailed and are not aggregated on a per-acre foot basis. *Id.* at

⁶⁴ DTX-090 at AR2012-011474-75, 84, 86, 88; DTX-110* at AR2012-016653, 016681-82, 016689, 016700.

011318. The study further noted that Met follows the four-step process set forth in American Water Works Association's Manual M-1 by identifying service functions cost, the classification of cost, and allocation of costs to rate design elements to develop a nexus between cost and revenue streams. *Id.* at 011322. Moreover, the study found that the rate design elements meet requirements set forth by AWWA's rate-setting principles and industry guidelines. *Id.*

8. 2010 Bartle Wells Associates Letters

San Diego retained Bartle Wells Associates to review Met's rates. In a March 2010 letter, Bartle Wells opined that Met improperly, and contrary to industry standards, misallocates some of its supply costs under the SWP contract to a conveyance and distribution category. AR2010-11207-14. According to Bartle Wells, this distorts Met's System Access Rate and Met's supply rates. *Id.* Bartle Wells' rationale was that Met does not own, maintain, or operate any of the SWP facilities, so its SWP costs are the cost of obtaining a supply from the SWP. *Id.* at 11208. Further, Bartle Wells stated that the SWP power costs should be charged to supply, and not the System Power Rate. *Id.* at 11208-09. Bartle Wells stated that three other contracting agencies allocate SWP costs as supply costs, and that it was not aware of any agency that allocated SWP costs in the same way Met does. *Id.* at 11209.

Bartle Wells also found that it was improper for Met to collect the Water Stewardship Rate through its conveyance charges. *Id.* at 11207-08. Bartle Wells explained that the service function was to increase water supply, so the cost should be allocated to supply rates. *Id.* at 11209-10.

Met's general manager and general counsel responded to these concerns in an April 2010 memorandum to the Met Board. AR2010-011307. In it, they asserted that (1) the SWP charges must be paid regardless of the quantity of water delivered; (2) Met uses the SWP as a

conveyance facility to convey both SWP and non-SWP water pursuant to the contract; and (3) Met has consistently recorded SWP capital costs as payments for use of the SWP facilities. *Id.* at 11306-07. Accordingly, they concluded that Met properly charges its SWP contract costs in its conveyance costs, as it pays for conveyance rights in the contract, avoiding a use fee that it would otherwise have to pay to use the facilities. *Id.* at 11307. As to the Water Stewardship Rate, they stated that all users benefit from lower capital costs as a result of resource management programs, so all users should bear a proportional cost for these services. *Id.* at 11307-08.

In an April 2010 letter, Bartle Wells supplemented the above opinions. AR2010-11393-400. In it, Bartle Wells concluded that Met's rates were not consistent with industry best practice or the AWWA Manual M-1⁶⁵ or the NARUC system of accounts, and that Met's rates are not apportioned among customers in a manner that reflects the proportionate cost to serve each. *Id.* Bartle Wells wrote that NARUC requires water purchase costs to reflect the cost of water purchased for resale at the point of delivery. *Id.* at 11394. Under NARUC, Bartle Wells stated that SWP costs should be allocated as supply, regardless of the manner in which the Department of Water Resources bills Met. *Id.* In addition, Bartle Wells asserted that Met does not comply with the AWWA manual because its rate system treats the cost of an imported water supply as a transportation cost, inflating Met's transportation charge and disproportionately impacting customers who purchase transportation rather than supply services. *Id.* at 11396. Bartle Wells also restated its conclusion that the Water Stewardship Rate is misallocated, and thus concluded that it is not in compliance with the AWWA manual. *Id.* at 11396-97.

⁶⁵ AWWA Manual M-1 is a part of the administrative record. *See* DTX-030 at AR2010-003865. The AWWA manual defines a cost-of-service approach as one that allocates costs to a customer or class of customers based on cost causation. *Id.* at 003997. The manual discusses charting operation and maintenance expenses, noting that NARUC has a uniform system of accounts that is widely used and can be modified for government-owned utilities. *Id.* at 003904.

The April 2010 letter addressed Met's response to the March 2010 letter. *Id.* at 11397. It responded to Met's argument that uses the SWP as a conveyance facility by stating that Met does not own or control the SWP, but is merely a customer under a water supply contract. *Id.* It responded to Met's argument that it is appropriate for all users to pay the Water Stewardship Rate because all users benefit from reduced capital costs by asserting that Met must measure what portion of the benefit accrues to each class of Met customers to fairly apportion its rates. *Id.* at 11397-98. Bartle Wells states that Met has failed to do that accounting. *Id.*

In March 2012, Bartle Wells confirmed that its position remained the same as to the 2013/2014 rates.⁶⁶

9. 2012 FCS

In March 2012, the FCS Group provided a review of Met's 2013/2014 rates at San Diego's request. AR2012-16156-91, 16160*. FCS found that Met's rates were deficient in the following respects: (1) the supply rate should, but does not, include costs to obtain water supplies from the SWP and from local projects that are instead recovered through the System Access Rate, the System Power Rate, and the Water Stewardship Rate; (2) the Readiness-to-Serve Charge was improperly charged to wheeling parties; and (3) the rates did not adequately address seasonal or sporadic annual peaking because the rates consider only peak day cost through the capacity charge. *Id.* at 16163-64. With respect to the Water Stewardship Rate, FCS argued that Met failed to demonstrate that the rate provides a proportionate and direct benefit to transportation in spite of its obligation to demonstrate a reasonable nexus between the charge and the service provided. *Id.* at 16173. With respect to sporadic annual peaking, FCS stated that agencies with constant demand subsidize those with fluctuating demand by paying to maintain standby capacity, whether demand fluctuates based on conservation measures, price elasticity at

⁶⁶ AR2012-16215-16*.

the local retail level, mandatory water curtailments, weather patterns, the local agency's supply conditions, or other factors. *Id.* at 16176, 16178. FCS opined that Met's capacity charge and Tier 2 Supply Rate recover only a small portion of the billions Met spends on drought insurance, such that agencies with more stable demand end up subsidizing those with variable demand. *Id.* at 16178.

The Met general manager and general counsel responded in a memorandum to Met's Board. AR2012_016583*. They asserted that Met has an integrated system, including Met's right to use SWP facilities, from which all system users, including wheelers, benefit. *Id.* at 016586. They stated that Met, as a supplemental supplier of water, must ensure that agencies that transport water acquired from other sources do not evade the costs of maintaining Met's system. *Id.* at 016588. They cite two examples in which Met used the SWP to transport non-SWP water to member agencies. *Id.* They suggest that those SWP costs would have been subsidized if the SWP contract were allocated solely to supply. *Id.* They also noted that each SWP contractor funds the systems development and operations through payments proportional to their rights to use the system, supporting Met's treatment of the SWP as an extension of its system. *Id.* They drew further support from the fact that the Department of Water Resources breaks its invoices into supply charges and transportation charges. *Id.* at 016589. As to the Water Stewardship Rate, they stated that all users benefit from the programs it funds, so all should pay. *Id.* at 016590. They raise the concern that a failure to charge the rate to wheelers would mean that wheelers enjoy the benefits of the program without paying their share. *Id.* As to peaking, they state that Met recovers its standby costs through the Readiness-to-Serve Charge and its distribution peaking costs through the Capacity Charge. *Id.* at 016592.

Summary of Arguments

San Diego argues that Met's System Access Rate, System Power Rate, Water Stewardship Rate, and wheeling rate are illegal and should be invalidated. San Diego Post-Trial Brief at 4. San Diego argues that (1) Met recovers the costs Met pays the SWP for transportation through its transportation rates without any basis for treating the SWP as its own conveyance system; and (2) Met charges its full Water Stewardship Rate in its wheeling rate even though the programs that are funded by the rate are primarily *supply* benefits. *Id.* at 3-4.

San Diego also contends that Met incurs dry-year peaking costs which benefit some member agencies (such as Los Angeles) which are recovered disproportionately from other member agencies (such as San Diego) through the transportation rates, among others. *Id.*

Met argues that it is reasonable to allocate SWP transportation costs to its transportation rates for four reasons: (1) SWP transportation costs are Met transportation costs;⁶⁷ (2) Met uses SWP facilities as an extension of its own system;⁶⁸ (3) Met has an integrated, regional system that delivers a blend of water which includes SWP water; and (4) Met's allocation is consistent with industry guidelines.⁶⁹ Met Closing Brief at 45-60. San Diego counters that the SWP costs are supply costs, i.e., costs incurred to obtain a supply of water. San Diego Post-Trial Brief at 20-25. San Diego accuses Met of improperly protecting member agencies that do not wheel water from facing increased rates when wheeling member agencies purchase water from other sources. *Id.* at 7.

⁶⁷ Met relies on the facts that (1) its contract with the Department of Water Resources breaks down its charges to Met to reflect both costs associated with supply water and those associated with water delivery; and (2) it pays a share of the capital costs of expanding the SWP system in the reaches it uses. Met Post-Trial Brief, 45-49.

⁶⁸ Met relies on its contractual right to use SWP facilities to transport non-project water and the fact that it has exercised that right. Met Closing Brief, 49-53.

⁶⁹ Met points to the 1993 Raftelis textbook, the RMI reports, and the 2010 Raftelis report. Met Closing Brief, 55-59.

Second, Met contends that it is reasonable to allocate the Water Stewardship Rate to its transportation rates because the Water Stewardship Rate recovers the cost of funding programs that help avoid or defer transportation-related capital expenses and increase system capacity. Met Closing Brief at 61-74.⁷⁰ San Diego responds that the programs funded by the Water Stewardship Rate are primarily designed to meet supply programs; therefore Met should have studied and quantified the transportation benefits of those programs if they were to allocate any of the costs of those programs to a charge other than their supply rates. San Diego Post-Trial Brief at 26-29.

Third, Met argues that San Diego's dry-year peaking claim fails because: (1) Met recovers storage-related costs;⁷¹ (2) annual variation in demand has a number of causes; (3) there are only minor differences in member agency demand fluctuations;⁷² (4) Met's rates recover the costs of variations in water purchases from year to year and within a single year;⁷³ and (5) San Diego lacks standing. Met Closing Brief at 87-100. San Diego responds that Met's SWP contract, its demand management programs, its conveyance capacity, and its reservoirs and storage are all necessary to meet dry year demand. San Diego Post-Trial Brief, 30-31. San Diego contends that agencies that have a higher annual variation enjoy these benefits while paying a lesser share of the costs due to Met's use of volumetric rates. *Id.* at 33. That is, in a year when a highly variable agency uses less water, it pays less to maintain Met's system even

⁷⁰ Met refers to the 1996 IRP to demonstrate the importance of reduced demand. Met Closing Brief, 63. Further, Met notes that the goal of local resources programs have long included assisting local projects that improve regional water supply reliability and avoid or defer Met capital expenditures. *See* AR2010-002870.

⁷¹ Met states that it recovers drought storage through its supply rates. Met Closing Brief, 89.

⁷² Met emphasizes that San Diego's annual variation from its ten year average was 1.11, whereas Los Angeles' was 1.31. Met Closing Brief, 93. Met also argues that, even if this variation is significant, it is irrelevant because it does not impact Met's costs, based on system-sizing. *Id.* at 95.

⁷³ Met relies on (1) its volumetric rates, which ensure that an agency pays more in a year it purchases more water; (2) its tiered supply rates, which are tiered to reflect the cost of Met obtaining new supplies if a member agency executed a purchase order exceeding 90% of its base firm demand; (3) its Readiness-to-Serve Charge, which recovers standby, emergency storage, and capital costs for facilities to meet peak monthly or seasonal demand (based on a ten-year rolling average of past consumption); and (4) its Capacity Charge, which is based on peak week demands.

though it contributes to the overall need for system capacity and available water supply at a level based on its peak year. On the other hand, an agency that varies little pays a greater share of the burden of maintaining the whole system in a year in which the highly variable agency uses less water.

Fourth, Met asserts that its wheeling rate is reasonable because: (1) it is reasonably based on the principle that all member agencies should pay for the fixed, unavoidable system costs when using Met's system; (2) it is reasonable to recover system-wide SWP costs in the wheeling rate;⁷⁴ and (3) it is reasonable to charge the Water Stewardship Rate in connection with wheeling transactions.⁷⁵ Met Closing Brief, 74-87. San Diego argues that Met's wheeling rate illegally discourages wheeling by improperly including its SWP costs, Water Stewardship Rate, and dry-year peaking costs in its wheeling rate. San Diego Post-Trial Brief, 45, 48-58.

Discussion

The parties agree that Met is obligated to set its rates based on principles of cost causation, that is, that Met must charge for its services based only on what it costs to provide them. Met Closing Brief at 60; San Diego's Amended First Pretrial Brief at 1. This is the central focus of this case, and provides a good shorthand for the varied tests implicated by the varied causes of action, as revealed by the summaries just below.

For each of the claims, I now review whether the statutes or law apply.

⁷⁴ According to Met, this is because the wheeling statute allows Met to charge system-wide costs in its wheeling rate and Met exercises its contractual right to use SWP facilities to complete wheeling transactions. Met Closing Brief, 83-85.

⁷⁵ Met argues that this is because wheelers benefit from available capacity, as that enables Met to wheel water. Met Closing Brief, 86. Met also reiterates that this recovers from wheelers the cost of using the system. *Id.* at 85-86.

1. Application of Statutes

Proposition 26. Here the issue is whether rates are commensurate with the reasonable costs of the services. Proposition 26 does not apply, Met says, for four reasons. (1) The rates are not “imposed,” rather, the member agencies join voluntarily. I have previously rejected Met’s argument in denying its motion for judgment on the pleadings. Sept. 19, 2013 Order Denying Motion for Judgment on the Pleadings at 3 (citing *Bighorn-Desert View Water Agency v. Verjil*, 39 Cal. 4th 205 (2006)). I did allow for the possibility “that facts adduced at trial will reveal the extent to which the rates are or are not ‘imposed,’ such as the choices available to San Diego for water and water transport.” *Id.* at 3. But Met did not adduce any such facts, whether from the administrative record, to which this claim is limited at Met’s suggestion, or otherwise. Indeed the record contains numerous references to the fact that Met will “IMPOSE RATES AND CHARGES.” AR2010-6159-162 (capitalization in original); *see also, e.g.*, AR2010-6166-222; AR2010-6223-239; AR2010-6945-7029. More substantively, the 2012 Official Statement to Met’s bondholders confirms that SD had no choice but to use Met’s facilities to wheel water. AR2012-16429 at 16509*. (2) The rates are in fact reasonable. This is the issue on the merits; and I defer here to my discussions below on the merits. (3, 4) The rates are charges for the use of ‘local governmental property,’ and 2/3 of the appropriate “electorate” approved them. These are arguments which I have previously rejected in the September 19, 2013 Order, and my reasoning remains unchanged.

Propositions 26 applies here.

Proposition 13 (Govt. Code §§ 50075, 50076). The issue whether there is a fair or reasonable relationship between the rates and services. Met argues that Prop 13 does not apply,

because water rates are outside the purview of Proposition 13. Met cites *Brydon v. E. Bay Mun. Util. Dist.*, 24 Cal.App.4th 178 (1994), and *Rincon Del Diablo Mun. Water Dist. v. SDCWA*, 121 Cal.App.4th 813 (2004), suggesting that San Diego obtained just that ruling from the *Rincon* court. 121 Cal.App.4th at 821-22. San Diego agrees that the water rates in those cases were not taxes because they were “not designed to replace property tax monies lost in consequence of the enactment of California Constitution, article XIII A,” *Brydon*, 24 Cal.App.4th at 194; *accord Rincon*, 121 Cal.App.4th at 822. But in this case, San Diego tells us, Met’s Engineers’ Reports explicitly say the opposite about Met’s rates:

Since the passage of Article XIII A of the California Constitution, Metropolitan has necessarily relied more on water sales revenue than on ad valorem property taxes for the repayment of debt. Water sales have become the dominant source of revenue, not only for operation and maintenance of the vast network of facilities supplying water to Southern California, but also for replacement and improvement of capital facilities. The increased reliance on highly variable water sales revenue increases the probability of substantial rate swings from year to year. ***The use of water rates as a primary source of revenue has placed an increasing burden on ratepayers, which might more equitably be paid in part by assessments on land that in part derives its value from the availability of water.***⁷⁶

This Engineer Report does not distinguish *Brydon* and *Rincon*. The notion that in the abstract some sort of “assessments on land” might be used to pay for water does not mean the extant rates were as a matter of fact “designed to replace property tax monies lost in consequence of the enactment of California Constitution, article XIII A.” *Rincon*, 121 Cal.App.4th at 822. Met is correct that Proposition 13 does not apply here.

Wheeling statute (Water Code § 1810 *et seq.*). The issue is whether the rates are “fair compensation” for the services provided. Water Code § 1811(c).

⁷⁶ AR2010-11443 at 11511-12 (emphases added by San Diego); *accord* 2012-16594 at 16806-07*.

Govt. Code §§ 54999.7(a), 66013. The issue is whether the costs of providing the service are reasonable. Met argues that Govt. Code § 66013, which San Diego invokes solely in the 2012 action, does not apply. That sections reads, “[n]otwithstanding 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 approved by a popular two-thirds vote. This language does not suggest the statute applies to San Diego’s complaints—San Diego does not allege problems with water or sewer connections, or capacity charges as the term is used in that statute. As Met notes, the “legislative history does not show the Legislature intended to impose a new standard on water rates.” *Rincon Del Diablo Mun. Water Dist. v. San Diego Cnty. Water Auth.*, 121 Cal.App.4th 813, 820 (2004). Here I agree with Met.

Met also argues that § 54999.7(a) does not apply. This section provides that the rates and charges one public agency imposes on another for public utility service “shall not exceed the reasonable cost of providing the public utility service.” Gov’t Code § 54999.7(a). Met and San Diego are both public agencies. Met charges San Diego rates and charges for a “public utility service.” Nothing in the statute suggests that it is not applicable here. Met’s reference to services to “public schools” in § 54999.7(c) is not useful, as San Diego is not invoking that section, nor does § 54999.7(a) necessarily invoke or rely on § 54999.7(c). Here I agree with San Diego; the statute applies.

Met Act (Water Code Append. § 109-134). The Met Act requires that rates “be uniform for like classes of service throughout the district.” Water Code Append. § 109-134. The core issue is whether there is unjustifiable rate discrimination. San Diego must as an initial matter prove

that Met's rates are not "uniform for like classes of service" in the district. *Id.* That is, San Diego must establish as an initial matter that there is rate discrimination. San Diego may have misconstrued the court's pre-trial rulings to suggest that that burden may be met simply by showing there are "different classes of entities." Pretrial Rulings at 21 n.18 (dated November 5, 2013). Without showing varying rates of course San Diego's case is stymied, but proving those different rates alone is not the same as showing that there is rate discrimination. One might for example have different classes of entities but yet show no rate discrimination.

As Met notes,

In order to accommodate a water transfer market, Metropolitan maintains an unbundled rate structure based on types of service provided. As a result, member agencies pay rates based on the services they use, and agencies that use the same service pay the same rate. Agencies that purchase Metropolitan supplied water pay for supply, whereas agencies that purchase no water pay no supply costs. Agencies that take treated water cover treatment costs, whereas agencies that take untreated water pay no treatment costs. An agency that transports a third party's water through Metropolitan's system (known as "wheeling") pays transportation costs, but no supply costs.⁷⁷

In brief, Met charges different rates to users differently situated: one set of rates to member agency wheelers, and one to member agencies for water purchases. Based on that simple description, there is no reason to conclude that there is price *discrimination*, a concept which depends on a comparison between similarly situated entities. To be sure, San Diego argues—persuasively, I find below—that Met actually *does* charge supply costs to those who wheel, but that is a violation of other laws, not rate discrimination. Here, the entities (wheelers and non-wheelers) are not similarly situated, and accordingly the Met Act does not apply.

Common law. There are two aspects to this claim; one tracks the Met Act and asks whether there is unjustifiable discrimination between rate payers; the second asks whether there is a

⁷⁷ DTX-109* at AR2012-016587.

“reasonable basis” for the rates. *Inyo*. For reasons summarized just above, the latter, but not the former, rules apply here.

Summary. In sum, I conclude Proposition 26, the Wheeling statute, Govt. Code § 54999.7(a), and the common law (reasonable rates requirement) apply here. In each case the core inquiry is the same, and looks to cost causation, that is, whether the costs of the services (e.g. wheeling) are reasonably related to the costs of providing those services.

2. Analysis On The Merits

Setting aside San Diego’s challenge to the dry year peaking (discussed below), I summarize the challenges to Met’s rates, phrased as function of the cost causation principle: Is it reasonable for Met to include in its transportation rates (A) via the Systems Access Rate and the System Power Rate, the cost the state charges to Met to transport water to Met? (B) the Water Stewardship Rate?

I summarize here the basic guidance from the central cases. *MWD* tells us that the relevant costs may--or may not--be system-wide costs; but it is clear that I do not simply look to the marginal costs of providing e.g. wheeling services. (Had I done so, and because wheeling occurs solely when there is unused capacity, I might have concluded that aside from power and other costs required to literally move the wheeled water, no other costs could be included in wheeling rates.) *Morro Bay* reminds us that rates may not discourage wheeling, and loss of income attributable to lost water sales is not a permissible justification for [increasing] wheeling rates. *Palmdale* emphasizes cost causation, and bars unjustified price discrimination. *Griffith I* and *Griffith II* emphasize the rule that it is permissible to spread the costs of programs across all

benefitted users, and approves rates as long as they do not generate a surplus over and above what is needed to provide the program.

A. Met's System Access Rate and System Power Rate

These two rates include the state transportation costs, i.e., SWP's costs. Met's contract with the state makes clear that Met does not own or operate the SWP transportation facilities.⁷⁸ Previously, Met allocated SWP costs to supply, and none to transportation (including the SWP costs that DWR bills as its own transportation costs).⁷⁹ No reasonable basis appears in the record as to why this has changed. To be sure, the state now does disaggregate its bills to Met, and displays *its* transportation costs on those bills, but that does not suggest those are also (or instead?) *Met's* transportation costs, any more than the overhead or payroll costs of Ford Motor Company are the overhead or payroll costs of a customer who buys a Ford car. And while Met may from time to time use the state's transport capability to move some its water (Met Closing Brief at 49), that does not support the reasonableness of including **all** the state's transportation costs as part of Met's transportation costs. The record does not, for example, quantify the use of the state systems for Met's transportation,⁸⁰ nor does it establish whether it is necessary for wheeling at all. Nor does it matter whether Met delivers a blend of water to wheelers (Met Closing Brief at 53). The blend might be useful⁸¹ but, as to wheelers, the benefit is gratuitous, and not required by wheeling agreements. Nor, with one exception, does Met explain why the use of blended water requires the use of the state's transportation capability. The exception is to note RMI's opinions that the costs of operating Met's Colorado River Aqueduct arguably are

⁷⁸ AR2010-001 art. 13; PTX-237-A** (Admissions) Nos. 44-47; *Metro. Water Dist. of S. Cal. v. Marquardt*, 59 Cal.2d 159, 202 (1963)(Met is not an "equitable owner" of the SWP).

⁷⁹ 1969 Study*, AR2012-16288_1723 at 1743-46; Trial Transcript* at 469:23-470:12.

⁸⁰ Met Closing Brief at 49 ("SWP facilities **at times** serve *solely* a transportation function for MWD")(bolded emphasis supplied). Occasions on which this capability has been used are described at *id.*, 50-51.

⁸¹ Met has noted that the blend provides lower salinity water.

classifiable as transportation costs (Met Closing Brief at 57), but Met has not described how, or the extent to which, wheeling uses that aqueduct. Nor are the costs associated with transportation through that aqueduct the issue; the issue relates to costs associated with the movement of water through the SWP's facilities.

I do note, at Met's behest, the fact that in May 1996 RMI treated the SWP transportation costs as Met's like costs. The bases set forth there, however, are impenetrable. The bases are that the (a) transportation charges are disaggregated—an issue I address just above—and (b) capital charges for the transmission facilities are transmission related: which is a tautology. The issue is not whether they are transportation related; the issue is whether there is any reasonable basis to conclude they are *Met's* transmission charges. Unless I must accept as an adequate record any outside consultants' unsupported view (and I do not), this is insufficient.

There are other parts of the record that Met has urged support its view. Met's Closing Brief at 50. (a) DTX-055 (SWP Contract at Art. 55(a)), gives Met the right to use SWP facilities for transportation. (b) In DTX-087, Met discusses the fact that it has in fact conveyed non-project water through SWP facilities, for example on two occasions in 2009. *Id* at AR2012-011307. (c) DTX-109* is another statement by Met, dated April 2012, that it conveys non-project water through SWP facilities, *see e.g., id.* at AR2012-016586, referring to the same two events in 2009. *Id.* at AR2012-016588. And Met notes other occasions when it has bought non-project water (i.e. not from the SWP) to resell to its member agencies. Met Closing Brief at 51.

Fundamentally, Met's position seems to be based on the facts that (a) it does use SWP's facilities to move its own [non-project] water on occasion, and (b) all member agencies benefit in some way from that capability. From those predicates Met concludes that the sums it pays to the state attributable to the state's transportation costs are allocable to Met's own transportation

rates. Met Closing Brief at 53. But this is no syllogism. While one can easily conclude from these predicates that all water-purchasing member agencies should pay some share of those SWP's costs—indeed, of all costs billed by the SWP to Met—it does not follow that a given portion of those costs (such as SWP's transportation constituent) ought to be billed to wheelers who happen to be member agencies. This is especially true as it appears that the water moved by the SWP system, even when it is not water purchased from the SWP, is nevertheless generally water which is sold by Met to its member agencies, *not wheeled water*.

The position Met takes here reflects its position on the core legal dispute presented by this case, and I turn to that more specifically now.

The Core Dispute. Met writes that, on the subject of system-wide costs such as (i) those paid for SWP's transportation of water and (ii) for programs funded by the water stewardship rates, "In 1997, MWD recognized that if it did not charge these costs to wheelers as well as its full-service customers, then its full-service customers would end up subsidizing the costs of wheeling transactions." Closing Brief at 6. Compare, e.g., *MWD v. IID*, 80 Cal.App.4th at 1432-33.

The core dispute is whether, under the current rate structure, wheelers are subsidizing water purchasers. San Diego says that wheelers such as itself subsidize the other member agencies. Under the wheeling statute, for example, that is not permitted because it would discourage wheeling, and under the balance of the statutes at play in this case wheelers would be paying more than a reasonable fee for the service.

This core dispute centers on the impact of the so-called San Pedro principles adopted in 1997, which San Diego characterizes as implementing an illegal rate stability plan and Met

characterizes are implementing a legal plan to avoid having its full-service customers subsidize wheeling transactions. *See, MWD v. IID*, 80 Cal.App.4th at 1418-19 (outline of principles).

Underlying Met's approach here is the position that Met is entitled to sweep into all of its charges to members agencies apparently *any* of the system-wide costs it incurs, perhaps on the theory that member agencies, in their wheeling capacity, had a role in causing all system-wide costs. Met may have in mind the words of the *Griffith I* Court, 207 Cal.App.4th at 997:

The question of proportionality is not measured on an individual basis. Rather, it is measured collectively, considering all rate payors. ... Thus, permissible fees must be related to the overall cost of the government regulation. They need not be finely calibrated to the precise benefit each individual fee payor might derive. What a fee cannot do is exceed the reasonable cost of regulation with the generated surplus used for general revenue collection. An excessive fee that is used to generate revenue becomes a tax.

While Met on occasion appears to suggest that the *MWD* opinion determines the core dispute in its favor, Met accurately recites the impact of *MWD* thusly:

The question of whether system-wide costs may be included in MWD's wheeling rate at all was already decided by the California Court of Appeal, which held that system-wide costs may be included under the Wheeling Statute. *See MWD v. IID*, 80 Cal.App.4th at 1422-23. The inquiry for this Court is whether inclusion of **particular** system-wide costs (*i.e.*, MWD's fixed SWP costs and the Water Stewardship Rate) in MWD's rate for wheeling service charges fair compensation.

Met Closing Brief at 30 (bolded emphasis supplied).

MWD teaches us that system-wide changes are *eligible* for this sort of treatment. But the opinion did not obviate the cost causation requirement. In *MWD*, the Court endorsed *certain kinds* of system-wide costs as properly part of the wheeling charges—those that relate to the conveyance system:

Hence, the "fair compensation" (§ 1810) to which a water conveyance system owner is entitled for wheeling water includes reasonable capital, maintenance, and operation costs occasioned, caused, or brought about by "the use of the conveyance system." (§ 1811, subd. (c).) "[F]air compensation" (§ 1810) includes charges the owner, in this case the

Metropolitan Water District, becomes subject to or liable for in using the “conveyance system” (§ 1811, subd. (c)) to wheel water when it has unused capacity.

MWD, 80 Cal.App.4th at 1431.

I need not determine here whether the San Pedro principles are generally appropriate; but as they have been implemented to determine the wheeling rate, they are not supportable. Here’s Met’s assessment of that implementation:

In order to ensure that both full-service users and wheelers are ultimately held responsible for their respective costs, MWD determined that if a member agency purchasing MWD water “pays for the fixed, unavoidable costs of the system . . . then member agencies using that same system for wheeling must contribute to [MWD’s] fixed costs on an equivalent basis.” *Id.* MWD also determined that this principle is consistent with the San Pedro Integrated Resources Plan Assembly Statement “that wheeling should not result in adverse impacts to the rates and charges of any member agency.” *Id.* at 002458. In other words, MWD properly recognized that member agencies that wheel would gain an unfair subsidy if they did not have to pay for the costs that they caused MWD to incur, or for the benefits they received from MWD’s system, as a result of MWD’s fixed, unavoidable costs.

Met Closing Brief at 75-76.

RMI’s December 1995 report, putatively reflecting the San Pedro principles, too opined that that wheeling “**must not negatively impact the rates or charges to any other Member Agencies.**” AR2010-1222 at 1234 (emphasis in original).

Because one of Met’s chief “fixed, unavoidable costs” is the price of water it pays to the State, Met and its consultants may have thought that wheeling rates ought to be set such that there was no effect on the rates of non-wheelers, including rates attributable to the cost of water.

But under the wheeling statute and more generally the general cost causation principles which underlie all the claims in this case, only system-wide costs attributable to the “conveyance system” should be the basis for wheeling rates. *MWD*, above. To accommodate this reference to ‘conveyance facilities,’ Met argues that the state’s (DWR’s) conveyance facilities are a part of Met’s conveyance facilities. But with all deference to Met, I have found no reasonable basis for

this conclusion in the record. The language of *Griffith I*, 207 Cal.App.4th at 997, that proportionality is properly measured not “on an individual basis [but r]ather, it is measured collectively, considering all rate payors” is not a license to impose any system-wide charge on any user. San Diego as a purchaser of water may well have a variety of system-wide financial obligations, which presumably are reflected in the price it pays for the water it buys from Met, but that does not necessarily mean that San Diego as a wheeler must have those same financial obligations. At argument Met’s counsel stated that the wheeling rate to member agencies would rightfully include system-wide charges that a wheeling rate for non-member agencies would not.⁸² This approach inappropriately focuses on the identity of the customer as opposed to the cost of the service being rendered.

Because Met pays a fixed price for the water it buys, whether it sells it or not to member agencies, water prices to non-wheeling member agencies may rise as a function of increasing wheeling (and foregone purchases from Met). While that might result in “adverse impacts to the rates and charges” imposed on the other member agencies,⁸³ Met must nevertheless permit such wheeling. *Morro Bay*, 81 Cal.App.4th at 1050.

B. Water Stewardship Rate.

Met forthrightly notes that the Water Stewardship Rate recovers the costs of “demand management programs,” and those in turn provide incentives for recycling, groundwater recovery, desalinization programs and other water conservation efforts. Met Closing Brief at 61. Obviously, under these programs the demand for water of various member agencies is reduced, and so Met may in turn reduce its purchases. The record shows that at least a significant benefit of these programs is the creation of new water “supply,” reducing Met’s need to purchase water

⁸² Transcript of closing argument at 918-19 (January 23, 2014)**.

⁸³ Met Closing Brief at 75-76.

from other sources.⁸⁴ San Diego notes that Met’s brief, its witnesses and own documents all confirm that the primary purpose of these programs is to “incentivize development of *local* water *supplies*.”⁸⁵ The 1999 Raftelis Report also notes that at least some of the programs’ costs should be associated with supply.⁸⁶

Met itself knows that the *primary* benefit is not for transportation, but for supply: The central objective of Metropolitan’s water conservation program is to help ensure adequate, reliable and affordable water supplies for Southern California by actively promoting efficient water use. The importance of conservation to the region has increased in recent years because of drought conditions in the State Water Project watershed and court-ordered restrictions on Bay-Delta pumping, as described under “METROPOLITAN’S WATER SUPPLY—State Water Project” in this Appendix A under “METROPOLITAN’S WATER SUPPLY.”

Met Official Bond Statement: AR2012-16429 at 16519*.

The Raftelis’s textbook too states that “conservation costs” should be functionalized to “Source of supply.” AR2012-16288_5282 at 5291*. Raftelis wrote that “all or at least a portion” of programs for local “conservation, water recycling, and the recovery of contaminated groundwater” should be functionalized as “supply costs.” AR2012-16288_2114 at 2179*.⁸⁷

San Diego notes that Met has judicially admitted that it does not calculate the proportional benefits that individual member agencies receive from its Water Stewardship Rate or the programs it funds, neither on the basis of individual programs, nor in the aggregate. PTX-237-A** (RFA) Nos. 20, 32. Met has further judicially admitted that it “has never calculated the

⁸⁴ PTX-393** (Upadhyay Depo.) at 52:11-53:19; 109:16-111:19.

⁸⁵ MWD Br. at 7:14 (emphases added); *see also* AR2010-1101 at 1115, 1124; AR2010-1222 at 1249; AR-2012-16288_1723 at 1744*; PTX-037* at 14; PTX-119**; PTX-181**; PTX-183**; PTX-199**; PTX-237-A** (Admissions) Nos. 17-43; PTX-393** (Upadhyay Depo.) at 52:11-53:19; 104:17-105:25, 109:16-110:13, 116:1-117:14, 134:17-135:24; Ex. 77** (Arakawa Depo.) at 91:2-13; PTX-390** (Kostopoulos Depo.) at 42:14-42:23; PTX-392** (Thomas Depo.) at 79:3-22.

⁸⁶ AR2012-16288_2179*.

⁸⁷ The primary purpose of these programs is to “incentivize development of *local* water *supplies*.” MWD Br. at 7:14 (emphases added by San Diego). *See also* AR2010-1101 at 1115, 1124; AR2010-1222 at 1249; AR2012-16288_1723 at 1744*; PTX-037* at 14; PTX-119**; PTX-181**; PTX-183**; PTX-199**; PTX-237-A** (Admissions) Nos. 17-43; PTX-393** (Upadhyay Depo.) at 52:11-53:19; 104:17-105:25, 109:16-110:13, 116:1-117:14, 134:17-135:24; Ex. 77** (Arakawa Depo.) at 91:2-13; PTX-390** (Kostopoulos Depo.) at 42:14-42:23; PTX-392** (Thomas Depo.) at 79:3-22.

regional benefit to MWD created by the aggregate group of local water supply projects, seawater desalination projects, or conservation programs funded or subsidized with revenue collected through the Water Stewardship Rate in a given calendar year.” *Id.* No. 38.

Nevertheless Met argues that the demand management programs also reduce the demand for transportation. This, Met says, justified the inclusion of the Water Stewardship Rate in the transportation rates. Perhaps; perhaps to some extent. But the central problem here is that Met treats the *entirety* of the Water Stewardship Rate as a “transportation” rate that is then incorporated into the wheeling rate.

It is certainly reasonable to conclude that transportation capacity needs are reduced when supply needs are reduced, including reductions attributable to the demand management programs. See e.g. Met Closing Brief at 64-65. Met has documented at least a few of these. Upadhyay has testified (Met Closing Brief at 63) that some transportation facilities have been deferred as a result of conservation programs.⁸⁸ But the record does not show correlation between those avoided costs and water stewardship rates. While I cannot fault Met for not providing a transportation benefit number for *each* of the specific demand management programs, the best we can do with this record is to conclude that to some unspecified extent, some portion of the Water Stewardship Rate is causally linked to some avoided transportation costs. This is not enough to show that the costs of the service have a reasonable relationship to the service provided. The Rafetelis 1999 report suggests 50-50 allocation, but that suggestion was made simply because no data supported any other allocation;⁸⁹ the number is wholly arbitrary, as is the allocation of 100% of these Water Stewardship Rate charges to transportation.

It is also worth noting here that wheelers secure their benefits only when there is unused

⁸⁸ The 1996 IRP (DTX -019)(Met slide 28).

⁸⁹ AR2012-16288_2114 at 2179, 2216-17.

capacity in the extant transportation system. Wheeling is “[s]ubject to the General Manager’s determination of available system capacity.” Admin. Code § 4405(a). And Met notes, “MWD also resolved that it would make the determination of whether there is unused capacity in its conveyance system (as required by the Wheeling Statue) on a ‘case-by-case basis in response to particular requests for wheeling [services].’ DTX-680 at AR2012-002450; JTX-1 AR2010-002450.” Met Closing Brief at 20. While wheelers would benefit as a general matter by reason of increased capacity in that they might be able to wheel more water, those who in fact are permitted to wheel do so in a system built out to move non-wheeled water, that is, water that Met sells to its member agencies. Thus the costs and avoided costs attributable to the demand management programs relate to the transportation needs to provide purchased water. This too suggests that the cost of wheeling, while properly a function of system-wide costs associated with transportation as such, should not be a function of system-wide avoided costs of transporting purchased water.

C. Dry Year Peaking

San Diego alleges that costs attributable to dry year peaking are improperly part of the wheeling rate. Here’s how San Diego phrases it:

The dry-year peaking costs at issue here are those associated with purchasing and storing water and having capacity available in MWD’s facilities to deliver water supplies to its member agencies when they “roll on” to MWD’s system in dry years. For example, Los Angeles has a long history of rolling on and off the system, depending on the hydrological conditions in the Owens Valley where it obtains much of its water: between 2004 and 2009, Los Angeles’s purchases from MWD swung from 367,000 acre-feet in 2004 to 208,000 acre-feet in 2006 and back up to 434,000 acre-feet in 2009
San Diego’s Amended Reply To MWD’s First Pretrial Brief at 17.

It remains unclear exactly how these costs are part of the wheeling rate. Presumably some capital storage costs, some transportation costs, and some supply costs are part of what San Diego calls dry year peaking. *Cf.* San Diego’s Post-Trial Brief at 30:20-28. Of course dry year

peaking costs are not expressly part of the wheeling charges; indeed, Met argues that there is no such thing as dry year peaking (as opposed to, for example, peaking for other reasons). Perhaps it is done implicitly, in the sense that portions of some rates San Diego pays *must* include it. As San Diego notes, Met has admitted that it does not separately allocate costs to “dry year peaking.”⁹⁰

Met has essentially two responses to San Diego’s complaint. First (as noted above) there is no such thing as dry year peaking, and secondly, the differences in demand patterns which underlie San Diego’s argument are in fact fairly handled by volumetric and other rates.

First, a few words on certain graphs the parties have presented, directed to whether there really is a material variation among member agencies in their patterns of demand on Met’s water. In an effort to show that the dry year peaking issue exists, San Diego prepared a chart⁹¹ to graphically represent peaking. This chart apparently shows that (assuming a baseline based on the average of 1994-2000 purchases) Los Angeles ranged from that baseline to 2.5 of that baseline average, down to a bit under 1.5 of that average, and up to about three time that ratio. San Diego’s ranges are within about 1.5 of the assumed average. Met also has a graph⁹² which shows 2003-2012 purchases, with vaguely similar curves for both Los Angeles and San Diego, dipping in the 2005-06 and 2011 periods and rising in between around 2007 (for San Diego) and around 2009 (for Los Angeles). This includes San Diego’s exchange water, but nevertheless it shows (i) that San Diego obtained more water from Met than did Los Angeles, and (ii) the variation of San Diego’s purchases (about 675,000-400,000, i.e., 275,000) as compared to those of Los Angeles (about 425,000-175,000, i.e., 250,000), which are accordingly roughly the same.

⁹⁰ Order on MILS, December 10, 2013 at 4.

⁹¹ SDCWA Opening Presentation, December 17, 2013, at unnumbered page 87, based on PTX-203**, 347**, 299**, 300**, 301**.

⁹² MWD’s Opening Presentation, December 17, 2013 at 34, based on DTX-691**.

Because it appears exchange water is included in Met's graph, it is not possible to make an even rough conclusion concerning the extent to which one of those two member agencies benefits more from expenditures to account for peaking. And it is not clear that measuring the net difference between high and low purchases, rather than deviations from an average baseline, helps ascertain the impact of peaking.

But San Diego's graph does not answer that question either. The fact that for some time period one customer as opposed to another has a higher ratio of maximum purchases to average purchases does not mean that the former customer imposes higher charges on the supplier who must keep water (and associated facilities) available for the peak demand. This is especially true when the customer with the lower ratio buys more water during 'peak' periods, as may be the case here.⁹³

It is of course true that as a general matter some members agencies in some years buy more water for various reasons, including drought. And it also true, as Met agrees (Closing Brief at 89), that Met incurs costs for this sort of contingency storage. Met also agrees that this contingency capacity is significant, and designed to meet unexpected needs. *Id.* But there are many reasons for a member agency to seek additional water, such as changes in the local economy. And as Met notes, in some times of drought many member agencies actually lowered, not increased, their demand for water. Met Brief at 92; DTX-110*. The record shows that while there are variations in demands, the variations have many causes. For example as the FCS document discussed above notes, demand may fluctuate as a result of conservation measures, price elasticity at the local retail level, mandatory water curtailments, weather patterns, the local agency's supply conditions, and other factors.

⁹³ I exaggerate for illustration: if customer X averages 2 gallons a year in purchases, but sometimes peaks to 20 gallons (a ratio of 1:10), the water supplier will nevertheless presumably spend more to keep standby capacity available for customer Y who varies from 100 to 150 gallons (a ratio of 1:1.5).

There is no reasonable basis supporting the notion that a given amount of storage infrastructure (or any amount) is attributable to ‘dry year peaking.’

Met does impose charges for the cost of this contingency capacity. First, of course, the more water one buys the more one pays. Next, Met’s Tier 2 rates impose higher charges per volume when member agencies substantially exceed their past annual demands. Met Brief at 96. Met’s Readiness To Serve and Capacity Charges also account for unexpected additional demands from member agencies. These latter charges do not necessarily recover expenses attributable to ‘dry year peaking’ but they do recover costs attributable to some aspects of peak usage; and the ‘peak usage’ which measures the Capacity Charge is not on an annual basis but rather on a maximum summer day basis. Met Closing Brief at 99.

In the end, I do agree with San Diego that the record does not tell us that all these charges are sufficient to account for all of the costs of providing what I have called contingency capacity, but it is also true that there is no showing that this is a problem. This conclusion does not place the burden on San Diego when contesting validity of assessment under Proposition 26; rather I have turned to San Diego to show me there is an ‘assessment’ in the first place.

There is no substantial evidence that some member agencies reap a benefit for ‘dry year peaking,’ or that they do so at the expense of other member agencies such as San Diego.

Conclusion

Aside from the Wheeling statute, I have been required to confine my review to the administrative record. The extra record evidence has not made any substantial difference to my evaluation in any event, although for purposes of background, illustration, or to show that some

proposition did not seem to be seriously disputed, I have from time to time mentioned that evidence.

As to the standard of review, the higher de novo standard probably applies to Proposition 26, and under the Wheeling statute to the question of whether a rate might properly include a certain component. Under the Wheeling statute, the deferential standard applies to the issue of fair compensation, as it does to Govt. Code § 549997(a) and the common law's 'reasonable basis' standard.

But in this case, regardless of the standard, the result the same. There is no substantial evidence in the record to support Met's inclusion in its transportation rates, and hence in its wheeling rate, of 100% of (1) the sums it pays to the California Department of Water Resources' SWP disaggregated by the SWP as for transportation of that purchased water; and (2) the costs for conservation and local water supply development programs recovered through the Water Stewardship Rate. Indeed, the record confirms that these rates over-collect from wheelers, because at least a significant portion of these costs are attributable to supply, not transportation. These rates – the System Access Rate, System Power Rate, Water Stewardship Rate, and Met's wheeling rate – therefore violate Proposition 26 (2013-14 rates only), the Wheeling statute, Govt. Code § 549997(a), and the common law. The Court invalidates each rate for both the 2011-2012 and 2013-2014 rate cycles.

So too, under either the substantial deference or de novo standard, San Diego has not shown that there is a "dry year peaking" phenomenon for which Met's rates fail to fairly account. No violation of the pertinent law has been shown with respect to 'dry year peaking'.

Further Orders. San Diego has asked me to retain jurisdiction to ensure compliance with this ruling. At least until judgment is entered an appeal is taken, such an order does not appear

necessary. San Diego has also suggested the entry of a separate order along the lines its proposed in its proposed statement of decision at 55-57. The parties should confer on the matter and report their views at the next case management conference.

Dated: April 24, 2014



Curtis E.A. Karnow
Judge Of The Superior Court

Superior Court of California
County of San Francisco

SAN DIEGO COUNTY WATER
AUTHORITY, et. al.,

Plaintiff(s)

vs.

METROPOLITAN WATER DIST. OF
SOUTHERN CALIFORNIA, et al
Defendant(s)

Case Number: CPF-10-510830
CPF-12-512466

CERTIFICATE OF ELECTRONIC SERVICE
(CCP 1010.6(6) & CRC 2.260(g))

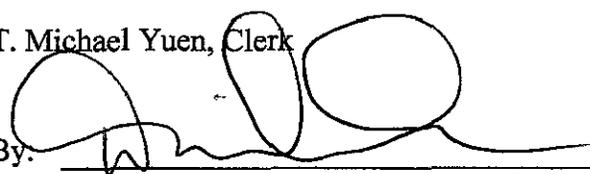
IN RE: SAN DIEGO COUNTY WATER
AUTHORITY

I, DANIAL LEMIRE, a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On April 24, 2014, I electronically served STATEMENT OF DECISION ON RATE SETTING CHALLENGES via File & ServeXpress on the recipients designated on the Transaction Receipt located on the File & ServeXpress website.

Dated: April 24, 2014

T. Michael Yuen, Clerk

By: 

DANIAL LEMIRE, Deputy Clerk



FILED
San Francisco County Superior Court

AUG 28 2015

CLERK OF THE COURT
BY: [Signature]
Deputy Clerk

SUPERIOR COURT OF CALIFORNIA
COUNTY OF SAN FRANCISCO

SAN DIEGO COUNTY WATER
AUTHORITY,

Plaintiff/Petitioner,

vs.

METROPOLITAN WATER DIST. OF
SOUTHERN CALIFORNIA, et al.

Defendants/Respondents.

Case No. CFP-10-510830
Case No. CFP-12-512466

STATEMENT OF DECISION

I. Introduction

San Diego County Water Authority (San Diego) claims that the Metropolitan Water District of Southern California (Met) breached the Exchange Agreement¹ and improperly computed preferential rights. Met disputes the merits and raised some affirmative defenses. I find for San Diego on both claims.

II. Factual Background²

San Diego is one of Met's member agencies. It purchases water from Met and may obtain wheeling services from Met. If San Diego purchases water from an entity other than Met, it is impossible for San Diego to receive the water without moving it through Met's facilities.

¹ The "Amended and Restated Agreement Between Metropolitan Water District of Southern California and the San Diego County Water Authority for the Exchange of Water." PTX-65.
² Most of this background is extracted from my April 24, 2014 Statement of Decision (April Statement of Decision).

1 This movement is termed ‘wheeling’ the water, i.e., the use of a water conveyance facility by
2 someone other than the owner or operator.

3 Met’s current rate structure dates to 2003. Met’s full-service water rate, charged when
4 Met sells a member agency water, includes supply rates, the System Access Rate, the System
5 Power Rate, and the Water Stewardship Rate. These are volumetric³ charges. Met’s Wheeling
6 Rate is different: it includes the System Access Rate, the Water Stewardship Rate, and the
7 incremental cost of power necessary to move the water.
8

9 San Diego acquired an annual supply of transfer water from the Imperial Irrigation
10 District (IID) in 1998. PTX-28. Later in 1998 San Diego and Met agreed to the 1998 Exchange
11 Agreement. PTX-31.⁴ There San Diego paid Met to take transfer water and have Met make
12 Exchange Water⁵ available to San Diego. *Id.* §§ 3.1-3.2, 5.2. The contract was to last 30 years.
13 *Id.* § 5.2. For the first 20 years, San Diego would pay \$90 per acre-foot plus an annual
14 percentage escalator. *Id.* For the final 10 years, San Diego would pay \$80 per acre-foot plus an
15 annual percentage escalator running from 1998. *Id.* The 1998 Exchange Agreement permitted
16 the parties to request a change in the price after 10 years. *Id.* § 5.3. The price term was close to
17 an \$80 per acre-foot wheeling rate proposed by Department of Water Resources Director David
18 Kennedy in January 1998 as a compromise between wheeling rates advocated by Met and San
19 Diego in a dispute over an appropriate wheeling rate. PTX-481 at MWD 2010-00264720.
20
21

22 There were no IID water transfers to San Diego between 1998 and 2003. Met Pre-Trial
23 Brief, 10; San Diego Post-Trial Brief for Phase II, 13. On October 10, 2003, the parties entered
24

25 ³ That is they are based on the volume of water at issue such as gallons, *Klein v. Chevron U.S.A., Inc.*, 202 Cal. App.
26 4th 1342, 1385 (2012), or acre feet where one acre-foot is an acre of water one foot deep.

27 ⁴ The “Agreement Between Metropolitan Water District of Southern California and the San Diego County Water
Authority for the Exchange of Water.”

⁵ Exchange Water is a creature of contract. It is water delivered to San Diego by Met in the same quantity as that
made available to Met by San Diego. PTX-31 § 1.1(q); PTX-65 § 1.1(m).

1 the operative Exchange Agreement. PTX-65 at MWD2010-00190698. That day, the parties and
2 other agencies signed two other agreements: the Quantification Settlement Agreement and the
3 Allocation Agreement. *Id.* §§ F-G.

4
5 Most importantly for present purposes, the operative Exchange Agreement contained a
6 revised price provision.⁶ The new price was initially \$253 per acre-foot, and thereafter “equal to
7 the charge or charges set by [Met’s] Board of Directors pursuant to applicable law and regulation
8 and generally applicable to the conveyance of water by [Met] on behalf of its member agencies.”
9 *Id.* § 5.2.⁷ By this term, Met charged San Diego the volumetric transportation rates it charged
10 when it sold full-service water as of 2003 – the System Access Rate, System Power Rate, and
11 Water Stewardship Rate.⁸ Met’s rate *structure* has remained the same since 2003, but Met
12 periodically adjusts the dollar figures for the rates. San Diego has paid those charges under the
13 Exchange Agreement.
14

15 16 **III. Procedural History**

17 This action includes two complaints, responsive to Met’s 2010 and 2012 rate settings
18 respectively. April Statement of Decision, 2-3. The 2010 case included six causes of action:
19 three that directly challenged Met’s rate setting, one breach of contract claim, a declaratory relief
20 claim on Rate Structure Integrity, and one declaratory relief claim on preferential rights. *Id.* The
21 2012 case included four causes of action: three that directly challenged Met’s rate setting and
22 one breach of contract claim. *Id.* at 3. I phased proceedings. Phase I addressed the rate
23

24 ⁶ The revised price term was proposed by San Diego as Option 2. Option 1 was closer to the original terms of the
25 1998 Exchange Agreement whereas Option 2 involved a more significant shift in responsibilities. Trial Transcript,
1214:1-1217:22.

26 ⁷ The revised price provision also contained a sentence addressing the parties’ rights to seek to change those charges.
The meaning of that sentence is disputed by the parties.

27 ⁸ The rates differ from Met’s full-service water rate because San Diego does not pay the supply rates. The rates
differ from Met’s wheeling rate because San Diego pays the System Power Rate rather than the incremental cost of
power to move wheeled water.

1 challenges and the declaratory relief claim on Rate Structure Integrity. Phase II concerns the
2 breach of contract and preferential rights claims.

3 On April 24, 2014, I issued a Statement of Decision following Phase I of trial. There I
4 invalidated Met's System Access Rate, System Power Rate, Water Stewardship Rate, and
5 Wheeling Rate for calendar years 2011-2014 because Met improperly included "100% of (1) the
6 sums it pays to the California Department of Water Resources' SWP disaggregated by the SWP
7 as for transportation of that purchased water; and (2) the costs for conservation and local water
8 supply development programs recovered through the Water Stewardship Rate" in its
9 transportation rates. *Id.* at 65. I found that "at least a significant portion of these costs are
10 attributable to supply, not transportation." *Id.* I did not determine the proper allocation of the
11 disputed charges.
12

13 Met had earlier moved for summary adjudication of, among other things, San Diego's
14 preferential rights claim. Met's motion was predicated on the rule that payments for the
15 purchase of water do not give rise to preferential rights credit. December 4, 2013 Order, 6-7.
16 Met argued that San Diego pays several volumetric rates under the Exchange Agreement and as
17 a wheeler that Met also charges for the purchase of water, such that San Diego essentially paid
18 for the purchase of water. *Id.* I denied summary adjudication, finding that San Diego did not
19 pay any rate for the cost of water under the Exchange Agreement and that indeed San Diego had
20 already paid *someone else* for the purchase of water in the Exchange Agreement and wheeling
21 contexts. *Id.* at 7. I held that Met had not established as a matter of law that San Diego was
22 purchasing Exchange Water as opposed to making some other sort of payment. *Id.*
23
24

25 The parties have now completed a Phase II bench trial on San Diego's breach of contract
26 and preferential rights claims. Closing argument was held on June 5, 2015. The parties
27

1 submitted supplemental briefs on June 19, 2015. I issued a proposed statement of decision,
2 granted Met's request for an extension of time to file objections, and now file this statement of
3 decision resolving the Phase II issues including Met's motion for partial judgment interposed at
4 the conclusion of San Diego's case in the Phase II trial.
5

6 7 **IV. Discussion**

8 **A. Breach of Contract**

9 To prove a cause of action for breach of contract a plaintiff must establish the contractual
10 terms, the plaintiff's performance or excuse for failure to perform, the defendant's breach, and
11 damage to the plaintiff resulting from the defendant's breach. *McKell v. Washington Mut., Inc.*,
12 142 Cal.App.4th 1457, 1489 (2006); CACI No. 303.
13

14 **1. Terms**

15 In the Exchange Agreement San Diego agreed to both pay a price and make "Conserved
16 Water" and/or "Canal Lining Water" and "Early Transfer Water" available to Met each year at
17 the "SDCWA Point of Transfer," in exchange for which Met agreed to make "Exchange Water"
18 available to San Diego each year at the "Metropolitan Point(s) of Delivery." PTX-65 §§ 3.1-3.2,
19 5.1.⁹ The aggregate quantity of Exchange Water delivered by Met in a given year was to be
20 equal to the aggregate quantity of Conserved Water (including Early Transfer Water) and Canal
21 Lining Water San Diego made available to Met in the same year. *Id.* §§ 1.1(m), 3.2(c).
22

23 The Exchange Agreement provided for the Price, as follows:
24

25 ⁹ The Exchange Agreement was one of several agreements executed pursuant to the Quantification Settlement
26 Agreement. PTX-65 § F. San Diego entered the Allocation Agreement on the same day. *Id.* at § G. In the
27 Allocation Agreement, Met assigned certain water rights to San Diego and its right to receive substantial
reimbursements for certain canal lining projects from San Diego. DTX-884 § 4A.1. San Diego's obligations under
the Exchange Agreement were subject to the execution and delivery of the Allocation Agreement, among other
things. PTX-65 § 7.2.

1 The Price on the date of Execution of this Agreement shall be [\$253]. Thereafter, the
 2 Price shall be equal to the charge or charges set by Metropolitan's Board of Directors
 3 pursuant to applicable law and regulation and generally applicable to the conveyance of
 4 water by Metropolitan on behalf of its member agencies. For the term of this Agreement,
 5 neither SDCWA nor Metropolitan shall seek or support in any legislative, administrative
 6 or judicial forum, any change in the form, substance, or interpretation of any applicable
 7 law or regulation (including the Administrative Code) in effect on the date of this
 8 Agreement or pertaining to the charge or charges set by Metropolitan's Board of
 9 Directors and generally applicable to the conveyance of water by Metropolitan on behalf
 10 of its member agencies; provided, however, that Metropolitan may at any time amend the
 11 Administrative Code in accordance with Paragraph 13.12, and the Administrative Code
 as thereby amended shall be included within the foregoing restriction; and, provided,
 further, that (a) after the conclusion of five (5) Years, nothing herein shall preclude
 SDCWA from contesting in an administrative or judicial forum whether such charge or
 charges have been set in accordance with applicable law and regulation; and (b) SDCWA
 and Metropolitan may agree in writing at any time to exempt any specified matter from
 the foregoing limitation.

12 PTX-65 § 5.2.

13 The first sentence of § 5.2 sets the initial price. The second sentence of § 5.2 constrains
 14 subsequent prices to charges Met sets pursuant to applicable law and regulation for the
 15 conveyance of water by Met to its member agencies.

16 The parties dispute the import of the lengthy third sentence of § 5.2. Met contends that
 17 San Diego there agreed to the rate structure Met had in place at the time of the Exchange
 18 Agreement but reserved the ability to challenge only *amendments* to Met's rate structure (after
 19 the five year period). Met Closing Brief, 20-22.¹⁰ San Diego contends that San Diego agreed
 20 not to challenge Met's existing rate structure or any amendments to it for five years, but reserved
 21 the ability to challenge Met's existing rate structure or any amendments to it after five years.
 22

23 San Diego's position is consistent with the plain language of the provision and Met's
 24 position is not.

25 The third sentence begins with a limitation on the parties' ability to seek changes to the
 26 form, substance, or interpretation of any applicable law or regulation, including the
 27

¹⁰ Citations to "Met Closing Brief" refer to Met's corrected closing brief.

1 Administrative Code, that pertains to the charge or charges set by Met and generally applicable
2 to Met's conveyance of water on behalf of its member agencies. This limitation is followed by a
3 proviso that permits Met to amend its Administrative Code and extends the scope of the
4 limitation to any of Met's amendments to the Administrative Code. The first proviso is followed
5 by a second proviso that constrains the scope of the general limitation in two ways – one that
6 sunsets restrictions on challenges brought by San Diego, and one that permits the parties to make
7 mutually agreeable changes.
8

9 This plain language shows the parties agreed to preclude certain challenges with the
10 exception of those challenges expressly permitted, including the specified challenges identified
11 in the final proviso. Among the permitted challenges are those brought by San Diego after the
12 passage of five years contesting Met's charges for the conveyance of water on the basis they
13 were not set pursuant to applicable law. Whether or not Met amended the underlying rate
14 structure is irrelevant to whether San Diego may challenge Met's rate structure.
15

16 Met's argument turns on the assertion that the second proviso modifies the first proviso,
17 not the general limitation. Met Closing Brief, 20-22. The key to Met's argument is the premise
18 that the language "such charge or charges" in the second proviso refers to the charge or charges
19 contained in any amendments made pursuant to the first proviso. *Id.* at 22. This reading is
20 irreconcilable with the plain language. The general limitation, not the first proviso, contains a
21 reference to "charge or charges." In using the "charge or charges" language, the general
22 limitation echoed the price term itself. The general limitation precludes San Diego from
23 attacking any law or regulation pertaining to Met's "charge or charges" "generally applicable to
24 the conveyance of water." The general limitation precludes San Diego from bringing a challenge
25 that could impact the contract price. The reference to "such charge or charges" in the second
26
27

1 proviso refers to those charges.¹¹ It does not refer to the first proviso, which contains no
2 reference to any “charge or charges.”

3 The structure of this section makes this conclusion inescapable. The first proviso begins
4 with the language “provided, however.” The second proviso begins with the language “and,
5 provided, further.” This makes it plain that the second proviso was a further proviso to the
6 general limitation.
7

8 Met hopes to inject ambiguity into the contract with extrinsic evidence such as the
9 testimony of Jeffrey Kightlinger, who negotiated the deal for Met. Met Closing Brief, 22; Trial
10 Transcript, 1327:21-1328:8. He said the purpose of the second proviso was to protect San Diego
11 from adverse changes in Met’s rate structure, *id.* at 1300:13-1307:2, 1328:9-14, noting that San
12 Diego’s negotiators told him that San Diego would not challenge Met’s existing rate structure
13 and that this concession was material to Met. *Id.* at 1300:13-1301:6, 1304:19-1305:7. One of
14 San Diego’s negotiators, Maureen Stapleton, disputed Kightlinger’s testimony. She said San
15 Diego always had concerns with the rates themselves and raised them repeatedly with Met. *Id.* at
16 1554:22-1555:14.¹²
17

18 Met also notes San Diego’s analysis of the future costs under the pricing agreement that
19 the parties ultimately adopted. San Diego analyzed the cost of that price plan over 20, 35, 45,
20 and 75 years, but not over five years. Met Closing Brief, 23; Trial Transcript, 1218:6-1221:6.
21 Met also seeks to corroborate its interpretation by looking to a San Diego memo to its Imported
22 Water Committee from 2007, in which San Diego stated that it did not intend to litigate Met’s
23
24

25 ¹¹ Met contends that if the second proviso refers to the general limitation then San Diego could challenge every
26 charge. Met Closing Brief, 22. Not so. The general limitation referred to a limited subset of Met’s charges, to which
27 the second proviso refers.

¹² Met disputes Stapleton’s credibility. Met Closing Brief, 22-23 n.10. But a Met person ‘most knowledgeable’ also
testified, in his deposition, that pursuant to these provisions San Diego could contest whether Met’s rates and
charges are consistent with applicable law after five years. PTX-392 at 121:10-124:25. I credit Stapleton’s
testimony, and not contrary Kightlinger testimony.

1 current rate structure but could not know what future actions Met may take. Met Closing Brief,
2 23; DTX-355 at 2.

3 None of this extrinsic evidence creates ambiguity in the contract.¹³ That San Diego
4 projected its exposure over periods exceeding five years is unsurprising, because even if San
5 Diego could succeed in a rate challenge San Diego would still pay Met's full, if reconfigured,
6 conveyance rates over the life of the Exchange Agreement. Stapleton testified that San Diego
7 was only interested in projecting a worst case scenario under the pricing plan. Trial Transcript,
8 1465:22-1466:1. A worst case scenario projection would not include savings from rate
9 restructuring as a result of litigation, even in the dubious event that one could estimate such
10 savings.
11

12 That in 2007 San Diego did not intend to challenge Met's existing rate structure does not
13 clarify the parties' intent when they signed the agreement in 2003. If anything, San Diego's
14 statement in 2007 is consistent with San Diego's interpretation of the contract, not Met's. By
15 stating that it did not intend to challenge Met's existing rate structure, San Diego implied that it
16 thought it had, or would soon have, a right to challenge Met's existing rate structure. (If San
17 Diego had no right to challenge Met's rate structure, there would be no reason for San Diego to
18 discuss whether it intended to do so.) This implication is inconsistent with Met's interpretation
19 of the contract, pursuant to which San Diego would never have any right to challenge Met's
20 existing, unamended, rate structure.
21

22 While Kightlinger's testimony supports Met's position, it is contradicted, and I reject it.
23 PTX-392 at 122:21-123:1; Trial Transcript, 1194:16-1196:6. His reading is in any event
24
25

26
27 ¹³ Only if the contract is reasonably susceptible to an interpretation urged does a court admit extrinsic evidence to aid in the interpretation of the contract. *Wolf v. Superior Court*, 114 Cal.App.4th 1343, 1350-51 (2004). The determination of whether an ambiguity exists is a question of law. *Id.* at 1351.

1 irreconcilable with the plain language of the contract. It does not create an ambiguity and the
2 unambiguous plain language controls.

3 The third sentence of § 5.2 permits San Diego to challenge Met's charges applicable to
4 the conveyance of water by Met to member agencies.¹⁴

6 2. Breach

7 In the rate years at issue, Met charged San Diego its transportation rates – the System
8 Access Rate, System Power Rate, and Water Stewardship Rate – pursuant to the price term.¹⁵
9 San Diego contends that Met breached the price term because Met's transportation rates were not
10 set pursuant to applicable law and regulation. San Diego Pre-Trial Brief, 1. In Phase I, I held
11 that Met's System Access Rate, System Power Rate, and Water Stewardship Rate were unlawful.
12 April Statement of Decision, 65. There is no dispute that those rates are the rates generally
13 applicable to Met's member agencies for the conveyance of water. Because Met's charges were
14 not consistent with law and regulation, Met breached § 5.2 of the Exchange Agreement. PTX-65
15 § 5.2.
16

17 To escape this result, Met argues that San Diego did in fact agree to Met's existing rate
18 structure by (1) agreeing to an initial price of \$253, based in turn on Met's existing rate structure;
19 (2) entering the Exchange Agreement knowing Met's existing rate structure; (3) voting in favor
20 of the challenged rate structure before and after the Exchange Agreement was entered into; and
21 (4) accepting Met's performance under the contract. Amended Motion for Partial Judgment, 2-3;
22 Met Pre-Trial Brief, 12.
23

24 ¹⁴ In passing, San Diego refers to this state of affairs as an "agree[ment] to disagree" about the law pertaining to
25 Met's rates. San Diego Post-Trial Brief for Phase II, 14. Met contends that San Diego agreed to a contract price
26 including the Water Stewardship Rate, the System Power Rate, and the System Access Rate, the latter two
27 components including State Water Project costs that the Department of Water Resources allocated to infrastructure.
Met Pre-Trial Brief, 12. Through this litigation Met has never contended the price term is uncertain or indefinite.
Compare, e.g., California Lettuce Growers v. Union Sugar Co., 45 Cal.2d 474, 481 (1955).

¹⁵ This is undisputed. *E.g.*, Met Pre-Trial Brief, 11; Met Closing Brief, 15; San Diego Post-Trial Brief for Phase II,
4, 21-22.

1 The first two points are not persuasive. Regardless of the parties' thinking which led to
2 the initial price, the parties just agreed to that number. San Diego's agreement to pay rates Met
3 set pursuant to applicable law and regulation does not amount to a tacit adoption of the then-
4 existing rate structure where the very same paragraph sets out provisions governing how and
5 when San Diego will be precluded from, and permitted to, a challenge whether those same
6 charges, whether or not amended, were in fact properly set pursuant to applicable law and
7 regulation. PTX-65 § 5.2.

8
9 Met contends there can be no breach when it uses the rate structure that has been in
10 existence since 2003, because San Diego entered the contract knowing Met's future performance
11 would be a continuation of that very structure. Amended Motion for Partial Judgment, 6. San
12 Diego may well have known that it was in substance agreeing to pay the Water Stewardship Rate
13 and for all State Water Project costs in Met's rate elements for five years. But San Diego also
14 bargained for the right to attack Met's conveyance rates after five years. If the charges were
15 removed from Met's generally applicable rates as the result of a change obtained by San Diego,
16 the charges would also be removed from the contract price. So San Diego did not agree to pay
17 any specific rate or abide by any specific rate structure for the life of the contract – it expressly
18 only agreed to pay rates set in accordance with applicable law and regulation, reserving the right
19 to challenge whether Met set its rates in accordance with applicable law and regulation (after five
20 years).

21
22 Accepting Met's performance for some period of time, even exceeding the five year
23 period, does not show San Diego agreed in the contract¹⁶ to a rate structure when at the same
24 time San Diego expressly retained the right to challenge Met's charges in court after the five year
25 period.
26
27

¹⁶ I separately address Met's waiver defense.

1 Below, I discuss the impact of San Diego's representatives' votes on Met's Board of
2 Directors on waiver. Here, I find that the voting history does not suggest that the plain language
3 of the contract is ambiguous or that San Diego agreed to pay under Met's existing rate structure
4 for the life of the contract. The unambiguous plain language again controls.
5

6 3. Damages

7 There are two issues under the rubric of damages. First, San Diego must prove the fact
8 that it suffered some damage as an element of its breach of contract claim. Second, if liability
9 for breach of contract is established, I must determine the appropriate measure of damages.
10

11 a. Background Law

12 Damages are of course an essential element of a breach of contract claim. *Behnke v.*
13 *State Farm General Ins. Co.*, 196 Cal.App.4th 1443, 1468 (2011); C.C. § 3300. "The damages
14 awarded should, insofar as possible, place the injured party in the same position it would have
15 held had the contract properly been performed, but such damages may not exceed the benefit
16 which it would have received had the promisor performed." *Brandon & Tibbs v. George*
17 *Kevorkian Accountancy Corp.*, 226 Cal.App.3d 442, 468 (1990); *Lewis Jorge Const.*
18 *Management, Inc. v. Pomona Unified School Dist.*, 34 Cal.4th 960, 967-68 (2004). "Where the
19 fact of damages is certain, the amount of damages need not be calculated with absolute certainty.
20 [Citations.] The law requires only that some reasonable basis of computation of damages be
21 used, and the damages may be computed even if the result reached is an approximation." *GHK*
22 *Associates v. Mayer Group, Inc.*, 224 Cal.App.3d 856, 873 (1990).
23

24 Importantly, a defendant cannot escape liability for its breach because damages cannot be
25 measured exactly. *SCI Cal. Funeral Servs., Inc. v. Five Bridges Foundation*, 203 Cal.App.4th
26 519, 571 (2012).
27

1 **b. Fact of Damages**

2 To establish the fact of damages San Diego relies on the April Statement of Decision as
3 well as testimony to the effect that Met's rates resulted in inflated conveyance rates. San Diego
4 Post-Trial Brief for Phase II, 21.¹⁷ In Phase I, I held that Met's conveyance rates over-collect
5 from wheelers because Met allocated all of the State Water Project costs for the transportation of
6 purchased water to its conveyance rates and all of the costs for conservation and local water
7 supply development programs to its conveyance rates. April Statement of Decision, 65. The
8 same logic applies to the Exchange Agreement. San Diego paid more than it agreed to under the
9 Exchange Agreement because Met improperly included all of the State Water Project costs for
10 the transportation of purchased water to its conveyance rates and all of the costs for conservation
11 and local water supply development programs to its conveyance rates.
12

13
14 Met responds that contract damages may only be the difference between the price Met
15 charged San Diego and the highest price Met could have charged San Diego had it performed its
16 obligation to set a lawful rate. Met Closing Brief, 3. So, Met says San Diego bore a burden of
17 proving at least that its damages theory is based on some lawful rate structure, and (possibly) that
18 under every imaginable lawful alternative rate structure San Diego would have paid less than it
19 did in the real world.¹⁸
20

21 There are two points to be made here. First, Met's present argument flies in the face of
22 the positions it has repeatedly taken in the past; and secondly, Met's argument does not in any
23 event obviate the obvious point that San Diego has established the fact of damages.

24 ¹⁷ See also, Trial Transcript, 991:16-992:6 (Dennis Cushman's testimony that San Diego has overpaid State Water
25 Project and Water Stewardship Rate charges as a result of Met's rates), 1911:24-1912:9 (testimony from Met's
26 expert to the effect that if the State Water Project costs should not have been included then San Diego overpaid
those charges).

27 ¹⁸ Met Closing Brief, 3 (arguing that San Diego did not prove that it paid more under the Exchange Agreement than
it could have under an alternative lawful rate structure, and therefore did not prove damages, because it did not
prove what alternative rate structures may exist); Amended Memorandum in Support of Partial Judgment, 8-9
(arguing that San Diego must prove its allocation is based on a lawful rate structure).

1 On the matter of stating or fixing damages through some sort of analysis of
2 counterfactual arguably legal rates, Met has repeatedly tried to have its cake and eat it too, as it
3 were. It has told me both that (i) only a new rate setting procedure may be used in this case to
4 fix lawful rates which in turn must be done before damages can be ascertained,¹⁹ and (ii) superior
5 courts may not do this. Met's January 9, 2015 Motion to Dismiss, 1-5; Trial Transcript, 2013:6-
6 2018:16; *see also* Met's March 27, 2014 Objections to Tentative Statement of Decision, 2-3
7 (court is not a rate-fixing body).²⁰ Met has had no useful response when I have enquired whether
8 its vision of damages requires me to defer a calculation of damages until after Met resets rates
9 (which would come after, and be a function of, appellate proceedings in this very case) which
10 new rates themselves might very well be subject to further independent litigation, pushing out
11 the decision on both the fact and calculation of damage in this case to many, many years hence.
12 Met's January 9, 2015 Motion to Dismiss, 5-6. These parties were keenly, almost painfully,
13 aware that contract litigation (after five years) was likely; but the notion that they also intended
14 to have the anticipated contract dispute resolved in this way is inconceivable.²¹

17 On the second point, Phase I established Met unlawfully included supply costs in
18 transportation rate elements. Met charged the same transportation rate elements to San Diego
19 under the Exchange Agreement as charges generally applicable to the conveyance of water by
20 Met on behalf of its member agencies. It is thus patently obvious that San Diego has established
21 that some costs should have been removed from the rates it paid under the Exchange Agreement
22

23 ¹⁹ E.g., Met's Amended Motion for Partial Judgment at 7:20 ("rates must be recalculated").

24 ²⁰ This logical twist got to the point where I had to instruct Met not to press a damages theory which Met at the same
25 time maintained I had no jurisdiction to entertain. Nov. 4, 2014 Order Setting Case Management Conference, 1-2;
26 Dec. 4, 2014 Order Denying Met's Motion to Reopen Expert Discovery. The effect of Met's fabricated conundrum
27 would be, of course, that damages could *never* be fixed if Met ever breached the Exchange Agreement. Despite this,
I allowed the parties, and Met specifically, to introduce evidence of a "lawful spectrum of rates" to estimate
damages. Order Re: Metropolitan's Motion To Dismiss For Lack Of Subject Matter Jurisdiction And [On] The
Parties' Motions In Limine, dated February 6, 2015. In the event, Met did not do so.

²¹ Dennis Cushman's testimony at e.g. DTX-710 at 443:10-444:2 is not to the contrary: he does not there endorse
this mode of calculating damages.

1 – the rates were obviously overinclusive. The precise amount of overinclusion is not established,
2 nor is any resulting impact on other Met rates.

3 I turn to Met’s argument that San Diego failed to account for (or set off) benefits it
4 secured by Met’s illegal rates, and as a consequence failed to establish damages.

5 Met argues the same conduct that breached the contract also must have resulted in
6 decreased supply rates, saving San Diego some money when it purchased full-service water from
7 Met. Met Closing Brief, 6. These savings must be treated as an offset against San Diego’s
8 damages, Met says, for it must have under-collected its supply costs in such a way that
9 necessarily resulted in under-collection from full-service water purchases.²² But Met as
10 defendant has the burden on matters of offset and unjust enrichment. *Textron Fin. Corp. v. Nat’l*
11 *Union Fire Ins. Co. of Pittsburgh*, 118 Cal.App.4th 1061, 1077 (2004), *disapproved of on other*
12 *grounds by Yanting Zhang v. Superior Court*, 57 Cal.4th 364 (2013). Met bore the burden of
13 demonstrating that San Diego’s damages were offset by incidental extra-contractual benefits San
14 Diego obtained as a result of the same conduct amounting to breach. *Space Properties, Inc. v.*
15 *Tool Research Co.*, 203 Cal.App.2d 819, 827 (1962) (defendant has burden of proof on defenses
16 such as unjust enrichment and or setoff). No evidence shows San Diego would have received a
17 consequential benefit from paying reduced supply charges that equaled or outweighed its
18 damages under the contract during the rate years in question if Met had reallocated the unlawful
19 transportation charges to its supply rates. Accordingly, Met’s argument for an offset does not
20 defeat liability. It has not met that burden.

21
22
23
24
25
26 ²² *Hicks v. Drew*, 117 Cal. 305, 314-15 (1897) (approving the jury instruction “If the jury find from the evidence that
27 the plaintiff has sustained any damage by the act of defendant, as she has complained against him, and that by the
same act she has received benefit, then, in estimating such damage, such benefit should be deducted”). See Trial
Transcript, 1136:25-1138:14.

1 Finally as I have suggested above a recalculation of Met's supply rates conflicts with
2 Met's view that such an approach is impermissible in superior court.

3 San Diego has proven by a preponderance of the evidence that it was in fact damaged by
4 paying conveyance rates that were higher than Met could have set pursuant to applicable law and
5 regulation. PTX-65 § 5.2. San Diego should not be required to prove the fact of damages
6 beyond any shadow of doubt by proving the entire universe of possible alternative legal rate
7 structures Met might have implemented.
8

9 **c. Amount of Damages**

10 San Diego seeks an award of \$188,295,602 plus interest. San Diego Post-Trial Brief for
11 Phase II, 29. San Diego computed its damages by removing the SWP costs and the Water
12 Stewardship Rate from the Price. *Id.* at 30. Met correctly notes the Phase I ruling did not go so
13 far as to hold that Met is not permitted to include any of its SWP costs or Water Stewardship
14 Rate in its conveyance rates. Met argues that San Diego bore a Phase II burden of demonstrating
15 the appropriate percentage that Met could have included; and failed to carry that burden. Met
16 Closing Brief, 5-6; Trial Transcript, 2033:15-22, 2035:20-2037:19. Met also argues that any
17 damage award should be offset by whatever increases San Diego would have paid in its supply
18 rates. Met Closing Brief, 6; Trial Transcript, 2021:4-10.
19
20

21 San Diego's approach may overcompensate San Diego, because San Diego (1) removed
22 all State Water Project costs from Met's conveyance rates although I have only ruled that Met
23 could not include 100% of those costs through its conveyance rates;²³ and (2) removed the entire
24

25 ²³ Met argues that Exchange Water included State Water Project water, so San Diego should be charged with some
26 costs from the State Water Project system under the Exchange Agreement. Met Closing Brief, 8-12. But the
27 question is not whether Met should recover State Water Project costs under the Exchange Agreement, the question is
whether State Water Project costs can properly be recovered through the lawfully set conveyance rates that San
Diego agreed to pay under the Exchange agreement. Met's argument that San Diego should have accounted for the
power costs to move water pursuant to the Exchange Agreement appears to suffer from the same defect. *Id.* at 13.
In a similar vein, Met challenges the methodology by which San Diego's expert recalculated the rates. Met Closing

1 Water Stewardship Rate from Met's conveyance rates although I only ruled that Met could not
 2 recover 100% of those costs through its conveyance rates. Nor does San Diego account for
 3 possible set-offs, although as suggested above it is not San Diego's burden to do so.²⁴
 4

5 There is no viable alternate methodology available. Neither party has computed alternate
 6 conveyance rates assuming that less than 100% of the charges are shifted from conveyance to
 7 supply. Neither party has explained the basis for an appropriate offset as a result of reduced
 8 supply rates.

9 Met seeks dismissal because of this uncertainty. Trial Transcript, 2033:12-19. But
 10 where, as here, the fact of damage flowing from the breach is proven the amount of damages
 11 may be fixed using an approximation if there is a reasonable basis for the approximation. *GHK*,
 12 224 Cal.App.3d at 873-74.²⁵ The rationale for San Diego's calculation is (1) San Diego has
 13 removed from Met's transportation rates only certain charges that this Court ruled cannot be
 14 wholly included in transportation rates; (2) attempting to allocate the charges at issue between
 15 transportation and supply would embroil the Court in an inappropriate ratemaking exercise (a
 16 proposition with which Met has repeatedly agreed) (Trial Transcript, 2017:23-2018:7; Met's
 17 January 9, 2015 Motion to Dismiss, 3-5; Met's March 27, 2014 Objections to Tentative
 18

19
 20 Brief, 7-8; Trial Transcript, 1140:5-17. San Diego's expert removed the challenged costs from the cost pool and
 21 divided the cost pool by the sales assumption. Trial Transcript, 1140:5-17. Met's expert opined that San Diego
 22 should have instead divided only Colorado River costs by Colorado River sales. Trial Transcript, 1899:8-1900:14.
 23 But, once again, the proper approach was to determine what Met's rate would have been if certain charges in Met's
 24 generally applicable conveyance rates were moved from conveyance to supply. To do this, it was appropriate to
 25 look at Met's total conveyance costs and its total sales assumption.

26 ²⁴ San Diego provided some evidence in support of a 15% figure. Trial Transcript, 1258:7-1260:8. While Met
 27 contends quantifying an offset is not its problem, Trial Transcript, 2022:11-14, defendants usually *do* have this sort
 of burden. *Textron Fin. Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 118 Cal.App.4th 1061, 1077 (2004),
disapproved of on other grounds by Yanting Zhang v. Superior Court, 57 Cal.4th 364 (2013). At closing argument
 Met expressed no confidence in or support for this 15% figure. E.g., Trial Transcript (closing argument) June 5,
 2015 at 2020. See also, Met Closing Brief, 7.

²⁵ The *GHK* Court noted that an approximation for which there is a reasonable basis is particularly permissible when
 the wrongful acts of the defendant created difficulty in proving the amount of lost profits or where the wrongful acts
 of the defendant caused the other party not to realize a profit to which it was entitled. *GHK*, 224 Cal.App.3d at 873-
 74.

1 Statement of Decision, 2-3). San Diego Post-Trial Brief for Phase II, 31; San Diego Pre-Trial
2 Brief, 11-12.

3 San Diego has offered a reasonable computation. It is not possible to know how Met may
4 in the future allocate its State Water Project conveyance costs or Water Stewardship Rate
5 between transportation and supply rates. One reasonable assumption is that the entirety of the
6 rate would have been moved. San Diego computed its damages under the contract for the 2011-
7 2014 rate years using that assumption.

8 Met did not offer a competing computation.

9 It asks too much of San Diego to require it to recalculate Met's rates with any useful
10 degree of precision. *MCI Telecommunications Corp. v. F.C.C.*, 59 F.3d 1407, 1415 (D.C. Cir.
11 1995) (inequitable to permit defendants who were in the best position to set their rates at lawful
12 levels in the first place and who later had opportunities to correct those rates to avoid
13 responsibility for those unlawful rates because the complainant to establish an appropriate rate
14 without making simplifying assumptions); *SCI*, 203 Cal.App.4th at 571 (defendant cannot escape
15 liability for breach simply because damages cannot be measured exactly).

16 For these reasons, San Diego has proven that it is entitled to damages in the amount of
17 \$188,295,602 plus interest.

18 **4. Affirmative Defenses**

19 **a. Waiver**

20 Met contends that San Diego waived²⁶ any claim for damages arising from Met's use of
21 the rate structure to set the Price by the following conduct inconsistent with an intent to claim
22 damages: (1) proposing the Price with knowledge of the rate structure and its components; (2)
23 voting, through its delegates to Met's Board of Directors, in favor of the rate structure and rates;

24 ²⁶ *Carmel Valley Fire Prot. Dist. v. California*, 190 Cal.App.3d 521, 534 (1987) (elements of waiver).

1 (3) failing to object to the structure of the rates until 2010; (4) stating in 2007 that San Diego did
 2 not intend to litigate Met's existing rate structure; and (5) accepting Met's performance with
 3 knowledge of the breach. Met Closing Brief, 14-20.

4 Met's waiver theories are precluded by the anti-waiver provision²⁷ in the Exchange
 5 Agreement. Met has not identified any conduct that could have waived the protections of the
 6 anti-waiver provision. *Id.* at 24-25. Nor has Met identified any written and signed waiver.
 7
 8 PTX-65 § 13.9.²⁸

9 **b. Consent**

10 Met asserts that San Diego consented²⁹ to using Met's then-existing rate structure to set
 11 the Price by entering the Exchange Agreement with knowledge of the unlawfulness of the rate
 12 structure, voting in favor of the rate structure, and accepting the benefits of the agreement. Met
 13 Closing Brief, 25-28.

14 First, San Diego's agreement to the price term in the Exchange Agreement does not
 15 amount to San Diego's approval of Met's rate structure. As discussed above,³⁰ contrary to Met's
 16 reading of the Exchange Agreement San Diego retained the right to challenge Met's existing rate
 17 structure after five years. San Diego agreed to pay only (1) a fixed initial rate; and (2) a rate set
 18
 19
 20

21 ²⁷ "No waiver of a breach, failure of condition, or any right or remedy contained in or granted by the provisions of
 22 this Agreement is effective unless it is in writing and signed by the Party waiving the breach, failure, right, or
 23 remedy. No waiver of a breach, failure of condition, or right or remedy is or may be deemed a waiver of any other
 24 breach, failure, right, or remedy, whether similar or not. In addition, no waiver will constitute a continuing waiver
 25 unless the writing so specifies." PTX-65 § 13.9.

26 ²⁸ Met looks to San Diego's written statement in 2007 that it did not intend to litigate Met's existing rate structure as
 27 a written waiver. Met Closing Brief, 19-20; DTX-355 at 2; DTX-1114 at 11-12; Trial Transcript, 1070:17-22. But
 none of these documents shows San Diego's intention to give up any right to challenge the existing rates. Rather,
 the documents reflect whether San Diego had the intent to challenge the existing rates in 2007. San Diego may not
 have *then* intended to challenge the existing rates, but still not have intended to give up the right to do so in the
 future.

²⁹ Consent is a free and mutual agreement to an act. C.C. § 1567. "A voluntary acceptance of the benefit of a
 transaction is equivalent to a consent to all the obligations arising from it, so far as the facts are known, or ought to
 be known, to the person accepting it." C.C. § 1589.

³⁰ Section IV(A)(1).

1 pursuant to applicable law. San Diego did not agree to Met's existing rate structure, but
2 bargained away the ability to challenge that rate structure for five years.

3
4 Second, the voting records do not support the assertion that San Diego consented to the
5 use of Met's rate structure in the years at issue. San Diego's representatives on Met's board
6 voted in favor of Met's rates in 2002, 2005, 2006, 2007, 2008, and 2009. Trial Transcript,
7 1506:14-17; DTX-129. San Diego's representatives voted against the rates in the years at issue
8 in this case. DTX-129. In voting, San Diego's representatives acted as Met's fiduciaries in the
9 scope of their duties as members of the board. Trial Transcript, 1506:12-13. Each time Met set
10 an unlawful rate, Met breached its obligations under the Exchange Agreement. *Arcadia*
11 *Development Co. v. City of Morgan Hill*, 169 Cal.App.4th 253, 262 (2008). Even if San Diego
12 can be said to have consented to Met's breaches in prior years because its delegates voted in
13 favor of the rates, a proposition with which I do not agree,³¹ San Diego's delegates did not vote
14 in favor of the rates at issue now.

15
16 Third, San Diego did not accept the benefits of the contract without protest in the rate
17 years at issue here. Again, each time Met sets unlawful conveyance rates, it breached its
18 obligations. Perhaps San Diego accepted Met's performance in prior years, even after the
19 expiration of the five year period; but San Diego did not accept Met's performance without
20 protest in the rate years at issue. Rather, it sued to challenge these breaches.

21
22 **c. Estoppel**

23 Met argues that San Diego is estopped³² from asserting that setting the Price based on the
24 existing rate structure is a breach of contract because San Diego's delegates to Met's Board of
25

26 ³¹ As the text suggests these delegates wore at least two hats, and in voting for Met rates may well have acted in the
27 best interests of Met.

³² In general, there are four elements of equitable estoppel: (1) the party to be estopped must be apprised of the facts;
(2) the party to be estopped must intend that his conduct shall be acted upon or have acted in such a way that the

1 Directors failed to disclose that Met's rate structure was unlawful and instead in effect
2 represented that the Price could be based on the existing rate structure. Met Closing Brief, 28-
3 31. Met asserts that San Diego agreed to a price term based on the rate structure and the 2003
4 rates; did not communicate that any of Met's rates might be unlawful; did not object to the price;
5 and represented that it did not intend to sue over the existing structure. *Id.* at 30.

7 In short Met contends that San Diego, knowing Met's rate structure was unlawful,
8 engaged in conduct that created the impression Met's existing rate structure was lawful, and that
9 Met, not knowing that its rate structure was unlawful, relied on San Diego's conduct.

10 But as Met recognized in its First Phase I Pre-trial Brief, the plain language of the
11 Exchange Agreement is itself an "open[] threat[] to litigate over [Met's] existing rate structure"
12 because San Diego agreed not to challenge Met's rates for five years after execution but reserved
13 the right sue to challenge the validity of Met's rates thereafter. Met Oct. 18, 2013 Brief, 14
14 (providing background concerning Met's use of Rate Structure Integrity provisions); PTX-65 §
15 5.2. San Diego's right to challenge Met's existing rate structure is itself part of the price term
16 section. Met could not have relied on San Diego's proposal of or agreement to this price term to
17 conclude that its rate structure is lawful. Moreover, the contract itself demonstrates that neither
18 party knew that Met's rate structure was unlawful;³³ both parties were bargaining in the context

21
22
23 party asserting estoppel had the right to believe the conduct was so intended; (3) the party asserting estoppel must be
24 ignorant of the true facts; and (4) the party asserting estoppel must rely on the conduct. *Ashou v. Liberty Mut. Fire*
25 *Ins. Co.*, 138 Cal.App.4th 748, 766-67 (2006). Met's arguments conceivably satisfy the first two elements, but not
26 the rest, so setting aside my discussions in the text the estoppel defense fails in any event. Met does not show it was
27 ignorant of facts to which San Diego was privy nor does it show reliance, that is, that it would have acted otherwise.
33 Indeed, my determination on the lawfulness of Met's rate structure is itself exceedingly likely to be appealed. The
notion that Met relied on representations from San Diego to act on the belief that its rate structure is lawful is
particularly unpersuasive where Met continues to set its rates based on the belief that its rate structure is lawful even
after San Diego voted against the rates, sued Met over the rate structure, and obtained my trial court ruling that the
rate structure is unlawful. Met, as experienced in state water law as any entity, and served by some of the best
lawyers in the country, has never been misled by San Diego; it just disagrees with San Diego.

1 of uncertainty. The negotiations and terms of the Agreement make it plain—in way that is not
2 often found in contracts—that a lawsuit was contemplated.

3 Nor, in this context, could Met have reasonably relied on San Diego's other conduct to
4 conclude that its rate structure was legal. For example, in 2007 San Diego stated in internal
5 documents that it did not intend to litigate Met's existing rate structure.³⁴ But San Diego could
6 have determined not to litigate Met's existing rate structure for a number of reasons, only one of
7 which is San Diego's likelihood of success; and an internal document surely could not create as
8 estoppel as to Met. Met also notes San Diego's delegates voted to approve Met's rates in 2002
9 and 2005-2009 but did not tell Met that its rate structure might be illegal. But again the plain
10 language of the Exchange Agreement eviscerates this argument. Even as San Diego acquiesced
11 to Met's rates on a year-to-year basis after the expiration of the five year period, the possibility
12 of a legal challenge to the rates was written into the Exchange Agreement.

13
14
15 San Diego did not represent to Met, by omission or by conduct on which Met could
16 reasonably rely, that Met's rates were lawful knowing Met's rates were in fact illegal. Rather,
17 San Diego bargained for the right to challenge Met's rates in court in the future, and Met
18 bargained to constrain San Diego's ability to do so. San Diego's suit is not barred by the
19 doctrine of equitable estoppel.

20
21 **d. Illegality**

22 Met argues that the Exchange Agreement is void as illegal if Met's rate structure or rates
23 in existence at the time the parties entered into the Exchange Agreement were illegal. Met
24 Closing Brief, 31-33. This is so because if San Diego is right, Met's performance of the price

25
26
27 ³⁴ Met Closing Brief, 19-20; DTX-355 at 2 (San Diego memo weighing whether to enter contracts with a Rate
Structure Integrity provision); DTX-1114 at 11-12; Trial Transcript, 1070:17-22.

1 term was unlawful, Met says, because the rate structure includes unlawful rates. Met Pre-Trial
2 Brief, 12.

3 Although San Diego agreed not to challenge the manner in which Met set its charge or
4 charges for the following five years, the parties did not agree the setting of charges was legal or
5 illegal. Fixing a \$253 price is not illegal. Nor is it illegal to require Met to set its charges for the
6 conveyance of water pursuant to applicable law and regulation; precisely the opposite is true.³⁵

7 The parties obviously bargained for—by definition—a *legal* price term.
8

9 **e. Mistake of Law**

10 Met argues that there was a mistake of law with respect to whether its existing rates at the
11 time the parties entered the Exchange Agreement were lawful. To the extent that neither party
12 was aware the rate structure was unlawful, Met contends that it is entitled to rescission based on
13 mutual mistake. Met Closing Brief, 34-35; C.C. § 1578(1).³⁶ To the extent that San Diego but
14 not Met was aware that Met's rate structure was unlawful, Met is entitled to rescission because
15 San Diego failed to rectify Met's mistake. Met Closing Brief, 35-36; C.C. § 1578(2). San Diego
16 says there was no mistake of law – the parties disagreed about the lawfulness of Met's rate
17 structure and bargained around that disagreement. San Diego Post-Trial Brief for Phase II, 28-
18 29.
19
20

21 Where parties are aware that a doubt exists in regard to a certain matter and contract on
22 that assumption, the risk of the existence of the doubtful matter is an element of the bargain.
23 *Guthrie v. Times-Mirror Co.*, 51 Cal.App.3d 879, 885 (1975). The kind of mistake that renders a
24

25 _____
26 ³⁵ "It is well settled that if a contract can be performed legally, it will not be presumed that the parties intended for it
27 to be performed in an illegal manner, and it will not be declared void merely because it was performed in an illegal
manner." *Freeman v. Jergins*, 125 Cal.App.2d 536, 546 (1954).

³⁶ Met never tells us how this rescission, based on mistake or other grounds, would be carried out. Presumably San
Diego would not have to return the transported water.

1 contract voidable does not include mistakes as to matters which the contracting parties had in
2 mind as possibilities and as to the existence of which they took the risk. *Id.*

3 It is not clear when San Diego reached the conclusion that Met's rates were unlawful.
4 San Diego notes evidence that San Diego suggested to Met that Met's wheeling rate was
5 unlawful and that Met understood the suggestion. PTX-398; PTX-392 at 121:10-124:25
6 (purpose of five year standstill was to permit San Diego to bring a challenge to the rates). Met
7 asserts that San Diego's own negotiator vacillated as to whether San Diego had identified
8 anything unlawful about Met's rates at the time the parties entered the Exchange Agreement.³⁷
9 The parties were unclear on exactly what the law was.³⁸

10 Neither party knew how a court would rule on Met's rate structure. But they contracted
11 around this uncertainty. For five years, the parties precluded San Diego from challenging Met's
12 interpretation of the law, whether or not that interpretation changed during that period.
13 Thereafter, if San Diego disagreed it was free to bring a judicial challenge. The structure of the
14 contract itself, against this backdrop of uncertainty, demonstrates that the parties knew San
15 Diego might challenge Met's rate structure, were unsure which party would prevail in such a
16 lawsuit, and contracted in a way that accounted for Met's interests if its rates were unlawful.³⁹
17 There was no mistake of law.

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³⁷ Compare Trial Transcript, 1590:7-1591:17 (Stapleton confronted with Slater's deposition testimony that San
23 Diego did not a violation although it knew there were laws that could be pertinent); with Trial Transcript, 1452:16-
24 1454:2 (Stapleton confronted with Slater's testimony that certain rates were unlawfully included in Met's
conveyance rates).

³⁸ Trial Transcript, 1237:8-1243:17, 1248:13-1253:20, 1255:25-1256:8.

³⁹ San Diego forfeited its ability to challenge Met's rates in court for five years; to the extent Met's rates were
25 unlawfully inflated, Met received a benefit at San Diego's expense at least for the first five years of the contract.
26 Kightlinger testified that he did not have any doubt as to the lawfulness of Met's rates and that Met would not have
27 entered the Exchange Agreement if San Diego had said that Met's rates were unlawful during negotiations. Trial
Transcript, 1316:3-18. In section IV(A)(1), I rejected Kightlinger's testimony that San Diego told him that San
Diego would not challenge Met's existing rate structure and that the concession was material to Met.

1 **f. Offset and Unjust Enrichment**

2 These defenses are subsumed within the damages questions and are addressed there.⁴⁰

3 **B. Preferential Rights**

4 San Diego seeks a declaration that Met's methodology of computing preferential rights
5
6 violates § 135 of the Metropolitan Water District Act⁴¹ because it excludes San Diego's
7 payments relating to the conveyance of water San Diego purchases from other sources. Third
8 Amended 2010 Complaint ¶¶ 113-15. Specifically, the parties dispute whether (1) San Diego's
9 payments pursuant to the Exchange Agreement should be included in the preferential rights
10 calculation; and (2) payments under wheeling agreements should be included in the preferential
11 rights calculation.⁴²

12 Section 135 includes the following:

13 Each member public agency shall have a preferential right to purchase from the district
14 ... a portion of the water served by the district which shall, from time to time, bear the
15 same ratio to all of the water supply of the district as the total accumulation of amounts
16 paid by such agency to the district on tax assessments and otherwise, excepting purchase
17 of water, toward the capital cost and operating expense of the district's works shall bear
18 to the total payments received by the district on account of tax assessments and
19 otherwise, excepting purchase of water, toward such capital cost and operating expense.

20
21 ⁴⁰ Met's briefing does not separately address these defenses.

22 ⁴¹ Water Code Appendix § 109-135.

23 ⁴² San Diego Post-Trial Brief for Phase II, 39-40 (referring to the Exchange Agreement and other wheeling
24 agreements); Met Closing Brief, 36-40 (addressing only the Exchange Agreement); Trial Transcript, 2037:20-
25 2038:1; Third Amended 2010 Complaint ¶¶ 113-15 ("113. ... The Water Authority formally requested a
26 determination that its preferential rights should include the amount paid as 'transportation' costs for Metropolitan's
27 conveyance of Non-Metropolitan Water through its pipelines and facilities. Metropolitan has formally denied that
request, taking the position that money paid by the Water Authority for the transportation of its IID and Canal
Lining water are for the 'purchase of water' (i.e., supply)... [¶] 114. In the absence of declaratory relief,
Metropolitan will continue its wrongful calculation of the Water Authority's preferential rights... [¶] 115.
Therefore, the Water Authority prays for a judicial declaration (a) that the current methodology used by
Metropolitan to calculate the Water Authority's preferential rights violates section 135 of the MWD Act; and (b)
directing Metropolitan to follow the requirements of the MWD Act by including the Water Authority's payments to
Metropolitan for transportation of IID Water and Canal Lining Water (which payments are not for 'purchase of
water') in the calculation of the Water Authority's preferential rights to water") (footnote omitted).

1 As explained by our Court of Appeal:

2 Under section 135, in the event of a water supply shortage, each Metropolitan member
3 public agency, including San Diego, has a preferential right to a percentage of
4 Metropolitan's available water supplies based on a legislatively established formula.
5 That formula affords each member an aliquot preference equal to the ratio of that
6 member's total accumulated payments toward Metropolitan's capital costs and operating
7 expenses when compared to the total of all member agencies' payments toward those
8 costs, excluding amounts paid by the member for "purchase of water."

7 *San Diego County Water Authority v. Metropolitan Water Dist.*, 117 Cal.App.4th 13, 17 (2004).

8 Met moved for summary adjudication of San Diego's preferential rights claim in 2013. I
9 denied Met's motion by order issued December 4, 2013. From *SDCWA*, I derived the rule that
10 the preferential rights calculation includes all payments for capital costs and operating expenses,
11 excluding those payments that were tied to the "purchase of water." Dec. 4, 2014 Order, 6. Met
12 attempted to draw a parallel to *SDCWA* based on the rate components charged for the purchase
13 of water in *SDCWA* and the similar rate components charged under, for example, the Exchange
14 Agreement. *Id.* at 6-7. I held that Met had not established that San Diego was purchasing water
15 from Met through the Exchange Agreement. *Id.* at 7.

17 At the Phase II closing argument, Met again pressed the argument that no payment of a
18 volumetric rate is properly credited to preferential rights. Trial Transcript, 2038:18-2039:11,
19 2040:21-2041:10. This reading contradicts the plain language of the statute and *SDCWA*. The
20 Court of Appeal agreed with Met's longstanding interpretation that "amounts paid for water
21 purchases are not to be taken into account in determining preferential rights, whatever those
22 amounts are used for." *SDCWA*, 117 Cal.App.4th at 24-25. The Court independently analyzed
23 the language of the statute, the structure of the statutory scheme, and the legislative history to
24 interpret the Legislature's intent. *Id.* at 25-28. *SDCWA* found the statute reflected the
25 Legislature's intent to create a general rule that all revenue used to pay capital costs and
26
27

1 operating expenses would count toward the calculation of preferential rights, except payments
2 for the purchase of water. *Id.* at 27. In the pure wheeling context, the wheeler does not purchase
3 water from Met but pays a volumetric rate for Met to move water that belongs to the wheeler. I
4 discern no basis for Met's decision to treat volumetric wheeling payments as payments for the
5 purchase of water. Volumetric payments to Met to cover Met's operating expenses that are not
6 connected to a purchase of water from Met are entitled to preferential rights credit under § 135 of
7 the Met Act and *SDCWA*.⁴³ Wheeling payments must be included in the preferential rights
8 calculation.

9
10 Whether payments specifically under the Exchange Agreement give rise to preferential
11 rights credit is a more difficult question. As in the wheeling context, San Diego pays volumetric
12 rates to cover Met's operating expenses in exchange for the conveyance of water. Unlike in the
13 wheeling context, the Exchange Agreement does not literally call for the conveyance of water
14 but instead for the *exchange* of water. PTX-65 §§ 3.1-3.2. The question here is whether the
15 exchange of water facilitated by the Exchange Agreement brings San Diego's payments into the
16 statutory "purchase of water" exception.
17

18 Met says that the Exchange Agreement facilitates a purchase of water because, under the
19 agreement, San Diego gives Met water and money and obtains different water⁴⁴ from Met. Met
20

21
22 ⁴³ Met argues that its interpretation of the statute to treat all volumetric payments as payments for the purchase of
23 water is entitled to deference. Met Closing Brief, 39; Trial Transcript, 1847:5-1848:13, 2040:21-2041:10. I do
24 defer, but this sort of deference is not tantamount to giving the agency a veto on the interpretation of the statute.
25 Courts must ultimately construe statutes. *Compare, SDCWA*, 117 Cal.App.4th at 22. The fact that Met uses
26 volumetric rates to collect its payments for the purchase of water as well as to collect payments under wheeling
27 contracts does not show payments under wheeling contracts are for the purchase of water. It is the purpose of the
28 payment, not the manner in which the amount of the required payment is computed, that controls under the statute.
29 Nothing in the statute or *SDCWA* supports Met's interpretation. *Compare, Met Supplemental Brief*, 5 (asserting that
30 *SDCWA* compels the conclusion that all volumetric payments are excluded from the preferential rights calculation,
31 presumably because all volumetric rates are payments for the purchase of water). Accordingly, I reject Met's
32 interpretation as contrary to the legislative intent of the statute, as interpreted in *SDCWA*.

⁴⁴ San Diego correctly argues that the Exchange Agreement defines Exchange Water as Local Water, not Met Water,
except for the purposes of the price provision and the Interim Agricultural Water Program, which are not relevant

1 Pre-Trial Brief, 15-16; Met Closing Brief, 39. San Diego contends that the Exchange Agreement
2 is, in practical terms, no different from any other conveyance agreement because in any wheeling
3 agreement the party receiving the service obtains molecules of water different from those
4 initially put into the conveyance system. San Diego's Post-Trial Brief for Phase II, 39-40.
5

6 The parties have not pointed me to legislative history or other sources which would
7 explain why the Legislature excluded payments for the purchase of water from the preferential
8 rights calculation. *SDCWA*, 117 Cal.App.4th at 24 (Legislature has not defined the "excepting
9 purchase of water" terminology). The fact remains that the Legislature included all contributions
10 toward capital costs or operating expenses in the preferential rights calculation with a single
11 exception: payments for the purchase of water.
12

13 San Diego is not purchasing water from Met. San Diego is exchanging water with Met to
14 make use of its own independent supplies. PTX-65 §§ 1.1(m), 3.1-3.2, 3.6.⁴⁵ The parties agreed
15 to exchange an equal amount of water; the only water quality requirement was for Met to provide
16 San Diego with water of at least the same quality as the water Met received from San Diego.
17 These facts underscore that the Exchange Agreement was not an agreement pursuant to which
18 San Diego obtained water from Met, but instead an agreement pursuant to which Met in effect
19 conveyed water on behalf of San Diego. That the Exchange Agreement differs in some respects
20 from a wheeling contract⁴⁶ does not mean that the Exchange Agreement was not in substance an
21

22 here. San Diego Supplemental Brief, 1; PTX-65 at §§ 4.1-4.2. Exchange Water is Met water for the purposes of the
23 price provision and the Interim Agricultural Program. PTX-65 at §§ 4.1-4.2.

24 ⁴⁵ The parties' characterization of the Exchange Water does not control whether the agreement is a purchase
25 agreement for the purposes of the preferential rights statute. PTX-65 §§ 4.1-4.2.

26 ⁴⁶ Met says there are five differences. Met Closing Brief, 38-39. But it remains unclear why these differences
27 matter. The differences Met asserts are: (1) wheelers can only move water when there is available capacity, but Met
makes deliveries every month regardless of capacity on the Colorado River Aqueduct; (2) water is wheeled only
when it is available, but Met wheels water every month regardless of the amount San Diego has made available; (3)
wheelers bear carriage losses as a result of loss in transit, but Met bears the carriage loss under the Exchange
Agreement; (4) San Diego was not billed for wheeling water, but instead for purchasing water with a monetary
credit for the supply it made available; and (5) to wheel Colorado River water, San Diego would have needed a

1 agreement to convey, rather than purchase, water. San Diego's payments under the Exchange
2 Agreement must be included in the preferential rights calculation.

3
4
5 **V. Conclusion**

6 On the breach of contract claim, San Diego is entitled to \$188,295,602 plus interest.
7 Met's motion for partial judgment is denied.

8 On the preferential rights claim, San Diego is entitled to a judicial declaration (a) that
9 Met's current methodology for calculating San Diego's preferential rights violates § 135 of the
10 Metropolitan Water District Act; and (b) directing Met to include San Diego's payments for the
11 transportation of water under the Exchange Agreement in Met's calculation of San Diego's
12 preferential rights.
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16 Dated: August 28, 2015



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Curtis E.A. Karnow
Judge of The Superior Court

24 federal contract, but San Diego did not need a federal contract under the Exchange Agreement because the water
25 would be Met water. *Id.* at 38-39. Met says this demonstrates that San Diego is in effect "paying" for the water
26 with—water; making Exchange Water a water "purchase." *Id.* at 8. There can be nice distinctions between barter,
27 currency and investment, and conceivably water might have any of these roles—and in circumstances of increasing
drought, water may be a currency of the future (see *Mad Max Beyond Thunderdome* (1985),
<http://www.imdb.com/title/tt0089530/>), but there is no good reason to treat it so in this case. And as noted above,
the parties' characterization of a transaction does not control whether the transaction is a purchase for the purposes
of the preferential rights statute.

CERTIFICATE OF ELECTRONIC SERVICE
(CCP 1010.6(6) & CRC 2.260(g))

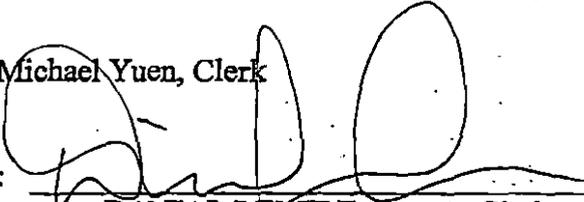
I, DANIAL LEMIRE, a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On : **AUG 28 2015**, I electronically served THE ATTACHED ORDER via File & ServeXpress on the recipients designated on the Transaction Receipt located on the File & ServeXpress website.

Dated: **AUG 28 2015**

T. Michael Yuen, Clerk

By:



DANIAL LEMIRE, Deputy Clerk

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Attachment 3
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CLERK OF THE COURT
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SUPERIOR COURT OF CALIFORNIA
COUNTY OF SAN FRANCISCO

SAN DIEGO COUNTY WATER
AUTHORITY,

Plaintiff/Petitioner,

vs.

METROPOLITAN WATER DIST. OF
SOUTHERN CALIFORNIA, et al.

Defendants/Respondents.

Case No. CFP-10-510830
Case No. CFP-12-512466

ORDER GRANTING SAN DIEGO'S
MOTION FOR PREJUDGMENT
INTEREST

I have previously found that the Metropolitan Water District of Southern California (Met) breached its Exchange Agreement with the San Diego County Water Authority (San Diego) and awarded San Diego nearly \$200 million in damages, "plus interest." Phase II Statement of Decision, 29. San Diego now moves for prejudgment interest, seeking an additional \$44,139,469.¹ I heard argument October 8, 2015.

Legal Background

Civil Code § 3287(a) provides that "[e]very person who is entitled to recover damages certain, or capable of being made certain by calculation, and the right to recover which is vested in him upon a particular day, is entitled also to recover interest thereon from that day...."

¹ San Diego initially requested \$47,277,747, but modified the request after Met pointed out a timing error. Opposition, 12-13; Reply, 1. I have further reduced this to a small extent to account for Met's further calculations. See n.8 below.

1 Section 3289 provides that when a contract “does not stipulate a legal rate of interest, the
2 obligation shall bear interest at a rate of 10 percent per annum after a breach.” The dispute here
3 centers on whether § 12.4(c) of the Exchange Agreement “stipulate[s] a legal rate of interest.”
4
5 The parties also disagree as to whether the damages awarded were “certain” or “capable of being
6 made certain.”

7 **The Agreement’s Language**

8 Section 12.4(c) of the Exchange Agreement reads:

9 In the event of a dispute over the Price, SDCWA shall pay when
10 due the full amount claimed by Metropolitan; provided, however,
11 that, during the pendency of the dispute, Metropolitan shall deposit
12 the difference between the Price asserted by SDCWA and the Price
13 claimed by Metropolitan in a separate interest bearing account. If
14 SDCWA prevails in the dispute, Metropolitan shall forthwith pay
15 the disputed amount, plus all interest earned thereon, to SDCWA.
16 If Metropolitan prevails in the dispute, Metropolitan may then
17 transfer the disputed amount, plus all interest earned thereon, into
18 any other fund or account of Metropolitan.

19 Met says § 12.4(c) establishes a legal rate for purposes of § 3289 and so the 10%
20 statutory rate does not apply. It asserts that the interest bearing account prescribed by § 12.4(c)
21 has accrued interest of \$4,156,907.46 – the maximum interest to which SDCWA could be
22 entitled. *Id.* at 2:1-3.

23 But at argument, Met explained that it had set aside less than the damages awarded.² So,
24 it has now in effect retrospectively increased the principal set aside amounts over the period of
25 the dispute to reach the awarded damages, and then Met has recalculated interest using whatever
26 interest Met had, historically, obtained on the set-side money. Thus, Met now proposes to give
27 San Diego not, as § 12.4(c) suggests, “all interest earned thereon” i.e. the interest historically

² This is not shocking. As I noted in my earlier discussion of § 12.4(c) when San Diego unsuccessfully presented it as a liquidated damages provision, there is no reason to think that money set aside under § 12.4(c) would perfectly match the damages award.

1 earned on the set-aside money, but *more* money to account for the damages which Met had *not*
2 set aside. This is the first signal that Met's proffered understanding § 12.4(c) is not correct.

3 Met argues both in its papers and at argument that that if I do not accept its reading, the
4 phrase "shall forthwith pay . . . all interest earned thereon" is meaningless. E.g., Opposition at 5.
5 I do not agree. The clauses on interest, just like the remainder of the section, as I have previously
6 interpreted it, are all designed to increase the odds that there will be money available to pay
7 damages. Just as it is wise to set aside principal for potential future damages, so too it is wise to
8 insist on an interest bearing account to account for the devaluation of money over time. Met's
9 reading is not necessary to give meaning to the terms.

10 And this leads to the central problem with Met's view. I have previously found, at Met's
11 urging, that § 12.4(c) was a security provision, not a damages provision. The provision's
12 "primary purpose . . . was to prevent either side from spending disputed funds during the
13 pendency of a dispute and to ensure that disputed funds were promptly available to the prevailing
14 party upon the resolution of a dispute." Phase II SOD at 7. One reason for this conclusion was
15 that, if read as a damages provision, SDCWA would be able to "fix extraordinarily high damages
16 through the simple expedient of *claiming* extraordinarily high damages." *Id.* The same logic
17 applies to the interest clause here.

18 Met's view is that the contract requires prejudgment interest generated on an amount that
19 may be totally different than the damages actually awarded. That's not reasonable; as I note
20 above, even Met does not so calculate interest.³

21 Met also argues that extrinsic evidence shows the parties meant this clause to reflect their
22 agreement on applicable interest. Met notes communications between the parties in 2011 and
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27 ³ That is, Met now adds more interest to account for the actual damages awarded; and I suppose, if I had awarded
less than the set-aside, Met would nevertheless not have turned over to San Diego either the full amount set
aside nor "all interest earned thereon".

1 2012 indicated that the disputed money was being set aside and would earn interest “using the
2 effective yield earned . . . on Metropolitan’s investment portfolio.” *Id.* at 7, citing Soper Decl.,
3 ¶3, Ex. B. San Diego, Met stresses, did not object to this characterization. *Id.* ⁴ San Diego retorts
4 that its failure to object to Met’s communications does not constitute “acceptance” of a
5 “stipulated rate.” Reply, 4. I agree. See e.g., *Unocal Corp. v. United States*, 222 F.3d 528, 542
6 (9th Cir. 2000) (interest rate unilaterally placed in invoice is not a stipulated legal interest rate
7 under § 3289). I agree.

8
9 Met also suggests that even if the contract is ambiguous, extrinsic evidence shows the
10 parties’ “intent that the interest to be paid would be the interest earned in the interest bearing
11 account.” Opposition at 9. But this is not so. Met’s evidence is just that it informed San Diego
12 that it would comply with § 12.4(c) by placing disputed funds in a separate account, and that San
13 Diego did not object. See Opposition at 7-8.

14 **Judicial Estoppel**

15
16 San Diego suggests Met is barred by judicial estoppel. See generally, *Jackson v. Cnty. of*
17 *Los Angeles*, 60 Cal.App.4th 171, 181 (1997); *MW Erectors, Inc. v. Niederhauser Ornamental &*
18 *Metal Works Co., Inc.* 36 Cal. 4th 412, 422 (2005). Met had previously insisted that § 12.4(c)
19 was a security deposit and did not pertain to damages at all. I agreed; § 12.4(c) only served to
20 prevent either side from spending disputed funds. But Met has not taken two positions which are
21 “totally inconsistent,” 60 Cal.App.4th at 183. It is at least conceivable that § 12.4(c) both acted to
22 secure some money towards damages *and* set forth the parties’ agreement on interest calculation.
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26 ⁴ Met also notes that San Diego’s second and third amended complaints requested interest “as a result of the express
27 term in section 12.4(c) . . .” *Id.*, citing Emanuel Dec., Ex. 4, ¶4. The same request appeared in San Diego’s June
2012 lawsuit. *Id. Nesbit v. MacDonald*, 203 Cal. 219, 222 (1928) notes “a prayer for ‘interest,’ without specifying
the rate, is deemed a prayer for legal interest” – here, set at 10 percent by statute. I do not take these allegations as
reasonable evidence that the parties had agreed to calculate interest as Met now claims.

1 But, while I do not think judicial estoppel applies to actually block Met's position now, as I have
2 noted the logic of my earlier ruling does refute it.

3 **Certainty**

4 San Diego must show that the damages I awarded were "certain, or capable of being
5 made certain" under § 3287(a). Met tells us that this means San Diego must show there was "no
6 dispute as to the computation of damages." Opposition at 9, citing *Fireman's Fund Ins. Co. v.*
7 *Allstate Ins. Co.*, 234 Cal.App.3d 1154, 1173 (1991). Because "the parties vigorously disputed
8 the computation," Met continues, there could not have been certainty. Opposition at 2. If this
9 were so, a party could avoid prejudgment interest merely by contesting damages at trial.
10

11 As San Diego notes cases distinguish between disputes over the measure of damages and
12 the absence of data necessary to allow the defendant to calculate damages. Only the latter makes
13 damages uncertain. Reply, 6. *Howard v. Am. Nat. Fire Ins. Co.*, 187 Cal.App.4th 498, 535
14 (2010) ("test for determining certainty under section 3287(a) is whether the defendant knew the
15 amount of damages owed to the claimant or could have computed that amount from reasonably
16 available information...") See also, *Collins v. City of Los Angeles*, 205 Cal.App.4th 140, 151
17 (2012).
18

19 Here I awarded exactly the amount of damages requested by San Diego. The calculation
20 was as San Diego suggested, a simple deduction of some sums from others. The calculation was
21 just "math" as Met's counsel noted.⁵ Met had all the information it needed to determine the
22 degree of the overcharges; indeed, the data came from Met. See *Chesapeake Indus., Inc. v.*
23 *Togova Enterprises, Inc.*, 149 Cal. App. 3d 901, 907 (1983) (prejudgment interest awarded if
24 defendant "from reasonably available information could ... have computed" damages). Thus
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⁵ See also TR 1913-1914 (San Diego's math correct, according to Met witness).

1 these damages were “capable of being made certain” and San Diego is entitled to prejudgment
2 interest.

3 In its papers, Met confronts San Diego with its earlier statements that damages were
4 difficult to quantify, statements made in connection with its liquidated damages argument on §
5 12.4(c). Met is accurate,⁶ but after I rejected its position San Diego changed its theory, and as
6 Met counsel agreed at argument, changes in damages theory do not demonstrate that damages
7 are uncertain.⁷

8
9 At argument Met emphasized its concerns that the damages here were uncertain in the
10 sense that they were a function of deduction of uncertain amounts of charges, that it was never
11 clear exactly what portion of certain charges could (had Met properly calculated them) be billed
12 to San Diego. Perhaps; but it was San Diego’s theory, repeated in communications to Met before
13 litigation and found in statements made during this case, that any such uncertainty was not its
14 problem; that it should not be required to pay those charges unless they were justified, that they
15 were not justified, and thus they should all be deleted from San Diego’s bill. My finding that Met
16 might have been able to justify some unknown portion of the challenged charges, but in the event
17 did not do so, is not a demonstration that the damages were uncertain. Of course Met disputed
18 both damages (including maintaining the position that the court was without power to calculate
19 them) as well as San Diego’s damage theories (not to speak of its liability theories) but not the
20 facts used to calculate the damages.
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24 ⁶ It is literally accurate to note San Diego’s argument that damages could be difficult to quantify, but the situation
25 was then more nuanced: San Diego was arguing that, *absent a liquidated damages* provision, damages could be or
26 were difficult to quantify, and so urged liquidated damages—which would have been exceedingly certain. San
27 Diego has not, I think, ever urged a theory of damages which is uncertain. See n.7.

⁷ The fact that a court might have to select among damages models does not mean the damages awarded are not
“capable of being made certain.” *Children’s Hosp. & Med. Ctr. v. Bonta*, 97 Cal. App. 4th 740, 774 (2002). San
Diego presented essentially two models, one of which I rejected; Met presented none, and each of San Diego’s
models was “capable of being made certain.”

1 The test may be focused this way: damages are not ‘certain’ when to fix damages, the
2 court is required to resolve (aside from the liability issues) “disputed facts,” *Collins v. City of Los*
3 *Angeles*, 205 Cal. App. 4th 140, 151 (2012) or “conflicting evidence,” Dennis L. Greenwald,
4 CALIFORNIA PRACTICE GUIDE: REAL PROPERTY TRANSACTIONS 11:134.2 (2014). While one can
5 imagine that I might have had to resolve disagreements on exactly how much of a rate ought to
6 have been included in San Diego’s bills (because, for example there was disagreement on how
7 much to allocate to supply (compare Met’s Opposition at 10:20)), in the event, I did not. No
8 party wanted to lead me down that path. These sorts of conflicts were avoided, and not presented
9 to me for resolution, by the parties’ approaches to damages.
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13 **Conclusion**

14 San Diego’s motion for prejudgment interest is granted. The parties agree that, using the
15 10 percent rate, the interest is \$43,415,802.⁸

16
17 Dated: October 9, 2015



18 _____
19 Curtis E.A. Karnow
20 Judge Of The Superior Court
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⁸ The parties agree that at 10% this is the minimum to which San Diego is entitled. Reply at 10:3-26.

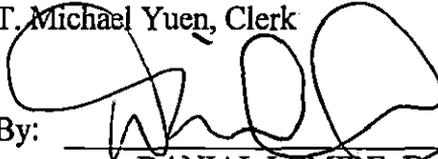
CERTIFICATE OF ELECTRONIC SERVICE
(CCP 1010.6(6) & CRC 2.260(g))

I, DANIAL LEMIRE, a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On **OCT 9 - 2015**, I electronically served THE ATTACHED DOCUMENT via File & ServeXpress on the recipients designated on the Transaction Receipt located on the File & ServeXpress website.

Dated: **OCT 9 - 2015**

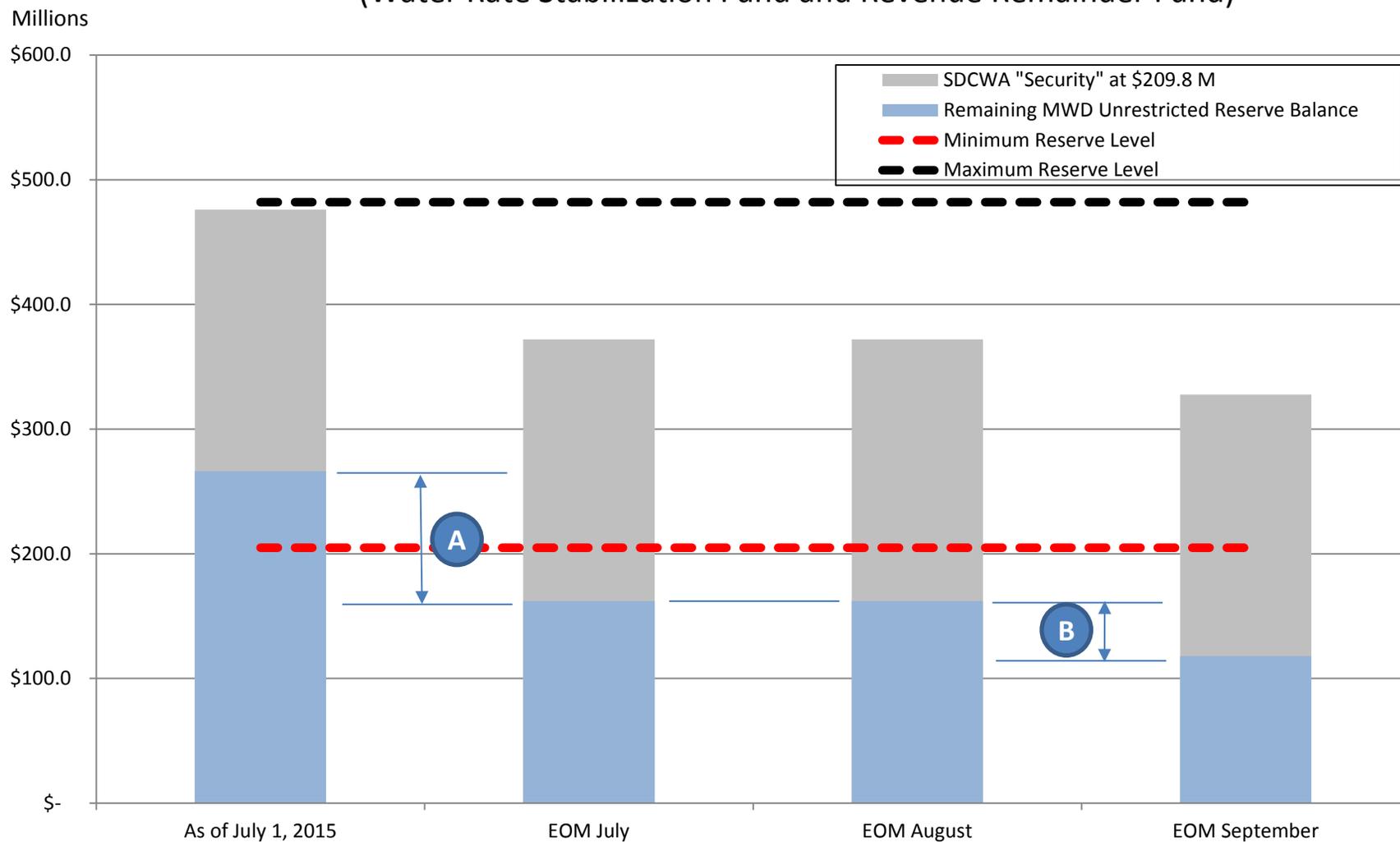
T. Michael Yuen, Clerk

By: 

DANIAL LEMIRE, Deputy Clerk

Unrestricted Reserves

(Water Rate Stabilization Fund and Revenue Remainder Fund)



A 07/14/15 - \$264 Million unbudgeted cash payment to acquire real property (\$104 million of which from unrestricted reserves).

B 09/22/15 - \$44.4 Million unbudgeted cash payment to Southern Nevada Water Authority

SUPREME COURT
FILED

Court of Appeal, Second Appellate District, Division Eight - No. B257964 APR 20 2016

S233207

Frank A. McGuire Clerk

IN THE SUPREME COURT OF CALIFORNIA

Deputy

En Banc

NEWHALL COUNTY WATER DISTRICT, Plaintiff and Respondent,

v.

CASTAIC LAKE WATER AGENCY et al., Defendants and Appellants.

The request for an order directing depublication of the opinion is denied.
The court declines to review this matter on its own motion. The matter is now
final.

Werdegar, J., was recused and did not participate.

CANTIL-SAKAUYE

Chief Justice



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Counsel

VIA HAND DELIVERY

March 21, 2016

The Honorable Chief Justice Tani G. Cantil-Sakauye
and Associate Justices of the California Supreme Court
350 McAllister Street
San Francisco, CA 94102-4797

Re: *Newhall County Water District v. Castaic Lake Water Agency*
Second Appellate District, Division Eight, Case No. B257964
Request for Depublication (Cal. Rules of Court, rule 8.1125(a)(1))

Honorable Chief Justice Cantil-Sakauye and Associate Justices:

The Metropolitan Water District of Southern California respectfully requests depublication of the opinion issued in *Newhall County Water District v. Castaic Lake Water Agency*, filed on January 19, 2016, which became final on February 18, 2016 (the "Opinion"). (See Cal. Rules of Court, rule 8.1125(a).) A copy of the Opinion is attached.

The Opinion should be depublished because it is wrong in its fundamental premise and is overly broad, giving rise to a risk of misapplication in future cases. (See Grodin, *The Depublication Practice of the California Supreme Court* (1984) 72 Cal. L.Rev. 514, 515.) First, the Opinion imposes substantive constitutional limits on the ability of wholesale water agencies to recover their costs of service, limits that are not found anywhere in the text of the California Constitution or existing case law. Specifically, purporting to apply Article XIII C, section 1 ("Proposition 26"), the Opinion would require voter approval for wholesale water rates, unless the wholesale agency proved that the rates are proportional to costs of service on a payor-by-payor basis. (Op. at 11.) This is inconsistent with the constitutional text and relevant legislative history. Second, the Opinion could be read to limit the ability of *any* water agency to fund water conservation if the water being conserved is not water provided by the agency. This conclusion is both unsupported and unnecessarily broad. (Op. at 22-23.)

Regardless of whether the Court of Appeal reached the right result in the Opinion when ruling against the wholesale agency on the record before it, its reasoning is misplaced and risks misapplication of Proposition 26 in future cases. The Opinion misinterprets and mischaracterizes the standards applicable to Proposition 26, without any legal analysis or

THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

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support. By contrast, this Court currently has before it cases which will address the appropriate constitutional standards for setting various kinds of rates pursuant to the various, applicable constitutional provisions. (See *Citizens for Fair REU Rates v. City of Redding* (2015) 233 Cal.App.4th 402, review granted, Mar. 3, 2015, 347 P.3d 89 (Cal. 2015), Cal. Sup. Ct. Case No. S224779; *City of San Buenaventura v. United Water Conservation Dist.* (2015) 235 Cal.App.4th 228, review granted, Jun. 24, 2015, 351 P.3d 228 (Cal. 2015), Cal. Sup. Ct. Case No. S226036¹; and see *Cal. Building Industry Assn. v. State Water Resources Control Bd.* (2015) review granted, Jul. 22, 2015, 352 P.3d 418 (Cal. 2015), Cal. Sup. Ct. Case No. S226753.) This Court should establish those standards—which are of statewide import, especially during this unprecedented drought—through a record of full briefing and analysis in the cases before it.

Interest of Metropolitan Water District of Southern California

Metropolitan is a public agency organized under the Metropolitan Water District Act. (Stats. 1969, ch. 209 as amended; West's California Water Code Append. §§ 109-134 (2015).) It operates as a cooperative of 26 member agencies, and each of those member agencies are themselves public agencies (12 special districts and 14 municipalities), all of which provide wholesale and/or retail water for municipal, domestic, and industrial use. (*Ibid.*) Metropolitan sells wholesale, supplemental water and provides other water services to its member agencies. Those member agencies, or their own member agencies, in turn serve nearly 19 million people throughout Southern California.

Water delivered by Metropolitan – which is then sold by the member agencies and their sub-agencies as applicable, often combined with water from local and alternative sources – makes up approximately 50% of the water consumed within Metropolitan's service area. Residents and businesses within the service area that do not consume water originating from Metropolitan also benefit from the availability of Metropolitan's water supplies, conservation efforts, and conveyance and distribution system. Indeed, in times of drought, Metropolitan's role as a supplemental water wholesaler is particularly critical, as its member agencies rely on Metropolitan storage and distribution system when local or alternative supplies are unavailable or restricted.

The rates Metropolitan charges its member agencies have been challenged under Proposition 26, and Metropolitan denies its applicability to its rates.² Thus, Metropolitan, like

¹ This Court granted Metropolitan's application to file an *amicus* brief in Case No. S226036 and deemed its brief filed on November 23, 2015.

² Metropolitan contends that its rates – which are wholesale rates for supplemental water services, set by a Board of Directors comprised entirely of representatives of Metropolitan's only customers, its member agencies – are not governed by either Propositions 26 or 218. Its rates,

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many water agencies, has an interest in ensuring proper and clear interpretations of Proposition 26. Additionally, as a water agency with a legislative mandate to increase conservation and local water resource development, Metropolitan has an interest in avoiding the misapplication of the Opinion's restrictive view of the manner in which an agency may recover conservation costs.

Summary of the Opinion

At issue in the Opinion is a wholesale water rate charged by Castaic Lake Water Agency ("Castaic"). (Op. at 2-3.) Castaic imports water from the State Water Project pursuant to its participation in the State Water Project system, and provides wholesale water service to four customers.³ (Op. at 5.) In addition, Castaic has statutory authority to manage the groundwater basin in its service area, though it does not own or provide groundwater, and its authority to regulate groundwater use requires prior approval by major groundwater pumpers, including Castaic's four customer agencies. (Op. at 5-6.)

In 2013, Castaic's Board changed the manner in which it charged its customers for imported water service. Castaic previously recovered all of its costs through a 100% volumetric rate. In 2013, its Board adopted a new rate structure to recover 80% of its costs through a fixed charge on each of its four customers. (Op. at 7-8.) Castaic represented that the purpose of the new fixed charge was (1) to encourage conservation and conjunctive use; (2) to ensure that Castaic had sufficient standby capacity to serve future water needs in its jurisdiction; and (3) to increase stability and ensure sufficient revenue to cover the long-term costs of maintaining Castaic's water-delivery system. (Op. at 7-8.)

One of the customer agencies, Newhall County Water District ("Newhall"), challenged the new fixed charge, because it was "based on each retailer's three-year rolling average of total water demand" (including imported water purchased from Castaic and groundwater customers pumped from the groundwater basin). (*Id.* at p. 9-10.) Newhall claimed that this rate structure violated Proposition 26, and the Superior Court and Court of Appeal agreed.

however, *are* governed by the common law reasonableness standard applicable to ratemaking, with which it has complied.

³ The State Water Project is part of the California Water Plan, "a comprehensive master plan for California's present and future water conservation, distribution, and utilization. The components of the Plan include the state water project, together with both federal and local developments" (collectively referred to as the State Water Resources Development System). (*Goodman v. County of Riverside* (1983) 140 Cal.App.3d 900, 903; see also Wat. Code, §12937.) The State Water Project is financed through contracts that require the contracting agency to make regular payments for all costs associated with the SWP, "in return for participation in the System." (*Id.* at p. 903-904.) Metropolitan is also a participant in the SWP.

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To reach this conclusion, the Court of Appeal first held Castaic's charges are subject to Proposition 26 and are "taxes," unless exempted as "[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." (Op. at 11, citing Cal. Const., art.⁴ XIII C, § 1, subd. (e)(2), emphasis added.)⁵ Rather than determine whether Castaic's rates constituted "reasonable costs," however, the Court of Appeal applied a stricter individual "proportionality requirement" derived from another constitutional provision, Article XIII D, section 6 which limits imposition of certain kinds of property-related fees. (Op. at 11, 17.) The Opinion contains no explanation for treating each of the constitutional provisions and their standards interchangeably. Thus, the Opinion also lacks any analysis for its reasons for deviating from the reasonableness standards applied by this Court in *California Farm Bureau Federation v. State Water Resources Control Board* (2011) 51 Cal.4th 421, 438 and the Sixth District of the Court of Appeal in *Griffith v. City of Santa Cruz* (2012) 207 Cal.App.4th 982 ("*Griffith*"), which hold otherwise.

The Opinion Wrongly Creates Restrictions Not Found in Proposition 26

The Court of Appeal's reasoning in the Opinion misstates Proposition 26 and risks misapplication to rate challenges in future cases; likely to result in unfounded invalidation of legitimate user fees. In the Opinion, the Court of Appeal wrongly imports the payor-proportionality standards of Article XIII D when evaluating Castaic's rates under Proposition 26. Article XIII D and Proposition 26 are not duplicates of each other. They each apply to different types of taxes, fees, and charges, and contain different language and requirements specific to their objective. Thus, whether a charge is subject to either provision is a question that must be analyzed pursuant to the specific language therein. The purpose of doing so is not to undertake an academic exercise; it is to ensure that each type of government levy or charge is subjected only to the requirements and restrictions intended by the voters. Otherwise, imperative government functions, such as the provision of water services, may be inadvertently disrupted by unnecessarily onerous and baseless requirements.

Article XIII D, passed by the voters in 1996 as part of Proposition 218, relates to fees imposed on real property and other property interests. It established procedural and substantive requirements and limitations on fees or charges imposed directly or indirectly on property

⁴ All references to "articles" or "art." are to the articles of the California Constitution, unless otherwise noted.

⁵ Notably, Proposition 26 includes seven exemptions to its definition of tax—some of which are tied to government costs and some of which are not. (Cal. Const., art. XIII C, § 1, subd. (e)(1)-(7).) In this case, however, the trial court does not appear to have considered any exemption other than the "service or product" exemption. (Op. at 11-12.)

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(through assessments and property-related fees). Amongst its substantive limitations, Article XIII D expressly requires cost proportionality *by parcel*. (Cal. Const., art. XIII D, §§4, subd. (a), 6, subd. (b)(3); see also *Schmeer v. County of Los Angeles* (2013) 213 Cal.App.4th 1310, 1317, 1319-1320 (“*Schmeer*”).) Individual proportionality is specific to exactions on real property and no historical or legal reasoning exists for extrapolating the requirement from Article XIII D into Proposition 26. Nevertheless, that is what the Opinion does – without any explanation or reasoning. (Op. at 11.) The result is the erroneous requirement that user fees for government services or products must meet a strict cost proportionality test to avoid the voting requirement for taxes. That was not the intent of the voters when they passed Proposition 26.

The voters passed Proposition 26 in 2010 to clarify the distinction between fees intended to fund government programs of general benefit and those “payor-specific” fees that fund governmental functions necessitated or connected to the payor in some way. (See *Schmeer, supra*, 213 Cal.App.4th at 1322. [Proposition 26 was passed “largely [as] a response to *Sinclair*,”⁶ a case holding user fees on paint companies are really taxes when used to fund programs of benefit to the public at large].) According to the proponents of the Proposition, fees imposed on a certain group to fund programs of general benefit are “hidden taxes” and should be treated as such. To achieve its purpose of subjecting “hidden taxes” to a voting requirement, Proposition 26 added a broad definition of “taxes” at article XIII C⁷ to encompass “any levy, charge, or exaction of any kind imposed by a local government.” (Cal. Const., art. XIII C, §1, subd. (e).) However, Proposition 26 also added seven exemptions to the definition, including an exemption for user fees for a government service or product, “which does not exceed the reasonable costs to the local government of providing the service or product.” (Cal. Const., art. XIII C, §1, (e)(2), emphasis added.) Other exemptions included fees for use of government property, regulatory fees, and fines for violations of law. (Cal. Const., art. XIII C, §1, (e)(3)-(5).)

Thus, Article XIII D expressly limits property-related fees to those that are proportional to the related benefits received by and the costs of providing service to the encumbered parcels. (Cal. Const., art. XIII D, § 6, subd. (b)(3).) By contrast, Proposition 26 limits fees for government service or products to those designed to recover the reasonable cost of providing the service in the aggregate. (See Cal. Const., art. XIII C, § 6, subd. (e)(2); *Griffith, supra*, 207 Cal.App.4th at 997.) The Opinion’s application of cost/benefit proportionality from Article XIII D to the government service or production exemption under Proposition 26 was, thus, inconsistent with the plain language of the constitutional provision it purported to apply. And that plain language should have been the primary basis for construing Proposition 26. (See *Lungren v. Deukmejian* (1988) 45 Cal.3d 727, 735.)

⁶ Referring to *Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866.

⁷ Proposition 26 also added a definition of “taxes” at Article XIII A for purposes of state taxes, not relevant to the present discussion.

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If and only if a court believes the language of a constitutional provision is ambiguous, however, it can look to voter intent, as illustrated by the supporting ballot materials, to determine its meaning. (*Legislature v. Eu* (1991) 54 Cal.3d 492, 504.) But Proposition 26's legislative history also counsels against the Opinion's unsupported conclusion here. As the Proposition 26 ballot pamphlet establishes, the voters intended for the exemptions to encompass most user fees that had always legitimately funded governmental functions provided to those who pay those fees. (See Ballot Pamp., Gen. Elec., Nov. 2, 2010,⁸ argument in favor, at p. 60, and Legislative Analysis at p. 58 ("Some Fees and Charges Are Not Affected. The change in the definition of taxes would not affect most user fees ..."); see also Cal. Const., art. XIII C, § 1, subd. (e)(1) – (7).) Although the voters sought to redefine local "taxes" to add the constitutional voting requirement to charges imposed by local agencies for services or government activity unrelated to the payor, the voters approved exemptions for payor-specific charges they believed would "Not [be] affected" by Proposition 26. (*Ibid.*) Indeed, the exemptions incorporate "nearly verbatim" the common law test for each type of user fee existing prior to Proposition 26. (See *Griffith, supra*, 207 Cal.App.4th at p. 996 [noting incorporation of common law standard for regulatory fees into (e)(3)]).

User fees for government services or products, such as the fees at issue in the Opinion, are the types of legitimate government fees the voters intended to leave unaffected. When voters passed Proposition 26, courts had never found the measure of reasonableness for user fees to be synonymous with the individual cost proportionality requirements of Article XIII D.⁹ Instead, user fees had been subject to a reasonableness standard measured by the collective costs and benefits of a service. (See *e.g., Rincon Del Diablo Water Dist. v. San Diego County Water Authority* (2004) 121 Cal.App.4th 813, 822-823 [applying a collective measure to evaluate the reasonableness of a user fee].) The Opinion does not, however, apply this correct measure of "reasonableness" for government service or product user fees. (See Op. at 11.) It applies the

⁸ Available at <http://voterguide.sos.ca.gov/past/2010/general/propositions/26/index.htm>

⁹ Although courts have held that fees and charges for retail water service and other *property-related* service are subject to Proposition 218; wholesale water and user fees, for example, unrelated to real property were not previously subject to Proposition 218 or considered a tax. (See *Arcade County Water Dist. v. Arcade Fire Dist* (1970) 6 Cal.App.3d 232, 240 ["characterization of [water] charges as a 'tax' is unfounded. A charge for services rendered is in no sense a tax"], citing *City of Oakland v. E.K. Wood Lumber Co* (1930) 211 Cal. 16, 25 [charge for service provided by government agency is not a tax imposed pursuant to police or other government power], superseded by statute at Gov. Code on other ground, § 53069.9; *Bighorn-Desert View Water Agency v. Verjil* (2006) 39 Cal. 4th 205, 216 [retail water service to real property is subject to Article XIII D, § 6 (added by Proposition 218), because the charges are imposed as an incident of property ownership]; *Griffith v. Pajaro Valley Water Mgmt Agency* (2013) 220 Cal.App.4th 586, 594 [groundwater pumping charge subject to Art. XIII D, § 6].

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Article XIII D individual proportionality test and does so only by citing a portion of the last unnumbered paragraph of Proposition 26. (*Ibid.*) The last unnumbered paragraph of Section 1(e) in Proposition 26 shifts the burden to the agency to prove the requirements or standards in the applicable exemption(s) (which vary depending on the exemption), but does not *add* requirements to each exemption. (Cal. Const., art. XIII C, §1, subd. (e), last unnumbered par.) Thus, the Opinion incorrectly requires agencies to establish cost allocation for user fees only previously applied to regulatory fees, without support. (See Op. at 11; see also *California Farm Bureau Fed'n v. State Water Res. Control Bd.* (2011) 51 Cal. 4th 421, 438-439 (“*Cal. Farm Bureau*”) [applying “nearly verbatim” the cost allocation language in the last unnumbered paragraph of §1(e) to regulatory fees – not user fees – and doing so also pursuant to a collective measure].)

As this Court has held, that reasonableness standard shall not be interpreted to mean a fee must be proportional to individual payors. (*Cal. Farm Bureau, supra*, 51 Cal.4th at p. 438.) “Rather, [reasonableness] is measured collectively considering all payors.” (*Ibid.*) Thus, user fees exempted under Section 1(e)(2) of Proposition 26 must remain unaffected as legitimate government fees and measured against a collective reasonableness standard. The Opinion’s unsupported conclusion that they may instead be measured against the individual cost proportionality of Proposition 218 should not stand.

**The Opinion Wrongly Creates a Restriction on Water Agencies’
Ability to Fund Conservation Measures Under Proposition 26 on the
Basis of an Incomplete Argument and Record**

The Opinion’s application of Proposition 26 to Castaic’s conservation efforts is also without support in the law and could be misconstrued in future cases to limit sharply the ability of water agencies to fund conservation efforts.

Purporting to apply Proposition 26, the Court of Appeal rejected Castaic’s argument that basing its fixed charge on customer agencies’ use of groundwater would encourage conjunctive use of water and conservation of the groundwater supply. (Op. at 20-23.) The court found that Castaic *could* structure its rates to encourage conservation of *imported* water, but only if it had authority to encourage conservation of groundwater it did not supply. (Op. at 21, citing Wat. Code, § 375, *City of Palmdale v. Palmdale Water Dist.* (2011) 198 Cal.App.4th 926, 936-937 (“*City of Palmdale*”).) This limit on conservation funding finds no basis in the law.

Certainly, nothing in the text or legislative history of Proposition 26 supports the conclusion. Water Code section 375 *authorizes* water agencies to establish programs to conserve their own water supplies; it does not limit or prohibit other kinds of conservation programs established by statute. And *City of Palmdale* merely held that water agencies’ obligation to

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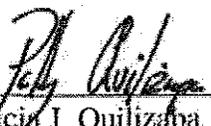
conserve water under Article X, section 2 of the California Constitution does not trump their obligation to set rates consistent with constitutional limitations. (*City of Palmdale, supra*, (2011) 198 Cal.App.4th at p. 936-937.) There is no justification for the distinction the court appears to have drawn here.

The primary justification for the court's apparently broad conclusion was the apparently inadequate argumentation and record evidence supporting Castaic's position. This is unquestionably a legitimate basis for the court to rule against Castaic, individually, in the course of a single rate challenge. But the court's analysis could be read much more broadly as establishing a bright-line rule in future cases. Public agencies should not have their funding options limited as a result of perceived defects in Castaic's presentation in an individual case.

CONCLUSION

As set forth herein, the Opinion contains unnecessarily expansive and incorrect statements of law. The Opinion expands the reach of Proposition 26 beyond both its express terms and the intent of the voters who adopted it. If permitted to remain published, the Opinion will invite ever-greater intervention by courts into the complex process of setting water rates, without the required constitutional authority. Accordingly, Metropolitan asks that the Court depublish the Opinion to avoid its misapplication in future cases.

Respectfully submitted,
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Filed 1/19/16

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION EIGHT

NEWHALL COUNTY WATER
DISTRICT,

Plaintiff and Respondent,

v.

CASTAIC LAKE WATER AGENCY et
al.,

Defendants and Appellants.

B257964

(Los Angeles County
Super. Ct. No. BS142690)

APPEAL from a judgment of the Superior Court for the County of Los Angeles.
James C. Chalfant, Judge. Affirmed.

Best Best & Krieger, Jeffrey V. Dunn, and Kimberly E. Hood for Defendants and
Appellants.

Colantuono, Highsmith & Whatley, Michael G. Colantuono, David J. Ruderman,
Jon R. di Cristina; Lagerlof, Senecal, Gosney & Kruse and Thomas S. Bunn III for
Plaintiff and Respondent.

SUMMARY

Plaintiff Newhall County Water District (Newhall), a retail water purveyor, challenged a wholesale water rate increase adopted in February 2013 by the board of directors of defendant Castaic Lake Water Agency (the Agency), a government entity responsible for providing imported water to the four retail water purveyors in the Santa Clarita Valley. The trial court found the Agency's rates violated article XIII C of the California Constitution (Proposition 26). Proposition 26 defines any local government levy, charge or exaction as a tax requiring voter approval, unless (as relevant here) it is 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." (Cal. Const., art. XIII C, § 1, subd. (e)(2).)¹

The challenged rates did not comply with this exception, the trial court concluded, because the Agency based its wholesale rate for imported water in substantial part on Newhall's use of groundwater, which was not supplied by the Agency. Consequently, the wholesale water cost allocated to Newhall did not, as required, "bear a fair or reasonable relationship to [Newhall's] burdens on, or benefits received from, the [Agency's] activity." (Art. XIII C, § 1, subd. (e), final par.)

We affirm the trial court's judgment.

FACTS

We base our recitation of the facts in substantial part on the trial court's lucid descriptions of the background facts and circumstances giving rise to this litigation.

1. The Parties

The Agency is a special district and public agency of the state established in 1962 as a wholesale water agency to provide imported water to the water purveyors in the Santa Clarita Valley. It is authorized to acquire water and water rights, and to provide, sell and deliver that water "at wholesale only" for municipal, industrial, domestic and

¹ All further references to any "article" are to the California Constitution.

other purposes. (Wat. Code Appen., § 103-15.) The Agency supplies imported water, purchased primarily from the State Water Project, to four retail water purveyors, including Newhall.

Newhall is also a special district and public agency of the state. Newhall has served its customers for over 60 years, providing treated potable water to communities near Santa Clarita, primarily to single family residences. Newhall owns and operates distribution and transmission mains, reservoirs, booster pump stations, and 11 active groundwater wells.

Two of the other three retail water purveyors are owned or controlled by the Agency: Santa Clarita Water Division (owned and operated by the Agency) and Valencia Water Company (an investor-owned water utility controlled by the Agency since December 21, 2012). Through these two retailers, the Agency supplies about 83 percent of the water demand in the Santa Clarita Valley. The Agency's stated vision is to manage all water sales in the Santa Clarita Valley, both wholesale and retail.

The fourth retailer is Los Angeles County Waterworks District No. 36 (District 36), also a special district and public agency, operated by the County Department of Public Works. It is the smallest retailer, accounting for less than 2 percent of the total water demand.

2. Water Sources

The four retailers obtain the water they supply to consumers from two primary sources, local groundwater and the Agency's imported water.

The only groundwater source is the Santa Clara River Valley Groundwater Basin, East Subbasin (the Basin). The Basin is comprised of two aquifer systems, the Alluvium and the Saugus Formation. This groundwater supply alone cannot sustain the collective demand of the four retailers. (The Basin's operational yield is estimated at 37,500 to 55,000 acre-feet per year (AFY) in normal years, while total demand was projected at 72,343 AFY for 2015, and 121,877 AFY in 2050.)

The groundwater basin, so far as the record shows, is in good operating condition, with no long-term adverse effects from groundwater pumping. Such adverse effects

(known as overdraft) could occur if the amount of water extracted from an aquifer were to exceed the amount of water that recharges the aquifer over an extended period. The retailers have identified cooperative measures to be taken, if needed, to ensure sustained use of the aquifer. These include the continued “conjunctive use” of imported supplemental water and local groundwater supplies, to maximize water supply from the two sources. Diversity of supply is considered a key element of reliable water service during dry years as well as normal and wet years.

In 1997, four wells in the Saugus Formation were found to be contaminated with perchlorate, and in 2002 and 2005, perchlorate was detected in two wells in the Alluvium. All the wells were owned by the retailers, one of them by Newhall. During this period, Newhall and the two largest retailers (now owned or controlled by the Agency) increased their purchases of imported water significantly.

3. Use of Imported Water

Until 1987, Newhall served its customers relying only on its groundwater rights.² Since 1987, it has supplemented its groundwater supplies with imported water from the Agency.

The amount of imported water Newhall purchases fluctuates from year to year. In the years before 1998, Newhall’s water purchases from the Agency averaged 11 percent of its water demand. During the period of perchlorate contamination (1998-2009), its imported water purchases increased to an average of 52 percent of its total demand. Since then, Newhall’s use of imported water dropped to 23 percent, and as of 2012,

² Newhall has appropriative water rights that arise from California’s first-in-time-first-in-right allocation of limited groundwater supplies. (See *El Dorado Irrigation Dist. v. State Water Resources Control Board* (2006) 142 Cal.App.4th 937, 961 [“ [T]he appropriation doctrine confers upon one who actually diverts and uses water the right to do so provided that the water is used for reasonable and beneficial uses and is surplus to that used by riparians or earlier appropriators.”]; *City of Barstow v. Mojave Water Agency* (2000) 23 Cal.4th 1224, 1241 [“ As between appropriators, . . . the one first in time is the first in right, and a prior appropriator is entitled to all the water he needs, up to the amount he has taken in the past, before a subsequent appropriator may take any [citation].”].)

Newhall received about 25 percent of its total water supply from the Agency. The overall average since it began to purchase imported water in 1987, Newhall tells us, is 30 percent.

The other retailers, by contrast, rely more heavily on the Agency's imported water. Agency-owned Santa Clarita Water Division is required by statute to meet at least half of its water demand using imported water. (See Wat. Code Appen., § 103-15.1, subd. (d).) Agency-controlled Valencia Water Company also meets almost half its demand with imported water.

4. The Agency's Related Powers and Duties

As noted above, the Agency's primary source of imported water is the State Water Project. The Agency purchases that water under a contract with the Department of Water Resources. The Agency also acquires water under an acquisition agreement with the Buena Vista Water Storage District and the Rosedale-Rio Bravo Water Storage District, and other water sources include recycled water and water stored through groundwater banking agreements. Among the Agency's powers are the power to "[s]tore and recover water from groundwater basins" (Wat. Code Appen., § 103-15.2, subd. (b)), and "[t]o restrict the use of agency water during any emergency caused by drought, or other threatened or existing water shortage, and to prohibit the wastage of agency water" (§ 103-15, subd. (k)).

In addition, and as pertinent here, the Agency may "[d]evelop groundwater management plans within the agency which may include, without limitation, conservation, overdraft protection plans, and groundwater extraction charge plans" (Wat. Code Appen., § 103-15.2, subd. (c).) The Agency has the power to implement such plans "subject to the rights of property owners and with the approval of the retail water purveyors and other major extractors of over 100 acre-feet of water per year." (*Ibid.*)

In 2001, the Legislature required the Agency to begin preparation of a groundwater management plan, and provided for the formation of an advisory council consisting of representatives from the retail water purveyors and other major extractors.

(Wat. Code Appen., § 103-15.1, subd. (e)(1)&(2)(A).) The Legislature required the Agency to “regularly consult with the council regarding all aspects of the proposed groundwater management plan.” (*Id.*, subd. (e)(2)(A).)

Under this legislative authority, the Agency spearheaded preparation of the 2003 Groundwater Management Plan for the Basin, and more recently the 2010 Santa Clarita Valley Urban Water Management Plan. These plans were approved by the retailers, including Newhall.

The 2003 Groundwater Management Plan states the overall management objectives for the Basin as: (1) development of an integrated surface water, groundwater, and recycled water supply to meet existing and projected demands for municipal, agricultural and other water uses; (2) assessment of groundwater basin conditions “to determine a range of operational yield values that will make use of local groundwater conjunctively with [State Water Project] and recycled water to avoid groundwater overdraft”; (3) preservation of groundwater quality; and (4) preservation of interrelated surface water resources. The 2010 Santa Clarita Valley Urban Water Management Plan, as the trial court described it, is “an area-wide management planning tool that promotes active management of urban water demands and efficient water usage by looking to long-range planning to ensure adequate water supplies to serve existing customers and future demands”

5. The Agency’s Wholesale Water Rates

The board of directors of the Agency fixes its water rates, “so far as practicable, [to] result in revenues that will pay the operating expenses of the agency, . . . provide for the payment of the cost of water received by the agency under the State Water Plan, provide for repairs and depreciation of works, provide a reasonable surplus for improvements, extensions, and enlargements, pay the interest on any bonded debt, and provide a sinking or other fund for the payment of the principal of that bonded debt”

(Wat. Code Appen., § 103-24, subd. (a).) The Agency’s operating costs include costs for management, administration, engineering, maintenance, water quality compliance, water resources, water treatment operations, storage and recovery programs, and studies.

Before the rate changes at issue here, the Agency had a “100 percent variable” rate structure. That means it charged on a per acre-foot basis for the imported water sold, known as a “volumetric” rate. Thus, as of January 1, 2012, retailers were charged \$487 per acre-foot of imported water, plus a \$20 per acre-foot charge for reserve funding.

Because of fluctuations in the demand for imported water (such as during the perchlorate contamination period), the Agency’s volumetric rates result in fluctuating, unstable revenues. The Agency engaged consultants to perform a comprehensive wholesale water rate study, and provide recommendations on rate structure options. The objective was a rate structure that would provide revenue sufficiency and stability to the Agency, provide cost equity and certainty to the retailers, and enhance conjunctive use of the sources of water supply and encourage conservation. As the Agency’s consultants put it, “[t]wo of the primary objectives of cost of service water rates are to ensure the utility has sufficient revenue to cover the costs of operating and maintaining the utility in a manner that will ensure long term sustainability and to ensure that costs are recovered from customers in a way that reflects the demands they place on the system.”

The general idea was a rate structure with both volumetric and fixed components. Wholesale rate structures that include both a fixed charge component (usually calculated to recover all or a portion of the agency’s fixed costs of operating, maintaining and delivering water) and a volumetric component (generally calculated based on the cost of purchased water, and sometimes including some of the fixed costs) are common in the industry.

6. The Challenged Rates

The Agency’s consultants presented several rate structure options. In the end, the option the Agency chose (the challenged rates) consisted of two components. The first component is a fixed charge based on each retailer’s three-year rolling average of total water demand (that is, its demand for the Agency’s imported water *and* for groundwater not supplied by the Agency). This fixed charge is calculated by “divid[ing] the Agency’s total fixed revenue for the applicable fiscal year . . . by the previous three-year average of total water demand of the applicable Retail Purveyor to arrive at a unit cost per acre

foot.” The Agency would recover 80 percent of its costs through the fixed component of the challenged rates. The second component of the Agency’s rate is a variable charge, based on a per acre foot charge for imported water.³

The rationale for recovering the Agency’s fixed costs in proportion to the retailers’ total water demand, rather than their demand for imported water, is this (as described in the consultants’ study):

“This rate structure meets the Agency’s objective of promoting resource optimization, conjunctive use, and water conservation. Since the fixed cost is allocated on the basis of each retail purveyor’s total demand, if a retail purveyor conserves water, then its fixed charge will be reduced. Additionally, allocating the fixed costs based on total water demand recognizes that imported water is an important standby supply that is available to all retail purveyors, and is also a necessary supply to meet future water demand in the region, and that there is a direct nexus between groundwater availability and imported water use – i.e., it allocates the costs in a manner that bears a fair and reasonable relationship to the retail purveyors’ burdens on and benefits from the Agency’s activities in ensuring that there is sufficient water to meet the demands of all of the retail purveyors and that the supply sources are responsibly managed for the benefits of all of the retail purveyors.”

The rationale continues: “Moreover, the Agency has taken a leadership role in maintaining the health of the local groundwater basin by diversifying the Santa Clarita Valley’s water supply portfolio, as demonstrated in the 2003 Groundwater Management Plan and in resolving perchlorate contamination of the Saugus Formation aquifer. Thus, since all retail purveyors benefit from imported water and the Agency’s activities, they should pay for the reasonable fixed costs of the system in proportion to the demand (i.e.

³ There was also a \$20 per acre foot reserve charge to fund the Agency’s operating reserves, but the Agency reports in its opening brief that it suspended implementation of that charge as of July 1, 2013, when reserve fund goals were met earlier than anticipated.

burdens) they put on the total water supply regardless of how they utilize individual sources of supply.”

The Agency’s rate study showed that, during the first year of the challenged rates (starting July 1, 2013), Newhall would experience a 67 percent increase in Agency charges, while Agency controlled retailers Valencia Water Company and Santa Clarita Water Division would see reductions of 1.9 percent and 10 percent, respectively. District 36 would have a 0.8 percent increase. The rate study also indicated that, by 2050, the impact of the challenged rates on Newhall was expected to be less than under the then-current rate structure, while Valencia Water Company was expected to pay more.

Newhall opposed the challenged rates during the ratemaking process. Its consultant concluded the proposed structure was not consistent with industry standards; would provide a nonproportional, cross-subsidization of other retailers; and did not fairly or reasonably reflect the Agency’s costs to serve Newhall. Newhall contended the rates violated the California Constitution and other California law. It proposed a rate structure that would base the Agency’s fixed charge calculation on the annual demand for imported water placed on the Agency by each of its four customers, using a three-year rolling average of past water deliveries to each retailer.

In February 2013, the Agency’s board of directors adopted the challenged rates, effective July 1, 2013.

7. This Litigation

Newhall sought a writ of mandate directing the Agency to rescind the rates, to refund payments made under protest, to refrain from charging Newhall for its imported water service “with respect to the volume of groundwater Newhall uses or other services [the Agency] does not provide Newhall,” and to adopt a new, lawful rate structure. Newhall contended the rates were not proportionate to Newhall’s benefits from, and burdens on, the Agency’s service, and were therefore invalid under Proposition 26, Proposition 13, Government Code section 54999.7, and the common law of utility ratemaking.

The trial court granted Newhall's petition, finding the rates violated Proposition 26. The court concluded the Agency had no authority to impose rates based on the use of groundwater that the Agency does not provide, and that conversely, Newhall's use of its groundwater rights does not burden the Agency's system for delivery of imported water. Thus the rates bore no reasonable relationship to Newhall's burden on, or benefit received from, the Agency's service. The trial court also found the rates violated Government Code section 54999.7 (providing that a fee for public utility service "shall not exceed the reasonable cost of providing the public utility service" (Gov. Code, § 54999.7, subd. (a)), and violated common law requiring utility charges to be fair, reasonable and proportionate to benefits received by ratepayers. The court ordered the Agency to revert to the rates previously in effect until the adoption of new lawful rates, and ordered it to refund to Newhall the difference between the monies paid under the challenged rates and the monies that would have been paid under the previous rates.

Judgment was entered on July 28, 2014, and the Agency filed a timely notice of appeal.

DISCUSSION

The controlling issue in this case is whether the challenged rates are a tax or a fee under Proposition 26.

1. The Standard of Review

We review de novo the question whether the challenged rates comply with constitutional requirements. (*Griffith v. City of Santa Cruz* (2012) 207 Cal.App.4th 982, 989-990 (*Griffith I.*)) We review the trial court's resolution of factual conflicts for substantial evidence. (*Morgan v. Imperial Irrigation District* (2014) 223 Cal.App.4th 892, 916.)

2. The Governing Principles

All taxes imposed by any local government are subject to voter approval. (Art. XIII C, § 2.) Proposition 26, adopted in 2010, expanded the definition of a tax. A "tax" now includes "any levy, charge, or exaction of any kind imposed by a local government,"

with seven exceptions. (*Id.*, § 1, subd. (e).) This case concerns one of those seven exceptions.

Under Proposition 26, the challenged rates are not a tax, and are not subject to voter approval, if they are “[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.” (Art. XIII C, § 1, subd. (e)(2).) The Agency “bears the burden of proving by a preponderance of the evidence” that its charge “is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor’s burdens on, or benefits received from, the governmental activity.” (*Id.*, subd. (e), final par.)

3. This Case

It is undisputed that the Agency’s challenged rates are designed “to recover all of its fixed costs via a fixed charge,” and not to generate surplus revenue. Indeed, Newhall recognizes the Agency’s right to impose a fixed water-rate component to recover its fixed costs. The dispute here is whether the fixed rate component may be based in significant part on the purchaser’s use of a product – groundwater – not provided by the Agency.

We conclude the Agency cannot, consistent with Proposition 26, base its wholesale water rates on the retailers’ use of groundwater, because the Agency does not supply groundwater. Indeed, the Agency does not even have the statutory authority to regulate groundwater, without the consent of the retailers (and other major groundwater extractors). As a consequence, basing its water rates on groundwater it does not provide violates Proposition 26 on two fronts.

First, the rates violate Proposition 26 because the method of allocation does not “bear a fair or reasonable relationship to the payor’s burdens on, or benefits received from,” the Agency’s activity. (Art. XIII C, § 1, subd. (e), final par.) (We will refer to this as the reasonable cost allocation or proportionality requirement.)

Second, to the extent the Agency relies on its groundwater management activities to justify including groundwater use in its rate structure, the benefit to the retailers from those activities is at best indirect. Groundwater management activities are not a “service . . . provided directly to the payor that is not provided to those not charged” (art. XIII C, § 1, subd. (e)(2)), but rather activities that benefit the Basin as a whole, including other major groundwater extractors that are not charged for those services.

For both these reasons, the challenged rates cannot survive scrutiny under Proposition 26. The Agency resists this straightforward conclusion, proffering two principal arguments, melded together. The first is that the proportionality requirement is measured “collectively,” not by the burdens on or benefits received by the individual purveyor. The second is that the “government service or product” the Agency provides to the four water retailers consists not just of providing wholesale water, but also of “managing the Basin water supply,” including “management . . . of the Basin’s groundwater.” These responsibilities, the Agency argues, make it reasonable to set rates for its wholesale water service by “tak[ing] into account the entire Valley water supply portfolio and collective purveyor-benefits of promoting conjunctive use, not just the actual amount of Agency imported water purchased by each Purveyor”

Neither claim has merit, and the authorities the Agency cites do not support its contentions.

a. *Griffin I* and the proportionality requirement

It seems plain to us, as it did to the trial court, that the demand for a product the Agency does not supply – groundwater – cannot form the basis for a reasonable cost allocation method: one that is constitutionally required to be proportional to the benefits the rate payor receives from (or the burden it places on) the Agency’s activity. The Agency’s contention that it may include the demand for groundwater in its rate structure because the proportionality requirement is measured “collectively,” not by the burdens on or benefits to the individual retail purveyor, is not supported by any pertinent authority.

In contending otherwise, the Agency relies on, but misunderstands, *Griffith I* and other cases stating that proportionality “is not measured on an individual basis,” but

rather “ ‘collectively, considering all rate payors,’ ” and “ ‘need not be finely calibrated to the precise benefit each individual fee payor might derive.’ ” (*Griffith I, supra*, 207 Cal.App.4th at p. 997, quoting *California Farm Bureau Federation v. State Water Resources Control Bd.* (2011) 51 Cal.4th 421, 438 [discussing regulatory fees under the Water Code and Proposition 13].) As discussed *post*, these cases do not apply here, for one or more reasons. *Griffith I* involves a different exemption from Proposition 26, and other cases involve Proposition 218, which predated Proposition 26 and has no direct application here. In addition to these distinctions – which do make a difference – the cases involved large numbers of payors, who could rationally be (and were) placed in different usage categories, justifying different fees for different classes of payors.

In *Griffith I*, the defendant city imposed an annual inspection fee for all residential rental properties in the city. The court rejected a claim that the inspection fee was a tax requiring voter approval under Proposition 26. (*Griffith I, supra*, 207 Cal.App.4th at p. 987.) *Griffith I* involves another of the seven exemptions in Proposition 26, the exemption for regulatory fees – charges imposed for the regulatory costs of issuing licenses, performing inspections, and the like. (Art. XIII C, § 1, subd. (e)(3) [expressly excepting, from the “tax” definition, a “charge imposed for the reasonable regulatory costs to a local government for . . . performing inspections”].)

The inspection fees in *Griffith I* met all the requirements of Proposition 26. The city’s evidence showed the fees did not exceed the approximate cost of the inspections. (*Griffith I, supra*, 207 Cal.App.4th at p. 997.) And the proportionality requirement of Proposition 26 was also met: “The fee schedule itself show[ed] the basis for the apportionment,” setting an annual registration fee plus a \$20 per unit fee, with lower fees for “[s]elf-certifications” that cost the city less to administer, and greater amounts charged when reinspections were required. (*Griffith I*, at p. 997.) The court concluded: “Considered collectively, the fees are reasonably related to the payors’ burden upon the inspection program. *The larger fees are imposed upon those whose properties require the most work.*” (*Ibid.*, italics added.)

Griffith I did, as the Agency tells us, state that “ ‘the question of proportionality is not measured on an individual basis’ ” but rather “ ‘collectively, considering all rate payors.’ ” (*Griffith I, supra*, 207 Cal.App.4th at p. 997.) But, as mentioned, *Griffith I* was considering a regulatory fee, not, as here, a charge imposed on four ratepayers for a “specific government service or product.” As *Griffith I* explained, “ ‘[t]he scope of a regulatory fee is somewhat flexible’ ” and “ ‘must be related to the overall cost of the governmental regulation,’ ” but “ ‘need not be finely calibrated to the precise benefit each individual fee payor might derive.’ ” (*Ibid.*) That, of course, makes perfect sense in the context of a regulatory fee applicable to numerous payors; indeed, it would be impossible to assess such fees based on the individual payor’s precise burden on the regulatory program. But the inspection fees *were* allocated by categories of payor, and were based on the burden on the inspection program, with higher fees where more city work was required.

Here, there are four payors, with no need to group them in classes to allocate costs. The *Griffith I* concept of measuring proportionality “collectively” simply does not apply. Where charges for a government service or product are to be allocated among only four payors, the only rational method of evaluating their burdens on, or benefits received from, the governmental activity, is individually, payor by payor. And that is particularly appropriate considering the nature of the Proposition 26 exemption in question: charges for a product or service that is (and is required to be) provided “directly to the payor.” Under these circumstances, allocation of costs “collectively,” when the product is provided directly to each of the four payors, cannot be, and is not, a “fair or reasonable” allocation method. (Art. XIII C, § 1, subd. (e), final par.)

b. *Griffith II* – the proportionality requirement and related claims

In *Griffith v. Pajaro Valley Water Management Agency* (2013) 220 Cal.App.4th 586 (*Griffith II*), the court concluded, among other things, that a groundwater augmentation charge complied with the proportionality requirement of Proposition 218. The Agency relies on *Griffith II*, asserting that the court applied the “concept of collective reasonableness with respect to rate allocations” Further, the case

demonstrates, the Agency tells us, that its activities in “management . . . of the Basin’s groundwater” justify basing its rates on total water demand, because all four retailers benefit from having the Agency’s imported water available, even when they do not use it. Neither claim withstands analysis.

Griffith II involved a challenge under Proposition 218, so we pause to describe its relevant points. Proposition 218 contains various procedural (notice, hearing, and voting) requirements for the imposition by local governments of fees and charges “upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property related service.” (Art. XIII D, § 2, subd. (e).) Fees or charges for water service (at issue in *Griffith II*) are exempt from voter approval (art. XIII D, § 6, subd. (c)), but substantive requirements apply. These include a proportionality requirement: that the amount of a fee or charge imposed on any parcel or person “shall not exceed the proportional cost of the service attributable to the parcel.” (*Id.*, subd. (b)(3).)

In *Griffith II*, the plaintiffs challenged charges imposed by the defendant water management agency on the extraction of groundwater (called a “groundwater augmentation charge”). The defendant agency had been created to deal with the issue of groundwater being extracted faster than it is replenished by natural forces, leading to saltwater intrusion into the groundwater basin. (*Griffith II, supra*, 220 Cal.App.4th at p. 590.) The defendant agency was specifically empowered to levy groundwater augmentation charges on the extraction of groundwater from all extraction facilities, “ “for the purposes of paying the costs of purchasing, capturing, storing, and distributing supplemental water for use within [defendant’s boundaries].” ’ ” (*Id.* at p. 591.) The defendant’s strategy to do so had several facets, but its purpose was to reduce the amount of water taken from the groundwater basin by supplying water to some coastal users, with the cost borne by all users, “on the theory that even those taking water from [inland] wells benefit from the delivery of water to [coastal users], as that reduces the amount of groundwater those [coastal users] will extract [from their own wells], thereby keeping the water in [all] wells from becoming too salty.’ ” (*Id.* at pp. 590-591.)

Griffith II found the charge complied with the Proposition 218 requirement that the charge could not exceed the proportional costs of the service attributable to the parcel. (*Griffith II, supra*, 220 Cal.App.4th at pp. 600-601.) Proposition 218, the court concluded, did not require “a parcel-by-parcel proportionality analysis.” (*Griffith II*, at p. 601.) The court found defendant’s “method of grouping similar users together for the same augmentation rate and charging the users according to usage is a reasonable way to apportion the cost of service,” and Proposition 218 “does not require a more finely calibrated apportionment.” (*Griffith II*, at p. 601.) The augmentation charge “affects those on whom it is imposed by burdening them with an expense they will bear proportionately to the amount of groundwater they extract at a rate depending on which of three rate classes applies. It is imposed ‘across-the-board’ on all water extractors. All persons extracting water – including any coastal users who choose to do so – will pay an augmentation charge per acre-foot extracted. All persons extracting water and paying the charge will benefit in the continued availability of usable groundwater.” (*Griffith II*, at pp. 603-604.)

The court rejected the plaintiffs’ claim the charge for groundwater extraction on their parcels was disproportionate because they did not use the agency’s services – that is, they did not receive delivered water, as coastal landowners did. This claim, the court said, was based on the erroneous premise that the agency’s only service was to deliver water to coastal landowners. The court pointed out that the defendant agency was created to manage the water resources for the common benefit of all water users, and the groundwater augmentation charge paid for the activities required to prepare and implement the groundwater management program. (*Griffith II, supra*, 220 Cal.App.4th at p. 600.) Further, the defendant agency “apportioned the augmentation charge among different categories of users (metered wells, unmetered wells, and wells within the delivered water zone).” (*Id.* at p. 601.) (The charges were highest for metered wells in the coastal zone, and there was also a per acre-foot charge for delivered water. (*Id.* at p. 593 & fn. 4.))

We see nothing in *Griffith II* that assists the Agency here. The Agency focuses on the fact that the defendant charged the plaintiff for groundwater extraction even though

the plaintiff received no delivered water, and on the court's statement that the defendant was created to manage water resources for the common benefit of all water users. (*Griffith II, supra*, 220 Cal.App.4th at p. 600.) From this the Agency leaps to the erroneous conclusion that the rates here satisfy the proportionality requirement simply because all four retailers "benefit from having the Agency's supplemental water supplies available," even when they do not use them. This is a false analogy. In *Griffith II*, the defendant charged all groundwater extractors proportionately for extracting water (and had the power to do so), and charged for delivered water as well. *Griffith II* does not support the imposition of charges based on a product the Agency does not supply.

We note further that in *Griffith II*, more than 1,900 parcel owners were subject to the groundwater augmentation charge, and they were placed in three different classes of water extractors and charged accordingly. (*Griffith II, supra*, 220 Cal.App.4th at pp. 593, 601.) Here, there are four water retailers receiving the Agency's wholesale water service, none of whom can reasonably be placed in a different class or category from the other three. In these circumstances, to say costs may be allocated to the four purveyors "collectively," based in significant part on groundwater not supplied by the Agency, because "they all benefit" from the availability of supplemental water supplies, would effectively remove the proportionality requirement from Proposition 26.

That we may not do. Proposition 26 requires by its terms an allocation method that bears a reasonable relationship to the payor's burdens on or benefits from the Agency's activity, which here consists of wholesale water service to be provided "directly to the payor." In the context of wholesale water rates to four water agencies, this necessarily requires evaluation on a "purveyor by purveyor" basis. (Cf. *Capistrano Taxpayers Assn., Inc. v. City of San Juan Capistrano* (2015) 235 Cal.App.4th 1493, 1514 (*Capistrano*) ["[w]hen read in context, *Griffith [II]* does not excuse water agencies from ascertaining the true costs of supplying water to various tiers of usage"; *Griffith II*'s "comments on proportionality necessarily relate only to variations in property location"; "trying to apply [*Griffith II*] to the [Proposition 218 proportionality] issue[] is fatally flawed".])

The Agency's claim that it is not charging the retailers for groundwater use, and its attempt to support basing its rates on total water demand by likening itself to the defendant agency in *Griffith II*, both fail as well. The first defies reason. Because the rates are based on total water demand, the more groundwater a retailer uses, the more it pays under the challenged rates. The use of groundwater demand in the rate structure necessarily means that, in effect, the Agency is charging for groundwater use.

The second assertion is equally mistaken. The differences between the Agency and the defendant in *Griffith II* are patent. In *Griffith II*, the defendant agency was created to manage all water resources, and specifically to deal with saltwater intrusion into the groundwater basin. The Agency here was not. It was created to acquire water and to "provide, sell, and deliver" it. It is authorized to develop and implement groundwater management plans only with the approval of the retail water purveyors (and other major groundwater extractors). In other words, while the Agency functions as the lead agency in developing and coordinating groundwater management plans, its only authority over groundwater, as the trial court found, is a shared responsibility to develop those plans. Further, in *Griffith II*, the defendant agency was specifically empowered to levy groundwater extraction charges for the purpose of purchasing supplemental water. The Agency here was not. As the trial court here aptly concluded, *Griffith II* "does not aid [the Agency] for the simple reason that [the Agency] has no comprehensive authority to manage the water resources of the local groundwater basin and levy charges related to groundwater."⁴

Finally, the Agency insists that it "must be allowed to re-coup its cost of service," and that the practice of setting rates to recover fixed expenses, "irrespective of a customer's actual consumption," was approved in *Paland v. Brooktrails Township*

⁴ The trial court also observed that, "[a]part from [the Agency's] lack of authority to supply or manage Basin groundwater, Newhall correctly notes that [the Agency] has presented no evidence of its costs in maintaining the Basin."

Community Services Dist. Bd. of Directors (2009) 179 Cal.App.4th 1358 (*Paland*).

Paland has no application here.

Paland involved Proposition 218. As we have discussed, Proposition 218 governs (among other things) “property related fees and charges” on parcels of property. Among its prohibitions is any fee or charge for a service “unless that service is actually used by, or immediately available to, the owner of the property in question.” (Art. XIII D, § 6, subd. (b)(4).) The court held that a minimum charge, imposed on parcels of property with connections to the district’s utility systems, for the basic cost of providing water service, regardless of actual use, was “a charge for an immediately available property-related water or sewer service” within the meaning of Proposition 218, and not an assessment requiring voter approval. (*Paland, supra*, 179 Cal.App.4th at p. 1362; see *id.* at p. 1371 [“Common sense dictates that continuous maintenance and operation of the water and sewer systems is necessary to keep those systems immediately available to inactive connections like [the plaintiff’s].”].)

We see no pertinent analogy between *Paland* and this case. This case does not involve a minimum charge imposed on all parcels of property (or a minimum charge for standing ready to supply imported water). Newhall does not contest the Agency’s right to charge for its costs of standing ready to provide supplemental water, and to recoup all its fixed costs. The question is whether the Agency may recoup those costs using a cost allocation method founded on the demand for groundwater the Agency does not supply, and is not empowered to regulate without the consent of groundwater extractors. The answer under Proposition 26 is clear: it may not. *Paland* does not suggest otherwise.⁵

⁵ The parties refer to other recent authorities to support their positions in this case. We may not rely on one of them, because the Supreme Court has granted a petition for review. (*City of San Buenaventura v. United Water Conservation District* (2015) 235 Cal.App.4th 228, review granted June 24, 2015, S226036.) The Agency cites the other case extensively in its reply brief, but we see nothing in that case to suggest that the challenged rates here comply with Proposition 26. (*Great Oaks Water Co. v. Santa Clara Valley Water District* 242 Cal.App.4th 1187 (*Great Oaks*).)

c. Other claims – conservation and “conjunctive use”

The Agency attempts to justify the challenged rates by relying on the conservation mandate in the California Constitution, pointing out it has a constitutional obligation to encourage water conservation. (Art. X, § 2 [declaring the state’s water resources must “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 [must] be prevented”].) The challenged rates comply with this mandate, the Agency contends, because reducing total water consumption will result in lower charges, and the rates encourage “a coordinated use of groundwater and supplemental water” (conjunctive use). This argument, too, misses the mark.

The Agency’s brief fails to describe the circumstances in *Great Oaks*. There, a water retailer challenged a groundwater extraction fee imposed by the defendant water district. Unlike this case, the defendant in *Great Oaks* was authorized by statute to impose such fees, and its major responsibilities included “preventing depletion of the aquifers from which [the water retailer] extracts the water it sells.” (*Great Oaks, supra*, 242 Cal.App.4th at p. 1197.) The Court of Appeal, reversing a judgment for the plaintiff, held (among other things) that the fee was a property-related charge, and therefore subject to some of the constraints of Proposition 218, but was also a charge for water service, and thus exempt from the requirement of voter ratification. (*Great Oaks*, at p. 1197.) The trial court’s ruling in *Great Oaks* did not address the plaintiff’s contentions that the groundwater extraction charge violated three substantive limitations of Proposition 218, and the Court of Appeal ruled that one of those contentions (that the defendant charged more than was required to provide the property related service on which the charge was predicated) could be revisited on remand. The others were not preserved in the plaintiff’s presuit claim, so no monetary relief could be predicated on those theories. (*Great Oaks*, at pp. 1224, 1232-1234.)

The Agency cites *Great Oaks* repeatedly, principally for the statements that the “provision of alternative supplies of water serves the long-term interests of extractors by reducing demands on the groundwater basin and helping to prevent its depletion,” and that it was not irrational for the defendant water district “to conclude that reduced demands on groundwater supplies benefit retailers by preserving the commodity on which their long-term viability, if not survival, may depend.” (*Great Oaks, supra*, 242 Cal.App.4th at pp. 1248-1249.) These statements, with which we do not disagree, have no bearing on this case, and were made in connection with the court’s holding that the trial court erred in finding the groundwater extraction charge violated the statute that created and empowered the defendant water district. (*Id.* at pp. 1252-1253.)

Certainly the Agency may structure its rates to encourage conservation of the imported water it supplies. (Wat. Code, § 375, subd. (a) [public entities supplying water at wholesale or retail may “adopt and enforce a water conservation program to reduce the quantity of water used by [its customers] for the purpose of conserving the water supplies of the public entity”]. But the Agency has no authority to set rates to encourage conservation of groundwater it does not supply. Moreover, article X’s conservation mandate cannot be read to eliminate Proposition 26’s proportionality requirement. (See *City of Palmdale v. Palmdale Water District* (2011) 198 Cal.App.4th 926, 936-937 [“California Constitution, article X, section 2 is not at odds with article XIII D [Proposition 218] so long as, for example, conservation is attained in a manner that ‘shall not exceed the proportional cost of the service attributable to the parcel.’ ”]; see *id.* at p. 928 [district failed to prove its water rate structure complied with the proportionality requirement of Proposition 218]; see also *Capistrano, supra*, 235 Cal.App.4th at p. 1511, quoting *City of Palmdale* with approval.)

The Agency also insists that basing its rates only on the demand for the imported water it actually supplies – as has long been the case – would “discourage users from employing conjunctive use” The Agency does not explain how this is so, and we are constrained to note that, according to the Agency’s own 2003 Groundwater Management Plan, Newhall and the other retailers “have been practicing the conjunctive use of imported surface water and local groundwater” for many years. And, according to that plan, the Agency and retailers have “a historical and ongoing working relationship . . . to manage water supplies to effectively meet water demands within the available yields of imported surface water and local groundwater.”

In connection, we assume, with its conjunctive use rationale, the Agency filed a request for judicial notice, along with its reply brief. It asked us to take notice of three documents and “the facts therein concerning imported water use and local groundwater production” by Newhall and the other water retailers. The documents are the 2014 and 2015 Water Quality Reports for the Santa Clarita Valley, and a water supply utilization table from the 2014 Santa Clarita Valley Water Report published in June 2015. All of

these, the Agency tells us, are records prepared by the Agency and the four retailers, after the administrative record in this case was prepared. The documents “provide further support” as to the “cooperative efforts of the Agency and the Purveyors in satisfying long-term water supply needs,” and “provide context and useful background to aid in the Court’s understanding of this case.” The Agency refers to these documents in its reply brief, pointing out that since 2011, Newhall has increased its imported water purchases because of the impact of the current drought on certain of its wells, while retailer Valencia Water Company increased groundwater pumping and purchased less imported water in 2014. These cooperative efforts, the Agency says, “reflect the direct benefit to Newhall of having an imported water supply available to it, whether or not it maximizes use of imported water in a particular year.”

We deny the Agency’s request for judicial notice. We see no reason to depart from the general rule that courts may not consider evidence not contained in the administrative record. (*Western States Petroleum Assn. v. Superior Court* (1995) 9 Cal.4th 559, 564; cf. *id.* at p. 578 [the exception to the rule in administrative proceedings, for evidence that could not have been produced at the hearing through the exercise of reasonable diligence, applies in “rare instances” where the evidence in question existed at the time of the decision, or in other “unusual circumstances”].) Denial is particularly appropriate where judicial notice has been requested in support of a reply brief to which the opposing party has no opportunity to respond, and where the material is, as the Agency admits, “further support” of evidence in the record, providing “context and useful background.” These are not unusual circumstances.

Returning to the point, neither conservation mandates nor the Agency’s desire to promote conjunctive use – an objective apparently shared by the retailers – permits the Agency to charge rates that do not comply with Proposition 26 requirements. Using demand for groundwater the agency does not supply to allocate its fixed costs may “satisf[y] the Agency’s constitutional obligations . . . to encourage water conservation,”

but it does not satisfy Proposition 26, and it therefore cannot stand.⁶ (Cf. *Capistrano, supra*, 235 Cal.App.4th at pp. 1511, 1498 [conservation is to be attained in a manner not exceeding the proportional cost of service attributable to the parcel under Proposition 218; the agency failed to show its tiered rates complied with that requirement].)

d. Other Proposition 26 requirements

We have focused on the failure of the challenged rates to comply with the proportionality requirement of Proposition 26. But the rates do not withstand scrutiny for another reason as well. Proposition 26 exempts the Agency's charges from voter approval only if the charge is imposed "for a specific government service or product provided *directly* to the payor that is *not* provided to those not charged" (Italics added.) The only "specific government service or product" the Agency provides directly to the retailers, and not to others, is imported water. As the trial court found: the Agency "does not provide Newhall groundwater. It does not maintain or recharge aquifers. It does not help Newhall pump groundwater. Nor does it otherwise contribute directly to the natural recharge of the groundwater Newhall obtains from its wells."

The groundwater management activities the Agency *does* provide – such as its leadership role in creating groundwater management plans and its perchlorate remediation efforts – are not specific services the Agency provides directly to the retailers, and not to other groundwater extractors in the Basin. On the contrary, groundwater management services redound to the benefit of all groundwater extractors in the Basin – not just the four retailers. Indeed, implementation of any groundwater

⁶ The Agency also cites *Brydon v. East Bay Municipal Utility District* (1994) 24 Cal.App.4th 178 for the principle that, in pursuing a constitutionally and statutorily mandated conservation program, "cost allocations . . . are to be judged by a standard of reasonableness with some flexibility permitted to account for system-wide complexity." (*Id.* at p. 193.) But *Brydon* predated both Proposition 218 and Proposition 26. (See *Capistrano, supra*, 235 Cal.App.4th at pp. 1512-1513 [*Brydon* "simply has no application to post-Proposition 218 cases"; "it seems safe to say that *Brydon* itself was part of the general case law which the enactors of Proposition 218 wanted replaced with stricter controls on local government discretion"].)

management plan is “subject to the rights of property owners and with the approval of the retail water purveyors *and other major extractors* of over 100 acre-feet of water per year.” (Wat. Code Appen., § 103-15.2, subs. (b)&(c), italics added.)

Certainly the Agency may recover through its water rates its entire cost of service – that is undisputed. The only question is whether those costs may be allocated, consistent with Proposition 26, based in substantial part on groundwater use. They may not, because the Agency’s groundwater management activities plainly are not a service “that is not provided to those not charged” (Art. XIII C, § 1, subd. (e)(2).)

In light of our conclusion the challenged rates violate Proposition 26, we need not consider the Agency’s contention that the rates comply with Government Code section 54999.7 and the common law. Nor need we consider the propriety of the remedy the trial court granted, as the Agency raises no claim of error on that point.

DISPOSITION

The judgment is affirmed. Plaintiff shall recover its costs on appeal.

GRIMES, J.

WE CONCUR:

BIGELOW, P. J.

FLIER, J.

PROOF OF SERVICE

Newhall County Water District v. Castaic Lake Water Agency
Second Appellate District-Division 8
Case No. B257964

I am employed in the City and County of Los Angeles, State of California. I am over the age of 18, and not a party to the within action. My business address is 700 North Alameda Street, Los Angeles, California 90012.

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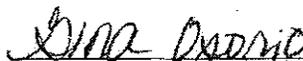
**LETTER OF THE METROPOLITAN WATER DISTRICT OF SOUTHERN
CALIFORNIA TO THE CALIFORNIA SUPREME COURT RE:
REQUEST FOR DEPUBLICATION**

on the interested parties in this action by placing a true and correct copy(s) or the original thereof, enclosed in a sealed envelope(s) addressed as follows:

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<i>Rendering Court:</i>	Presiding Justice Tricia A. Bigelow Associate Justices Madeleine Flier and Elizabeth A. Grimes Court of Appeal for the Second District- Div. 8 Ronald Reagan State Building 300 S. Spring Street, 2 nd Floor, North Tower Los Angeles, CA 90013

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- (FEDERAL)** I declare that I am employed in the offices of a member of the bar of this court at whose direction the service was made.

Executed on March 21, 2016, at Los Angeles, California


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15 SUPERIOR COURT OF THE STATE OF CALIFORNIA
16 COUNTY OF SAN FRANCISCO

18 SAN DIEGO COUNTY WATER
AUTHORITY,
19
20 Petitioner and Plaintiff,

21 v.

22 METROPOLITAN WATER DISTRICT OF
SOUTHERN CALIFORNIA; et al.,
23 Respondents and Defendants.

Case Nos. CPF-10-510830; CPF-12-512466

**RESPONDENT/DEFENDANT
METROPOLITAN WATER DISTRICT OF
SOUTHERN CALIFORNIA'S FIRST
PRETRIAL BRIEF**

Date: November 4, 2013
Time: 9:00 a.m.
Dept.: 304
Judge: Hon. Curtis E. A. Karnow

Actions Filed: June 11, 2010; June 8, 2012
Trial Date: December 17, 2013

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1 **I. INTRODUCTION**

2 On July 22, 2013 the Court issued a Case Management Order instructing the parties to
3 file pretrial briefs “expressing their views regarding, on a claim-by-claim basis (i) the standard of
4 review, if the court is reviewing the actions of another entity, (ii) the burden of proof; and (iii)
5 the evidence the court is required to evaluate.” July 22, 2013 Order at 3. On the third point, the
6 Court directed the parties to “include[e] (a) a description of the pertinent administrative record
7 and (b) a generic description of the witnesses which the court may or should consider including
8 (if the parties wish) argument on why the court ought not to consider evidence likely to be
9 offered by opposing parties.” *Id.* This pretrial briefing relates to all claims in the two cases
10 except for the breach of contract claims, which will be tried (if at all) at a later date and on which
11 the court did not request briefing. *Id.*

12 Accordingly, Respondent and Defendant Metropolitan Water District of Southern
13 California (“MWD”) submits its First Pretrial Brief in advance of the November 4, 2013 pretrial
14 hearing. Below, MWD discusses each of the San Diego County Water Authority’s (“SDCWA”)
15 claims in the *2010 Action* (Case No. CPF-10-510830) and the *2012 Action* (Case No. CPF-12-
16 512466) other than the breach of contract claims, and sets forth the standard of review, burden of
17 proof, and appropriate evidence for each claim.

18 **II. FACTUAL OVERVIEW**

19 A brief factual background is important to understand the standard of review, burden of
20 proof and the appropriate evidence on a claim by claim basis. At the December 17 final
21 hearing/trial, the Court will adjudicate three areas of claims: (1) the final hearing on SDCWA’s
22 rate challenges, which is the first three causes of action in both the *2010* and *2012 Actions*; (2)
23 the trial on SDCWA’s challenge to MWD’s rate structure integrity clause, which is the fifth
24 cause of action in the *2010 Action*; and (3) the trial on SDCWA’s preferential rights claim, which
25 is the sixth cause of action in the *2010 Action*. Below MWD sets forth the relevant factual
26 background for these three areas of claims.

27 **A. Factual Background Relevant to the Rate Challenges**

28 MWD is a public agency, and a supplemental supplier of wholesale water, meaning it is

1 not the sole supplier of wholesale water to its member agencies. It operates as a collective of its
2 member agencies, which themselves are public agencies, and it is governed by a Board of
3 Directors composed of representatives from these member agencies. Today, MWD is made up
4 of 26 member agencies.

5 To provide a supplemental wholesale water supply, MWD imports water from the
6 Colorado River via the Colorado River Aqueduct, and from the State Water Project (“SWP”).
7 The SWP is operated by the California Department of Water Resources (“DWR”). The water
8 MWD imports is delivered to member agencies through an extensive regional network of canals,
9 pipelines, and appurtenant facilities, as well as supply, treatment, and storage facilities. To pay
10 the costs associated with providing water to its member agencies, MWD sets and maintains
11 water rates and charges.

12 SDCWA’s claims challenge features of MWD’s rate structure that have been in place for
13 a decade and a half.

14 **1. The 1997 Wheeling Rate**

15 In January 1997, MWD’s Board of Directors voted to adopt a “postage stamp” wheeling
16 rate, effective January 15, 1997, applicable to member agencies that convey non-MWD water
17 through MWD’s water conveyance system in transactions of one year or less. A postage stamp
18 rate for wheeling a given quantity of water, as its name indicates, is the same regardless of how
19 far the water is transported. The postage stamp nature of the wheeling rate substantially benefits
20 SDCWA, because water must travel a longer distance to get to it as compared to most other
21 member agencies. The Board developed this rate in consultation and cooperation with MWD’s
22 26 member agencies, of which SDCWA is one. As a general matter, MWD’s wheeling rate
23 applies to the conveyance of non-MWD water through MWD’s system. It consists of certain
24 system-wide costs (*i.e.*, costs of capital, operation, and/or maintenance of MWD’s interconnected
25 facilities, as opposed to just those portions of the system used in the wheeling transactions).

26 This wheeling rate included, among other things, both MWD’s conveyance costs under
27
28

1 its “take-or-pay” contract¹ with DWR for SWP, water and costs to assist funding of water
2 conservation and other water demand management programs. Both of those cost allocations are
3 inconsistent with the allegations SDCWA now asserts—more than 15 years later—that all SWP
4 costs, including conveyance and power costs, and water conservation and demand management
5 program costs, must be allocated solely to MWD’s water supply rate. This wheeling rate was
6 assessed on any member agency engaged in a wheeling transaction of one year or less since
7 January 15, 1997, until it was modified in 2003 by the “unbundling” of MWD’s rate structure,
8 which unbundling is discussed in more detail below.

9 **2. The Unbundling of MWD’s Water Rates**

10 In the late 1990s, MWD began a revision of its overall water rates and charges, in
11 consultation and cooperation with SDCWA and MWD’s other member agencies. On October
12 16, 2001, MWD’s Board of Directors voted to adopt a revised rate structure, effective January 1,
13 2003. Among other things, this rate structure unbundled water rates and charges to reflect the
14 different services provided by MWD and to more transparently allocate costs to operation
15 functions.

16 Among the unbundled rates in the new structure are a “System Access Rate” charged on
17 every acre-foot of water conveyed through MWD’s conveyance system, whether the water is
18 purchased from MWD or is non-MWD water, a “System Power Rate” which recovers MWD’s
19 cost of pumping water through both SWP and MWD facilities, and a “Water Stewardship Rate”
20 to recover the costs of conservation and other demand management programs. In addition, the
21 rates for the wheeling of non-MWD water through MWD’s conveyance system for agreements
22 of one year or less, which slightly modified the wheeling rate adopted in 1997, include the
23 System Access Rate, Water Stewardship Rate and, for treated water, a treatment surcharge, as
24 well as power costs. The basis for MWD’s adoption of the unbundled rates was a detailed and
25 thorough administrative record.

26 On March 12, 2002, with the affirmative vote of SDCWA’s representatives on MWD’s

27 ¹ The SWP contract is “take or pay” because MWD must pay a certain amount under the contract
28 regardless of how much water it gets from the SWP.

1 Board, MWD adopted specific rates and charges to be effective on January 1, 2003, pursuant to
2 the rate structure adopted in 2001.

3 3. The Rate-Setting Process

4 For each rate-setting since the unbundling, MWD has engaged in a multi-step cost of
5 service (“COS”) process during which it assigns certain expenses to related operation functions.
6 Procedurally, as in prior years, MWD undertook the following steps to set its 2011 and 2012
7 rates, as well as its 2013 and 2014 rates.

8 First, MWD determined its revenue requirements for the given fiscal year. Next, MWD
9 allocated those revenue requirements (*i.e.*, MWD’s expenses) to operation functions. Each of
10 MWD’s rate components is designed to generate revenue to pay costs of the operation functions
11 related to it. For example, MWD generates revenue to pay for its conveyance expenses by
12 allocating conveyance-related expenses to its transportation functions. Likewise, MWD
13 generates revenue to pay for supplies of water by allocating supply-related expenses to its supply
14 function. Next, MWD broke its operation functions down into cost classifications, and then
15 corresponding rate design elements. As discussed, the rate components at issue in these actions
16 are the System Access Rate, the System Power Rate, and the Water Stewardship Rate. SDCWA
17 also erroneously asserts in the *2012 Action*² that MWD’s rates and charges do not account for
18 “peaking” and “standby” service, when they in fact do.

19 SDCWA and all of MWD’s member agencies have been fully aware of these cost
20 allocation decisions in MWD’s structure of rates and charges, as evidenced by the written
21 proposals and analyses that MWD regularly provides to them, their own knowledge and
22 understanding of these charges, and especially in SDCWA’s case, the affirmative votes of its
23 representatives on MWD’s Board in favor of these rates and charges in multiple rate cycles.

24 Each year, MWD’s Board of Directors adopts by majority vote the specific rates and
25 charges for the coming fiscal year or, more recently, for the coming two fiscal years. Several

26 _____
27 ² While the TAC contains a few references to dry year peaking in the factual background section,
28 it is not a basis for any of the claims in the first three causes of action in the *2010 Action*. See
TAC ¶¶ 68-97.

1 months in advance of the meeting at which the rate vote is to take place, MWD's General
2 Manager presents to each Board member, member agency, and the public a detailed letter setting
3 forth the proposed revenue requirements and proposed rates and charges for the coming fiscal
4 year or, more recently, for the coming two fiscal years. The proposed rates are presented and
5 discussed at public meetings, Board meetings, and its Business and Finance Committee and
6 Executive Committee meetings, meetings with all member agency managers, and a noticed
7 public hearing. Following these meetings and hearing, the General Manager presents to each
8 Board member, member agency, and the public a second comprehensive letter setting forth the
9 details of the proposed rates for the coming fiscal year or, more recently, for the coming two
10 fiscal years, a list of the Board's options as they pertain to the rate structure, and a staff
11 recommendation. This ensures that Board members, and the member agencies they represent,
12 are fully informed in advance of each vote and have sufficient time to consider and raise
13 questions, comments, and objections, as SDCWA did regularly. This documentation creates a
14 detailed administrative record sufficient to support MWD's adoption of each year's rate
15 structure.

16 Minutes of MWD's Board meetings indicate that in 2005, 2006, and 2007, the Board
17 adopted new rates under the existing cost-of-service methodology without comment or objection
18 from SDCWA. For 2002, 2009, and 2012 (for the 2013 and 2014 fiscal years) the minutes show
19 that SDCWA's representatives on the Board actually voted to approve rates under the structure
20 SDCWA now challenges.

21 The different components of MWD's rate structure are interrelated in that they must
22 collectively recoup MWD's costs as a water district. SDCWA has voted in favor of rates under
23 the rate structure that was adopted in 2001, and has accepted the financial benefits of that rate
24 structure, for a decade or more before commencing litigation to challenge it. If MWD's rate
25 structure were reorganized in the manner SDCWA now claims it should be—in other words, to
26 exempt all SWP costs, as well as the Water Stewardship Rate, from the rates charged on all
27 water conveyed through MWD's system—other rate components and charges would have been
28 higher and would be higher in the future for all member agencies.

1 MWD, as noted, is a supplemental supplier. Thus, member agencies have options
2 regarding how they obtain their water supplies, including local water supply, water purchases
3 and conveyance from non-MWD third-party providers, purchases from MWD, or purchases from
4 third-party providers and conveyance using MWD services and facilities. Wheeling charges are
5 incurred only if an agency elects to use MWD's conveyance services and facilities to transport
6 non-MWD water. In that sense, the charges are voluntary, not imposed.

7 The member agencies are each separate public agencies, all of which have their own
8 independent governing bodies (*e.g.*, boards of directors, city councils, or other governing
9 bodies). Each has at least one representative on MWD's Board. SDCWA has four
10 representatives on the MWD Board (no member agency has more than four) and SDCWA
11 controls approximately 18% of the Board's vote. Each member agency has staff who educate
12 themselves and inform and advise the member agency's representatives on the issues before
13 MWD's Board. If staff of any separate agencies wish to meet to discuss water strategy or other
14 matters, they may legally hold meetings and engage in advocacy like any other interested party.

15 Despite SDCWA's allegations, MWD has never "colluded" with any member agency or
16 group of member agencies. No member agency or member agency group exerts unlawful
17 influence over MWD. SDCWA's claims that MWD has made decisions, including regarding its
18 rate structure, rates, "dry year peaking," and awards of "subsidy contracts" to intentionally
19 discriminate against SDCWA are untrue, and, as this court has held, are irrelevant to the claims
20 alleged in SDCWA's Third Amended Petition/Complaint ("TAC") in the *2010 Action* and
21 SDCWA's Petition/Complaint in the *2012 Action* ("2012 Complaint"). 7/2/2012 Tr. at 40:26-
22 43:1 and 62:27-63:6 (the Court ruled that SDCWA's allegations of a "cabal" are "not part of this
23 case.")

24 **4. The Rates at Issue**

25 The rates and charges that have been assessed in every year since 2003, through the
26 present—and in support of which SDCWA has repeatedly voted—reflect the cost-of-service
27 methodology that SDCWA challenges here. Specifically, in every year since 2003, MWD has (i)
28 included in its System Access Rate and System Power Rate, not in its water Supply Rate, SWP

1 conveyance and power costs charged to MWD under its take-or-pay SWP contract; and (ii)
2 charged the Water Stewardship Rate to all users of the MWD system. These are the three cost
3 allocation practices that SDCWA challenges in these actions.

4 The System Access Rate generates revenues to pay for maintenance of conveyance
5 facilities by recovering the cost of providing conveyance and distribution capacity to meet
6 average annual demands. This includes the facilities costs for conveying water from non-MWD
7 facilities to MWD. The System Access Rate is charged on a volumetric, acre-foot basis.

8 The System Power Rate pays for the cost of power necessary to move water through
9 MWD's and DWR's conveyance facilities, including the costs of pumping water from DWR's
10 facilities to MWD, and the cost of pumping MWD water to its member agencies. The System
11 Power Rate also is charged on a volumetric, acre-foot basis.

12 The Water Stewardship Rate, recovers the budgeted costs for local resources
13 development, regional water conservation, and seawater desalination programs, which
14 incentivize development of local water supplies and the conservation of water. This
15 conservation and local resource development reduces the demand and burden on MWD's
16 conveyance system; decreases and avoids operating and capital maintenance and improvement
17 costs, such as costs for repair of and construction of additional or expanded water conveyance,
18 distribution, and storage facilities; and frees up capacity in MWD's system to convey both MWD
19 water and water from other non-MWD sources. The Water Stewardship Rate is also charged on
20 a volumetric, acre-foot basis.

21 SDCWA also asserts that MWD's rates and charges are flawed because it does not have a
22 charge specifically for "dry-year peaking." By way of background, MWD incurs certain
23 expenses due to the need to have or have access to facilities that are capable of handling peak
24 water demands, including peak seasonal or summer water deliveries. These peaking-related
25 expenses concern the overall need to have facilities capable of handling peak usage and do not
26 relate to whether the peaking occurs because a particular period of time is "dry" (*i.e.*, less rainfall
27 or snowfall), or if peak usage is due to greater water demand, to relative price differentials
28 between MWD water and other water supplies available to a given member agency, or another

1 reason. Also, these expenses related to peaking facilities concern peak usage, not year-to-year
2 variability in member agency demands as SDCWA's allegation concerns.

3 In these lawsuits, SDCWA uses the term "peaking" in a way that is inconsistent with
4 industry guidelines to refer to an agency's *annual* variations in water purchases and reliance on
5 MWD's system. MWD properly uses the term "peaking" as the busiest times of year, or the
6 times at which demand on MWD's system is at its highest peak. Regardless of nomenclature,
7 however, MWD's rates and charges appropriately recover costs associated with both annual
8 variations and peak usage. If a member agency purchases or conveys greater quantities of water
9 in one year as opposed to another, this is accounted for across MWD's rates and charges: in the
10 Readiness-to-Serve Charge and the volumetric Supply Rate, System Access Rate, System Power
11 Rate, and Water Stewardship Rate. For instance, a member agency that purchases more water
12 pays more under the volumetric Supply Rate and the three volumetric conveyance rates. And, if
13 the member agency's water purchases exceed a certain level, the member agency pays a higher
14 Supply Rate (the Tier 2 Rate, rather than the lower Tier 1 Rate).

15 MWD recoups the costs of conferring the benefit of standby and peaking capability
16 (correctly defined) through its Readiness-to-Serve and Capacity Charges. The Readiness-to-
17 Serve Charge recovers the costs of standby service for peak-related capacity; and the Capacity
18 Charge accounts for peaking-capacity costs. Both the Readiness-to-Serve and Capacity Charges
19 are allocated among member agencies based on their historical use of, or reliance on, standby
20 and peaking facilities and capacity. For instance, MWD calculates the Readiness-to-Serve
21 Charge for each member agency by using a ten-year rolling average of that member agency's
22 past total consumption, *i.e.*, all firm deliveries including water transfers and exchanges that use
23 MWD capacity. And the Capacity Charge is a fixed charge assessed on each member agency
24 based on the maximum summer day demand placed on MWD's system between May 1 and
25 September 30 for a three-calendar year period. Therefore, member agencies pay the Readiness-
26 to-Serve and Capacity Charges in proportion to their reliance on MWD's system and facilities.

27 MWD first implemented its Readiness-to-Serve Charge in fiscal year 1995-96. In fiscal
28 year 2002-03, MWD adopted a new calculation of the Readiness-to-Serve Charge, which

1 remains in place today. MWD’s Capacity Charge was first implemented in 2003. In 2004,
2 MWD redesigned this charge as the present day Capacity Charge.

3 In every year since 2003, MWD has maintained a System Access Rate, System Power
4 Rate, Water Stewardship Rate, Readiness-to-Serve Charge, and Capacity Charge, and has used a
5 consistent methodology for allocating costs to these rates and charges and for apportioning the
6 rates and charges among member agencies. Indeed, when MWD’s Board considered and
7 reaffirmed its cost allocation methodology on November 10, 2009, SDCWA voted in the
8 affirmative. Likewise, SDCWA proposed and voted in favor of a 3% rate increase for the
9 2013/14 years based on this same rate structure that it is now challenging for those years.

10 **B. Factual Background Relevant to the Rate Structure Integrity**
11 **Provision Claim**

12 **1. MWD’s Integrated Resources Plan and Statutory Mandates**
13 **Provide the Foundation for MWD’s Water Demand**
14 **Management Programs**

15 Southern California’s nearly 19 million residents depend on MWD’s continuing
16 investments in water demand management programs that help ensure a reliable and high quality
17 water supply. During the two-year budget cycle that ends in June 2014 alone, MWD has
18 budgeted more than \$40 million to fund water conservation programs and another \$66 million on
19 water recycling and groundwater recovery programs. Over the past 20 years, MWD has invested
20 more than \$322 million on conservation efforts and another \$413 million on recycled water and
21 groundwater recovery. MWD is slated to spend hundreds of millions of dollars more in the
22 future on its demand management programs to meet its local water development and
23 conservation goals. These commitments are part of a larger blueprint for reliability, detailed in
24 MWD’s key water supply planning and reporting document—the Integrated Water Resources
25 Plan (“IRP”). Developed in 1996, updated in 2004 and again in 2010, the IRP sets forth MWD’s
26 long-term plan to protect the region from future water supply shortages. It emphasizes a diverse
27 “preferred mix” of water resources, including conservation and local resource development. To
28 that end, the IRP sets water resource targets to achieve MWD’s water supply reliability goals
over the next 25 years. For example, the 2010 IRP update set the following targets to be

1 achieved by the year 2035: (1) an annual savings of 2,168,000 acre-feet³ of water through water
2 use efficiency efforts, including conservation and recycling; and (2) the production of an
3 additional 2,025,000 acre-feet annually through local resources.

4 Furthermore, these commitments are essential to meeting statutory mandates that require
5 an increased focus on conservation and local resource development. In 1999, the California
6 Legislature passed Senate Bill 60, which amended the MWD Act to require that MWD place an
7 “increased emphasis on sustainable, environmentally sound, and cost-effective water
8 conservation, recycling, and groundwater storage and replenishment measures.” MWD Act
9 § 130.5. In 2009, the Legislature added a provision to the California Water Code that requires
10 the state to reduce its per capita water use by 20% by 2020. Cal. Water Code § 10608.16. The
11 Legislature requires MWD to provide yearly reports outlining its progress toward these
12 conservation goals. These “SB60 reports” detail MWD’s achievements in promoting
13 conservation, recycling, and groundwater recharge, and quantify the number of acre-feet of water
14 developed and/or conserved by various projects and programs implemented throughout MWD’s
15 service region.

16 2. MWD’s Water Demand Management Programs are 17 Implemented Through Contracts with Member Agencies

18 To achieve its long-term IRP regional water supply reliability goals and statutory
19 mandates, MWD has implemented three programs aimed at developing or conserving local water
20 resources: the Local Resources Program (“LRP”), the Conservation Credits Program (“CCP”),
21 and the Seawater Desalination Program (“SDP”). To carry out these programs, MWD enters into
22 project contracts with its member agencies and, at times, with third parties, which require these
23 entities to develop and implement local resource development, conservation, and desalination
24 projects. Under the LRP and SDP contracts, MWD typically pays up to \$250 for each acre-foot
25 of water actually produced. Under the CCP contracts, MWD pays a certain specific amount of
26 money for each acre-foot of water estimated to be conserved. Revenues collected through

27 ³A single acre-foot of water is approximately 326,000 gallons—enough to supply 5-7 people
28 with water for a full year.

1 MWD's water rates fund the payments under these project contracts, many of which have 25-
2 year terms. More specifically, they are funded by MWD's Water Stewardship Rate, which is
3 integrated with and interdependent on MWD's other water rate components in MWD's rate
4 structure.

5 MWD does not offer LRP, CCP, or SDP contracts to the general public. Rather, at its
6 discretion, MWD enters into these contracts with those member agencies whose projects meet
7 certain performance criteria. Although member agencies have the right to apply for LRP, CCP,
8 and SDP funds, they have no right to obtain them. The payments made under these project
9 contracts are not grants. They are payments made by MWD in exchange for the development or
10 conservation of a specific amount of water.

11 MWD's Board of Directors made a policy decision to undertake local conservation and
12 resource development programs in consideration of the regional benefits they provide. Water
13 conserved or developed at the local level benefits MWD, its member agencies, and the general
14 public throughout MWD's service region in several ways. For example, every acre-foot of water
15 conserved or developed by a member agency within the region reduces reliance on future
16 increases of imported water from MWD. As a result, less water must be conveyed through
17 MWD's system than might otherwise be needed. This reduces the demand and burden on
18 MWD's conveyance system; decreases and avoids operating, maintenance, capital, and
19 improvement costs, such as costs for repair of additional water conveyance, distribution, and
20 storage facilities, and costs for construction of additional or expanded water conveyance,
21 distribution, and storage facilities; and frees up capacity in MWD's system to convey both MWD
22 water and water from other non-MWD sources. The development of local resources also
23 increases the amount of water available throughout MWD's service region; water that would
24 have otherwise been purchased by a member agency is made available to other member
25 agencies. With more water available from diverse sources, water supply reliability is increased
26 throughout the region. Were it not for these programs, MWD would be required to develop
27 alternative sources to avoid water shortages.

28 SDCWA has admitted the existence of these regional benefits. In a January 2010 letter to

1 the Coastal Commission, SDCWA represented that there are “regional benefit[s] from new
2 recycling projects, groundwater recovery projects and water use efficiency gains developed
3 under MWD’s and the Water Authority’s longstanding local resource and conservation
4 programs.” SDCWA further acknowledged that the project contracts provided by MWD are
5 aimed at “avoiding the following costs:

- 6 • Acquisition of new imported supplies such as transfers and exchanges;
- 7 • State Water Project (SWP) energy consumption for pumping imported supplies;
- 8 • Treating imported supplies; and
- 9 • MWD distribution system expansions.”

10 These benefits are also supported by MWD’s in depth 1996 analysis of the economic
11 benefits of conservation and local resource development efforts. This analysis—set forth in an
12 issue paper entitled “Economic Benefits of Local Water Management Programs”—quantified,
13 among other things, the economic benefits associated with groundwater storage and local
14 resource development projects, including avoided capital costs. These benefits were quantified
15 by estimating MWD’s projected costs over 25 years under three scenarios: one that assumed no
16 local resource development or groundwater storage programs, a second that assumed
17 groundwater storage programs but no local resource development, and a third that assumed a
18 preferred mix of both groundwater storage and local resource development. This analysis
19 revealed that by developing the preferred mix of groundwater and local resource programs,
20 MWD could expect to save approximately \$2.27 billion over 25 years.

21 These benefits are further demonstrated by the sheer number of acre-feet of water
22 developed and/or conserved on an annual basis through these programs. These benefits are
23 reflected in MWD’s yearly SB60 Reports to the Legislature. For example, in fiscal year 2011-
24 2012, MWD-assisted conservation programs saved approximately 156,000 acre-feet of water—
25 enough to provide water for more than 750,000 to 1 million people for a full year. In that same
26 year, LRP programs contributed an additional 171,000 acre-feet of recycled water for non-
27 potable uses and another 40,000 acre-feet of recovered groundwater for municipal use. Since
28 1991, these programs have produced almost 4 million acre-feet of water for the residents of

1 Southern California. In addition to these direct benefits, these programs also have derivative
2 consequences resulting in additional water conservation and local resource development because
3 of factors such as changed behavior and legislative actions.

4 **3. MWD Funds Its LRP, CCP, and SDP Contracts** 5 **through Revenue from Its Integrated Rate Structure**

6 MWD funds its LRP, CCP, and SDP contracts through revenue generated by its
7 integrated rate structure. Starting in July 1998, MWD began the long and arduous process of
8 unbundling its water rate into various rate components. In October 2001, after years of
9 consideration and planning, MWD's Board voted to adopt its current rate structure, effective as
10 of January 2003. As previously discussed, under the existing rate structure, MWD's rates are
11 unbundled into the following components: the Tier 1 and Tier 2 Supply Rates; the System
12 Access Rate; the System Power Rate; the Water Stewardship Rate; and a Treatment Surcharge
13 (when MWD delivers treated water). MWD also collects fixed, non-volumetric charges from its
14 member agencies, including a Capacity Charge and a Readiness-to-Serve Charge.

15 Every two years MWD's Board sets a rate for each component based on MWD's overall
16 budgeted costs. Thus, the unbundled nature of MWD's integrated rate structure does not change
17 the fact that the rate components are interdependent. In that regard, while the Water Stewardship
18 Rate is set to recover MWD's LRP, CCP, and SDP related costs, that rate component is
19 integrated with the System Access Rate and System Power Rate, all of which are set to recover
20 MWD's budgeted costs related to the conveyance of water. To ensure that MWD's overall costs
21 are accounted for, an adjustment to any one of these rates could necessitate an adjustment to all
22 of the rates, which may undermine the funding for project contracts.

23 **4. MWD Adopted and Implemented the RSI Provision**

24 Having made the collective decision to commit hundreds of millions of dollars to
25 conservation, local resources and seawater desalination projects, MWD recognized the financial
26 risk—to both itself and its member agencies—posed by the threat of legal or legislative actions
27 that might undermine the existing rate structure that was designed, in part, to generate the
28 revenues necessary to fund these local projects. This threat was not imagined. In the years

1 leading up to the adoption of the RSI provision, MWD had faced both legal and legislative
2 challenges to its rates. For example, in 1997 SDCWA and IID challenged the validity of
3 MWD's "wheeling" rate, which led to years of protracted litigation that culminated in appellate
4 court decision. *See Metropolitan Water Dist. of S. Cal. v. Imperial Irrigation District*, 80 Cal.
5 App. 4th 1403 (2000).

6 Moreover, the threat of future litigation was made explicit by SDCWA in the context of
7 negotiating its 35-year water exchange agreement ("Exchange Agreement") with MWD in late
8 2003. Under the Exchange Agreement, SDCWA makes available water it purchases from the
9 Imperial Irrigation District to MWD at the intake to MWD's Colorado River Aqueduct on Lake
10 Havasu, and MWD, in turn, delivers an equivalent amount of Exchange Water to SDCWA. In
11 negotiating the Exchange Agreement's Price provision, SDCWA agreed not to challenge
12 MWD's water rates for a period of five years after its execution. Thereafter, SDCWA reserved
13 its right to challenge the validity of MWD's rates "in an administrative or judicial forum." In
14 that context, SDCWA openly threatened to litigate over MWD's existing rate structure and
15 destabilize MWD's rates.

16 Given the risks posed by this threat, in early 2004 MWD began considering options to
17 ensure the availability of long-term funding for its LRP, CCP, and SDP contracts. To that end,
18 in April 2004, MWD proposed the inclusion of an early draft of the RSI provision in an LRP
19 contract with one of its member agencies, Metropolitan Water District of Orange County.
20 Thereafter, in a June 18, 2004 memorandum to all member agency managers, MWD's then CEO,
21 Ron Gastelum, proposed including the RSI provision in all future LRP, CCP, and SDP contracts.
22 The principal objective of this proposal was to ensure sufficient funding for long-term local
23 project contracts by protecting the stability of MWD's rate structure. To do so, the provision
24 encourages member agencies that avail themselves of these funds to make a commitment to
25 resolve challenges to MWD's existing rate structure through the MWD Board process rather than
26 through piecemeal litigation or legislative challenges.

27 The RSI proposal was vigorously debated among the member agencies, with SDCWA
28 objecting to the proposal in detail. SDCWA was represented and advised by counsel in

1 developing its objections. Specifically, SDCWA claimed that the RSI provision was overbroad
2 in that it sought to protect MWD's entire rate structure, not just the Water Stewardship Rate.
3 SDCWA further objected that the provision would impose an unconstitutional condition on its
4 claimed constitutional right to petition the courts. SDCWA was given the opportunity to air its
5 objections to the RSI proposal and present its analysis to MWD's Board.

6 MWD responded to SDCWA's criticisms. For example, in November 2004, before the
7 RSI proposal was presented to MWD's Board for consideration, MWD explained that, given the
8 integrated and interdependent nature of its rate structure, to be effective, the RSI provision had to
9 apply not only the Water Stewardship Rate, but to all of MWD's rates. Because all of MWD's
10 costs must be recovered through its rates, an attack on any one rate component would amount to
11 an attack on the entire rate structure. If any one component was eliminated or found to be
12 unlawful, the other rate components would have to be adjusted to account for lost revenue from
13 the challenged component, leading to increases in other rates. Thus, piecemeal attacks on
14 individual rate components that fail to consider all of the factors the Board must consider in
15 allocating costs and setting rates threatens to destabilize MWD's entire rate structure. Instability
16 in its existing rate structure affects not only MWD, but all of MWD's member agencies, which
17 are left unable to properly plan and budget for the future. By encouraging member agencies to
18 address objections to MWD's rates through the Board process, the RSI provision stabilizes
19 MWD's existing rate structure by ensuring that rate decisions are made in consideration of the
20 larger picture, taking into account MWD's overall costs and revenue streams.

21 Between the time the RSI provision was initially proposed to the member agencies and
22 December 2004, when it was considered by MWD's Board, the provision changed significantly
23 to address issues raised by the member agencies. For example, in the initially proposed version,
24 any member agency that violated its terms would be subject to automatic termination of the
25 project contract. However, the final version gave MWD's Board discretion on whether to
26 ultimately terminate a project contract in the event of a violation. The final version also added a
27 term allowing the member agencies to challenge MWD's rates if (1) there was a "material
28 change" in MWD's existing rate structure and/or cost-of-service methodology, or (2) MWD

1 failed to comply with the requisite procedural requirements in amending its rate structure.

2 MWD's Board was presented with four options at its December 14, 2004 meeting, and
3 the Board voted to adopt the RSI provision at issue. As adopted, the RSI provision requires
4 parties that enter into these project contracts with MWD to address "any and all future issues,
5 concerns and disputes relating to [MWD's] existing rate structure, through administrative
6 opportunities available to them pursuant to Metropolitan's public board process." If, however, a
7 contracting party chooses to challenge MWD's rate structure through outside litigation and/or
8 legislation, MWD has the option to initiate a termination process, and if the mandated mediation
9 is unsuccessful, MWD's Board has the option of terminating payments under the contract. The
10 RSI provision does not prohibit litigation over MWD's rates. Nor does it purport to exempt
11 MWD from liability. Rather, it simply provides that a party cannot avail itself of the project
12 contract payments while simultaneously challenging the very source of those funds.

13 **5. SDCWA Executed Project Contracts with MWD that** 14 **Contain the RSI Provision**

15 On July 22, 2004, before the MWD Board adopted the RSI proposal, SDCWA's Board
16 established a policy not to enter into any project contracts with an RSI provision. For the next
17 three years, SDCWA followed that policy and refused to enter into any LRP, CCP, or SDP
18 contracts with MWD. In 2007, however, SDCWA's Board changed its position. SDCWA did
19 so because it wanted the money from MWD, and SDCWA admits that, at the time, it did not plan
20 to litigate MWD's rate structure.

21 Between 2007 and 2010, SDCWA entered into six project contracts with MWD that
22 included the RSI provision. Under these contracts, SDCWA agreed to develop and implement
23 local conservation and water recycling projects subject to certain performance provisions. In
24 consideration, MWD agreed to make payments to SDCWA based on the acre-feet of water
25 developed or conserved. Under each of the project contracts between MWD and SDCWA,
26 SDCWA accepted money from MWD.

27 SDCWA was represented by counsel in the negotiation of each of these project contracts,
28 and SDCWA's counsel executed the contracts. None contain any purported "reservation of

1 rights,” and SDCWA never communicated any such reservation to MWD, either orally or in
2 writing, after SDCWA’s Board authorized execution of project contracts with the RSI provision.

3 **6. SDCWA Filed Suit, Triggering the RSI Provision**

4 On June 11, 2010, SDCWA filed its lawsuit challenging the rates adopted by MWD’s
5 Board in April 2010. Thereafter, on August 17, 2010, MWD’s Board authorized its general
6 manager to initiate the termination process with regard to six outstanding project contracts with
7 SDCWA that contained the RSI provision. MWD’s general manager gave SDCWA the requisite
8 notice of its intent to terminate. In response, SDCWA requested mediation, which was
9 ultimately unsuccessful. By the time mediation was complete, there were only four ongoing
10 project contracts subject to termination, as the other two had been fully performed according to
11 their terms.

12 On June 14, 2011, MWD’s Board voted to terminate two of the four active contracts with
13 SDCWA, one that funded landscaping retrofits and the other for construction of a water
14 recycling unit for the San Vicente Golf Course. The other two active contracts—the
15 commercial and residential conservation agreements—were amended to provide payments
16 directly to residents and businesses.

17 As part of its decision to initiate the termination process of existing project contracts,
18 MWD’s Board also voted to defer the execution of three pending project contracts with
19 SDCWA. These contracts had not yet been finalized and were in various stages of negotiation.
20 Two of these deferred agreements provided funding for water conservation—one for an
21 agricultural conservation program and the other for research regarding flow control valves. The
22 third deferred contract was for a proposed Seawater Desalination Project in Carlsbad, California.
23 This project was designed to produce 56,000 acre-feet of potable water a year from desalinated
24 seawater. Under the proposal, SDCWA requested from MWD up to \$350 million for
25 approximately 1.4 million acre-feet of water over the span of 25 years. Ultimately, the Carlsbad
26 project went forward without MWD’s participation. SDCWA has admitted that this project will
27 provide region-wide benefits.
28

1 **C. Factual Background Relevant to the Preferential Rights Claim**

2 Under section 135 of the MWD Act, each member agency has a preferential right to
3 purchase a certain percentage of MWD’s available water supply based on the Legislature’s
4 formula set forth in that section. Section 135 was enacted in 1927 and amended in 1931; it
5 provides:

6 Each member public agency shall have a preferential right to
7 purchase from the district . . . a portion of the water served by the
8 district which shall, from time to time, bear the same ratio to all of
9 the water supply of the district as the total accumulation of
10 amounts paid by such agency to the district on tax assessments and
11 otherwise, *excepting purchase of water*, toward the capital cost and
operating expense of the district’s works shall bear to the total
payments received by the district on account of tax assessments
and otherwise, *excepting purchase of water*, towards such capital
costs and operating expenses.

12 (Emphasis added.) Under this formula, each member agency’s preferential right is based on the
13 total accumulation of amounts paid by that member agency on “tax assessments and otherwise”
14 that go to MWD’s “capital costs and operating expenses,” “excepting purchase of water.” Thus,
15 payments for the “purchase of water”—even if used for capital costs and operating expenses—
16 are not included in the preferential rights calculation.

17 MWD collects revenues from its member agencies in a variety of ways, including ad
18 valorem property taxes and fixed charges unrelated to the purchase of water, and uniform
19 volumetric water rates for each unit of water purchased. As stated above, in October 2001,
20 MWD adopted its existing rate structure, effective as of January 2003, which unbundled its rates
21 into the Tier 1 and Tier 2 Supply Rates; the System Access Rate; the System Power Rate; the
22 Water Stewardship Rate; and a Treatment Surcharge (applied when MWD delivers treated
23 water). The System Access Rate, the System Power Rate, and the Water Stewardship Rate are
24 set to recover MWD’s budgeted costs related to delivery (or transportation) of water. MWD also
25 collects fixed, non-volumetric charges from its member agencies, including a Capacity Charge
26 and a Readiness-to-Serve Charge.

27 MWD calculates each member agency’s preferential right annually. It does so by
28 calculating the accumulative total monies paid by that member agency in taxes, Readiness-to-

1 Serve Charges, Capacity Charges, and various other fixed charges and then calculating the
2 percentage of that amount against the same accumulative amounts paid by all of the member
3 agencies. MWD excludes from that calculation the member agencies' payments for the
4 "purchase of water" through the volumetric water rate components, including the System Access
5 Rate, the System Power Rate, and the Water Stewardship Rate.

6 Each member agency, when receiving water from MWD, pays the System Access Rate,
7 the System Power Rate, and the Water Stewardship Rate components per acre-foot of water
8 delivered. If the water is from MWD-developed supplies, the member agency receiving the
9 water also pays a Tier 1 or Tier 2 Supply Rate for each acre-foot of water; if the water being
10 delivered initially originated from a third party, the member agency does not pay the Supply
11 Rate.

12 SDCWA purchases from MWD both water from MWD-developed supplies, i.e., MWD
13 water, and Exchange Water under the 2003 Exchange Agreement. Under the 2003 Exchange
14 Agreement, SDCWA makes available water it purchases from the Imperial Irrigation District to
15 MWD at the intake to MWD's Colorado River Aqueduct on Lake Havasu, and in turn, MWD
16 delivers an equivalent amount of "Exchange Water" to SDCWA at various delivery points within
17 San Diego County. Exchange Water means "water that is delivered to SDCWA by
18 Metropolitan . . . in a like quantity as the quantity of water that SDCWA has Made Available to
19 Metropolitan. . . ." "The Exchange Water may come from whatever source or sources"
20 available to MWD. SDCWA pays MWD a Price for each acre-foot of Exchange Water MWD
21 delivers, *i.e.*, a volumetric water rate. The Price is defined as "the applicable amount to be paid
22 per acre-foot of Exchange Water delivered by Metropolitan to SDCWA" The Price
23 SDCWA pays for Exchange Water under the Exchange Agreement is composed of (1) the
24 System Access Rate, (2) the System Power Rate, and (3) the Water Stewardship Rate, each of
25 which, SDCWA admits, is a component of MWD's volumetric water rates. In short, SDCWA
26 pays MWD "water rates" to obtain Exchange Water under the Exchange Agreement.

27 As SDCWA pays MWD's volumetric water rate components under the Exchange
28 Agreement for each acre-foot of Exchange Water delivered to SDCWA, those payments are for

1 the “purchase of water” under section 135, particularly as that provision has been interpreted by
 2 the Court of Appeal in prior litigation that SDCWA initiated on the issue. *See SDCWA v. MWD*,
 3 117 Cal. App. 4th 13 (2004). MWD thus properly excludes those payments from the preferential
 4 rights calculation. SDCWA’s own documents repeatedly admit that the “[c]urrent Preferential
 5 Rights Formula does not include any component of the water rate.” SDCWA admits that this
 6 statement constitutes its paraphrasing of section 135. SDCWA’s internal documents further
 7 acknowledge: “Section 135 does not include revenue collected through water rates in the
 8 preferential rights calculations.”

9 **III. STANDARD OF REVIEW, BURDEN OF PROOF, AND ADMISSIBLE**
 10 **EVIDENCE FOR THE RATE CHALLENGES (FIRST THREE CAUSES**
 11 **OF ACTION)**

12 The rate challenges in the first three causes of action in both the *2010* and *2012 Actions*
 13 consist of a writ of mandate (first cause of action), request for declaratory relief (second cause of
 14 action), and request for determination of invalidity of the rates (third cause of action). Each of
 15 these causes of action in both actions alleges that MWD’s rates violate the following five laws:
 16 the MWD Act, common law, Government Code Section 54999.7(a), Water Code Section 1810,
 17 *et seq.*, and Proposition 13. In addition, in the *2012 Action* only, SDCWA alleges MWD’s rates
 18 also violate Proposition 26. As the Court has previously recognized, stated in simplest terms
 19 under all laws the Court is to assess whether the rates are reasonable. *See 3/27/2013 Tr. at*
 20 *15:10-16* (Court stating that whether evaluating MWD’s rates and charges under Proposition 26
 21 or any other law, “the substantive issue, of course, as we all know, will be exactly the same,
 22 which is the reasonableness of the rates.”).

23 **A. Standard of Review Generally Applicable to Challenges to Quasi-**
 24 **Legislative Decisions Such As MWD’s Rate-Setting**

25 In determining whether MWD’s rates comply with California law, this Court “is
 26 reviewing the actions of another entity” (July 22, 2013 Order at 3); specifically, MWD’s rate-
 27 making decisions. As is well established, challenges to the lawfulness of quasi-legislative
 28 decisions are reviewed under the “arbitrary and capricious” standard of review. *See Brydon v.*
East Bay Mun. Util. Dist., 24 Cal. App. 4th 178, 196 (1994); *Am. Coatings Ass’n, Inc. v. S.*

1 *Coast Air Quality Dist.*, 54 Cal. 4th 446, 460 (2012).

2 There is no question that MWD engages in a quasi-legislative process when it sets its
3 water rates, and therefore the arbitrary and capricious standard applies here. *See 20th Century*
4 *Ins. Co. v. Garamendi*, 8 Cal. 4th 216, 277 (1994) (“When performed by an administrative
5 agency, ratemaking has uniformly been considered a quasi-legislative action.”); *see also Brydon*
6 *v. East Bay Mun. Util. Dist.*, 24 Cal. App. 4th 178, 196 (1994) (enactment of a water rate
7 structure design is “quasi-legislative [in] nature”); *Durant v. Beverly Hills*, 39 Cal. App. 2d 133,
8 139 (1940) (“the matter of fixing water rates is . . . legislative in character”).

9 This standard requires that a challenge to an agency action be denied unless that action
10 was “entirely lacking in evidentiary support.” *Brydon*, 24 Cal. App. 4th at 196 (“Given the
11 quasi-legislative nature of the District’s enactment of the rate structure design, review is
12 appropriate only by means of ordinary mandate where the court is limited to a determination of
13 whether District’s actions were arbitrary, capricious or entirely lacking in evidentiary support.”)
14 (citations omitted); *see also Am. Coatings*, 54 Cal. 4th at 460 (“In assessing the validity of a
15 quasi-legislative [decision] in an action for mandamus under Code of Civil Procedure section
16 1085, our inquiry necessarily is confined to the question whether the classification is ‘arbitrary,
17 capricious, or without reasonable or rational basis.’”) (citations omitted).⁴

18 Under this standard, review is highly deferential (*see Brydon*, 24 Cal. App. 4th at 196,
19 204) and California courts have recognized that “[s]ubstantial deference must be given to
20 [MWD’s] determination of its rate design.” *San Diego Cnty. Water Auth. v. Metro. Water Dist.*

21 _____
22 ⁴ The arbitrary and capricious standard of review applies equally to SDCWA’s causes of action
23 for declaratory relief and determinations of invalidity. The standard for mandamus review
24 applies regardless of how the case is captioned or how the plaintiff articulates its requested relief;
25 the relevant inquiry is whether the action challenges a quasi-legislative agency decision, not
26 whether plaintiff seeks its relief in the form of a writ, declaratory judgment, or statement of
27 decision. *See generally Bunnett v. Regents of the University of California*, 35 Cal. App. 4th 843,
28 848 (1995) (regardless of how denominated, “the causes of action are no more than challenges to
the administrative decision of a state agency,” and therefore the standards applicable to “a writ of
mandate” apply); *Le Strange v. City of Berkeley*, 210 Cal. App. 2d 313, 320 (1962) (“[t]he
appropriate method of reviewing the decisions or orders of local administrative agencies . . . is
by mandamus,” and when the complaint is captioned otherwise, “it may be regarded as a petition
for a writ of mandate”).

1 of *S. Cal. (SDCWA v. MWD)*, 117 Cal. App. 4th 13, 23 n.4 (2004) (observing that while SDCWA
2 did not allege any “untoward conduct” by MWD in structuring its rates, even if SDCWA had
3 “[t]hat argument would be futile. Substantial deference must be given to [MWD’s] Board’s
4 determination of its rate design.”) (citations omitted). As part of the substantial deference given
5 to the ratemaking agency, “where the [agency] had the legislatively delegated authority to enact
6 the regulatory means in dispute, it must be presumed the board did not act arbitrarily or
7 unreasonably . . . but that it was guided by sound discretion and a conscientious and intelligent
8 judgment.” *Brydon*, 24 Cal. App. 4th at 196.

9 Quasi-legislative decisions are entitled to significant deference for two important reasons:
10 first, to guarantee that courts will not “usurp legislative power and thereby violate the separation
11 of powers,” and, second, because agencies such as MWD “develop a high degree of expertise” in
12 their subject areas. *Western States Petroleum Ass’n v. Super. Ct.*, 9 Cal. 4th 559, 572 (1995); *see*
13 *also Pitts v. Perluss*, 58 Cal. 2d 824, 834-35 (1962) (“The substitution of the judgment of a court
14 . . . in quasi-legislative matters would effectuate neither the legislative mandate nor sound social
15 policy”); *Carrancho v. California Air Resources Bd.*, 111 Cal. App. 4th 1255, 1272 (2003) (“A
16 court passing on the means employed by an agency to effectuate a statutory purpose will not
17 substitute its judgment for that of the agency in the absence of arbitrary and capricious action.”);
18 *Brydon*, 24 Cal. App. 4th at 196 (“Such limited review is grounded on the doctrine of the
19 separation of powers which (1) sanctions the delegation of authority to the agency and (2)
20 acknowledges the presumed expertise of the agency.”) (quoting *Garrick Development Co. v.*
21 *Hayward Unified School Dist.*, 3 Cal. App. 4th 320, 328 (1992)) (citations omitted); *Durant v.*
22 *City of Beverly Hills*, 39 Cal. App. 2d 133, 139 (1940) (“The universal rule is that . . . the court is
23 not a rate-fixing body”).

24 While the arbitrary and capricious standard is even “*more* deferential to agency
25 decisionmaking” than the highly deferential substantial evidence standard (*see Am. Coatings*, 54
26 Cal. 4th at 461 (emphasis added)), courts often utilize the substantial evidence test to determine
27 if an agency’s decision is arbitrary and capricious. *See Golden Drugs Co., Inc. v. Maxwell-Jolly*,
28 179 Cal. App. 4th 1455, 1467 (2009) (“We recognize that not everyone acknowledges a

1 distinction between ‘devoid of evidentiary support’ and ‘substantial evidence’”) (citations
2 omitted). Indeed, the arbitrary and capricious standard “generally means that a court cannot
3 disturb the agency’s decision if substantial evidence in the administrative record supports the
4 decision.” *Plastic Pipe and Fittings Ass’n v. California Bldg. Standards Comm’n*, 124 Cal. App.
5 4th 1390, 1406 (2004).

6 The crux of the Court’s inquiry is whether MWD can “cite[] a legitimate reason” for its
7 rate structure design. *San Joaquin Local Agency Formation Comm’n v. Super. Ct.*, 162 Cal.
8 App. 4th 159, 170 (2008); *see also Am. Coatings*, 54 Cal. 4th at 461 (the arbitrary and capricious
9 standard “require[s] a reasonable basis for the [agency] decision”) (citations omitted). Indeed, in
10 rate discrimination cases, reasonableness “is the beginning and end of the judicial inquiry.”
11 *Hansen v. City of San Buenaventura*, 42 Cal. 3d 1172, 1181 (1986).

12 Therefore, any allegations of bias SDCWA has or may make are irrelevant to the
13 reasonableness inquiry. *Wilson v. Hidden Valley Mun. Water Dist.*, 256 Cal. App. 2d 271, 286
14 (1967) (it is well established that “[a]ny claim of prejudgment, bias or prejudice” on the part of
15 an agency “is beside the point” in reviewing the legality of quasi-legislative decisions).⁵ The
16 California Supreme Court has held that “the validity of a legislative act does not depend on the
17 subjective motivation of its draftsmen but rests instead on the objective effect of the legislative
18 terms.” *Cnty. of Los Angeles v. Super. Ct.*, 13 Cal. 3d 721, 727 (1975). A duly enacted rate
19 supported by substantial evidence in the record cannot be invalidated because it was alleged to
20 have “resulted from” subjective feelings or purposes that the court found impure or distasteful.
21 *San Francisco v. Cooper*, 13 Cal. 3d 898, 905 (1975) (“the judiciary has no authority to
22 withdraw the legislative prerogative on the basis of allegedly improper influences brought to
23 bear upon individual legislators”). Indeed, courts have rejected allegations that water districts
24 are biased that are similar to those SDCWA has made in this matter:

25 Any claim of prejudgment, bias or prejudice in favor of this policy on the
26 part of the four directors in acting upon the petitions is beside the point.

27 ⁵ As noted, this Court has ruled that SDCWA’s allegations of a “cabal” are “not part of the case.”
28 7/2/2012 Tr. at 40:26-43:1 and 62:27-63:6.

1 1. **Standard of Review**

2 As discussed in Section III.A *supra*, the standard of review for determining whether
3 MWD's rates comply with the law is the arbitrary and capricious standard. "Substantial
4 deference must be given to [MWD's] Board's determination of its rate design. Rates established
5 by the lawful rate-fixing body are presumed reasonable, fair and lawful." *SDCWA v. MWD*, 117
6 Cal. App. 4th at 23 n.4 (citations omitted).

7 Where there is any dispute over the meaning or interpretation of MWD Act Section 134,
8 MWD's interpretation is entitled to substantial deference. In *SDCWA v. MWD*, where SDCWA
9 challenged MWD's compliance with a different section of the MWD Act, the Court of Appeal
10 stated that it must "accord[] great weight and respect to [MWD's] construction." 117 Cal. App.
11 4th at 22. This is in keeping with the long-standing rule that courts "give deference to an
12 agency's interpretation" of a statute "by its implementing agency." *Kern Cnty. Water Agency v.*
13 *Watershed Enforcers*, 185 Cal. App. 4th 969, 982 (2010); *see also San Bernardino Valley*
14 *Audubon Soc'y v. City of Moreno Valley*, 44 Cal. App. 4th 593, 603 (1996) ("[W]e give great
15 deference to an agency's interpretation of its governing statutes."); *City of Long Beach v. Dep't*
16 *of Indus. Relations*, 34 Cal. 4th 942, 956 (2004) ("In construing an ambiguous statute, courts
17 generally defer to the views of an agency charged with administering the statute.").

18 2. **Burden of Proof**

19 SDCWA bears the burden of establishing that MWD's water rates violate the MWD Act.
20 Common law dictates that MWD's rates must be presumed reasonable and the "burden of
21 overcoming this presumption is on the assailant." *Boynton v. City of Lakeport Mun. Sewer Dist.*
22 *No. 1*, 28 Cal. App. 3d 91, 95 (1972). Specifically, the burden of proof first falls on the plaintiff
23 to establish that the rates are different for like classes of people, and then it "shifts to defendants
24 to establish that the rates were fixed by a lawful rate-fixing body." *Elliott v. City of Pac. Grove*,
25 54 Cal. App. 3d 53, 60 (1975). "Upon such a showing an assumption of fact is required to be
26 made that the rates fixed are reasonable, fair and lawful." *Id.* Finally, "[t]he burden then shifts
27 back to plaintiff to establish . . . that the rates fixed are unreasonable, unfair or unlawful." *Id.*

28 The rebuttable presumption affecting the burden of proof as to whether MWD's rates are

1 fair and reasonable under common law similarly affects whether MWD's rates are *lawful* under
2 the MWD Act. *See e.g.*, Cal. Evid. Code § 660 (all other rebuttable presumptions established by
3 law that fall within the criteria of Section 605 are presumptions affecting the burden of proof).
4 Because "[r]ates established by [a] lawful rate-fixing body are presumed reasonable, fair and
5 lawful," (*Hansen*, 42 Cal. 3d at 1180) SDCWA ultimately bears the burden of overcoming this
6 presumption and establishing that MWD's rates are not lawful, and, instead, violate the MWD
7 Act.

8 3. Evidence the Court Is Required to Evaluate

9 a. Scope of Allowable Evidence

10 The California Supreme Court has stated the "well settled" rule that "extra-record
11 evidence is generally not admissible in . . . traditional mandamus actions challenging quasi-
12 legislative administrative decisions." *Western States*, 9 Cal. 4th at 574. In other words, a court
13 should "consider *only* the administrative record" (which excludes extra-record documents, as
14 well as fact and expert witness testimony) in determining whether a quasi-legislative decision
15 was reasonable. *Id.* at 573 (emphasis added); *see also Am. Coatings*, 54 Cal. 4th at 460 (when
16 evaluating the validity of a quasi-legislative decision, courts "consider only the administrative
17 record before the agency at that time [the decision was made]"); *Plastic Pipe & Fittings Ass'n.*,
18 124 Cal. App. 4th at 1406 (review of quasi-legislative action was limited to determining whether
19 agency action was arbitrary, capricious, or "entirely without evidentiary support," which
20 "generally means that a court cannot disturb the agency's decision if . . . evidence in the
21 administrative record supports the decision").

22 The Courts of Appeal have unanimously followed the rule in *Western States* on this
23 point: "An unbroken line of cases holds that, in traditional mandamus actions challenging quasi-
24 legislative administrative decisions, . . . 'extra-record evidence' is not admissible." *Carrancho*,
25 111 Cal. App. 4th at 1269 (citations omitted); *see also San Joaquin*, 162 Cal. App. 4th at 163,
26 167 (granting writ petition to quash discovery on this basis).⁷

27 _____
28 ⁷ *See also, e.g., Poway Royal Mobilehome Owners Ass'n v. City of Poway*, 149 Cal. App. 4th
1460, 1479 (2007) ("The scope of judicial review of a legislative type activity is limited to an

1 The prohibition on reviewing extra-record evidence includes fact and expert witness
2 testimony. *See, e.g., Carrancho*, 111 Cal. App. 4th at 1271 (upholding grant of a protective
3 order prohibiting depositions of California Air Resources Board personnel about a quasi-
4 legislative proposal to control rice-burning in the Central Valley because “[t]he trial court
5 correctly ruled that extra-record evidence was not admissible” and “review is properly confined
6 to the administrative record”); *San Joaquin*, 162 Cal. App. 4th at 172 (holding that review of
7 extra-record evidence would “violate the deliberative process privilege,” and thus depositions
8 ordered by the trial court could not take place). As the Supreme Court explained in *Western States*,
9 the existence of substantial evidence in the administrative record is a “question of law”—not a
10 question of fact. 9 Cal. 4th at 573. Therefore, “the only evidence that is relevant to the question of
11 whether there was substantial evidence to support a quasi-legislative administrative decision . . . is
12 that which was *before the agency at the time it made its decision.*” *Id.* at 574, n.4 (emphasis added).
13 In other words, extra-record evidence such as fact or expert witness testimony or documents that
14 were not before the agency when it made its decision may not be admitted to challenge the
15 substantiality of the evidence before the agency, and is therefore irrelevant to administrative record
16 review. *Id.* at 573.

17 There are two primary reasons for such limited review. First, courts must not “usurp
18 legislative power and thereby violate the separation of powers,” and, second, courts recognize

19 examination of the Record . . . to test for sufficiency with legal requirements.”) (citations
20 omitted); *Neilson v. City of California City*, 146 Cal. App. 4th 633, 641 (2007); *Evans v. San*
21 *Jose*, 128 Cal. App. 4th 1123, 1143 (2005) (“A fundamental rule of administrative law is that a
22 court’s review is confined to an examination of the record before the administrative agency”);
23 *Shapell Indus., Inc. v. Governing Bd.*, 1 Cal. App. 4th 218, 233 (1991); *Morgan v. Cmty.*
24 *Redevelopment Agency*, 231 Cal. App. 3d 243, 258-60 (1991) (affirming a trial court’s order
25 prohibiting discovery in a validation action seeking review of a quasi-legislative decision);
26 *Fosselman’s, Inc. v. City of Alhambra*, 178 Cal. App. 3d 806, 810-13 (1986); *Karlson v. City of*
27 *Camarillo*, 100 Cal. App. 3d 789, 803-04 (1980); *Lewin v. St. Joseph Hasp. of Orange*, 82 Cal.
28 App. 3d 368, 387 n.13 (1978); *E.M. Consumer Corp. v. Christensen*, 47 Cal. App. 3d 642, 653
(1975) (“[T]he court is authorized to review only the administrative record and is not permitted
to admit new evidence.”); *Beverly Hills Fed. Sav. &*
Loan Ass’n v. Super. Ct., 259 Cal. App. 2d 306, 324 (1968) (“The sufficiency of the evidence . . .
stands or falls on the administrative record [T]he trial court did not abuse its discretion in
refusing to permit the requested discovery.”); *Pitts*, 58 Cal. 2d at 833 (1962); *Brock*
v. Super. Ct., 109 Cal. App. 2d 594, 605 (1952).

1 that agencies such as MWD “develop a high degree of expertise” in their subject areas. *Western*
2 *States*, 9 Cal. 4th at 572; *see also id.* at 574 (“We have neither the resources nor . . . expertise to
3 engage in such analysis, even if the statutorily prescribed standard of review permitted us to do
4 so.”); *Brydon*, 24 Cal. App. 4th at 196 (“Such limited review is grounded on the doctrine of the
5 separation of powers which (1) sanctions the delegation of authority to the agency and (2)
6 acknowledges the presumed expertise of the agency.”).

7 SDCWA has not pointed to any legitimate reason to stray from the rule generally
8 applicable to judicial review of quasi-legislative decisions. As MWD demonstrates herein, its
9 rate-setting process is highly complex, and took years of consultation and cooperation with
10 MWD’s 26 member agencies, including SDCWA. Any extra-record evidence SDCWA may rely
11 on could only contradict the evidence MWD’s Board relied on when setting its rates, or look to
12 the subjective motivations of MWD’s Board when setting the rates, both of which are
13 impermissible under the law.⁸ *See, e.g., Western States*, 9 Cal. 4th at 579 (“[E]xtra record
14 evidence can never be admitted merely to contradict the evidence the administrative agency
15 relied on in making a quasi-legislative decision or to raise a question regarding the wisdom of
16 that decision.”); *Wilson*, 256 Cal. App. 2d at 286 (it is well established that “[a]ny claim of
17 prejudice, bias or prejudice” on the part of an agency “is beside the point” in reviewing the
18 legality of quasi-legislative decisions).

19 Additionally, earlier this year, the Court confirmed that the “usual situation in a review of
20 administrative decisions” is that review “is based. . . solely on the administrative record, where
21 [the Court is] generally speaking barred from going outside the record.” April 29, 2013 Order at
22 2. While the Court stated review could be based on the administrative record and “possibly other
23 evidence” with regard to SDCWA’s Wheeling Statute claims, it is clear that this is unnecessary.
24 *See id.* When the Court revisited the issue of extra-record evidence regarding the Wheeling
25 Statute claim in response to IID’s deposition notices, the Court clarified that IID would only be
26 entitled to discovery into extra-record evidence if such discovery would protect IID from being

27 ⁸ This Court has ruled that SDCWA’s allegations of a “cabal” are “not part of the case.”
28 7/2/2012 Tr. at 40:26-43:1 and 62:27-63:6.

1 “caught off guard as Metropolitan (at trial) explains its rate structure and rationales.” *See* May
2 28, 2013 Order at 2. The Court explained that “[a]s long as Imperial is given an adequate
3 opportunity to review and respond to Metropolitan’s [explanation and bases for its rate
4 structure], the interests animating [IID] in this discovery dispute will be satisfied.” *Id.* Because
5 MWD does not intend to introduce extra-record evidence to explain or justify its rate structure at
6 trial, there is no reason for IID or SDCWA to introduce extra-record evidence, including witness
7 testimony, at trial.

8 On December 13, 2011, MWD filed with the Court the administrative record for the rate
9 challenge in the *2010 Action*. That record consists of 40 volumes, totaling 11,574 pages. On
10 March 19, 2013, MWD filed with the Court the administrative record for the rate challenge in the
11 *2012 Action*. That record consists of 61 volumes, totaling 17,522 pages. These administrative
12 records contain the documents that MWD’s Board was presented and considered when setting
13 the 2011/12 and 2013/14 water rates.⁹ Although it had ample time and opportunity to do so,
14 SDCWA has not attempted to supplement the administrative record with a single additional
15 document it contends was before MWD’s Board at the time it set MWD’s 2011/12 and 2013/14
16 water rates.

17 When the Court reviews the evidence in these administrative records, its inquiry must be
18 whether MWD’s rates are reasonable, *i.e.*, whether MWD can “cite[] a legitimate reason” for its
19 rate structure design. *San Joaquin*, 162 Cal. App. 4th at 170.

20 While MWD believes there is ample evidence in its administrative records to support a
21 finding that the rates are reasonable, review of an agency’s administrative record is deferential
22 and the agency’s action should only be overturned if the record shows that it is arbitrary,
23 capricious, or “entirely without evidentiary support.” *Plastic Pipe & Fittings Ass’n*, 124 Cal.
24 App. 4th at 1406. Evidence in the administrative record is sufficient to support a quasi-

25 ⁹ An administrative record consists of the evidence that “was before the agency at the time it
26 made its decision.” *Western States*, 9 Cal. 4th at 574 n.4; *see also* Continuing Education of the
27 Bar, *California Civil Writ Practice*, § 7.7 (4th Ed.) (an administrative record in a traditional
28 mandamus case consists of the documents and testimony “presented to the decision-making body
that are relevant to the petitioner’s challenge to the underlying action or decision”).

1 legislative decision “if a reasonable trier of fact could conclude that the evidence is reasonable,
 2 credible, and of solid value.” *Id.* at 1407; *see also id.* at 1407-08 (court found that an agency’s
 3 reliance on a single comment letter in the record constituted substantial evidence to support its
 4 decision); *Associated Builders & Contractors, Inc. v. San Francisco Airports Com.*, 21 Cal.4th
 5 352, 374-75 (1999) (concluding that substantial evidence supported an agency decision based on
 6 a record consisting of only two public meetings to hear evidence and argument on the
 7 desirability of the agreement at issue as well as a declaration submitted by the Commission in
 8 opposition to the agreement).

9 Therefore, the Court’s review of SDCWA’s MWD Act (as well as all of the other claims
 10 in SDCWA’s rate challenges,¹⁰ as discussed below), should be limited to the administrative
 11 records in the *2010* and *2012 Actions*.

12 **b. Pertinent Administrative Record Documents**

13 Documents in each action’s administrative record shows that SDCWA’s challenge under
 14 the MWD Act fails at the outset under the plain language of the statute. As stated, SDCWA
 15 relies on section 134 of the MWD Act, which provides that MWD’s rates must be “uniform for
 16 like classes of service throughout the district.” To have a claim under section 134, SDCWA
 17

18 ¹⁰ The rule limiting review of the legality of MWD’s rates to the administrative record applies to
 19 all causes of action that challenge MWD’s rate structure and rates—whether styled as a petition
 20 for writ of mandate, a claim for declaratory relief, or a validation action under Code of Civil
 21 Procedure §§ 860 *et seq.* Regardless of how a cause of action is styled, the relevant inquiry is
 22 whether the action challenges a quasi-legislative agency decision. *See, e.g., Voss v. Super. Ct.*,
 23 46 Cal. App. 4th 900, 922-23 (1996) (stating that both mandamus and declaratory relief are
 24 available “to challenge the quasi-legislative actions of the [agency]” and that such actions are
 25 reviewed “within the bounds of the standards applicable to judicial review of such [actions]”);
 26 *Poway Royal Mobilehome Owners Ass’n v. City of Poway*, 149 Cal. App. 4th 1460, 1478-79
 27 (2007) (holding that in validation actions “[t]he scope of judicial review of a legislative type
 28 activity is limited to an examination of the record before the authorized decision makers to test
 for sufficiency with legal requirements”); *Kucharczyk Regents of Univ. of Cal.*, 946 F. Supp.
 1419, 1434 (N.D. Cal. 1996) (“Plaintiffs contend that mandamus does not apply at all in this
 action, which they characterize as a breach of contract action. However, the plaintiff’s
 characterization of his cause of action is not determinative.”); *see also Western States*, 9 Cal. 4th
 at 576 (as a result of the deference afforded to quasi-legislative decisions, the California
 Supreme Court held “that extra-record evidence is generally not admissible” even on claims
 “that the agency has not proceeded in a manner required by law”).

1 would need to identify two classes of service that are “like” each other but for which MWD
2 charges non-uniform rates. SDCWA makes no attempt to do that, and cannot.

3 As explained below, the record shows that MWD’s postage stamp rates are *uniform, i.e.*,
4 each member agency is charged the same volumetric rate per acre-foot of water; SDCWA simply
5 does not like what expenses they recover or that they are charged to all system users. And, even
6 if section 134 contained a hidden “reasonableness” requirement, record evidence supports the
7 conclusion that MWD’s rates would satisfy that standard too.

8 The documents in the administrative record show that MWD’s current rate structure,
9 including the rates challenged here, is the result of a lengthy and reasoned analysis of the
10 propriety of recouping expenses from related operation functions, through the application of
11 MWD’s Cost of Service (“COS”) methodology. A rates consultant engaged by MWD, a well-
12 respected and nationally recognized expert in the field,¹¹ concluded in his April 6, 2010 report
13 that the rates are “consistent with water industry best practices, and [comply] with COS and rate
14 guidelines in the American Water Works Association’s (‘AWWA’) Manual M-1, *Principles of*
15 *Water Rates, Fees, and Charges.*” See 2010/2012 Administrative Records (“2010 Record” and
16 “2012 Record”, respectively) Document No. 591.¹² The review further determined that MWD’s
17 “rate methodology is reasonable”, “consistent with Board policies and, more specifically, with
18 the 2001 Rate Structure Framework” and “accurate and consistent with the 2001 COS.” *Id.*

19 (1) Allocation of SWP Transportation Costs

20 With regard to MWD’s allocation of SWP expenses to its System Access Rate and
21 System Power Rate, evidence in the administrative record shows that MWD’s allocation of
22 DWR contract expenses for water transportation to the System Access Rate and System Power
23 Rate is reasonable because these rate elements generate revenue to pay MWD’s transportation-
24 related expenses.¹³

25 _____
26 ¹¹ See 2010/2012 Records Document No. 183 (consultant was a contributing member to the
27 American Water Works Association’s (‘AWWA’) Manual M-1, *Principles of Water Rates, Fees,*
28 *and Charges*, (5th Ed.)).

¹² All citations to administrative record documents are to the administrative record index number.

¹³ Case law acknowledges that a water seller with a take-or-pay contract (such as MWD has with

1 Under its contract with DWR, MWD pays to DWR separate supply and transportation
2 charges. Article 22 of the contract establishes a supply charge (called the “Delta Water
3 Charge”), which is “for project water.” 2010/2012 Records Document No. 1. Article 23
4 establishes the transportation charge “to *deliver* project water” and states that it consists of
5 “capital, operation, maintenance, power and replacement costs.” *Id.* (emphasis added). Article
6 24 describes the capital cost component of the transportation charge, which “shall return to the
7 State . . . those costs of all project transportation facilities necessary to deliver project water to
8 [MWD].” *Id.* Article 25 sets forth a minimum transportation charge for “operation,
9 maintenance, power and replacement” of DWR’s transportation facilities “irrespective of the
10 amount of project water delivered to the contractor.” *Id.* This charge covers such expenses as
11 operating and repairing the California Aqueduct, a transportation facility necessary for water to
12 be transported to MWD and its member agencies. The transportation charge also contains a
13 variable charge for operation, maintenance, power and replacement costs, which is dependent
14 upon the amount of water delivered to MWD. *Id.* This variable transportation charge is
15 principally composed of the power cost to pump water through the aqueduct and over the
16 Tehachapi Mountains to transport water to MWD and its member agencies.

17 The DWR contract also allows MWD to use SWP “transportation facilities to transport
18 water procured . . . from [non-DWR] sources for delivery to [its] service areas,” and provides the
19 charge for using SWP facilities to transport this water. *See id.*

20 MWD allocates these transportation costs based on their *transportation function* and
21 recovers the costs from member agencies through MWD’s transportation charges, namely the
22 System Access Rate and System Power Rate. The DWR transportation charges in Articles 23-26
23 and 55 are part of MWD’s transportation expenses because they are what MWD must pay for the
24 fixed capital, operations, and maintenance of the SWP facilities that transport water from the

25 DWR) may charge its customers for both supply and transportation. The California Court of
26 Appeal has observed that all parties to the water contract at issue there, for which the DWR
27 Contract was a prototype, “must make payments according to their respective maximum annual
28 water entitlements and the portion of the System *required to deliver* such entitlements.”
Goodman v. Cnty. of Riverside, 140 Cal. App. 3d 900, 904 (1983) (emphasis added).

1 sources of supply (in Northern California) to MWD’s service area, as well as for the variable
2 power-related cost of pumping water through those facilities, and for MWD’s contractual right to
3 use the SWP facilities to transport non-SWP water.

4 The administrative record shows that allocation of these SWP costs to the System Access
5 Rate and System Power Rate is reasonable, because the System Access Rate and System Power
6 Rate recoup the capital, operation, and maintenance costs MWD must pay for SWP
7 transportation facilities, as well as the costs to convey water to MWD’s internal distribution
8 system. *See id.*; *see also* 2010/2012 Records Document No. 310; 2010/2012 Records Document
9 No. 599; 2012 Record Document No. 944. The 2010 review of MWD’s rate methodology
10 concluded that “[f]unctionalizing [SWP] costs in this manner is appropriate because: 1) DWR
11 invoices in a very detailed manner that allows MWD staff to functionalize costs . . . and 2)
12 DWR does not aggregate invoices to MWD on a per-acre-foot basis.” 2010/2012 Records
13 Document No. 591.

14 In addition, allocation of the SWP transportation charges to MWD’s System Access Rate
15 is reasonable because MWD uses DWR’s conveyance facilities to transport both “Project and
16 Non-Project water [to] Metropolitan and its member agencies.” 2010/2012 Records Document
17 No. 590; *see also* 2010/2012 Records Document No. 84. Furthermore, the rationale behind
18 including fixed system-wide costs from all users, including SWP costs, in the System Access
19 Rate has been upheld by the California Court of Appeal. In *Metro. Water Dist. of S. Cal. v.*
20 *Imperial Irrigation Dist.*, 80 Cal. App. 4th 1403 (2000) (hereinafter “*MWD v. IID*”), the Court
21 held that MWD may recover fixed system-wide costs from all users in the comparable context of
22 MWD setting its wheeling rate. *Id.* at 1427. The Court stated that passing these costs on to users
23 was reasonable because it prevented some users from subsidizing others, and enabled member
24 agencies receiving comparable services to pay comparable costs. *Id.* at 1427-32.

25 In terms of the System Power Rate, Article 26 of the DWR contract states that “[t]he
26 variable operation, maintenance, power and replacement component of the Transportation
27 Charge [returns] to the State those costs of the project transportation facilities necessary to
28 deliver water to the contractor.” 2010/2012 Records Document No. 1. It is difficult to imagine

1 how else MWD would have reasonably allocated the SWP transportation facility and power
2 costs given that conveyance of water is the very essence of transportation.

3 The primary argument SDCWA has raised to support allocating SWP transportation
4 charges to MWD's Supply Rate as opposed to its transportation rates is that MWD does not own
5 the SWP conveyance facilities. *See, e.g.*, TAC ¶¶ 3, 25; 2010/2012 Records Document No. 581.
6 The administrative record shows that this argument lacks merit. Documents in the administrative
7 record show that MWD allocates its expenses to different rate elements based on operation
8 functions, not ownership. *See, e.g.*, 2010/2012 Records Document No. 590. Even though MWD
9 does not own the conveyance facilities, MWD must pay DWR for the costs invoiced by DWR,
10 including costs that DWR bills as "Transportation Costs" under DWR Contract Articles 23-26
11 and Article 55. *See* 2010/2012 Records Document No. 1; 2010/2012 Records Document No.
12 591. MWD possesses the right to use the SWP for transportation of water and must pay for this
13 right. There is no operational difference between a transportation expense MWD incurs from a
14 third party, and a transportation expense MWD incurs by use of its own facilities. Indeed, the
15 very purpose of water rates is to recover a water district's expenses. MWD Act §134 (MWD's
16 Board "shall fix such rate or rates for water as will result in revenue which . . . will pay the
17 operating expenses of the district, provide for repairs and maintenance, provide for payment of
18 the purchase price or other charges for property or services or other rights required by the
19 district"); 2010/2012 Records Document No. 183 ("In providing adequate water service to its
20 customers, every water utility must receive sufficient total revenue to ensure proper operation
21 and maintenance . . . and preservation of the utility's financial integrity. Nearly all of total
22 revenue requirements for most utilities are met from revenues derived from selling water to their
23 customers.").

24 (2) Allocation of the Water Stewardship Rate

25 The administrative record also supports MWD's contention that including the Water
26 Stewardship Rate in transportation charges is reasonable because development of local water
27 resources decreases the need for additional conveyance facilities, and thus reduces conveyance
28

1 costs. Specifically, as demonstrated in the administrative record, the Water Stewardship Rate
2 recovers the budgeted costs for conservation and local resource development, which reduces the
3 demand and burden on MWD's conveyance system; decreases and avoids operating and capital
4 maintenance and improvement costs, such as costs for repair of and construction of additional or
5 expanded water conveyance, distribution, and storage facilities; and frees up capacity in MWD's
6 system to convey both MWD water and water from other non-MWD sources.

7 In the Cost of Service process, MWD allocated the costs that the Water Stewardship Rate
8 is designed to recover to its "Demand Management" function. 2010/2012 Records Document
9 No. 599; 2012 Record Document No. 944. The purpose of Demand Management is to generate
10 additional local resources, which reduces the amount of water that must otherwise be transported
11 through MWD's system. "Investments in demand side management programs like conservation,
12 water recycling and groundwater recovery . . . help defer the need for additional conveyance,
13 distribution, and storage facilities." 2010/2012 Records Document No. 599 (estimating financial
14 benefits to water conveyance, storage, distribution and supply programs from Demand
15 Management); 2012 Record Document No. 944 (same); 2010/2012 Records Document No. 590
16 ("Demand management is an important part of Metropolitan's resource management efforts.
17 Metropolitan's incentives in these areas contribute to savings for all users of the system in terms
18 of lower capital costs that would otherwise have been required to expand the system."). The
19 costs recovered by the Water Stewardship Rate therefore reduce system capacity expansion costs
20 and increase available capacity for water transfers through MWD's facilities. Without
21 investments in conservation and recycling, MWD would have to build additional system
22 capacity, which would burden all the member agencies. 2010/2012 Records Document No. 310
23 (Investments in conservation "reduce and defer system capacity expansion costs; and create
24 available capacity to be used to complete water transfers. Because conservation measures and
25 local resource investments reduce the overall level of dependence on the imported water system,
26 more capacity is available in existing facilities for a longer period of time. The capacity made
27 available by conservation and recycling is open to all system users and can be used to complete
28 water transfers.").

1 944. Pertinent functionalized costs include Conveyance and Aqueduct, which includes the
2 capital, operations, maintenance, and overhead costs for SWP and Colorado River Aqueduct
3 facilities that convey water to MWD's distribution system; Storage, which includes drought
4 storage that produces additional supplies during times of shortage; and Distribution, which
5 includes the capital, financing, operating, maintenance, and overhead costs for MWD's
6 distribution system to its member agencies within its service area. 2010/2012 Records
7 Document No. 599; 2012 Record Document No. 944. The method MWD used to classify its
8 costs—the modified Commodity/Demand method—distinguishes between utility costs “incurred
9 to meet average or base demands and costs incurred to meet peak demands.” 2010/2012 Records
10 Document No. 599; 2012 Record Document No. 944. The commodity and demand
11 classifications recoup, respectively, MWD's supply costs and costs incurred to meet peak
12 demands. 2010/2012 Records Document No. 599; 2012 Record Document No. 944. MWD
13 modified this method to include a separate cost classification for costs related to providing
14 standby service (*i.e.*, ensuring system reliability by having water available for its member
15 agencies in the event of an emergency such as an earthquake). 2010/2012 Records Document
16 No. 599; 2012 Record Document No. 944.

17 MWD classified both Conveyance and Aqueduct and Distribution costs into its demand
18 and commodity categories (and also allocated Conveyance and Aqueduct to its standby
19 category), and conducted an analysis to determine the appropriate allocation to each category.
20 This included determining the percentage of available capacity used to meet peak monthly and
21 daily deliveries to its member agencies (which falls into the demand classification). 2010/2012
22 Records Document No. 599; 2012 Record Document No. 944. MWD then allocated the demand
23 and standby cost classifications to its Readiness-to-Serve Charge, Capacity Charge, and
24 Treatment Surcharge. 2010/2012 Records Document No. 599; 2012 Record Document No. 944.
25 MWD allocated its drought storage operation function to its fixed commodity classification, and
26 finally to its supply rates. 2010/2012 Records Document No. 599; 2012 Record Document No.
27 944.

28 Administrative record evidence shows that allocating costs associated with satisfying

1 peak demand in this manner is reasonable.

2 The Readiness-to-Serve Charge recovers SWP-related conveyance costs associated with
3 peak demand as well as emergency and peak-related storage costs and standby costs. *See*
4 2010/2012 Records Document No. 599; 2012 Record Document No. 944. MWD calculates the
5 Readiness-to-Serve Charge for each member agency by using a ten-year rolling average of that
6 member agency's past total consumption, *i.e.*, all firm deliveries including water transfers and
7 exchanges that use MWD capacity. 2010/2012 Records Document No. 599; 2012 Record
8 Document No. 944. This calculation leads to a relatively stable Readiness-to-Serve Charge that
9 reasonably represents an agency's potential long-term need for standby services and access to
10 MWD's facilities under different demand conditions, including peak demand. 2010/2012
11 Records Document No. 599; 2012 Record Document No. 944. MWD allows its member
12 agencies to choose whether or not to pay a Standby Charge (a property tax) as a way to offset
13 their Readiness-to-Serve Charge. 2010/2012 Records Document No. 599; 2012 Record
14 Document No. 944.

15 The Readiness-to-Serve Charge is a fixed charge that does not vary with sales in a current
16 year, and thus it ensures that agencies that only occasionally buy water from MWD, but receive
17 the reliability benefits of MWD's system, pay in proportion to their share of the cost to provide
18 that reliability.¹⁴ *See* 2010/2012 Records Document No. 599; 2012 Record Document No. 944.
19 Because of the fixed nature of the Readiness-to-Serve Charge, member agencies pay the charge
20 each and every year regardless of the amount of water they take in a given year. It is reasonable
21 to recover these costs in this manner because MWD is standing by ready to serve in any given
22 year. 2010/2012 Records Document No. 310.

23 The capital facilities the Readiness-to-Serve Charge funds benefit all system users as
24

25 ¹⁴ A major advantage of a firm revenue source is that it contributes to revenue stability during
26 times of drought or low water sales. The Readiness-to-Serve Charge affords MWD additional
27 security, when borrowing funds, that a portion of its revenue stream will be unaffected by
28 drought or by rainfall. This security helps maintain MWD's historically high credit rating, which
results in lower interest expenses to MWD, and therefore, lower overall costs to the residents of
its service area. *Id.*

1 these facilities contribute directly to the reliable delivery of water supplies throughout MWD's
2 service area. 2010/2012 Records Document No. 599; 2012 Record Document No. 944.

3 MWD also recoups costs associated with peaking through its Capacity Charge, which
4 recovers the cost of providing seasonal peak storage capacity and MWD's distribution facilities
5 for peak usage "while providing an incentive for local agencies to decrease their use of the
6 Metropolitan system to meet peak day demands and to shift demands into lower use time periods
7 particularly October through April." 2010/2012 Records Document No. 599; 2012 Record
8 Document No. 944. The Capacity Charge is a fixed charge assessed on each member agency
9 based on the maximum summer day demand placed on MWD's system between May 1 and
10 September 30 for a three-calendar year period. 2010/2012 Records Document No. 599; 2012
11 Record Document No. 944. SDCWA has not argued, and it could not, that the Capacity Charge
12 violates any law. Indeed, when MWD's Board first decided a decade ago to implement the
13 current Capacity Charge, SDCWA stated that it believed that the Capacity Charge would
14 "provide the greatest economic incentive to actively manage system peaking." 2010/2012
15 Record Document No. 335.

16 Furthermore, drought storage creates supply, and is one component of the portfolio of
17 resources that result in a reliable amount of annual system supplies, especially during times of
18 peak need during dry times. 2010/2012 Records Document No. 599; 2012 Record Document
19 No. 944. As a result, it is logical to recoup MWD's costs associated with drought storage
20 through its Supply Rates.

21 As the record shows, MWD has clearly allocated costs associated with peak demand on
22 its system to the member agencies through its rates and charges. Furthermore, these allocations
23 are reasonable because they are directly related to each member agency's peaking behavior, *i.e.*,
24 each member agency pays the Readiness-to-Serve and Capacity Charges based on its share of
25 historical projections for total and peak demands. 2010/2012 Records Document No. 599; 2012
26 Record Document No. 944. For example, as evidenced by the Peak Day Demand tables MWD
27 prepares as part of its COS for calculating the Capacity Charge, it is clear that SDCWA
28 historically exerts the *highest* peak demand on MWD's system from May 1-September 30, and

1 therefore pays the highest Capacity Charge. *See* 2010/2012 Records Document No. 599; 2012
2 Record Document No. 944. For the years at issue in the *2010* and *2012 Actions*, SDCWA’s peak
3 demand accounted for around 26% of the total member agency 3-year peak demand, and
4 SDCWA paid between 25.2 and 25.9% of the Readiness-to-Serve Charge. 2010/2012 Records
5 Document No. 599; 2012 Record Document No. 944. Thus, evidence in the administrative
6 record shows that the member agencies, including SDCWA, pay MWD’s rates and charges
7 associated with peak demand in nearly direct proportion to the amount they themselves utilize
8 MWD to satisfy their peak demand.

9 As noted above, in this litigation SDCWA uses the word “peaking” in a manner that is
10 contrary to industry guidelines to refer to an agency’s annual variations in water purchases and
11 reliance on MWD’s system. As explained in greater detail herein and in Sections III.B.3.b.1-2,
12 MWD’s rates and charges already account for the costs associated with the member agencies’
13 annual variations. If a member agency purchases or conveys greater quantities of water in one
14 year as opposed to another, this is accounted for in the Readiness-to-Serve Charge and the
15 volumetric Supply Rate, System Access Rate, System Power Rate, and Water Stewardship Rate.
16 For instance, a member agency that purchases more water pays more under the volumetric
17 Supply Rate and the three volumetric conveyance rates. And, if the member agency’s water
18 purchases exceed a certain level, the member agency pays a higher Supply Rate (the Tier 2 Rate,
19 rather than the lower Tier 1 Rate). *See* 2010/2012 Records Document No. 599 (“The Tier 2
20 Supply Rate also recovers a greater proportion of the cost of developing additional supplies from
21 member agencies that have increasing demands on the Metropolitan system” and the price is set
22 based at least in part on “the uncertainty about supply and critically dry conditions.”); 2012
23 Record Document No. 944 (same).

24 Finally, it is clear from the record that MWD’s rates are uniform. As the record shows,
25 all member agencies pay the same volumetric System Access Rate, System Power Rate, and
26 Water Stewardship Rate. 2010/2012 Records Document No. 591 (“All member agencies pay the
27 [System Access Rate] to use MWD’s system for conveyance and distribution.”); 2010/2012
28 Records Document No. 599; (“All system users (member agency or third party) pay the System

1 Access Rate to use Metropolitan’s conveyance and distribution system.”); 2012 Record
2 Document No. 944 (same); 2010/2012 Records Document No. 310 (The System Power Rate “is
3 applied to all deliveries to member agencies. Wheeling parties will pay for the actual cost (not
4 system average) of power needed to move the water.”); 2010/2012 Records Document No. 599
5 (“All system users (member agency or third parties) will pay the same proportional costs for
6 existing and future conservation and recycling investments.”); 2012 Record Document No. 944
7 (same); 2010/2012 Records Document No. 591 (“All users will pay the same proportional costs
8 for [investments made from the Water Stewardship Rate revenue]”). And, as discussed above,
9 the Readiness-to-Serve and Capacity Charges are calculated in the same way for each member
10 agency: either the ten-year rolling average of an agency’s past total consumption, or a three-year
11 rolling average of that agency’s peak summer demand. And, a member agency’s supply charges
12 are directly proportionate to the amount of water that member agency purchases from MWD in a
13 given year.

14 C. SDCWA’s Common Law Claim

15 SDCWA alleges that MWD’s 2011/12 and 2013/14 water rates violate California
16 common law because they are not fair, reasonable, and proportionate to the cost of service. *See,*
17 *e.g.*, TAC ¶¶ 73, 83; 2012 Complaint ¶¶ 74, 84, 98.

18 1. Standard of Review

19 As discussed, courts review ratemaking under the arbitrary and capricious standard of
20 review. *See* Section III.A. “Rates established by [a] lawful rate-fixing body are presumed
21 reasonable, fair, and lawful” and reasonableness “is the beginning and end of the judicial
22 inquiry.” *Hansen*, 42 Cal.3d at 1180-81.

23 Under the common law, “[i]t is only unjust or unreasonable discrimination which renders
24 a rate or charge unreasonable.” *Hansen*, 42 Cal.3d at 1180-81. Unreasonable discrimination is
25 defined as “draw[ing] an unfair line or strik[ing] an unfair balance between those in like
26 circumstances having equal rights and privileges.” *Id.* (citations omitted); *see also Brydon*, 24
27 Cal. App. 4th at 197 (same); *Durant*, 39 Cal. App. 2d at 138 (The “fundamental theory of rate
28 making . . . is that there shall be but one rate for a particular service”) (quoting 51 C.J. 29, 30) (a

1 charge is unreasonable if it is “made to one patron or consumer different from that made to
 2 another, for the same service under like circumstances”). “[A] utility may, *without being guilty*
 3 *of unlawful discrimination*, classify its customers or patrons upon *any reasonable basis*, as
 4 according to the purpose for which they receive the utility’s service or product.” *Id.* at 139
 5 (quoting same) (emphasis added); *see also City and Cnty. of San Francisco v. Western Air Lines,*
 6 *Inc.*, 204 Cal. App. 2d 105, 134 (1962) (“In this state there is no cause of action at common law.
 7 . . . in the absence of allegation and proof that the charges paid by the plaintiff were unreasonable
 8 and excessive.”).

9 Therefore, employing the arbitrary and capricious standard, the Court should
 10 review MWD’s rates only for reasonableness.

11 **2. Burden of Proof**

12 As discussed above, SDCWA bears the burden of establishing that MWD’s rates violate
 13 the common law. *See* Section III.B.2, *supra*.¹⁵ Applying this rule to SDCWA’s common law
 14 claim, SDCWA must first show that MWD’s 2011/12 and 2013/14 water rates are different for
 15 like classes of member agencies. If it can do so, the burden would then shift to MWD to show
 16 that it was lawfully authorized to set its 2011/12 and 2013/14 water rates. Finally, the burden
 17 would shift back to SDCWA to establish that the 2011/12 and 2013/14 water rates are
 18 unreasonable.

19 **3. Evidence the Court Is Required to Evaluate**

20 **a. Scope of Allowable Evidence**

21 Because this claim challenges the lawfulness of the quasi-legislative act of rate setting
 22 (like SDCWA’s MWD Act claim discussed above), the Court’s review of evidence is limited to
 23 the administrative records in the *2010* and *2012 Actions* and should exclude extra-record
 24

25 _____
 26 ¹⁵ SDCWA bears the burden of establishing that MWD charges non-uniform rates to like classes
 27 of people, and then MWD must establish that the rates were fixed by a lawful rate-fixing body.
 28 *See Elliott*, 54 Cal. App. 3d at 60. Upon such showing, “an assumption of fact is required to be
 made that the rates fixed are reasonable, fair and lawful.” *Id.* Finally, “[t]he burden then shifts
 back to plaintiff to establish . . . that the rates fixed are unreasonable, unfair or unlawful.” *Id.*

1 documents and witness testimony.¹⁶ *See* Section III.C.3.a, *supra*. Judicial review of quasi-
 2 legislative actions, such as MWD’s determination of its rate structure and water rates, is limited
 3 to a deferential analysis based on the existing administrative record.

4 **b. Pertinent Administrative Record Documents**

5 The evidence in the administrative record, discussed above in Section III.B.3.b
 6 demonstrates that MWD’s allocation of SWP costs to its System Access Rate and System Power
 7 Rate, and the calculation of those rates and the Water Stewardship Rate based on quantities of
 8 water conveyed, is reasonable. Furthermore, the evidence shows that, contrary to SDCWA’s
 9 allegations, MWD does have rates and charges in place to recover peaking-related costs, and
 10 those rates and charges are also reasonable. *See id.*

11 **D. SDCWA’s Government Code Section 54999.7 Claim**

12 SDCWA also contends that MWD’s rates violate Government Code section 54999.7(a).
 13 *See, e.g.*, TAC ¶¶ 71, 96; 2012 Complaint ¶¶ 71, 98. That provision states:

14 Any public agency providing *public utility service* may impose a fee, including a
 15 rate, charge, or surcharge, for any product, commodity, or service provided to a
 16 public agency, and any public agency receiving service from a public agency
 17 providing public utility service shall pay that fee so imposed. Such a fee for
 18 public utility service, other than electricity or gas, shall not exceed the
 reasonable cost of providing the *public utility service*.
 Cal. Gov. Code § 54999.7(a) (emphasis added).

19 This statute is inapplicable to MWD—and SDCWA agrees. First, in a letter to MWD’s
 20 Board of Directors concerning the rate dispute at issue, SDCWA admitted that Section 54999 “is
 21 a provision of the San Marcos legislation governing the application of water service and other
 22 public utility rates to schools and other public agencies,” and it “*does not apply to a water*
 23 *wholesaler like [Metropolitan].*” TAC, Ex. D (emphasis added). Second, the statute also cannot
 24 apply to MWD for the additional reason that, on its face, it requires that rates charged to public
 25 agencies be the same as those charged to *non-public* agencies. MWD’s 26 customers are all

26 _____
 27 ¹⁶ Where a quasi-legislative agency action is being reviewed, courts “consider only the
 28 administrative record” in determining whether a quasi-legislative decision was reasonable.
Western States, 9 Cal. 4th at 573.

1 public agencies. Third, the statute cannot apply because MWD’s rates are not imposed (for the
2 same reasons discussed below under Proposition 26).

3 To further explain SDCWA’s concession, Government Code section 54999 was enacted
4 in response to the California Supreme Court’s decision in *San Marcos Water Dist. v. San Marcos*
5 *Unified Sch. Dist.*, 42 Cal. 3d 154 (1986). *San Marcos* involved a sewer capacity right fee that a
6 retail water district had imposed onto its end-user customers, including a school district. *Id.* at
7 157-58. The Supreme Court held that the capacity fee amounted to a special assessment or tax
8 and under the California Constitution and public entities are generally excepted from liability for
9 such charges absent specific statutory authorization. *Id.* at 168. In response, the California
10 Legislature passed Government Code section 54999 providing that, under certain circumstances,
11 such charges were not assessments, but capacity fees that could be levied against public entities.
12 Cal Gov. Code § 54999(b) (“The Legislature . . . finds that the holding in [*San Marcos*] should be
13 revised to authorize payment and collection of capital facilities fees . . .”). There is no reasonable
14 claim that MWD’s rates and charges are special assessments that cannot be levied against other
15 public entities unless they conform to the requirements set out in the *San Marcos* legislation.

16 The inapplicability of Government Code section 54999.7(a) to MWD’s rates and charges
17 is made especially clear by subsection 54999.7(c), which states that “[a] public agency providing
18 public utility service shall complete a cost of service study at least once every 10 years that
19 addresses the cost of providing public utility service *to public schools.*” (emphasis added).
20 MWD does not provide any service to school districts and does not levy any charges on school
21 districts. The San Marcos legislation is clearly not directed at charges and rates such as MWD’s.

22 1. Standard of Review

23 Even assuming *arguendo* that Section 54999.7 applied to wholesale water charges at all,
24 or applied to components of charges for water services as opposed to water service as a whole, or
25 applied where all customers are public agencies, the standard of review for SDCWA’s claim
26 would be the same as the standard described above under common law. *See* Section III.B.1. The
27 Government Code does not provide for a particular standard of review for claims under section
28 54999.7 and MWD is not aware of any case law specifying the standard of review for such

1 claims. However, there are strong indications that the standard of review for claims challenging
2 the quasi-legislative act of rate making under common law would apply here.

3 First, the application of the common law standard for public entity rate-setting is
4 consistent with the plain language of Government Code section 54999.7(a) which requires that
5 fees subject to the statute “shall not exceed the reasonable cost of providing the public utility
6 service.” The word “reasonable” contemplates a range of choices that may be permissible, rather
7 than one fixed fee, which is consistent with the discretion the common law gives to public
8 entities engaged in rate-setting.

9 Likewise, section 54999.7(c) delegates to the public entity the task of determining rates
10 in the first instance that it will charge to public schools by using “appropriate industry
11 ratemaking principles” for “public agencies providing public utility service.” Cal. Gov. Code §
12 54999.7(c) (“A public agency providing public utility service shall complete a cost of service
13 study at least once every 10 years that addresses the cost of providing public utility service to
14 public schools. The study shall describe the methodology for the determination of cost
15 responsibility, which may be identified by reference to appropriate industry ratemaking
16 principles . . . [such as guidance] issued by the American Water Works Association or guidance
17 associated with other comparable industry principles recognized by public agencies providing
18 public utility service.”). Although the reference to “public schools” makes it obvious that this
19 statute has no application to wholesale providers such as MWD, the generalized reference to
20 “appropriate industry ratemaking principles” is another indicator that the traditional standard of
21 review applicable to public entities engaged in rate-setting is appropriate.

22 Second, because section 54999.7 simply restored the ability of a publicly owned utility to
23 assess a particular type of utility fee on another public entity, the standard of review should be
24 the pre-existing standard that normally applies to such fees, *i.e.*, the common law standards
25 discussed above. Section 54999.7 was enacted to overturn the California Supreme Court’s
26 decision in *San Marcos Water Dist.*, which “held that the constitutional public entity exemption
27 from special assessments prohibited a local water district from imposing a capacity fee used to
28 fund capital improvements to the water system, absent legislative authorization.” *Regents of*

1 *Univ. of Cal. v. East Bay Mun. Util. Dist.*, 130 Cal. App. 4th 1361, 1366 (2005); *see generally id.*
2 at 1368-72. “In direct response to the *San Marcos* decision, the Legislature granted public
3 utilities authority to impose capital facilities fees on other public entities, thereby removing the
4 public entity exemption as to those fees.” *Id.* at 1370-71.

5 Third, the established procedure for a public entity to challenge another public entity’s
6 rates indicates that the common law standard should apply. As a general principle, public utility
7 fees charged to public entities are outside the regulatory jurisdiction of the Public Utilities
8 Commission, which regulates privately owned entities. *See County of Inyo v. Public Utils.*
9 *Comm’n*, 26 Cal. 3d 154, 165-67 (1980). Instead, if one public entity wishes to challenge
10 another public entity’s utility rates, it “can institute suit in superior court.” *Id.* at 159. “Judicial
11 review of rates, however, does not provide protection comparable to PUC proceedings.” *Id.* The
12 plaintiff can only “sue to enjoin rates which are themselves ‘unreasonable, unfair, or fraudulently
13 or arbitrarily established’ (*Durant*, 39 Cal. App. 2d at 139), or which discriminate without a
14 reasonable and proper basis (*Elliott*, 54 Cal. App. 3d at 59).” *Id.* The Supreme Court’s citation
15 to the common law rate-setting cases *Durant* and *Elliott* in the context of a rate challenge by one
16 public entity (the County of Inyo) against another public entity (the Los Angeles Department of
17 Water and Power) indicates that the common law standard of review applies in this context.

18 Accordingly, SDCWA’s Government Code claim must be reviewed under the arbitrary
19 and capricious standard, with substantial deference given to MWD’s rate-setting expertise. *See*
20 Section III.C.1.

21 **2. Burden of Proof**

22 For the same reasons that the common law standard of review should apply to a
23 Government Code section 54999.7 claim, the common law burden of proof (as discussed in
24 Section III.B.2) should also apply. MWD’s rates are presumed reasonable (because “rates
25 established by [a] lawful rate-fixing body are presumed reasonable, fair and lawful” (*Hansen*, 42
26 Cal.3d at 1180), and SDCWA bears the burden of overcoming this presumption and establishing
27 that MWD’s rates violate Government Code section 54999.7 by failing to charge only for the
28 “reasonable cost of providing the public utility service” (Cal. Gov. Code § 54999.7(a)); *Hansen*,

1 42 Cal.3d at 1180-81 (reasonableness “is the beginning and end of the judicial inquiry”).

2 **3. Evidence the Court Is Required to Evaluate**

3 **a. Scope of Allowable Evidence**

4 Because this claim challenges the reasonableness of a charge for a public utility service
 5 (allegedly MWD’s 2011/12 and 2013/14 water rates), the Court’s review of evidence is limited
 6 to the administrative records in the *2010* and *2012 Actions* (*i.e.*, excludes extra-record documents
 7 and fact and witness testimony). *See* Section III.B.3.a, *supra*. As explained, this is because
 8 MWD’s setting of its water rates is a quasi-legislative act (*Brydon*, 24 Cal. App. 4th at 196;
 9 *Durant*, 39 Cal. App. 2d at 139) and review of the reasonableness of quasi-legislative acts is
 10 limited to the administrative record before the agency at the time of the act. *Western States*, 9
 11 Cal. 4th at 573.

12 **b. Pertinent Administrative Record Documents**

13 Even if section 54999.7 applied to wholesale water charges at all, or applied to
 14 components of charges for water service rather than to water service as a whole, or applied
 15 where all customers are public agencies, the administrative record shows that MWD’s rates do
 16 “not exceed the reasonable cost of providing the public utility service.” This is because, for the
 17 reasons explained above, the System Access Rate, System Power Rate and Water Stewardship
 18 Rate recoup amounts MWD pays for conveyances-related expenses, and therefore allocating
 19 them to MWD’s transportation rate is reasonable, and MWD’s rates and charges address peaking
 20 reasonably. *See* Section III.B.3.b.

21 **E. SDCWA’s California Water Code Claim (the “Wheeling Statute”)**

22 SDCWA alleges that MWD’s 2011/12 and 2013/14 water rates violate California’s
 23 Wheeling Statute (Cal. Water Code §§ 1810-14) “because the rates [MWD] charges for
 24 conveyance to [SDCWA] exceed ‘fair compensation’ for use of [MWD’s] system.” TAC ¶ 96;
 25 2012 Complaint ¶ 98; *see also* TAC ¶¶ 72, 101; 2012 Complaint ¶ 73. The Wheeling Statute
 26 govern the rates an agency sets for “wheeling,” which is a term for the conveyance of non-
 27 agency water through the agency’s system. *See MWD v. IID*, 80 Cal. App. 4th at 1407.

28 MWD maintains a wheeling rate, which applies only to the use of MWD’s facilities to

1 transport (1) *non-MWD water*; (2) to *MWD’s member agencies*; (3) for a period of up to one
2 year. MWD Administrative Code §§ 4119, 4405.¹⁷

3 As SDCWA has pointed to no transaction for which it is paying a wheeling rate that is
4 subject to the Wheeling Statute, it is unclear why the Wheeling Statute is relevant to the legality
5 of MWD’s water rates generally.¹⁸

6 If SDCWA means to suggest that the Exchange Agreement between it and MWD is a
7 wheeling transaction subject to the Wheeling Statute, it is indisputable that SDCWA is incorrect
8 for three reasons (despite the fact the Wheeling Statute mentions the exchange of water).

9 First, SDCWA agrees the Exchange Agreement is not a wheeling agreement. As is set
10 forth in MWD’s concurrently filed motion in limine regarding SDCWA’s Wheeling Statute
11 claims, both SDCWA and IID have previously, and successfully, asserted that the Exchange
12 Agreement is not a wheeling agreement and is therefore not governed by the Wheeling Statute.
13 SDCWA and IID are estopped from changing their positions now. *See* Defendant’s Motion in
14 Limine #5.

15 Second, the Wheeling Statute applies only to the use of an agency’s facilities to transport
16 *third party water*, not water owned by the agency. *See* Cal. Water Code § 1811. Here, as
17 SDCWA states in the TAC, it “purchases . . . water *from Metropolitan*” for transport through
18 MWD’s facilities. TAC ¶ 2 (emphasis added). This type of transaction is not wheeling under
19 the Water Code. Similarly, as explained in the TAC, SDCWA also “purchases water from the
20 Imperial Irrigation District.” *Id.* Pursuant to the Exchange Agreement, SDCWA makes
21 available to MWD the water it obtains from IID, and in return MWD delivers a like quantity of
22 Exchange Water to SDCWA.” TAC, Ex. A. MWD provides the Exchange Water from *any*
23 *available source*. *Id.* This Exchange Water is a blend of SWP water, water from the Colorado

24
25 ¹⁷ The price for other wheeling transactions – wheeling for a duration of more than one year,
26 and/or wheeling to a party other than a MWD member agency – are negotiated on a one-to-one
27 contractual basis.

28 ¹⁸ SDCWA does not currently have any active wheeling agreements with MWD. Neither does
IID, who like SDCWA, has asserted that MWD’s rates violate the Wheeling Statute. *See* IID’s
Answer to SDCWA’s TAC, ¶ 96, First Affirmative Defense.

1 River, and other sources. *See id.* MWD delivers the Exchange Water to SDCWA using the
2 facilities as determined by MWD. *See id.* The Wheeling Statute does not apply to *exchanges* of
3 water such as the one created by the Exchange Agreement; it is only applicable to conveyance of
4 third party water. *See* Cal. Water Code § 1811.

5 Third, the Wheeling Statute only allows bona fide transferors of water the right to use
6 70% of an agency’s conveyance facilities’ “*unused capacity*, for the period of time for which that
7 capacity is available.” Cal. Water Code §§ 1810, 1814 (emphasis added). This means that if an
8 agency, such as MWD, has no available capacity in its facilities, it is not obligated to provide
9 wheeling service. Under the Exchange Agreement, service to SDCWA is *uninterruptible*; MWD
10 is *obligated* to exchange IID water for Exchange Water and convey this Exchange Water to
11 SDCWA regardless of whether there is unused capacity or its level. And the Exchange
12 Agreement requires MWD to dedicate sufficient capacity in its facilities for the exchange for at
13 least 35 years, not just for the short term of a specific wheeling transaction. *See* TAC, Ex. A.

14 1. Standard of Review

15 The Wheeling Statute has a “substantial evidence” standard of review. Cal. Water Code
16 § 1813. Under the Wheeling Statute, no “public agency may deny a bona fide transferor of water
17 the use of a water conveyance facility which has unused capacity, for the period of time for
18 which that capacity is available, if fair compensation is paid for that use” Cal. Water Code §
19 1810. “Fair compensation” is defined as “the reasonable charges incurred by the owner of the
20 conveyance system, including capital, operation, maintenance, and replacement costs, increased
21 costs from any necessitated purchase of supplemental power” *Id.* § 1811(c). In making the
22 determinations required by the Wheeling Statute, the “public agency shall act in a reasonable
23 manner consistent with the requirements of law to facilitate the voluntary sale, lease, or exchange
24 of water and shall support its determinations by written findings.” *Id.* § 1813. “[T]he court shall
25 sustain the determination of the public agency if it finds that the determination is supported by
26 substantial evidence.” *Id.* Therefore, in sum, the Wheeling Statute inquiry is reasonableness.

27 The determination of what constitutes “fair compensation” for use of its system to wheel
28 water lies within MWD’s discretion. *San Luis Coastal Unified Sch. Dist. v. City of Morro Bay*,

1 81 Cal. App. 4th 1044, 1051 (2000) (under the Wheeling Statute, determination of fair
2 compensation constitutes an act of discretion and “[m]andate may not order the exercise of
3 discretion in a particular manner unless discretion can be lawfully exercised only one way under
4 the facts.”); *MWD v. IID*, 80 Cal. App. 4th at 1425, 1428 (“The water conveyance facility owner,
5 in this case the Metropolitan Water District, is specifically authorized to determine what is ‘fair
6 compensation’ provided the determination is made in a timely and reasonable manner” and
7 “[t]he construction of the Wheeling Statute by the Metropolitan Water District is entitled to great
8 weight and respect.”) (citations omitted).

9 As with the arbitrary and capricious standard, the substantial evidence standard is “highly
10 deferential.” *Western States*, 9 Cal.4th at 572. Indeed, the two standards are nearly identical in
11 practice; they both require a reasonable basis for an agency decision. *See id.*(under substantial
12 evidence standard a court’s review is limited to evaluating an administrative decision based on
13 whether it was “rational in light of the evidence before the agency” and not “whether it was the
14 wisest decision given all the available scientific data”); *Golden Drugs Co., Inc.*, 179 Cal. App.
15 4th at 1467 (“we recognize that not everyone acknowledges a distinction between ‘devoid of
16 evidentiary support’ and ‘substantial evidence’”) (citations omitted); *Warmington Old Town*
17 *Assocs. v. Tustin Unified Sch. Dist.*, 101 Cal. App. 4th 840, 850 (2002) (upon reviewing a quasi-
18 legislative action of the School District, court held that “the inquiry into arbitrariness or
19 capriciousness is like substantial evidence review in that both require a reasonable basis for the
20 decision.”); *Balch Enters. v. New Haven Unified Sch. Dist.*, 219 Cal. App. 3d 783, 792 (1990)
21 (court could see “no way, however, that [the arbitrary and capricious] determination can be
22 distinguished from application of the substantial evidence rule as applied in administrative
23 mandamus actions — in either case the question is whether there was a reasonable basis for the
24 decision”).

25 Thus, the standard of review for SDCWA’s Wheeling Statute claim is highly deferential
26 and as long as the Court finds that the charges are “reasonable” as supported by “substantial
27 evidence,” they must be upheld. *See* Section III.B.1.

2. Burden of Proof

The Wheeling Statute does not specify which party would bear the burden of proof under a proper claim that MWD's wheeling rate exceeds "fair compensation." However, as discussed throughout, "rates established by [a] lawful rate-fixing body are presumed reasonable, fair and lawful." See Sections III.A and III.B.2, *supra*. MWD's determination of its wheeling rate, as with the determination of its 2011/12 and 2013/14 water rates, is an exercise of its discretion subject to a presumption of reasonableness, fairness, and lawfulness. As such, the common law burden of proof would apply to a proper claim brought under the Wheeling Statute. See Sections III.B.2 and III.C.2.

3. Evidence the Court Is Required to Evaluate

a. Scope of Allowable Evidence

While review of claims challenging the reasonableness of MWD's water rates is limited to the administrative record, in January 2012, the Court carved out a narrow exception *for discovery* under the Wheeling Statute to "see what's out there." 1/6/2012 Tr. at 5:16-21; 9:8. The Court explained that, despite the allowance of discovery, a judicial determination would still need to be made regarding the relevance of extra-record evidence. *Id.* at 9:8-11 (once the discovery has resulted in the gathering of facts "there would be the need to screen what was relevant and what is not relevant").

In May 2013, the Court provided further clarification in an order denying IID's request to take depositions concerning MWD's rates. The Court stated that the Wheeling Statute might authorize "discovery . . . which explores extra-record justifications for the rates, or discovery which in some fashion undermines those justifications." May 28, 2013 Order on IID's Deposition Notices at 2. However, as discussed, the Supreme Court has expressly prohibited extra record evidence in cases challenging quasi-legislative acts which serves "merely to contradict the evidence the administrative agency relied on in making a quasi-legislative decision or to raise a question regarding the wisdom of that decision." *Western States*, 9 Cal. 4th at 579. Even if limited extra-record evidence were admissible under the Wheeling Statute, which it is not, SDCWA cannot use such evidence merely to "undermine," or contradict, MWD's rate-

1 making. As *Western States* makes clear, under the substantial evidence standard prescribed by
2 the Wheeling Statute, a court’s review is limited to evaluating an administrative decision based
3 on whether it was “rational in light of the evidence before the agency” and not “whether it was
4 the wisest decision given all the available scientific data.” *Id.* at 572.

5 The Court disallowed IID’s requested depositions because “[t]he proposed discovery in
6 essence demands that Metropolitan explain itself, including why its determination were in accord
7 with law,” but “Metropolitan will presumably do so during the briefing to be schedule in
8 connection with the final hearing in this matter.” May 28, 2013 Order at 2. As the Court
9 expected, MWD will “explain itself, including why its determinations were in accord with law”
10 at the December final hearing. Further, MWD does not intend to offer any extra-record
11 justifications for its wheeling rate. As explained, there are not any particular wheeling
12 transactions at issue in this case. Therefore, the only adjudication here would be regarding
13 MWD’s fixed wheeling rate for transactions of one year or less, not in the context of any
14 particular transaction. *See* MWD Administrative. Code §§ 4119, 4405.

15 Accordingly, what is relevant to SDCWA’s claim is the evidence in the administrative
16 record. The Wheeling Statute requires only that MWD’s wheeling rate be comprised of
17 “reasonable charges.” Cal. Water Code § 1811. As defined in its Administrative Code, MWD’s
18 wheeling rate for transactions of one year or less consists of the System Access Rate, Water
19 Stewardship Rate, and the actual cost of power for a wheeling transaction (if the wheeling party
20 does not provide its own power). MWD Administrative Code § 4119, 4405(b). As MWD
21 intends to show at the December hearing, the evidence in the administrative record demonstrates
22 that the only wheeling rate components that can be assessed outside of a particular transaction –
23 the System Access Rate and Water Stewardship Rate – are reasonable. Furthermore, limiting
24 review of SDCWA’s Wheeling Statute claim (which, as discussed, contains a “substantial
25 evidence” standard) to the administrative record comports with the California Supreme Court’s
26 holding in *Western States*. 9 Cal. 4th at 572-73 (explaining that, where a statute contained a
27 “substantial evidence” standard, review was limited to “*only* the administrative record”)
28 (emphasis added).

1 provides that “Cities, Counties and special districts, by a two-thirds vote of the qualified electors
 2 of such district, may impose *special taxes* on such district, except ad valorem taxes on real
 3 property or a transaction tax or sales tax on the sale of real property within such City, County or
 4 special district.” Cal. Const., art XIII A, § 4 (emphasis added). Proposition 13’s implementing
 5 statute, Cal. Gov. Code § 50076, clarifies what falls *outside* the definition of a “special tax”
 6 under Section 4: A “‘special tax’ *shall not include* any fee which does not exceed the reasonable
 7 cost of providing the service or regulatory activity for which the fee is charged. . . .” (emphasis
 8 added).

9 As with SDCWA’s Government Code claim, its Proposition 13 claim fails at the outset
 10 because MWD’s water rates fall outside the scope of Proposition 13. *See Brydon*, 24 Cal. App.
 11 4th at 194 (“[I]f the fee is not the type of exaction which article XIII A was designed to reach,
 12 then resort to sections 50075-50077, the enabling legislation for the article, is unnecessary.”)
 13 Two courts have held that water rates fall outside Proposition 13. *See Brydon*, 24 Cal. App. 4th
 14 at 194-95; *Rincon*, 121 Cal. App. 4th at 822. And SDCWA cannot plausibly deny this, although
 15 it has attempted to do so in these actions. SDCWA itself successfully argued before the Court of
 16 Appeal that Proposition 13 does not apply to water rates, and obtained a published opinion with
 17 that holding that is now conclusive here. *See Rincon*, 121 Cal. App. 4th at 821-22.¹⁹

18 In *Brydon*, the court considered an “inclining block rate structure” that “imposes higher
 19 charges per unit of water as the level of consumption increases” charged by a publicly owned
 20 public utility to end user customers. 24 Cal. App. 4th at 182-84. The court held that “[t]he
 21 inclining block rate structure *bears none of the indicia of taxation* which the California
 22 Constitution, article XIII A purported to address.” *Id.* at 194 (emphasis added). “The rates were
 23 levied against water consumers in accordance with patterns of usage, and at no cost to taxpayers
 24 generally.” *Id.* The court noted that the “prior submission of water rates to the voters for
 25

26 ¹⁹ Remarkably, in response to this definitive impediment, SDCWA’s counsel previously told this
 27 Court that merely that it was entitled to take different positions in different cases. *See 7/2/2012*
 28 *Tr.* at 57:4-13 (SDCWA contended that MWD is “wrong” in asserting that by making “one
 argument in the *Rincon* case in 2004. . . now [SDCWA] can’t make a different argument”).

1 approval would be nonsensical.” *Id.* (citations omitted) (emphasis added). In short, it “[could
2 not] conclude that California Constitution, article XIII A was intended either by the framers or
3 the electorate to accomplish the essential destruction of the rate setting structure of public
4 utilities, nor the evisceration of constitutional mandates compelling water conservation.” *Id.* at
5 195. Accordingly, the court “conclude[d] that the rate structure enacted by the District is not a
6 ‘special tax’ requiring two-thirds voter approval by the local electorate.” *Id.*

7 After *Brydon* came *Rincon*, the SDCWA decision that is controlling on the question of
8 whether Proposition 13 applies to MWD’s water rates. *Rincon* dealt with wholesale water sales
9 by SDCWA to its member districts, 121 Cal. App. 4th at 815, and in this respect is directly on
10 point with respect to the present challenge to MWD’s wholesale rates.²⁰ Further, in *Rincon*
11 SDCWA defended against a challenge specifically to its water transportation charges, *see* 121
12 Cal. App. 4th at 816, the equivalent charges that SDCWA challenges here.

13 The specific question in *Rincon* was whether SDCWA could have a “postage stamp”
14 transportation rate, like MWD does, *i.e.*, a flat dollar rate for each acre-foot of water transported,
15 regardless of distance or which portions of the transportation infrastructure available to MWD
16 were used. *Id.* at 816. In answering this question, the court recognized the traditional distinction
17 between water rates (which are a commodity charge) and special assessments (which are a tax).
18 Under California case law, “water rates are considered user or commodity charges because they
19 are based on the actual consumption of water.” *Id.* at 819. The court explained that “user rates
20 are functionally distinct from special assessments, which are compulsory charges levied against
21 certain properties for public improvements that directly or indirectly benefit the property owner
22 and are not related to the use of the public improvement.” *Id.* “It also reasoned that “the power
23 to set water rates comes from the public agency’s proprietary and quasi-public capacity, while
24 the power to impose special assessments or other capital charges derives from the taxing power.”
25

26 ²⁰ SDCWA is essentially just like MWD: It is a water wholesaler that sells only to its member
27 public agencies. SDCWA has 24 member agencies. SDCWA is governed by a Board of
28 Directors, comprised of representatives of its member agencies. The SDCWA Board votes on
matters, including the quasi-legislative decision of the setting of SDCWA’s rates.

1 *Id.* (citations omitted).

2 The court then addressed Proposition 13 directly. The plaintiff challenging SDCWA’s
3 transportation rate argued that the rates covering certain capital costs had to be deemed a special
4 tax rather than a user fee “in order to adhere to the spirit of Proposition 13.” *Id.* at 821. The
5 court rejected that argument, *holding that Proposition 13 does not apply to water rates. Id.* at
6 821-22. The court quoted at length from *Brydon*, and reasoned that “[a]lthough the
7 transportation rate is a postage stamp rate rather than a block rate . . . we find the analysis in
8 *Brydon* compelling. *The transportation rate was not designed to replace property tax revenue*
9 *lost due to Proposition 13 nor is there any indication the Legislature intended to revise the*
10 *statutory scheme governing water rates.” Id.* at 822 (emphasis added).²¹

11 In sum, the outcome in *Rincon* is controlling here because MWD’s water rates are the
12 same kind of rates at issue in that case. The rates in *Rincon* were wholesale postage stamp water
13 rates. *Id.* at 816. MWD’s 2011/12 and 2013/14 water rates are also wholesale postage stamp
14 water rates. Moreover, SDCWA of course is well aware of Proposition 13’s inapplicability to
15 wholesale postage stamp water rates, as it was the party that made that argument to the Court of
16 Appeal in *Rincon* and established that law. *See* RJN in Support of MWD’s Demurrers to the
17 First Through Fourth Causes of Action In, And Motions to Strike portions of, the Second
18 Amended Petition/Complaint in the *2010 Action*, Ex. 15 at 34 (Brief for SDCWA, *Rincon Del*
19 *Diablo Mun. Water Dist. v. San Diego Cnty. Water Auth.*, 121 Cal. App. 4th 813 (2004)
20 (SDCWA stating “more to the point, *water rates were not the type of charge Proposition 13 was*
21 *intended to reach.”*) (emphasis added)).

22 Even if these authorities did not control here, Proposition 13 is inapplicable because
23 MWD’s rates are not “imposed.” *See* discussion in Section III.F.1, *infra*. And, the

24
25 ²¹ Like MWD, SDCWA does have the power to tax property. *See* County Water Authority Act,
26 Water Code Append., ch. 45, §§ 45-5(8), 45-7(j); *see also* MWD Act § 124 (“[MWD] may levy
27 and collect taxes on all property within the district for the purposes of carrying on the operations
28 and paying the obligations of the district . . .”). However, the court found that SDCWA was not
exercising its taxation power when it enacted its transportation rate based on the historical
distinction between “water rates” and “special assessments.” *Rincon*, 121 Cal. App. 4th at 822.

1 aforementioned cases show that neither Proposition 13 or its implementing statute—both
2 directed at real property taxes and supplemental charges to replace lost real property tax
3 revenue—was applied to a charge, like MWD’s rates, which were established by a governing
4 board of directors made up of representatives of member agencies and charged only to those
5 member agencies who choose to purchase property, purchase a product, or engage a service.
6 Nothing suggests that the voters intended Proposition 13 to cover such a charge.

7 **a. Standard of Review**

8 To assert a violation of Proposition 13, SDCWA must show that MWD’s water rates in
9 the aggregate bear no reasonable relationship to the costs they recoup. *See, e.g., Evans v. City of*
10 *San Jose*, 3 Cal. App. 4th 728, 736-37 (1992) (Proposition 13 “does not embrace fees . . . that do
11 not exceed the reasonable cost of providing services necessary to the activity for which the fees
12 are charged.”). This Court’s inquiry into the reasonableness of MWD’s water rates for purposes
13 of Proposition 13’s reasonableness requirement is straightforward: “[P]ermissible fees must be
14 related to the *overall* cost of the” governmental service. *Cal. Farm Bureau Fed’n v. State Water*
15 *Res. Control Bd.*, 51 Cal. 4th 421, 438 (2011) (emphasis added). “They need not be finely
16 calibrated to the precise benefit each individual fee payor might derive.” *Id.*

17 In determining whether a fee exceeds the reasonable cost of the service, California courts
18 ignore whether the fee charged to the user is proportional to the benefit received by that user or
19 the burden that user’s conduct imposes on the system. A “fee does not become a tax simply
20 because the fee may be disproportionate to the service rendered to individual payors. The
21 question of proportionality is not measured on an individual basis. Rather, it is measured
22 collectively, considering *all* rate payors.” *Id.* (emphasis added); *see also Rincon*, 121 Cal. App.
23 4th at 823 (holding that water rates need not be proportionate to the specific burden caused by
24 particular rate payors, because “when the Legislature intends a fee be based upon a particular
25 user’s burden on the facility, it has stated that intention clearly”); *Griffith v. Pajaro Valley Water*
26 *Mgmt. Agency*, Nos. H038087, H038264, 2013 Cal. App. LEXIS 822, at *26-27 (Cal. App. 6th
27
28

1 Dist. Oct. 15, 2013) (in the Proposition 218 context²², Court of Appeal stated that
2 “[a]pportionment is not a determination that lends itself to precise calculation” and a
3 proportionality requirement does not compel a “parcel-by-parcel proportionality analysis.”). In
4 *Griffith*, the Court held that where, as here, a proposition prescribes no particular method for
5 apportioning a fee other than that the amount shall not exceed the proportional cost of the
6 service, grouping similar users together for the same rate and charging them according to usage
7 is a reasonable way to apportion the cost of service. *Griffith*, 2013 Cal. App. LEXIS 822, at *27
8 (“That there may be other methods favored by plaintiffs does not render defendant’s method
9 unconstitutional.”).

10 Accordingly, SDCWA’s contention that MWD’s water rates are not finely calibrated to
11 the precise benefit each individual fee payor receives is irrelevant. *See* TAC ¶ 52 (alleging that
12 SDCWA is “uniquely situated among [MWD’s] member agencies” and is being “overcharge[d]”
13 by MWD’s 2011 and 2012 water rates); 2012 Complaint ¶ 52. The only inquiry for the Court is
14 whether MWD’s 2011/12 and 2013/14 water rates, in the aggregate, bear a reasonable
15 relationship to the costs they recoup. As stated (*see* Section III.A), when determining the
16 reasonableness of the quasi-legislative act of rate making, a court applies an arbitrary and
17 capricious standard of review and presumes the rates are reasonable. This standard applies
18 equally in the Proposition 13 context. *See Shapell Industries*, 1 Cal. App. 4th at 233-34 (finding
19 that lower court erred by admitting extra-record evidence in a Proposition 13 case because “[t]he
20 determination whether the decision was arbitrary, capricious or entirely lacking in evidentiary
21 support must be based on the ‘evidence’ considered by the administrative agency.”) (citations
22 omitted).

23 Thus, the Court should employ the arbitrary and capricious standard when determining
24 whether MWD’s 2011/12 and 2013/14 water rates violate Proposition 13.

25
26 _____
27 ²² The court in *Griffith* notes that Proposition 218 is closely related to Proposition 13, and,
28 indeed, applies Proposition 13 case law when construing Proposition 218. *See* 2013 Cal. App.
LEXIS 822, at *10, 27 (citing *Cal. Farm Bureau Fed’n v. State Water Res. Control Bd.*, 51 Cal.
4th 421 (2011)).

1 **b. Burden of Proof**

2 If the Court permits the Proposition 13 claims in both actions to go forward despite its
3 inapplicability to MWD’s rates, then under Proposition 13 case law, SDCWA “bears the burden
4 of proof to establish a prima facie case showing that the fee is invalid.” *Cal. Farm Bureau*, 51
5 Cal. 4th at 436. If SDCWA’s evidence is sufficient, MWD then bears the “burden of
6 production” to show that the challenged components of its 2011/12 and 2013/13 rates bear a “fair
7 or reasonable relationship” to the costs of the service MWD provides. *Id.* at 436-37. MWD’s
8 burden requires producing evidence demonstrating that the manner in which it apportioned
9 contemplated transportation costs to its transportation rate bears a “fair or reasonable relation to
10 [its member agencies’] burden on, and benefits from, [MWD’s] system.” *Beaumont Investors v.*
11 *Beaumont-Cherry Valley Water Dist.*, 165 Cal. App. 3d 227, 235 (1985). Similarly, MWD’s
12 burden requires producing evidence demonstrating the manner in which it accounts for peaking
13 bears a fair or reasonable relationship to its member agencies’ burden on, and benefits from,
14 MWD’s system. *Id.* California courts have held that the agency’s burden is only one of
15 production; at all times SDCWA bears the burden of proof on its Proposition 13 claim. *Cal.*
16 *Farm Bureau*, 51 Cal. 4th at 436 & n. 18 (The burden of proof is “synonymous” with the
17 “burden of persuasion” and is different from the “burden of production,” which may shift
18 between the parties. “The burden of proof does not shift . . . it remains with the party who
19 originally bears it.”).

20 **c. Evidence the Court Is Required to Evaluate**

21 **(1) Scope of Allowable Evidence**

22 As with the other rate challenges claims discussed above, because SDCWA’s Proposition
23 13 claim challenges the quasi-legislative act of rate setting, the Court’s review of evidence is
24 limited to the administrative records in the *2010* and *2012 Actions* and should exclude extra-
25 record documents and fact and expert witness testimony. *See* Section III.B.3.a.

26 **(2) Pertinent Administrative Record Documents**

27 Even if Proposition 13 and its implementing statute did apply to the water rates at issue,
28 the administrative record demonstrates that MWD’s water rates in the aggregate bear a

1 reasonable relationship to the costs they recover.

2 As noted above, charges can be considered “taxes” subject to Proposition 13 only when
3 the revenue they generate exceeds the reasonable cost of the service, for which they were
4 imposed in the aggregate, or in other words, measuring all rate payors together. MWD’s rate-
5 setting process ensures that this does not happen. The evidence shows that MWD’s rates are set
6 at a level designed to recover costs. When determining the amounts of the water rate elements,
7 MWD first estimates its revenue requirements for the coming fiscal year, which it then allocates
8 to different operation functions. *See, e.g.*, 2010/2012 Records Document No. 599; 2012 Record
9 Document No. 944. MWD’s allocation of costs to operation functions makes sure that MWD’s
10 rates generate revenue to pay for related expenses. *See* 2010/2012 Records Document No. 599;
11 2012 Record Document No. 944 (MWD uses functional allocation to “correlate charges for
12 different types of service with the costs of providing those different types of service”). Then
13 MWD uses these operation functions to assign costs to various cost classifications, and finally
14 the rate components to which they relate. 2010/2012 Records Document No. 599; 2012 Record
15 Document No. 944. MWD’s rate component allocations are designed to “fully recover” the cost
16 of service for that fiscal year. 2010/2012 Records Document No. 599; 2012 Record Document
17 No. 944.²³

18 Furthermore, Section III.B.3.b, *supra*, sets forth evidence in the administrative record that
19 demonstrates MWD’s water rates in aggregate are reasonably related to the overall cost of the
20 governmental service, including peaking and transportation. Because the evidence in the
21 administrative record demonstrates that MWD’s System Access Rate, System Power Rate, Water
22 Stewardship Rate, and other rates and charges reasonably charged all of the member agencies
23 according to both their use of MWD’s conveyance system for MWD’s reasonable costs related to
24 transportation, and for their use of MWD’s facilities to satisfy peak demand, MWD’s water rates

25 _____
26 ²³ California case law specifically sanctions this approach. *See Griffith*, 2013 Cal. App. LEXIS
27 822, at *24-25 (Court rejected plaintiff’s argument that defendant “improperly ‘worked
28 backwards”” by following a revenue-requirement model like the one MWD follows. Further, the
court stated that following this approach was recommended by the American Water Works
Association Manual, which does not offend the proportionality requirement in Proposition 218.).

1 are not special taxes and thus Proposition 13 does not apply.

2 **2. Article XIII C (Proposition 26): 2012 Action only**

3 SDCWA alleges that MWD's 2013/14 water rates²⁴ violate Article XIII C, Section 1
4 because they meet that section's definition of "tax" and were not approved by a two-thirds vote.
5 *See, e.g.*, 2012 Complaint ¶ 56. It is SDCWA's position that MWD's 2013/14 water rates are
6 special taxes because they exceed the costs MWD bears to provide services to its member
7 agencies and because MWD allegedly misclassifies various supply-related costs as
8 transportation. *Id.* at ¶ 58. Article XIII C defines the "tax" that requires two-thirds voter
9 approval as "any levy, charge, or exaction of any kind imposed by a local government," and
10 states seven exceptions to its application. *See* Cal. Const. art. XIII C, § 1(e)(1)-(7).

11 As MWD explained in its recent briefing on Article XIII C, the provisions added by
12 Proposition 26 are inapplicable to MWD's water rates because MWD's rates are not taxes
13 subject to Proposition 26 for two separate reasons: (1) the rates are not "imposed"; and (2) even
14 if they were, MWD's rates fall within two exceptions to Proposition 26. Moreover, as also
15 previously briefed, even assuming *arguendo* that MWD's rates were subject to Proposition 26,
16 Proposition 26 has been satisfied because the rates were approved by 2/3 of the relevant
17 electorate. *See generally* Memorandum of Points and Authorities in Support of MWD's Motion
18 for Judgment on the Pleadings; MWD's Reply in Support of its Motion for Judgment on the
19 Pleadings. While the Court denied MWD's motion, it did so on procedural grounds and because
20 it found that the applicability of Proposition 26 depends on factual issues. *See* September 19,
21 2013 Order at 3; 9/18/2013 Tr. at 9:9-15 ("[T]here are a lot of factual issues that still remain. . .
22 and it's very possible that Metropolitan will win on some of these or all of these issues. But
23 there are factual issues. . . so I can't grant the motion today."). While MWD believes the
24 inapplicability of Proposition 26 and the fact that MWD satisfied the requisite vote are legal
25 questions based on judicially noticeable facts, as set forth in MWD's prior briefing, MWD will

26 _____
27 ²⁴ On March 29, 2013, the Court dismissed SDCWA's Proposition 26 claim in the *2010 Action*
28 on the ground that Proposition 26 does not apply retroactively to rates passed before its
enactment. March 29, 2013 Order at 6.

1 present further factual explanation from the administrative record at the December hearing as
2 the Court's September 19, 2013 Order requested. MWD is confident that the Court will agree
3 that SDCWA's Article XIII C/Proposition 26 claim should be dismissed.

4 **a. Standard of Review and Burden of Proof**

5 The charges governed by Article XIII C are only those that are "imposed" by a
6 government entity. *See* Cal. Const. art. XIII C, § 1(e). Therefore, the Court's inquiry begins
7 with determining if MWD's rates are imposed. If the Court determines that the rates are
8 imposed, the Court next looks to see if MWD's rates and charges fall into one of the seven
9 enumerated exceptions to Proposition 26. *See* Cal. Const. art. XIII C, § 1(e)(1)-(7). Several
10 exceptions require that the charge "not exceed the reasonable costs." *E.g.*, Cal. Const. art. XIII
11 C, § 1(e)(2). Others, such as Article XIII C Section 1(e)(4), do not contain such a requirement.
12 If the Court finds that no exception applies, and MWD's rates and charges fall under the
13 provisions of Proposition 26, then the Court must determine whether the rates were approved by
14 a two-thirds vote of the relevant electorate. Cal. Const. art. XIII C, §§ 1(e), (2)(d).

15 At trial, MWD intends to prove (a) that its water rates do not fall under the definition of
16 taxes because they are not "imposed,"; and (b) even if the water rates were imposed, the rates are
17 excepted from the definition of taxes for two separate reasons: because they are charges for the
18 purchase or use of "local government property" (Cal. Const. art. XIII C, § 1(e)(4)) and because
19 they are charges imposed for a specific government service provided directly to the payor and
20 which do not exceed the reasonable costs of providing the service (Cal. Const. art. XIII C, §
21 1(e)(2)). Moreover, at trial MWD intends to prove that even assuming *arguendo* its rates are
22 considered a tax under Proposition 26 (which they are not), its rates satisfy Proposition 26
23 because they were approved by 2/3 of the relevant electorate: the MWD Board of Directors.
24 Pursuant to Article XIII C, Section 1, it is only under exception (e)(2) that MWD is required to
25 prove its water rates are reasonable by a preponderance of the evidence.

26 An unnumbered paragraph of Article XIII C, § 1(e) which provides the preponderance of
27 the evidence burden has *no effect* on the exceptions that do not contain a reasonableness
28

1 requirement, such as exception (e)(4).²⁵ This is because the requirement for proof that a charge
2 does not exceed the reasonable costs of the government activity and is allocated based on a fair
3 or reasonable relationship to the payor’s burdens mirrors requirements set forth in the exceptions
4 stated in sections (e)(1) through (e)(3) of Article XIII C, § 1, which were also added by
5 Proposition 26. In contrast, the exceptions stated in sections (e)(4) through (e)(7) contain no
6 such requirements. All of section (e) must be read together, so that the requirements set out in
7 the unnumbered paragraph can only be applicable to those exceptions that include the same
8 standards. Where an exception to the definition of “tax” states no reasonable requirement (like
9 section (e)(4)), there can be no reasonableness requirement nor a burden to prove this.

10 To establish the exception provided in Article XIII C section 1(e)(2), MWD must prove
11 by a preponderance of the evidence that the “fees are imposed to cover the cost of performing
12 [the service provided].” *Griffith*, 207 Cal. App. 4th at 997; *see also* Cal. Const. art. XIII C, §
13 1(e)(2) (under this exception, MWD bears the burden of proving by a preponderance of the
14 evidence that its water rates (1) are no more than necessary to recover the reasonable costs of
15 providing the service and (2) that the manner in which the costs were allocated bears a fair or
16 reasonable relationship to the burden on or benefits received from the service provided).

17 In *Griffith*, a landlord filed a petition for writ of mandate seeking to invalidate an
18 ordinance enacted by the City of Santa Cruz which called for annual inspections of residential
19 rental properties, arguing, among other things, that the ordinance imposed a tax in violation of
20 Proposition 26. *Id.* at 987. In evaluating the ordinance under Proposition 26, the court applied
21 the holdings in *Cal. Farm Bureau Federation v. State Water Resources Control Bd.* (“*Cal. Farm*
22 *Bureau*”), 51 Cal.4th 421 (2011), which addressed Proposition 13. *Id.* at 996-97. While *Cal.*
23 *Farm Bureau* did not concern Proposition 26 directly, the *Griffith* court found its analysis

24
25 _____
26 ²⁵ That paragraph was added by Proposition 26 and states: “The local government bears the
27 burden of proving by a preponderance of the evidence that a levy, charge, or other exaction is not
28 a tax, that the amount is no more than necessary to cover the reasonable costs of the
governmental activity, and that the manner in which those costs are allocated to a payor bear a
fair or reasonable relationship to the payor’s burdens on, or benefits received from, the
government activity.”

1 controlling in the Proposition 26 context because the court in that case analyzed the language
2 that originated in case law and was later adopted by the drafters of Proposition 26. *Id.*

3 The *Griffith* court therefore held that under Proposition 26, “permissible fees must be
4 related to the overall cost of the governmental regulation. They need not be finely calibrated to
5 the precise benefit each individual fee payor might derive.” *Id.* at 997 (quoting *Cal. Farm*
6 *Bureau*, 51 Cal.4th at 438). Furthermore, a fee does not become a tax simply because the fee
7 may be disproportionate to the service rendered to individual payors; “[t]he question of
8 proportionality is not measured on an individual basis. Rather, it is measured collectively,
9 considering *all* rate payors.” *Id.* (quoting *Cal. Farm Bureau*, 51 Cal.4th at 438) (emphasis
10 added).

11 California case law “suggest[s] a flexible assessment of proportionality within a broad
12 range of reasonableness in setting fees.” *Equilon Enters. LLC v. State Bd. of Equalization*, 189
13 Cal. App. 4th 865, 882 (2010) (citations omitted). It does not matter for purposes of the
14 apportionment requirement that a challenger can propose an alternative better suited to a fee’s
15 purposes as long as an agency’s apportionment of costs among payers is reasonable in light of
16 the fee’s purpose. *Id.* at 882-86 (Court rejected plaintiff gasoline company’s argument that its
17 allocation of a lead program fee was unreasonable because the majority of childhood lead
18 poisoning comes from paint, not gasoline, because the fee allocation was directed at addressing
19 childhood lead exposure, not just poisoning, and thus the fee did not need to be allocated based
20 on responsibility for lead contamination.); *see also Griffith v. City of Santa Cruz*, 207 Cal. App.
21 4th 982, 997 (2012) (court found city satisfied the reasonableness requirements of Proposition 26
22 because fees imposed on rental property owners pursuant to a new ordinance were equal to or
23 less than the cost of implementing the ordinance); *Griffith*, 2013 Cal. App. LEXIS 822, at *26-27
24 (court of appeal stated that “[a]pportionment is not a determination that lends itself to precise
25 calculation” and a proportionality requirement does not compel a “parcel-by-parcel
26 proportionality analysis.”).

1 **b. Evidence the Court Is Required to Evaluate**

2 **(1) Scope of Allowable Evidence**

3 The Court is limited to review of solely the administrative record when addressing
4 whether MWD’s rates and charges comply with Proposition 26. As discussed, it is well
5 established that the Court’s inquiry into the reasonableness of MWD’s rates and charges is
6 limited to review of the administrative record because, as with SDCWA’s other rate challenges,
7 SDCWA’s Proposition 26 claim challenges the quasi-legislative act of rate setting through a
8 mandamus proceeding. *See, e.g., Western States*, 9 Cal. 4th at 573, 576; *Coachella Valley Unif.*
9 *Sch. Dist. v. State of Cal.*, 176 Cal. App. 4th 93, 117 (2009); *Shapell Indus.*, 1 Cal. App. 4th at
10 233-34. Although Proposition 26 changed the traditional rule concerning which party bears the
11 burden of proof under certain circumstances (as relevant here, the determination regarding the
12 applicability of exception (e)(2)), the Proposition says nothing about altering the rule that review
13 of a quasi-legislative agency decision is limited to the administrative record. Where, as here,
14 there is no clear indication that a new law was meant to change an established rule, the existing
15 rule should stand. *See Aryeh v. Canon Business Solutions, Inc.*, 55 Cal. 4th 1185, 1193 (2013)
16 (laws “should not be interpreted to alter the common law, and should be construed to avoid
17 conflict with common law rules . . . unless [a law’s] language clearly and unequivocally
18 discloses an intention to depart from, alter, or abrogate the common-law rule”) (citations
19 omitted).

20 Therefore, review of evidence pertaining to whether MWD’s rates and charges fall under
21 or satisfy Proposition 26 is limited to the administrative record in the *2012 Action* and should
22 exclude extra-record documents and fact and expert witness testimony. *See* Section III.B.3.a,
23 *supra*.

24 **(2) Pertinent Administrative Record Documents**

25 During the September 18, 2013 hearing, and in its September 19, 2013 Order, the Court
26 set out two outstanding factual issues relating to whether SDCWA has asserted a valid claim
27 under Article XIII C: (1) whether MWD’s rates are “imposed,” and therefore taxes under the
28 law, and (2) whether the water and facilities MWD provides constitute “government property”

1 such that the rates fall into Article XIII C, section 1(e)'s exception to Proposition 26. *See*
2 September 19, 2013 Order at 3-4; 9/18/2013 Tr. at 10:22-27, 11:20-22 (Court stated that
3 outstanding factual issues with regard to the application of Proposition 26 include (1) whether
4 "Metropolitan has a monopoly on [the water SDCWA purchases]," *i.e.*, "whether or not San
5 Diego actually has a choice as to whether it gets its water this way or whether there are other
6 ways in which it can get its water" and (2) "whether we have an exemption because we have
7 governmental property at issue.").

8 As explained, the Court may only evaluate evidence in the administrative record to
9 address these preliminary issues, which evidence supports MWD's position that the rates at issue
10 in the *2012 Action* are exempt from the requirements of Proposition 26. First, evidence shows
11 that the rates are not imposed because all payors – the member agencies – are voluntary members
12 of MWD and set the rates themselves via their representatives on the MWD Board of Directors,
13 which votes in accordance with state law mandate. MWD Act § 57. Second, evidence shows
14 MWD's water rates are not "imposed" and MWD is not an alleged monopoly because, by law,
15 MWD is only a supplemental supplier of water. *See id.* § 130. Third, evidence shows that
16 MWD's water rates are not "imposed" because SDCWA has many choices regarding where it
17 purchases its water; as SDCWA itself alleges, it purchases a large share of its water supplies
18 from third party sources. *See, e.g.*, 2012 Complaint ¶ 3 (SDCWA "purchases conserved
19 Colorado River water from [IID and] has also obtained conserved water from the lining of the
20 All American and Coachella Canals"). SDCWA also has access to local sources of water.
21 Instead of obtaining water from alternate sources, however, SDCWA chose both to purchase
22 water from MWD, and to enter into a *voluntary* contract with MWD in which SDCWA agreed to
23 exchange water purchased from IID for a like quantity of Exchange Water from MWD. *See*
24 TAC Ex. A. Evidence shows, therefore, that SDCWA's receipt of water from MWD is not due
25 to any alleged monopoly over all available water sources, but is rather a consequence of a series
26 of voluntary choices SDCWA has made to obtain water from MWD. Because MWD's rates and
27 charges are not "imposed," they do not fall within the ambit of Proposition 26.

28 Evidence also supports application of the government service/reasonable costs exception.

1 As discussed above, evidence in the administrative record makes clear that even if SDCWA’s
 2 Proposition 26 claim is valid, MWD’s water rates fall under an exception to Article XIII C
 3 (section 1(e)(2)) because they are no more than necessary to recover the reasonable costs of
 4 providing MWD’s services and the manner in which MWD’s costs were allocated to its rates and
 5 charges bears a reasonable relationship to the burden on or benefits received from the member
 6 agencies. *See* Sections III.B.3.b and III.F.1.c.2, *supra* (setting forth evidence in the
 7 administrative record that demonstrates MWD’s water peaking and transportation rates and
 8 charges in aggregate are reasonably related to the overall cost of the governmental service and
 9 are uniformly and reasonably allocated to the member agencies).

10 Evidence also supports application of the government property exception to MWD’s
 11 rates. As also discussed in MWD’s briefing on Proposition 26, MWD’s water rates are charges
 12 for use of MWD’s own conveyance facilities, as well as MWD’s contractual right to use the
 13 SWP. *See* MWD’s Reply in Support of its Motion for Judgment on the Pleadings at 5-7.
 14 Charges to use either MWD’s facilities or facilities MWD has a property interest in are for the
 15 “use of local government property” which are excepted from Proposition 26’s definition of tax.
 16 *See* MWD’s Reply in Support of its Motion for Judgment on the Pleadings at 7; 2012 Record
 17 Document No. 1 (contract between MWD and DWR for use of the SWP). Purchases of water
 18 also fall under this exception because the water MWD conveys to SDCWA is its property, which
 19 is also properly considered “government property” within the exception to Proposition 26. *See*
 20 MWD’s Reply in Support of its Motion for Judgment on the Pleadings at 6-7; 2012 Record
 21 Document No. 1; TAC Ex. A.

22 **IV. STANDARD OF REVIEW, BURDEN OF PROOF, AND**
 23 **ADMISSIBLE EVIDENCE FOR THE RATE STRUCTURE**
 24 **INTEGRITY PROVISION CLAIM (FIFTH CAUSE OF ACTION IN**
 25 **2010 ACTION)**

26 SDCWA’s fifth cause of action for declaratory relief regarding the RSI provision
 27 contained in MWD’s project contracts is without merit. SDCWA alleges that the RSI provision
 28 imposes an unconstitutional condition on its right to petition the courts under Article I, section 3,
 of the California Constitution. (TAC ¶¶ 104-105.) SDCWA also attacks the RSI provision

1 under California Civil Code section 1668, alleging that the term operates to illegally exempt
2 MWD from liability for its rates decisions. (TAC ¶ 106.) SDCWA seeks a judicial declaration
3 that the RSI provision is invalid and unenforceable, and an order reinstating all project contracts
4 that were terminated pursuant to the RSI provision. (TAC, Prayer for Relief ¶ 5.) SDCWA's
5 claims fail for at least five reasons: (1) SDCWA, a government agency, lacks a constitutional
6 right to petition the government; (2) consideration paid under the project contracts does not
7 qualify as a "public benefit" to which the unconstitutional conditions doctrine applies; (3)
8 SDCWA waived its claimed right to petition regarding MWD's "existing rate structure" by
9 executing project contracts with the RSI provision and consented to the RSI provision by
10 accepting payments under the project contracts; (4) even if the Court were to find the
11 unconstitutional conditions doctrine applies, the RSI provision satisfies the relevant test; and
12 (5) the RSI provision does not "exempt" MWD from responsibility, rendering section 1668
13 inapplicable.

14 MWD has a pending Motion for Summary Adjudication as to SDCWA's Fourth, Fifth,
15 and Sixth Causes of Action, set for hearing on December 3, 2013 ("MWD's Motion for
16 Summary Adjudication"), which MWD believes should be granted as it addresses legal issues
17 only. Below MWD addresses the matters requested by the Court in its July 22, 2013 Case
18 Management Order, in the event SDCWA's fifth cause of action proceeds to trial.

19 **A. Standard of Review and Burden of Proof**

20 SDCWA's fifth cause of action asserts civil claims for declaratory relief regarding the
21 RSI provision included in project contracts between MWD and SDCWA. As such, it does not
22 involve any separate standard of review. Rather, the burden of proof that applies to SDCWA's
23 RSI provision challenge is the same as with regard to any civil claim: as the plaintiff, SDCWA
24 bears the burden of proving its claims by a preponderance of the evidence. Cal. Evid. Code
25 §§ 115 & 500.

26 **1. Legal Standard Applicable to SDCWA's Unconstitutional Conditions**
27 **Claim**

28 SDCWA bears the burden of establishing that the unconstitutional conditions doctrine

1 applies to the RSI provision and to SDCWA. Specifically, SDCWA must show that (1) it is a
2 potential recipient of a “public benefit” to which the unconstitutional conditions doctrine applies;
3 (2) the RSI provision implicates a constitutional right enjoyed by SDCWA; and (3) the RSI
4 provision impinges on that constitutional right. *See Sanchez v. Cnty. of San Diego*, 464 F.3d
5 916, 930-31 (9th Cir. 2006) (“A plaintiff alleging a violation of the unconstitutional conditions
6 doctrine, however, must first establish that a constitutional right is infringed upon.”) (citing
7 *Parrish v. Civil Service Comm’n of the County of Alameda*, 66 Cal. 2d 260 (1967)).

8 If SDCWA carries this initial burden, which MWD believes it cannot do (*see* Section
9 IV.C below and MWD’s Motion for Summary Adjudication), the burden shifts to MWD to
10 demonstrate, by a preponderance of the evidence, the “practical necessity for the limitation.”
11 *Robbins v. Super. Ct. of Sacramento County*, 38 Cal. 3d 199, 213 (1985); *Lee v. Civil Service*
12 *Comm’n of L.A. Cnty.*, 129 Cal. App. 3d 9, 13 (1982). To do so, MWD must show that: “(1) the
13 condition reasonably relates to the purpose of the legislation which confers the benefit; (2) the
14 value accruing to the public from imposition of the condition manifestly outweighs any resulting
15 impairment of the constitutional right; and (3) there are no available alternative means that could
16 maintain the integrity of the benefits program without severely restricting a constitutional right.”
17 *Robbins*, 38 Cal. 3d at 213.

18 2. Legal Standard Applicable to SDCWA’s Section 1668 Claim

19 California Civil Code section 1668 provides: “All contracts which have for their object,
20 directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to
21 the person or property of another, or violation of law, whether willful or negligent, are against
22 the policy of the law.” Cal. Civ. Code § 1668. SDCWA must establish by a preponderance of
23 the evidence that the RSI provision violates section 1668.

24 B. Evidence the Court Is Required to Evaluate

25 As SDCWA’s fifth cause of action is a civil claim, the Court may consider all evidence
26 admissible under the rules of evidence regarding the RSI provision issues. This includes both
27 documentary evidence and testimony from fact witnesses. MWD expects to introduce testimony
28 from its current Manager of the Water Resources Management Group and its current Manager of

1 Bay Delta Initiatives, who will testify to the facts surrounding MWD’s adoption and
 2 implementation of the RSI provision. MWD may also present testimony from its Manager of the
 3 Budget and Financial Planning Section to testify regarding the nature of MWD’s rate structure to
 4 the extent it relates to the RSI provision issues. In addition, MWD may present testimony by
 5 SDCWA’s Assistant General Manager, Dennis Cushman, who was deposed as SDCWA’s
 6 “person most knowledgeable” on RSI-related issues. Finally, MWD may offer expert testimony
 7 with regard to issues set forth herein. MWD expects that the evidence at trial will establish,
 8 among other things, the facts regarding the RSI provision set forth above in Section II.B.

9 **C. SDCWA Will Be Unable to Prove Its Unconstitutional Conditions Claim**

10 **1. The Unconstitutional Conditions Doctrine Does Not Apply Here**

11 MWD has briefed the inapplicability of the unconstitutional conditions doctrine in detail
 12 in its Motion for Summary Adjudication. Accordingly, set forth below is a summary of MWD’s
 13 position demonstrating that the doctrine does not apply.

14 **a. SDCWA, a Government Agency, Does Not Have a**
 15 **Constitutional Right to Petition Under the California**
 16 **Constitution**

17 It is undisputed that SDCWA is a public agency. As such, it does not enjoy a
 18 constitutional right to petition the courts.²⁶ As the California Supreme Court has held, certain
 19 provisions of the state and federal constitutions confer “fundamental rights on individual
 20 citizens,” not on units of the government. *Star-Kist Foods, Inc. v. Cnty. of Los Angeles*, 42 Cal.
 21 3d 1, 8 (1986) (quoting *San Diego Unified Port Dist. v. Gianturco*, 457 F. Supp. 283, 290
 22 (1978)). These types of constitutional rights, “which are intended to limit governmental action
 23 vis-à-vis individual citizens,” cannot be asserted by political subdivisions, such as SDCWA. *Id.*
 24 Indeed, Article I, section 3, of the California Constitution explicitly provides, “The *people* have
 25 the right to instruct their representatives, petition government for redress of grievances, and
 26 assemble freely to consult for the common good.” Cal. Const. Art. I, § 3(a) (emphasis added).
 27 Neither this section nor any other section within Article I makes any reference to government

28 ²⁶See MWD’s Motion for Summary Adjudication, at 7-9.

1 agencies. *Id.* This is entirely fatal to SDCWA’s claim. Under California law, because SDCWA
 2 is a public agency, it does not enjoy a right to petition under the California Constitution and
 3 therefore lacks standing to assert an unconstitutional conditions claim here.²⁷

4 **b. Payments Made by MWD Under the Project Contracts Are**
 5 **Not “Public Benefits” to Which the Unconstitutional**
 6 **Conditions Doctrine Applies**

7 Payments by MWD to its member agencies pursuant to LRP, CCP, and SDP project
 8 contracts are not “public benefits” protected by California’s unconstitutional conditions
 9 doctrine.²⁸ These payments are distinguishable from the “public benefits” at issue in California’s
 10 unconstitutional conditions cases. As the California Supreme Court has recognized, the
 11 unconstitutional conditions doctrine is implicated when the government “implements a general
 12 public benefit program.” *Comm. to Defend Reproductive Rights v. Myers*, 29 Cal. 3d 252, 269-
 13 70 (1981). Specifically, the Court has held that the doctrine applies to such public benefits as
 14 “access to a public forum, public employment, welfare benefits, public housing, unemployment
 15 benefits, or the use of public property.” *Id.* at 264.²⁹ There is no comparable “general public

16 ²⁷See *Star-Kist Foods*, 42 Cal. 3d at 5-9 (discussing cases); *Native Am. Heritage Comm’n v. Bd.*
 17 *of Trustees*, 51 Cal. App. 4th 675, 683 (1996) (rejecting first amendment claim asserted by one
 18 state agency against another); *San Miguel Consol. Fire Prot. Dist. v. Davis*, 25 Cal. App. 4th
 19 134, 143-45 (1994) (holding special fire and municipal improvement districts had no standing to
 20 challenge provisions of revenue and tax code on equal protection, due process, or other
 21 constitutional grounds); *Bd. of Supervisors v. McMahon*, 219 Cal. App. 3d 286, 296-97 (1990)
 22 (dismissing county’s due process challenge to state welfare statute); see also *S. Lake Tahoe v.*
 23 *Cal. Tahoe Reg’l Planning Agency*, 625 F.2d 231, 233 (9th Cir. 1980) (holding city had no
 24 standing to assert takings and due process challenge to regional transportation plan); *Santa*
 25 *Monica Cmty. Coll. Dist. v. Pub. Emp’t Relations Bd.*, 112 Cal. App. 3d 684, 690 (1980) (citing
 26 “long line of cases” holding that a public entity, being a creature of the state, is not a “person”
 27 within the meaning of the due process clause); *Cnty. of Los Angeles v. Super. Ct. of Alameda*
 28 *Cnty*, 128 Cal. App. 522, 526 (1933) (“the county is not a ‘person’ within the meaning of either
 the federal or the state Constitution”); *Riley v. Stack*, 128 Cal. App. 480, 484 (1933) (same).

²⁸See MWD’s Motion for Summary Adjudication, at 9-11.

²⁹Lower courts throughout California have applied the doctrine to similar “public benefits.” See,
 e.g., *Evans v. City of Berkeley*, 38 Cal. 4th 1 (2006) (use of public property); *Smith v. Los*
Angeles Cnty. Bd. of Supervisors, 104 Cal. App. 4th 1104 (2002) (welfare benefits); *Ofsevit v.*
Trustees of Cal. State Univ. & Colleges, 21 Cal. 3d 763 (1978) (public employment); *Atkisson v.*
Kern Cnty. Housing Auth., 59 Cal. App. 3d 89 (1976) (public housing); *Thornton v. Dep’t of*
Human Res. Dev., 32 Cal. App. 3d 180 (1973) (unemployment benefits).

1 benefit program” at issue here. Rather, SDCWA seeks to convert payments under the project
2 contracts into “public benefits” so that it may try to avail itself of the unconstitutional conditions
3 doctrine. But, unlike the parties in California’s unconstitutional conditions cases, SDCWA is not
4 a private citizen receiving funding from a general public benefits program, and MWD does not
5 act as a governmental benefactor when it enters into the project contracts. What SDCWA
6 attempts to cast as “public benefits” is in reality consideration paid by one contracting party to
7 another.

8 MWD’s payments to contracting parties under the LRP, CCP, and SDP contracts are not
9 generalized benefits paid to the general public. They are restricted to member agencies and
10 certain third parties involved in conservation, desalination, and local resource development
11 projects. MWD enters into these project contracts at its discretion. Member agencies submit
12 project proposals, but they are not automatically entitled to payments under the LRP, CCP, and
13 SDP programs. In consideration of payments made under the contracts, member agencies are
14 required to deliver a tangible item in return—local water conservation and development. Under
15 the LRP and SDP contracts, MWD pays up to \$250 for each acre-foot of water produced, and,
16 under the CCP contracts, MWD pays a specific amount for each acre-foot of water estimated to
17 be conserved. Thus, the consideration paid under the project contracts by MWD to its member
18 agencies is inapposite to the “public benefits” conferred through a “general public benefit
19 program” that are at issue in California’s unconstitutional conditions cases, rendering the
20 doctrine inapplicable here.

21 **c. SDCWA Waived Its Claimed Right to Petition by Executing**
22 **the Project Contracts, and Consented by Accepting Payments**
23 **Thereunder**

24 Even assuming *arguendo* that SDCWA could assert an unconstitutional conditions claim
25 here, SDCWA waived its claimed right to petition regarding MWD’s existing rate structure by
26 executing six separate RSI-containing project contracts with MWD, and further consented to the
27 RSI provision by accepting payments under those contracts.³⁰ *See Miller v. Elite Ins. Co.*, 100

28 ³⁰*See* MWD’s Motion for Summary Adjudication, at 11-13.

1 Cal. App. 3d 739, 753-54, (1980); *Saret-Cook v. Gilbert, Kelly, Crowley & Jennett*, 74 Cal. App.
2 4th 1211, 1226 (1999) (“[V]oluntary acceptance of the benefit of a transaction is equivalent to a
3 consent of all the obligations arising from it.”). Purported constitutional rights, including the
4 right to petition, may be waived upon clear and convincing evidence that the waiver was
5 knowing, voluntary, and intentional. *D. H. Overmyer Co. v. Frick Co.*, 405 U.S. 174 (1972);
6 *Miller*, 100 Cal. App. 3d at 753-54 (“Waiver is the voluntary and intentional relinquishment of a
7 known right.”).³¹

8 SDCWA waived its claimed right to petition here. SDCWA was fully aware of the RSI
9 provision and its implications at the time it executed the project contracts. SDCWA was
10 represented by competent counsel in considering the RSI proposal and later entering into the
11 contracts. Indeed, in 2004, before MWD’s Board voted to include an RSI provision in future
12 project contracts, SDCWA led a campaign to defeat the proposal, objecting extensively and in
13 great detail. During these negotiations, SDCWA even considered whether executing the
14 contracts might constitute a waiver of its rights. Nonetheless, after approximately three years of
15 standing by its objections and refusing to enter into any project contracts that contained the RSI
16 provision, SDCWA reconsidered its position, and in 2007, decided to apply for project contract
17 funding from MWD.

18 Over the next two years, SDCWA entered into six separate project contracts with MWD,
19 all of which contain the RSI provision. In executing these contracts, SDCWA conceded that
20 MWD’s existing rate structure was “properly adopted in accordance with [MWD’s] rules and
21 regulations.” SDCWA further acknowledged that MWD’s existing rate structure “provides the
22 revenues necessary to support the development of new water supplies by local agencies” under
23 MWD’s LRP, CCP, and SDP programs. Each contract was executed by SDCWA managers and
24 counsel. SDCWA’s objections to the RSI provision do “not make [its] execution of the

25 _____
26 ³¹See also *Navellier v. Sletten*, 29 Cal. 4th 82, 97 (2002) (“Many preexisting legal relationships
27 may properly limit a party’s right to petition, including enforceable contracts in which parties
28 waive rights to otherwise legitimate petitioning.”); *Sanchez v. Cnty. of San Bernardino*, 176 Cal.
App. 4th 516, 528 (2009) (“It is possible to waive even First Amendment free speech rights by
contract.”); *Leonard v. Clark*, 12 F.3d 885, 889 (9th Cir. 1993) (same).

1 agreement any less voluntary.” *Leonard v. Clark*, 12 F.3d 885, 890 (9th Cir. 1993). SDCWA
2 thus knowingly and voluntarily waived any right to petition it claims to have had by executing
3 the project contracts with MWD, and consented by accepting payments thereunder. *See id.*;
4 *Saret-Cook*, 74 Cal. App. 4th at 1226; *see also Sanchez*, 176 Cal. App. 4th at 528 (enforcing
5 waiver of First Amendment rights by contract); *Lockyer v. R.J. Reynolds Tobacco Co.*, 107 Cal.
6 App. 4th 516, 533 (2003) (enforcing provision in settlement agreement that waived all state and
7 federal constitutional challenges).

8 2. **The Evidence Demonstrates the Validity of the RSI Provision Under** 9 **California’s Unconstitutional Conditions Doctrine**

10 Even if the Court were to apply the unconstitutional conditions doctrine, the evidence
11 will demonstrate the validity of the RSI provision under the *Robbins* standard, which is set forth
12 above.

13 Not all restrictions on a constitutional right rise to the level of an “unconstitutional
14 condition.” *See, e.g., Lee*, 129 Cal. App. 3d at 13-14; *Norton v. City of Santa Ana*, 15 Cal. App.
15 3d 419, 426-27 (1971). Indeed, courts have consistently recognized that the “government may,
16 when circumstances inexorably so require, impose conditions upon the enjoyment of publicly
17 conferred benefits despite a resulting qualification of constitutional rights.” *Lee*, 129 Cal. App.
18 3d at 13-14; *Norton*, 15 Cal. App. 3d at 426-27. In particular, restrictions on the exercise of
19 constitutional rights in the context of a commercial transaction, where the relinquishment of
20 rights constitutes consideration under the associated contract, are fundamentally different from
21 restrictions in other contexts. As the evidence will demonstrate, the elements of California’s
22 unconstitutional conditions test are satisfied here.

23 a. **The RSI Provision’s Restriction on Receipt of LRP, CCP, and** 24 **SDP Funding Relates Directly to the Purpose of the Programs** 25 **that Offer that Funding**

26 As stated, the RSI provision was implemented to ensure funding for long-term project
27 contracts by protecting the stability of MWD’s existing rate structure, which provides the funds
28 necessary to pay for the LRP, CCP, and SDP contracts. To that end, the provision encourages
member agencies who wish to avail themselves of LRP, CCP, and SDP funds to resolve disputes

1 over MWD's rates through the Board process rather than through piecemeal litigation or
2 legislative challenges.

3 The RSI provision applies to all member agencies that seek funding from MWD and
4 enter into project contracts. MWD has undertaken and expects to undertake future commitments
5 to pay hundreds of millions of dollars under the project contracts, many of which have 25-year
6 terms. Those project contracts and MWD's ability to fund them are necessary to reach MWD's
7 long-term water supply reliability targets set forth in its IRP and to satisfy statutory mandates to
8 promote water conservation. MWD funds the project contracts through its existing rate
9 structure. The requirement that member agencies may forgo project contract payments if they
10 challenge MWD's existing rate structure is aimed at preserving the integrity of the very
11 mechanism by which the funds for such projects are collected.

12 By encouraging resolution of disputes regarding the existing rate structure through the
13 MWD Board process, the RSI provision protects the stability of MWD's existing rate structure
14 by ensuring that rate decisions are made in consideration of the larger picture, taking into
15 account MWD's overall costs and revenue streams. Without a stable rate structure to provide
16 funding for the LRP, CCP, and SDP programs, these programs could cease to exist in the manner
17 calculated to reach MWD's IRP targets, which in turn would adversely affect MWD's plan for
18 long-term water supply reliability. The following is illustrative. If, for example, MWD was
19 required to eliminate its Water Stewardship Rate, MWD would have to make fundamental
20 changes in its overall rate structure, which would be destabilizing. In particular, absent changes
21 in MWD's budgeted costs, MWD would have to increase its other rates to cover the cost of
22 existing LRP, CCP, and SDP programs and contractual commitments. This kind of unplanned
23 for rate increase would interfere with MWD and its member agencies' ability to properly plan
24 and budget for the future. So, faced with the choice between disruptive rate increases and
25 lowering overall costs to avoid such increases, MWD's Board would have to consider decreasing
26 or discontinuing its investment in local conservation and resource development projects.

27 Thus, the RSI provision, which protects the stability of MWD's rates, bears more than a
28 reasonable relationship to the purpose of the LRP, CCP, and SDP programs—it is directed to

1 protect the very existence of those programs.

2 **b. The Compelling Public Benefits Protected by the RSI Provision**
 3 **Manifestly Outweigh the Limited Restriction on SDCWA's**
 4 **Claimed Right to Petition**

5 The benefits that accrue to the general public as a result of the RSI provision, which
 6 protects the ongoing administration of the LRP, CCP, and SDP programs, cannot be overstated:
 7 these programs allow MWD, in cooperation with its member agencies, to ensure a safe and
 8 reliable water supply for the almost 19 million people who live and work in Southern California.
 9 As SDCWA has said, water is “a literal essential of life.”³² In an effort to ensure the continued
 10 availability of this precious resource, since 1991, these programs have produced almost 4 million
 11 acre-feet of water. This undeniable public benefit, which requires a stable funding source,
 12 manifestly outweighs the limited condition placed on SDCWA's claimed right to petition.

13 MWD's Board made a policy decision to undertake local conservation and resource
 14 development efforts in consideration of the regional benefits attained by these programs. Water
 15 conserved or developed at the local level benefits MWD, its member agencies, and the general
 16 public throughout MWD's service region in several ways:

- 17 • Every acre-foot of water developed by a member agency decreases that member
 18 agency's reliance on imported water from MWD.
- 19 • Reducing the amount of water that must be imported by MWD and conveyed
 20 through its system reduces the demand and burden on MWD's conveyance
 21 system.
- 22 • Reducing the amount of water that must be conveyed through MWD's system
 23 decreases and avoids operating, maintenance, capital and improvement costs.
- 24 • Reliance by member agencies on locally developed water frees up space in
 25 MWD's system to convey both MWD water and water from non-MWD sources,
 26 allowing for transactions such as the 2003 Exchange Agreement.

27 ³²SDCWA's Memorandum of Points and Authorities in Support of Plaintiff SDCWA's Motion
 28 for Summary Adjudication (Fifth Cause of Action), at 1:16-19.

- 1 • Developing and conserving local water resources increases the amount of water
2 available throughout MWD’s region, so water that would have otherwise been
3 purchased by a member agency is made available to other member agencies who
4 may be facing increased demands.
- 5 • Reducing Southern California’s need for future increases of imported water
6 reduces MWD’s future supply and transportation costs.
- 7 • With more water available from diverse sources, water supply reliability is
8 improved throughout the region.
- 9 • Absent these programs, MWD would be required to develop and pay for
10 alternative water supply sources to avoid water shortages, and pay for additional
11 capital development and operation costs in connection with importing that
12 alternative water supply.

13 In 1996, MWD’s economic analysis showed that, among other things, by developing a preferred
14 mix of groundwater storage and local resource programs, MWD could expect to save
15 approximately \$2.27 billion over 25 years. To that end, since 1991, these programs have
16 produced almost 4 million acre-feet of water for the residents of Southern California—a palpable
17 and significant regional benefit.

18 As stated, SDCWA is well aware of the regional benefits of the LRP, CCP, and SDP
19 programs. SDCWA admitted that there are “regional benefit[s] from new recycling projects,
20 groundwater recovery projects and water use efficiency gains developed under MWD’s and the
21 Water Authority’s longstanding local resource and conservation programs.” SDCWA also
22 admits that the project contracts provided by MWD are aimed at “avoiding the following costs:

- 23 • Acquisition of new imported supplies such as transfers and exchanges;
- 24 • State Water Project (SWP) energy consumption for pumping imported supplies;
- 25 • Treating imported supplies; and
- 26 • MWD distribution system expansions.”

27 The condition imposed by the RSI provision is minor in comparison to the public benefits
28 that flow from MWD’s LRP, CCP, and SDP programs. Although SDCWA attempts to

1 characterize the RSI provision as extinguishing its claimed right to petition, such is not the case.
2 The RSI provision does not prevent a member agency from challenging MWD's rates in court, as
3 this action shows. Rather, it simply prevents a member agency from challenging the source of
4 the project funding judicially or legislatively, while simultaneously receiving that funding. *See*
5 *Graham v. Kirkwood Meadows Publ. Utils. Dist.*, 21 Cal. App. 4th 1631, 1643-44 (1994)
6 (holding that "[t]he question is not whether a man is free to live where he wishes, it is whether a
7 man is free to live where he wishes and at the same time insist upon employment by the
8 government.") To that end, the RSI provision provides that a member agency that decides to
9 challenge MWD's existing rate structure in the courts or legislature may forgo continued funding
10 under the project contract. The RSI provision thus seeks to discourage member agencies that
11 enter into LRP, CCP, and SDP project contracts from engaging in judicial and legislative
12 challenges that threaten to disrupt the continued administration of the programs that fund those
13 projects, and instead seeks to encourage any challenge to be pursued through the MWD Board
14 process, where all relevant policy decisions can be weighed and considered by the collective
15 stakeholders.

16 This is precisely the kind of condition California courts have found permissible. *See Lee*,
17 129 Cal. App. 3d at 13-14. *Lee* is instructive. There, a civil service worker employed by the
18 county department of public social services decided to run for state senate and was fired as a
19 result. *Id.* at 10-11. The county fired Lee because, under the Hatch Act (5 U.S.C. § 1501 *et*
20 *seq.*), his participation in the election threatened the department's continued federal funding. *Id.*
21 Specifically, the Hatch Act provides that a local agency may be faced with a withdrawal of
22 federal funds unless it discharges an employee found to be in violation of the Act. *Id.* Because
23 Lee's participation in the election threatened the department's funding, the benefit of the
24 condition was found to manifestly outweigh the restriction imposed on Lee's right to run for
25 office. *Id.* at 13-14. As the court explained, California courts have "recognized the right of
26 governmental agencies to preserve their harmonious operation by restricting such political
27 activities as directly threaten administrative disruption or loss of integrity." *Id.*

28 The benefits of the LRP, CCP, and SDP programs similarly outweigh the limited

1 restriction on SDCWA’s claimed right to petition. A piecemeal attack on individual rate
2 components that fails to consider all of the factors MWD’s Board must consider in allocating
3 costs and setting rates threatens to destabilize MWD’s entire rate structure. This in turn threatens
4 the continued administration of the LRP, CCP, and SDP programs because without a stable rate
5 structure, MWD cannot ensure the continued availability of funds necessary to administer these
6 programs and honor its contractual commitments under the programs. By encouraging member
7 agencies to address any objections to MWD’s existing rate structure through the Board process,
8 the RSI provision seeks to protect the stability of that rate structure by ensuring that rate
9 decisions are made in consideration of the larger picture, taking into account MWD’s overall
10 costs and revenue streams. As such, the value accruing to the member agencies and the general
11 public from inclusion of the RSI provision outweighs any resulting impairment of SDCWA’s
12 claimed right to challenge MWD’s existing rate structure judicially without consequence. *See*
13 *Lee*, 129 Cal. App. 3d at 14; *see also Norton v. City of Santa Ana*, 15 Cal. App. 3d 419 (1971)
14 (upholding condition that sought to prevent “a direct challenge to the structure of the
15 department” and its continued efficiency).

16 **c. The RSI Provision Is Narrowly Tailored to Maintain the**
17 **Integrity of MWD’s LRP, CCP, and SDP Programs**

18 After considering multiple alternatives, some of which were proposed by member
19 agencies, including SDCWA, MWD’s Board adopted an RSI provision that is both narrow in
20 scope and necessary to protect the public benefits of its LRP, CCP, and SDP programs. First, the
21 RSI provision, unlike a statute of general application, is a contract term that applies only to those
22 member agencies and third parties that enter into project contracts voluntarily with MWD.
23 MWD could have instead amended its Administrative Code to limit rate challenges, but chose to
24 adopt a more narrow restriction tied directly to the project contracts that provide LRP, CCP, and
25 SDP funding. Second, as noted above, the provision does not preclude a contracting member
26 agency from exercising a claimed right to petition. Instead, it simply provides that a member
27 agency cannot continue to accept project contract payments while challenging MWD’s existing
28 rate structure—the very source of those payments—outside the Board process. Third, the

1 provision is limited to challenges to MWD’s existing rate structure; member agencies remain
2 free, without consequence, to bring legal and/or legislative challenges to other acts by MWD,
3 including any “material changes” to the existing rate structure and/or procedural deficiencies in
4 the adoption of MWD’s rates.

5 *Norton* is instructive. There, a city police lieutenant was dismissed after filing various
6 defamation lawsuits against his captain. 15 Cal. App. 3d at 427. In upholding this restriction on
7 the lieutenant’s right to petition the courts, the court noted that “[t]he departmental rules do not
8 impose an absolute prohibition against resort to the courts. . . . It was not that petitioner filed an
9 action; rather, it was that he filed the specific actions” that threatened the structure and efficiency
10 of the department. *Id.* The lieutenant’s dismissal was therefore justified under the
11 circumstances. *Id.* The RSI provision is similarly narrow in that it does not apply to *all* legal
12 and/or legislative challenges; it applies only to those challenges that threaten the stability of
13 MWD’s rate structure, the continued administration of the LRP, CCP, and SDP programs, and
14 MWD’s and its member agencies’ ability to plan and budget for the future.

15 The RSI provision is also appropriately tailored to fit the circumstances in which it was
16 adopted and implemented. As opposed to typical unconstitutional conditions cases involving
17 statutes of general application, the alleged “imposition” on a constitutional right in this case is
18 incorporated into a contract. This is significant. Unlike a statute of general applicability that, by
19 definition, imposes conditions upon everyone, contractual provisions incorporate the
20 consideration received by both parties in exchange for the burdens imposed. Here, as in many
21 commercial agreements, SDCWA agreed to accept some limitations on its right to litigate, in
22 exchange for a financial benefit. An agreement with a general release of claims, which is of
23 course both common and lawful, is far more of a limitation on a party’s ability to sue, since that
24 ability is completely extinguished. Removing a contractual burden without removing a
25 corresponding contractual benefit is clearly inappropriate. In addition, any imposition on a
26 claimed right to petition here is limited to the terms and conditions of individual contracts, which
27 may be terminated by either party for other reasons or amended when circumstances change.

28 SDCWA’s claim that the RSI provision is fatally overbroad because it seeks to protect

1 not just the Water Stewardship Rate, but all rates, is without merit. First, even under SDCWA's
2 argument, the RSI provision is not overbroad as applied here because SDCWA's has challenged
3 the Water Stewardship Rate in this action. Second, although the Water Stewardship Rate is set
4 to recover LRP, CCP, and SDP project contract costs, that rate is integrated with and
5 interdependent on the various other rate components. And while it is true that a successful legal
6 challenge to MWD's rate structure would not preclude MWD's Board from resetting its rates to
7 cover its current overall costs, the story does not end there. Indeed, such a result would create
8 the destabilizing effect on MWD and its member agencies that the RSI provision was intended to
9 prevent. Especially given that MWD's current rate structure, in place since 2003, took years to
10 develop.

11 If MWD, for example, were required to eliminate its Water Stewardship Rate, absent
12 changes in MWD's budgeted costs, MWD would have to increase its other rates to cover the cost
13 of existing LRP, CCP, and SDP programs. This threat to the stability of MWD's existing rate
14 structure undermines the ability of both MWD and its member agencies to properly plan and
15 budget for the future. To avoid future disruptive rate increases, MWD's Board would be faced
16 with the possibility of having to decrease or discontinue funding for local conservation and
17 resource development projects, despite long-term contractual commitments of up to 25 years.
18 Thus, an attack on any one of MWD's rate components amounts to an attack on the stability of
19 the entire rate structure, which in turn threatens the continued administration of the LRP, CCP,
20 and SDP programs. The RSI provision is therefore narrowly tailored to meet the goal of
21 protecting LRP, CCP, and SDP program funding.

22 **D. SDCWA Will Be Unable to Prove Its Section 1668 Claim**

23 As more fully briefed in conjunction with MWD's Motion for Summary Adjudication,
24 SDCWA's claim that the RSI provision violates California Civil Code section 1668 is entirely
25 without merit. Section 1668 "invalidates contracts that purport to *exempt* an individual or entity
26 from liability" for certain tortious or unlawful acts. *Frittelli, Inc. v. 350 N. Canon Drive, LP*,
27 202 Cal. App. 4th 35, 43 (2011) (emphasis added). Accordingly, courts have routinely voided
28 express contractual provisions discharging a party from liability. *See City of Santa Barbara v.*

1 *Super. Ct.*, 41 Cal. 4th 747, 757-58 (2007) (collecting cases). In *City of Santa Barbara*, for
 2 example, the California Supreme Court invalidated a contract term that purported to release the
 3 City “from all liability” for “any loss, damage, or claim[.]” *Id.* at 751 n.3; *see also Tunkl v.*
 4 *Regents of Univ. of Cal.*, 60 Cal. 2d 92, 94, 97 (1963) (invalidating provision that required
 5 patients to “release[] . . . the hospital from any and all liability”).

6 In contrast, section 1668 has been held inapplicable where the challenged provision does
 7 not “totally exempt” a party from liability. *See, e.g., Beynon v. Garden Grove Med. Grp.*, 100
 8 Cal. App. 3d 698, 710 (1980); *Lagatree v. Luce, Forward, Hamilton & Scripps LLP*, 74 Cal.
 9 App. 4th 1105 (1999). In *Beynon*, for example, the court refused to apply section 1668 to an
 10 arbitration provision that allowed the hospital to reject an arbitrator’s decision without cause and
 11 to require resubmission of the controversy to a second arbitration panel of physicians. 100 Cal.
 12 App. 3d at 710. The court reasoned that even though the provision was “heavily weighted in
 13 favor of the health care provider,” it did not “totally exempt” the hospital from liability. *Id.*

14 Unlike the facially exculpatory provisions held invalid by courts under section 1668, the
 15 RSI provision does not purport to “exempt,” “exculpate,” or otherwise release MWD from *any*
 16 liability for unlawful rates or any other violation of law. It does not prevent SDCWA from
 17 bringing a rate challenge, as SDCWA has done here. It does not discharge MWD’s
 18 responsibility for allegedly illegal rates. And it does not restrict the claims or remedies available
 19 to SDCWA or others. While the RSI provision provides that SDCWA may forgo continued
 20 payments under a project contract if it chooses to judicially or legislatively challenge MWD’s
 21 existing rate structure, the RSI provision neither exempts MWD from liability nor prevents
 22 SDCWA from filing a lawsuit. Section 1668 is simply inapplicable here.

23 **V. STANDARD OF REVIEW, BURDEN OF PROOF, AND ADMISSIBLE**
 24 **EVIDENCE FOR THE PREFERENTIAL RIGHTS CLAIM (SIXTH**
 25 **CAUSE OF ACTION IN 2010 ACTION)**

26 SDCWA’s sixth cause of action regarding MWD’s preferential rights calculation under
 27 section 135 of the MWD Act is an attempt to re-litigate issues SDCWA already lost in
 28 *SDCWA v. MWD*, 117 Cal. App. 4th 13 (2004). SDCWA asserts a claim for declaratory relief

1 regarding MWD’s “preferential rights” calculations under section 135 of the MWD Act. (TAC
2 ¶¶ 112-115.) SDCWA alleges that MWD has improperly calculated its preferential right because
3 MWD does not include SDCWA’s payment of volumetric water rates for the purchase of
4 water—which is expressly excluded from the preferential rights calculation by section 135—
5 under the 2003 Exchange Agreement. According to SDCWA, these payments do not constitute
6 payments for the “purchase of water” and should therefore be included in calculating its
7 preferential right. SDCWA seeks a judicial declaration that MWD’s current method for
8 calculating SDCWA’s preferential right violates section 135, and an order directing MWD to
9 include in the calculation SDCWA’s payments under the 2003 Exchange Agreement. (TAC,
10 Prayer for Relief at ¶ 6.)

11 **A. Standard of Review and Burden of Proof**

12 SDCWA’s sixth cause of action asserts a civil claim for declaratory relief. SDCWA’s
13 claim turns on an interpretation of section 135 of the MWD Act. As MWD is the agency tasked
14 with implementing section 135, SDCWA’s claim requires this Court to review MWD’s
15 administrative construction of section 135. MWD’s construction of section 135 must be
16 accorded deference—“great weight” and “respect.” As held by the Court of Appeal in
17 *SDCWA v. MWD*: “Here, we are called upon to review the language of section 135. . . . [T]he
18 judiciary, although taking ultimate responsibility for the construction of the statute, accords *great*
19 *weight* and *respect* to the administrative construction.” 117 Cal. App. 4th at 22-23 (emphasis
20 added); *see also Kern County Water Agency*, 185 Cal. App. 4th at 982 (courts “give deference to
21 an agency’s interpretation” of a statute “by its implementing agency”); *San Bernardino Valley*
22 *Audubon Soc’y*, 44 Cal. App. 4th at 603 (“We give great deference to an agency’s interpretation
23 of its governing statutes.”); *City of Long Beach*, 34 Cal. 4th at 956 (“In construing an ambiguous
24 statute, courts generally defer to the views of an agency charged with administering the
25 statute.”). As the Court recognized in SDCWA’s earlier unsuccessful preferential rights
26 challenge, judicial deference is particularly appropriate to MWD’s interpretation and
27 implementation of its preferential rights statute; in that case the Court “hesitate[d] to pronounce
28 the preferential rights formula in section 135 inequitable” because “water policy in this state has

1 proven to be an exquisitely political endeavor.” *SDCWA*, 117 Cal. App. 4th at 28, n.8.

2 As set forth in MWD’s Motion for Summary Adjudication, the facts relevant to
 3 SDCWA’s preferential rights claim are not in dispute. Thus, the question to be decided is a legal
 4 one: whether payments made by SDCWA under the Exchange Agreement qualify as payments
 5 for the “purchase of water” under section 135. If, however, the Court determines that summary
 6 adjudication of SDCWA’s preferential rights claim is precluded by a factual dispute, at trial
 7 SDCWA bears the burden of proving a violation of section 135 by a preponderance of the
 8 evidence. Cal. Evid. Code §§ 115 & 500.

9 **B. Evidence the Court Is Required to Evaluate**

10 The Court may consider all relevant evidence admissible under the rules of evidence that
 11 pertains to MWD’s calculation of preferential rights under section 135. This includes both
 12 documentary evidence and testimony from MWD fact witnesses, including but not necessarily
 13 limited to MWD’s current Manager of the Budget and Financial Planning Section, who MWD
 14 expects will testify regarding MWD’s method of calculating preferential rights under section 135
 15 and related matters. MWD may also present testimony by SDCWA’s Assistant General
 16 Manager, Dennis Cushman, who SDCWA designated as its “person most knowledgeable” on the
 17 subject. MWD expects that the evidence at trial will establish the facts regarding MWD’s
 18 calculation of preferential rights set forth above in Section II.C.

19 **1. MWD’s Method of Calculating Preferential Rights Is Valid, and**
 20 **SDCWA Is Collaterally Estopped from Arguing Otherwise**

21 **a. SDCWA v. MWD Held that All Water Rate Payments Toward**
 22 **Capital Costs and Operating Expenses Constitute the**
 23 **“Purchase of Water” Under Section 135**

24 As in this case, in *SDCWA v. MWD*, SDCWA sought declaratory relief turning on an
 25 “[i]nterpretation of Section 135” based on MWD’s then bundled rates. 117 Cal. App. 4th at 18.
 26 In that action, SDCWA argued that the calculation of preferential rights must include “that
 27 portion of the water rates being used by Metropolitan for capital expenditures and operating
 28 expenses, excepting only that portion spent for the direct purchase of water.” *SDCWA*, 117 Cal.
 App. 4th at 20. SDCWA’s statement of the issue in that case covers its claim here: “Does § 135

1 exclude all water rate revenue from preferential rights credit?” The court said yes. This Court
 2 entered judgment for MWD, *SDCWA v. MWD* affirmed, and the Supreme Court denied review.
 3 *SDCWA*, 117 Cal. App. 4th at 13; *SDCWA v. MWD*, No. S124550, 2004 Cal. LEXIS 6433 (Cal.
 4 July 14, 2004).

5 After an extensive interpretive analysis of section 135, including review of section 135’s
 6 text, purpose, statutory context, and Legislative history³³ and intent, the Court of Appeal
 7 interpreted section 135 to mean that all components of MWD’s “charge for the ‘purchase of
 8 water’ to its members may include amounts allocated for capital costs and operating expenses.”
 9 *SDCWA v. MWD*, 117 Cal. App. 4th at 26. The court held that “the statute excludes from the
 10 preference formula any amount of capital costs and operating expenses which might be included
 11 as part of the ‘purchase of water.’” *Id.* The court specifically “reject[ed] San Diego’s
 12 interpretation of the phrase ‘purchase of water’ as being intended to mean only ‘the cost of the
 13 water resource,’ and not the ‘bundled’ charge for water inclusive of capital costs and operating
 14 expenses.” *Id.* at 17, 26. The court rejected SDCWA’s “attempt to draw any meaningful
 15 distinction between the Water Code’s use of the alternative phrases ‘water rates’ (which
 16 [SDCWA] argues can include capital and operating costs) and the ‘purchase of water.’” *Id.* at 26
 17 n.6. The court further held that “the Legislature’s inclusion of the language ‘excepting purchase
 18 of water’ supports the evident purpose of *excluding any portion of water rates* used to pay capital
 19 costs and operating expenses from the formula for calculating preferential rights.” *Id.* at 28
 20 (emphasis added). In short, *SDCWA v. MWD* adopted MWD’s interpretation and application of
 21 section 135, which is the same interpretation at issue here.

22 **b. SDCWA’s “Water Rate” Payments Under the Exchange**
 23 **Agreement Are Properly Excluded in Calculating Its**
 24 **Preferential Right**

25 SDCWA will be unable to establish that MWD’s method for calculating preferential
 26 rights is invalid. SDCWA admits that it pays MWD’s “water rates,” specifically three

27 ³³In 1984, the Legislature overhauled the MWD Act but did not change section 135. In fact, the
 28 Legislature affirmatively *rejected* a bill proposed by San Diego’s state legislators to *include*
 water rates in the preferential rights calculation. Senate Bill No. 2192.

1 components of these rates, to obtain Exchange Water under the Exchange Agreement. As
2 SDCWA pays MWD’s “water rates” under the Exchange Agreement for each acre-foot of
3 Exchange Water delivered to SDCWA, those payments are for the “purchase of water” under
4 section 135, and MWD properly excludes them from the preferential rights calculation.

5 SDCWA contends, however, that its payments for Exchange Water under the 2003
6 Exchange Agreement should be included in calculating its preferential right because it is not
7 purchasing the “supply” of water from MWD and is paying only the transportation rate MWD
8 charges its member agencies for transportation in its unbundled rate structure. *See* TAC ¶¶ 61-
9 63, 113. But SDCWA’s fallacy is its attempt to equate “purchase of water” under section 135
10 with MWD’s “supply” rates. *Id.* (referring to “purchase of water’ (i.e., supply)”). *SDCWA v.*
11 *MWD* expressly rejected that interpretation. “[P]urchase of water” in section 135 is not limited
12 to payments for the “direct purchase of water”; rather, it includes all portions of “water rates”—
13 regardless of whether the rate is used to pay for “supply” or for MWD’s other capital costs and
14 operating expenses. For purposes of section 135 under *SDCWA v. MWD*, whether SDCWA’s
15 water rate payments pay for “supply” costs, *i.e.*, the cost of the water resource, or the costs of
16 conveying water, *does not matter*: Any payment by SDCWA of “water rates” constitutes
17 “purchase of water” under section 135. SDCWA’s interpretation of section 135 is wrong as a
18 matter of law and has already been rejected by *SDCWA v. MWD*.

19 There is no material difference between *SDCWA v. MWD* and this action.³⁴ To the extent
20 SDCWA argues that its claim here involves payments for the “transportation” of Exchange
21 Water under the Exchange Agreement rather than payments for the purchase of MWD water,
22 that is a distinction without a difference for purposes of the preferential rights calculation under
23 section 135. In both instances, SDCWA pays MWD’s volumetric water rate components for
24 delivery of water, which as a matter of law constitute payments for the “purchase of water”
25 under section 135. It matters not whether the System Access Rate, System Power Rate, or Water

26 _____
27 ³⁴When *SDCWA v. MWD* was initiated, MWD had a “bundled” rate that included both supply
28 and conveyance costs. Since 2003, MWD has unbundled its rates, meaning that the rates now
expressly state which rate components are allocated for conveyance costs and supply costs.

1 *San Diego County Water Authority v. Metropolitan Water District of Southern California, et al.*,
2 San Francisco County Superior Court Case Nos. CPF-10-510830 and CPF-12-512466

3 **PROOF OF SERVICE**

4 I am over eighteen years of age, not a party in this action, and employed in San
5 Francisco County, California at Three Embarcadero Center, San Francisco, California 94111-
6 4067. I am readily familiar with the practice of this office for collection and processing of
7 correspondence for mail/fax/hand delivery/next business day Federal Express delivery, and they
8 are deposited that same day in the ordinary course of business.

9 On October 18, 2013, I served the attached:

10 **RESPONDENT/DEFENDANT METROPOLITAN WATER DISTRICT OF**
11 **SOUTHERN CALIFORNIA'S FIRST PRETRIAL BRIEF**



(VIA LEXISNEXIS) by causing a true and correct copy of the document(s) listed
13 above to be sent via electronic transmission through LexisNexis File & Serve to
14 the person(s) at the address(es) set forth below.

15 as indicated on the following **Service List**.

16 I declare under penalty of perjury under the laws of the State of California that the
17 foregoing is true and correct and that this declaration was executed on October 18, 2013, at San
18 Francisco, California.

19 
20 _____
Kelley A. Garcia

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2 San Francisco County Superior Court Case Nos. CPF-10-510830 and CPF-12-512466

3 **PROOF OF SERVICE**

4 I am over eighteen years of age, not a party in this action, and employed in San
5 Francisco County, California at Three Embarcadero Center, San Francisco, California 94111-
6 4067. I am readily familiar with the practice of this office for collection and processing of
7 correspondence for mail/fax/hand delivery/next business day Federal Express delivery, and they
8 are deposited that same day in the ordinary course of business.

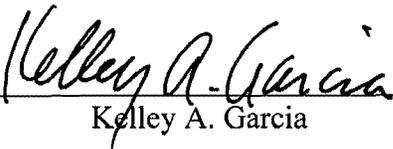
9 On October 18, 2013, I served the attached:

10 **RESPONDENT/DEFENDANT METROPOLITAN WATER DISTRICT OF**
11 **SOUTHERN CALIFORNIA'S FIRST PRETRIAL BRIEF**

12 (VIA LEXISNEXIS) by causing a true and correct copy of the document(s) listed
13 above to be sent via electronic transmission through LexisNexis File & Serve to
14 the person(s) at the address(es) set forth below.

15 as indicated on the following **Service List**.

16 I declare under penalty of perjury under the laws of the State of California that the
17 foregoing is true and correct and that this declaration was executed on October 18, 2013, at San
18 Francisco, California.

19 
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21 Kelley A. Garcia
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15 as indicated on the following **Service List**.

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19 
20 _____
Kelley A. Garcia

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January 10, 2016

Randy Record and
Members of the Board of Directors
Metropolitan Water District of Southern California
P.O. Box 54153
Los Angeles, CA 90054-0153

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

RE: Board Memo 8-3: Adopt the 2015 Integrated Water Resources Plan Update - REQUEST TO DEFER BOARD ACTION ADOPTING 2015 IRP UPDATE, OR IN THE ALTERNATIVE, OPPOSE

Dear Chairman Record and Board Members:

The Water Authority supports action by the Board to **receive and file**, and defer adoption of, the Draft 2015 Integrated Water Resources Plan (IRP) Update and Appendices (Attachments 1 and 2 to Board Memo 8-3), presented to the Board at its December 2015 board meeting, as well as the 2015 IRP Technical Update Issue Paper Addendum, presented to the Board at its October 2015 board meeting (collectively, these documents are referred to in this letter as the staff "Technical Report"). This action would be consistent with the 2015 IRP update process that has previously and consistently been described by MWD staff to the Board as a "two-part process" that would include not only the Technical Report from staff (but instead now presented as the final proposed 2015 IRP Update), but also a subsequent board process that would include "resource policy issues discussion" prior to adoption of the 2015 IRP Update.ⁱ

We do not support adoption of the Draft 2015 IRP Update at this time because the MWD Board of Directors is only now *beginning* the Phase 2 process of reviewing the technical data prepared by staff and deliberating the core planning and policy issues associated with the update and adoption of the IRP. At the board policy level, this review should certainly include deliberation of MWD's reliability and water supply development "targets," *because those targets greatly impact the cost and affordability of MWD Water*. The purpose of the Board's review should be to ensure that the IRP accomplishes the six objectives established by the Board in 1996, and carried forward since that time, namely,

OTHER REPRESENTATIVE

County of San Diego

- Acknowledge environmental and institutional constraints; and ensure:
- Reliability;
- Affordability;ⁱⁱ
- Water quality;
- Diversity; and
- Flexibility

Chairman Record and Members of the Board

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With this set of policy objectives in mind, we wanted to share some preliminary observations at the "50,000 foot view," before the Board reviews the technical data and has an opportunity to discuss policy issues and the assumptions staff has made in the draft 2016 IRP Update, at a workshop or next board meeting. Except where otherwise specifically noted, all analyses contained in this letter are based on the data included in the IRP or taken from other MWD documentary sources. These preliminary observations do not signify agreement with all of the stated assumptions, conclusions and recommendations by staff in the Technical Report, which should more properly be within the province of the Board of Directors during this Phase 2 process.

We request board discussion, and further staff analysis as directed by the Board, of the following issues:

1. Demand for MWD Water. The Technical Report projects an increased demand for MWD Water that is not supported by the underlying data, which evidences instead a declining demand for MWD Water. See Attachment 1. It is critical that the Board consider the near and long term implications of the declining demand for MWD Water over time and how the IRP should be adapted now to plan for it.ⁱⁱⁱ
2. Likelihood of success of member agency projects. The Technical Report understates existing and near-term local water supply development that will further and permanently reduce demand for MWD Water. See Attachment 2. The supply "gap" in the Technical Report^{iv} is driven in large measure by the assumption for planning purposes that all but 20,000 acre-feet (AF) of local water supply projects that are not currently under construction will fail to be implemented. This includes projects that are currently in the full design phase with funds appropriated or at the advanced planning stage with completed certified environmental review. In addition to seven projects within the Water Authority's service area which will be implemented, MWD assumes projects being developed by the following agencies will fail:
 - City of Beverly Hills;
 - City of Torrance;
 - Los Angeles Department of Water and Power;
 - Inland Empire Utility Agency;
 - Upper San Gabriel Valley MWD;
 - Eastern MWD;
 - Municipal Water District of Orange County (MWDOC)/Orange County Water District; and
 - Calleguas MWD

The Technical Report and proposed IRP should "adapt" now to account for the likely success of these projects, or, at a minimum, factor in some percentage of the yield that will be developed.^v If only 50% of the yield from these projects - currently at the advanced planning stage with completed design, funding and/or certified environmental review - is realized, the Technical Report understates local water supply coming on line by more than 100,000 AF annually. This number does not take into account the almost 500,000 AF of additional yield from projects currently under feasibility investigation or in the conceptual planning phase. See Technical Report at Attachment 2, Appendix 5 at pages A.5-1-A.5-13.

Chairman Record and Members of the Board

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Page 3

3. State Water Project. The Technical Report hardwires a "worst case" assumption regarding the yield of the State Water Project (SWP) that is premature at best, assuming a sudden 400,000 AF reduction of SWP supplies in 2020 based on speculation what regulatory action may be taken (and which MWD would presumably object to). It is, again, the staff's assumption that drives creation of a supply "gap." MWD should identify the factors driving the potential magnitude and timing of a potential SWP export reduction, monitor these factors to see if and when they may occur and define thresholds that when reached would trigger action -by MWD and/or its member agencies to address the risk.
4. Colorado River. MWD has made substantial investments in Colorado River supplies recently; however, only a small portion of the supplies have been included in The Technical Report's forecast of Colorado River Aqueduct supplies. See Technical Report, Attachment 1 at page 3-27, stating that "flexible" supplies including the PVID program and Intentionally Created Surplus are not included in the forecast. As with the SWP, the IRP should present a risk assessment identifying the factors that will impact the magnitude and timing of restrictions on the availability of Colorado River water and the risk of the factors being triggered.
5. LACSD project. The Technical Report has not included or accounted for the water supply proposed to be developed by MWD and the Los Angeles County Sanitation Districts (LACSD) to meet groundwater replenishment demand in Los Angeles, Orange counties and San Bernardino. MWD's groundwater production numbers should be updated to include this water supply which staff has indicated is being developed to meet the water replenishment needs of the Los Angeles, Orange County and San Bernardino groundwater agencies.
6. Reliability objective. The Technical Report continues to use an outdated reliability goal, planning to meet 100% of retail water demands under all hydrologic conditions; this objective is outdated at best and should be changed now by the Board as part of the 2015 IRP Update to be more in line with the state's and MWD's own water conservation ethic, state law and standards.
7. Affordability objective. The Technical Report's "do nothing" approach to analyzing MWD Water demand, coupled with its "do everything PLUS" water supply planning strategy, fails to take the Board's affordability objective into account. The IRP's "belt and suspenders" planning strategy which the Technical Report "builds on," should be reconsidered by the Board against declining MWD Water sales and increasing local water supply development. Can our ratepayers afford for MWD to plan 100% water supply reliability (under "core resources" strategy or "IRP Approach") plus 500,000 or 200,000 AF ("uncertainty" or "buffer" supply) plus "Foundational" or "Future Supply Actions"? At the very least, the Board should be presented with an affordability analysis.^{vi} If the IRP is truly adaptive, as it should be, there is no justification for spending ratepayer money now on projects and programs that may never be necessary and may ultimately end up as stranded investments.
8. Adaptive management. Although the Technical Report calls for an "adaptive management strategy," there is no consideration of phasing investments or identifying "triggers" (for example, a planned local project fails to be developed) that would allow MWD to truly "adapt" in order to avoid unnecessary costs, expenditures, and stranded assets. The strategy described in the

Chairman Record and Members of the Board

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Page 4

Technical Report is a "do-everything-and-more" strategy that is inconsistent with the Board's affordability objective.

9. Impact of higher MWD Water rates. The Technical Report's discussion of MWD Water demand fails to take into account the inevitable impact of higher MWD rates and charges across a shrinking sales base due to declining sales and demand for MWD Water. Significant MWD Water rate increases are inevitable given the approach recommended in the Technical Report and those higher rates increases will continue to dampen demand for MWD water sales. Higher MWD rates will increase the economic incentive for the development of local water supplies such as is already occurring. See Attachment 2.
10. Stranded costs. The IRP Update should analyze and factor in the risk of stranded investments resulting from the reduced demand for MWD Water and rising MWD Water rates being spread across a shrinking ratepayer base.

Conclusion

An IRP that does not consider and incorporate actual available data and affordability creates a material risk that MWD investments will be made on illusionary foundations. Ultimately, this Board of Directors will be accountable to the public and ratepayers we serve. We sincerely hope that the Board will insist upon having an opportunity to deliberate these and many other issues and questions that should be addressed in the previously planned Phase 2 of the IRP process.

Sincerely,



Michael T. Hogan
Director



Keith Lewinger
Director



Fern Steiner
Director



Yen C. Tu
Director

Attachment 1: Demand for MWD Water

Attachment 2: Examples of member agency water projects not included by staff in calculation of demand for MWD Water

ⁱ From the beginning of the 2016 IRP Update process, MWD staff said that it would be a two-part process, with the Technical Report scheduled for adoption in January 2016. See April 8, 2015 Member Agency Kick-off Workshop RE 2015 Integrated Water Resources Plan Update ("final IRP Technical Update Report" for Board consideration scheduled for adoption in January 2016 [not the IRP itself]). More recently, see <http://edmsidm.mwdh2o.com/idmweb/cache/MWD%20EDMS/003736313-1.pdf>, where several of the policy issues raised by the Board are outlined for future board discussion. The Board's policy discussion should not be limited to issues relating to "implementation" of the staff's IRP. Nor is there any reason why the IRP needs to be adopted now, prior to the Phase 2 board deliberations.

ⁱⁱ Affordability is not addressed anywhere in the Technical Report or Attachments 1 and 2 to the 2015 Draft IRP and Appendices.

ⁱⁱⁱ The Technical Report notes the importance of identifying and accounting for "changed circumstances" (e.g., Technical Report at Attachment 1, page v: "The 2015 IRP Update focuses on

Chairman Record and Members of the Board

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Page 5

ascertaining how conditions have changed in the region since the last IRP update in 2010"), but fails to identify or account for the most material change that has occurred, namely, the fact that local water supply development is widely viewed as both more reliable and now, cost-effective when contrasted with the present and anticipated future cost of MWD Water. See Attachment 2 statements by various member agencies seeking support for local projects. The Technical Report appears to acknowledge this, at least indirectly, by noting that if the California WaterFix is implemented, it may need to seek "new markets" for this water supply. Technical Report at Attachment 1, page vi ("[t]he potential completion of the California WaterFix and a modernized water system in the Delta, for example, would create a new physical ability to move additional supplies in average and above-average years. In addition to providing water for storage management, this could also create opportunities for new markets and partnerships." The Water Authority questions this premise and believes that MWD's legal obligation and mission is to provide its own service area and ratepayers with supplemental water, not to develop it for sale to others and not to protect unidentified "broad public interests" that do not pay MWD's rates and charges (see Technical Report at Attachment 1, page vii ("MWD's baseline imported supplies has proven to be a highly cost-effective investment that protects broad public interests as well as Southland ratepayers"). This is also an issue that warrants further examination in the context of the LACSD project where MWD proposes to pay 100% of project costs and assume substantial risks in order to develop a water supply with respect to which member agencies of the LACSD would have a right of first refusal. See Board Memo 8-3, November 2015 MWD Board meeting. Ultimately, MWD must link its rates to the agencies that are benefitting from the costs MWD is incurring (i.e., it must show "cost causation").

^{iv} The Technical Report states that, "[t]hrough the 2015 IRP Update process, foreseeable challenges and risk scenarios were identified that point to the potential of 200,000 AF of additional water conservation and local supplies needed to address these risks." Technical Report at Attachment 1, page iv. However, this "gap" results in part from the planning assumption that more than 200,000 AF of local projects and conservation measures will fail to be implemented (see Technical Report, Attachment 1, Table 3-5 making clear that supply projections only include projects that are currently producing water or are under construction). The "gap" is also the result of the planning assumption that SWP supplies will be reduced by 400,000 AF; and, because the analysis also fails to include the 168,000 AF of supply for groundwater replenishment from the LACSD project.

^v The Technical Report emphasizes MWD's engagement with member agencies but does not explain why or if member agency staff and Board members agreed that it is reasonable to assume for planning purposes that the local projects listed on Attachment 2 would likely fail to be implemented. It isn't possible to reconcile this assumption with the presentations member agencies have made to their respective communities and ratepayers seeking approval and funding of these local projects and the actual progress that is being made toward implementation.

^{vi} The Technical Report describes Future Supply Actions spending as including "exploring the feasibility of new local supply options, investing in water-saving technologies, acquiring land and proposing ways to reduce regulatory impediments to supply development." Staff needs to explain why these actions and spending projects would not already be included in the 100% supply reliability PLUS "buffer" supply. Given this lack of definition or any standard for triggering Foundational Actions spending, it is apparent that the Technical Report isn't a "plan" at all, but is rather, a blank check that could not possibly be a rational basis for establishing MWD's revenue requirements.

Attachment 1 - Demand for MWD Water

The IRP's projection of increased demand for MWD Water is not supported by MWD's own data, which evidences instead, a declining demand for MWD Water

IRP Projections (million AF)¹

	2016	2020	2025	2030	2035	2040
Retail Demand after Conservation²	3.84	4.12	4.19	4.22	4.26	4.27
Local Supply³	2.20	2.31	2.36	2.39	2.41	2.43
MWD Water Demand	1.64	1.81	1.83	1.83	1.85	1.84
Cumulative Increase MWD Demand		0.17	0.19	0.19	0.21	0.20

¹ The retail demand and local supply numbers are taken from the Technical Report, Attachment 1, Draft 2015 IRP Update, Table ES-1. The resulting calculation of MWD Water Demand is simply a mathematical calculation.

² Retail demand as calculated by MWD assumes only 50% compliance with Model Water Efficient Landscape Ordinance (MWELO).

³ MWD does not include in its calculation of local supply any of the Water Authority's independent Colorado River water supplies (280,000 AF over time); it also assumes only 20,000 AF of member agency local projects will be successfully implemented.

IRP Projections (million AF) adjusted only for San Diego's Colorado River water

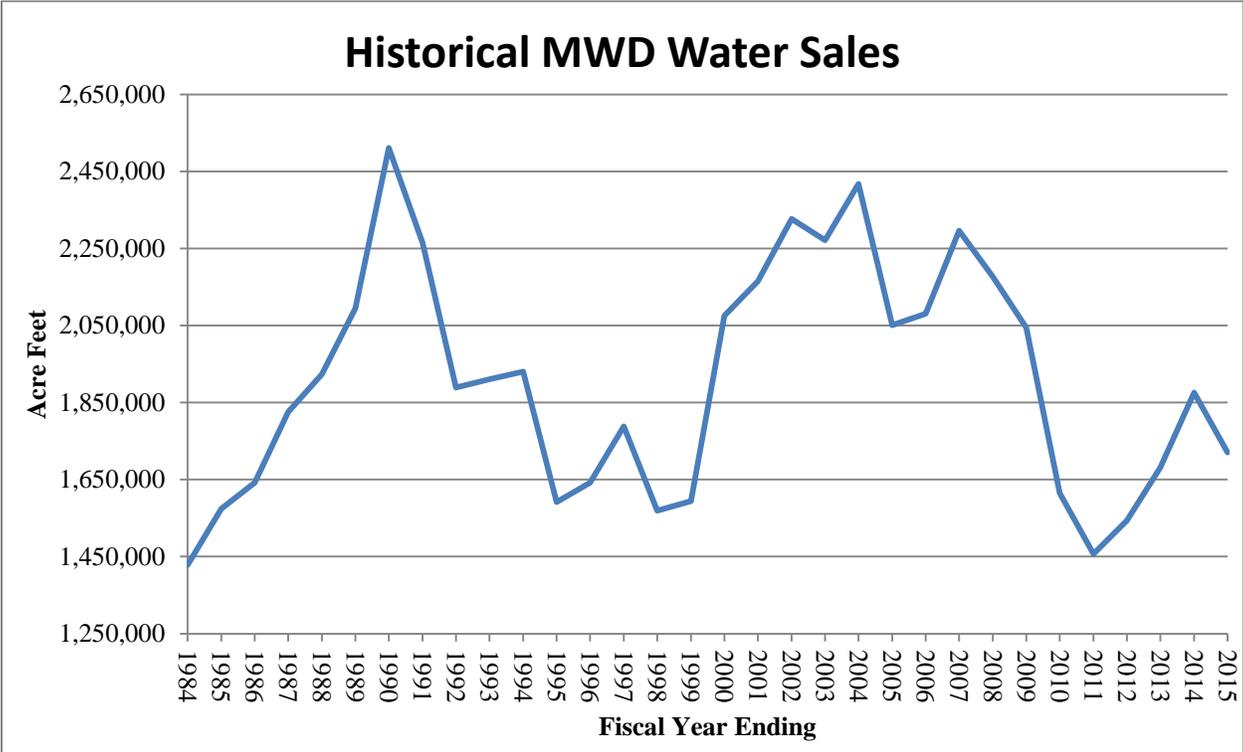
	2016	2020	2025	2030	2035	2040
Retail Demand after Conservation	3.84	4.12	4.19	4.22	4.26	4.27
Local Supply⁴	2.38	2.59	2.64	2.67	2.69	2.71
MWD Water Demand	1.46	1.53	1.55	1.55	1.57	1.56
Cumulative Increase MWD Demand		0.07	0.09	0.09	0.11	0.10

⁴ Local supply corrected to include Water Authority's actual independent Colorado River supplies over time pursuant to fully executed agreements.

IRP Projections (million AF) adjusted for San Diego's Colorado River Water and 50% yield from member agency projects that are currently in full design with funds appropriated or at the advanced planning stage with certified environmental review complete

	2016	2020	2025	2030	2035	2040
Retail Demand after Conservation	3.84	4.12	4.19	4.22	4.26	4.27
Local Supply	2.38	2.59	2.64	2.67	2.69	2.71
50% yield of Member Agencies		0.08	0.10	0.10	0.10	0.10
MWD Water Demand	1.46	1.45	1.45	1.45	1.47	1.46
Cumulative Increase MWD Demand		-0.01	-0.01	-0.01	0.01	0.00

The Technical Report and other historical MWD documents confirm that MWD Water sales are on a long-term declining trend that is no longer based on hydrology but on the development of local water supplies that will permanently replace and reduce demand for MWD Water



Attachment 2

Examples of member agency projects not included by staff in calculation of demand for MWD Water

Member Agency	Status of Member Agency Project
City of Beverly Hills	<p>Feasibility Project Groundwater development- 2,000 AF</p> <p>Status: Water Enterprise Plan- Adopted July 2015 Through a variety of projects and measures including groundwater development, <i>“the City has the potential to decrease its MWD purchases from the current 12,495 AFY to approximately 8,485 AFY by 2024/25.”</i> This amounts to a 4,010 AF (32 percent) reduction of the City's demand for MWD Water.</p> <p>http://www.beverlyhills.org/cbhfiles/storage/files/13699920851488612043/FINALPsomasCBHWEPRreport_08102015V2.pdf</p>
Calleguas MWD	<p>Advanced Planning (EIR/EIS Certified) Projects North Pleasant Valley Desalter- 7,300 AF</p> <p>Feasibility Projects 2 projects 7,800 AF</p> <p>Status: Calleguas is working with several agencies and the City of Oxnard to develop additional water supplies and reclaim brackish groundwater. These projects are in various stages of development with the largest being the EIR certified North Pleasant Valley Desalter. It is also building a regional salinity management pipeline in phases. Phase 1 is completed and Phase 2 is in design and, according to the Los Angeles Regional Water Quality Control Board, <i>expected to be completed within the next permitting cycle in 2018.</i></p> <p>http://www.waterboards.ca.gov/rwqcb4/board_decisions/tentative_orders/individual/npdes/Calleguas_Municipal_Water_District/PublicNoticeCalleguasRSMPEAmendment.pdf</p>
Eastern MWD	<p>Full Design & Appropriated Funds Project Perris Desalter II, 4,000 AF</p> <p>Feasibility Project Indirect Potable Reuse- 24,070 AF</p> <p>Status: <i>Perris Desalter scheduled for bid advertise, November 2016 (9/8/2015 Eastern Presentation)</i></p>

	<p><i>IPR shown to be less expensive than MWD supplies, according to 8/20/2014 Eastern MWD presentation.</i> http://www.emwd.org/home/showdocument?id=13335 page 15</p>
Inland Empire Utility Agency	<p>Advanced Planning (EIR/EIS Certified) Projects IEUA Regional Recycled Water Distribution System- 20,000 AF Status: IEUA's Ten-year Capital Improvement Plan identifies immediate and long term capital projects (including pipelines) needed to <i>"utilize 100% of the region's projected recycled water supplies, increasing recycled water deliveries from approximately 37,000 to 55,000 by 2025."</i> http://www.ieua.org/wp-content/uploads/2015/04/TYCIP-Final-Amended-project-list-3-30-15.pdf</p>
LADWP	<p>Full Design & Appropriated Funds Projects Terminal Island Water Reclamation- 7,880 AF Advanced Planning (EIR/EIS Certified) Projects Downtown and Sepulveda Expansion- 2,600 AF; Tujunga Well Treatment- 24,000 AF Feasibility Projects 9 projects-32,865 AF Conceptual Projects 4 projects -38,270 AF Status: From 11/20/2015 Presentation by David Pettijohn to Los Angeles Chamber of Commerce: <i>Plans to reduce MWD purchases by 145,000 AF</i> Increase Groundwater by 45,535 AF 40,000 AF Water Transfers 25,000 AF Stormwater Capture 50,451 Increased Water Reclamation http://www.lachamber.com/clientuploads/EWE_committee/11.20.15_LADWP%20-%20LA%20Chamber%20Presentation%2011.20.15%20final.pdf</p>
MWDOC	<p>Advanced Planning (EIR/EIS Certified) Projects Huntington Beach Seawater Desalination Project- 56,000 AF Status: <i>Decision from Coastal Commission expected within 2 months</i></p>
City of Santa Monica	<p><i>Plans to eliminate the purchase of MWD Water</i> Status: The following is the first two paragraphs of the City's Water Sustainability Master Plan: The City of Santa Monica (City) supplies imported and local water to approximately 91,000 residents</p>

	<p>covering an area of approximately 8 square miles. Looking to its future, the City hopes to eliminate its reliability on imported water by addressing the challenge of existing groundwater quality, identifying new sources of local water supply, and more effectively reduce and manage its water demands.</p> <p><i>With an adopted goal of water self-sufficiency achieved by eliminating reliance on Metropolitan Water District of Southern California (MWD) supply by 2020</i>, the City of Santa Monica retained Kennedy/Jenks Consultants to develop an integrated Sustainable Water Master Plan (SWMP).</p> <p>This SWMP combines relevant components of existing plans with an evaluation of a broad range of water supply and demand management options to assist the City in meeting its goals.</p> <p>This plan has been prepared with the objective of developing a comprehensive document to define supply and demand management options to cost effectively reduce future water demands and enhance local water supply production capabilities.</p> <p>https://www.smgov.net/uploadedFiles/Departments/Public_Works/Water/SWMP.pdf</p>
City of Torrance	<p>Full Design & Appropriated Funds Projects Madrona Desalter Expansion- 2,400 AF Status: Received \$3.9 Prop 84 funds and \$3.0 M Prop. 50 funding. <i>Estimated Completion 2018</i> http://bondaccountability.resources.ca.gov/Project.aspx?ProjectPK=12317&PropositionPK=4</p>
Upper San Gabriel Valley MWD	<p>Full Design & Appropriated Funds Projects Direct Reuse- 2 projects 730 AF Indirect Reuse Replenishment- 10,000 AF Status: Upper District adopted an Indirect Reuse Action Plan in 2011 which set forth specific tasks to complete the Indirect Reuse Replenishment Project. It has received \$790,000 in grants to date to further the project. <i>According to MWD the project is scheduled to be on-line in 2018.</i></p> <p>http://upperdistrict.org/wp-content/uploads/2012/11/FY-15-16-Budget.pdf</p>
Western MWD	<p>Feasibility Projects Rancho California Reclamation Expansion/Demineralization Western AG- 13,800 AF Status: <i>Scheduled for 2018 completion, according to MWD.</i></p> <p>Link to Rancho California Water Facilities Master Plan: http://www.ranchowater.com/documentcenter/view/1802</p>

Integrated Resources Planning Committee

Attachment 7

Item #7a

Subject: IRP Board Retreat Follow-up

Purpose: To review major IRP related elements discussed on day one of the April 26-27, 2016 Board Retreat

Integrated Resources Planning Committee

Attachment 7

Item #7a

This oral report provides an overview of the major IRP discussion items from the April 26-27, 2016 Board Retreat, and presents the next steps for the IRP Policy Process.



IRP Board Retreat Follow-up

Integrated Resources Planning Committee

Item 7a

June 14, 2016

2015 IRP Update Policy Discussions

Policy Issues Have Been Identified Attachment

- Policy issues were identified through IRP Committee discussion, IRP Technical Workgroup, IRP Issue Paper review, and public outreach
- Policy discussion and direction is needed to refine approaches for implementing IRP targets
 - Regional and retail water supply reliability
 - Conservation program and approach
 - Local Resources development and regional role
 - Storage management goals and operational framework
 - Transfers and Exchanges approach

Summary of Policy Questions

(Details Presented in December 2015)

- Regional and retail water supply reliability
 - Is reliability a guarantee?
 - What level of reliability should we plan for?
- Conservation program and approach
 - How do we achieve permanent reductions in outdoor water use in conjunction with MWELO?
- Local Resources development and regional role
 - What is the regional role in developing local water?

Summary of Policy Questions

(Details Presented in December 2015)

- Storage management and operational framework
 - How should regional and local storage work to meet reliability?
- Transfers and Exchanges
 - How can transfers and storage work together to improve reliability?

Recap of Board Retreat IRP Discussions

Board Retreat Discussion Topics Attachment 7

April 26, 2016

- Metropolitan History and the Laguna Declaration
- Current IRP Strategy and Approach to Uncertainty
- How Does the California WaterFix fit into the IRP?

Key Themes – MWD History and the Laguna Declaration

- Metropolitan is the supplier, backup, and insurance provider for regional reliability
 - “Local responsibility” doesn’t imply abandonment
- Metropolitan should expand its role in regional supply development, partnerships, interactions at the local level
- Appropriate local and regional roles should be determined on a case-by-case basis
- Current business model of paying incentives and agencies “rolling off” is not sustainable

Key Themes – Current IRP Strategy and Approach to Uncertainty

Attachment 7

- All areas of IRP targets are important
- Future options for supply development are trending towards higher-tech and higher cost options
 - **May be inaccessible to smaller agencies**
- IRP will continue to evolve and adapt through time and through major project decision points

Key Themes – How Does the CA WaterFix fit into the IRP?

- Benefits of the California WaterFix should be evaluated on a longer timeline, 100+ years
- Water supply estimates in the 2020-2029 timeframe may be too optimistic
 - Reliance on adaptive management vs. physical facility solution
 - Alternatives may be needed in the mid-term
- CRA supplies may be too optimistic as well
 - Concern with Colorado River shortage impacts

Next Steps

- Development of Policy Principles
 - Policy principles will help to guide in the review and reformation of program implementation
- Areas for Policy Principles
 - Conservation Approach
 - Local Resources Approach/Water Supply Allocation Plan
 - WSDM Plan review for storage management
 - Water Transfers and Exchanges





San Diego County Water Authority

4677 Overland Avenue • San Diego, California 92123-1233
(858) 522-6600 FAX (858) 522-6568 www.sdcwa.org

November 17, 2014

Randy Record and
Members of the Board of Directors
Metropolitan Water District of Southern California
P.O. Box 54153
Los Angeles, CA 90054-0153

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

RE: Board Memo 8-1 - Approve the proposed terms for Purchase Orders with Member Agencies; authorize the General Manager to execute Purchase Orders with Member Agencies consistent with the proposed terms; and approve the Proposed Amendments to the Administrative Code – **OPPOSE**

Dear Chair Record and Board Members,

We have reviewed Board Memo 8-3, the November 17, 2014 PowerPoint Presentation and documents provided to the Board at the July 7, September 8 and October 13 Finance and Insurance Committee meetings. No other information or data has been provided by staff at the three Member Agency Manager Meetings listed on page 2 of the PowerPoint (July 11, September 12 and October 17) to support the conclusions stated in the Board Memo.

New board members may not be aware that the two-tiered pricing structure and Purchase Order date back to the October 16, 2001 board action approving the rate structure proposal that remains in place today (a copy of the October 16, 2001 Board Memo 9-6 (Rate Structure Board Memo) is attached for ease of reference). At that time, MWD management stated that the purpose of the two-tiered pricing structure was to encourage efficient water resource management and conservation (Rate Structure Board Memo at page 1). Further, the board action specified that the Tier 2 Supply Rate "would be set at a level that reflects Metropolitan's cost of acquiring new supplies" (Rate Structure Board Memo at page 2, paragraph A; Attachment 1, Page 4 of 6, paragraph A; and Attachment 1, page 6 of 6 at paragraph A [*Addressing New Demands*]). The Board Memo further stated that the benefits of the rate structure included:

Tiered supply rates provides (sic) pricing signals for water users with increasing demands and incentives to maintain existing local supplies.

Tiered water supply rates: (1) reflect higher costs of new MWD supply development; (2) signals users when local resources development and conservation might be more cost-effective; and (3) passes appropriate costs

A public agency providing a safe and reliable water supply to the San Diego region

Chair Record and Member of the Board
 November 17, 2014
 Page 2

of new supply development to those member agencies that rely on MWD for growing demands (Rate Structure Board Memo at Attachment 1, Page 2 of 6).

The Purchase Order request form was also part of the new rate structure adopted by the board as a means to implement the tiered pricing structure.

This month's Board Memo 8-1 describes the Purchase Orders as an "adjunct" to the cost-of-service study, "in that they implement MWD's tiered supply pricing structure." *But there is no reference whatsoever in MWD's cost of service study to substantiate any linkage between cost of service and the newly proposed terms of the Purchase Order.* Indeed, the newly proposed terms stand in stark contrast to the terms and objectives described in 2001.ⁱ Now, instead of recovering the cost of acquiring new supplies through the Tier 2 rate, MWD proposes to allow its member agencies to buy more water than it has available to sell at the lower Tier 1 rate.ⁱⁱ

The Purchase Order is clearly not based on cost of service, because the costs of acquiring new water supplies that Tier 2 was intended to recover have not just disappeared; they are simply being shifted -- without any data or cost-of-service analysis -- to MWD's other rates and charges (for which no cost-of-service study has been performed).

Lastly, and regrettably, the Purchase Order does nothing to provide any meaningful level of financial stability for MWD as it embarks on expensive new water supply development programs. MWD's own staff has admitted as much.ⁱⁱⁱ This is noteworthy given that the MWD board suspended its tax rate limitation twice in the past few years claiming it was necessary to ensure MWD's "fiscal integrity." Rather than developing a long-term finance plan and rates that can provide the financial stability MWD needs, MWD is now moving in exactly the opposite direction.

It is long past time for MWD and its board of directors to return to the difficult, but necessary process of developing a real long-term finance plan to support MWD's future water supply investments. Execution of Purchase Orders with these terms by the member agencies, as recommended by MWD management, will do nothing to achieve that objective.

Sincerely,



Michael T. Hogan
 Director



Keith Lewinger
 Director



Fern Steiner
 Director



Yen C. Tu
 Director

Attachment: MWD Board Memo 9-6, dated 10/16/01

Chair Record and Member of the Board

November 17, 2014

Page 3

ⁱ MWD has adamantly maintained that it has not changed its rate structure or rates since they were adopted in 2001; however, for the reasons stated in this letter, it is not possible to reconcile the 2001 objectives of the Tier 2 rates (and the associated costs) as described in the Rate Structure Board Memo with the Purchase Order terms recommended in Board Memo 8-1.

ⁱⁱ Total sum of Tier 1 maximum for member agencies would be 2.05 MAF, according to this month's memo.

ⁱⁱⁱ In September Finance and Insurance committee, CFO Gary Breaux said that the purchase order "from a year-to-year standpoint, it doesn't provide that much stability."

- **Board of Directors**

October 16, 2001 Board Meeting

9-6

Subject

Approve Rate Structure Proposal

Description

Background

On September 10, 2001, the Subcommittee on Rate Structure Implementation (Subcommittee) considered a proposal by several member agency managers (Calleguas Municipal Water District, Eastern Municipal Water District, the City of Los Angeles, Central Basin Municipal Water District and West Basin Municipal Water District) to implement Metropolitan's new rate structure in a manner consistent with the Rate Structure Action Plan that was adopted by the Board in December 2000. This proposal addressed many of the concerns raised by Board members during the past nine months as the Subcommittee reviewed the December Action Plan, including the use of property taxes, financial impacts, the relative burden of financial risk, financial commitment and water resource management. The details of the Member Agency Managers' Proposal (Proposal) is included in [Attachment 1](#).

The Subcommittee then reviewed staff's evaluation of the Proposal at the Subcommittee's September 18, 2001 meeting. On September 25, 2001, the Board held a Board Workshop on the Proposal. At that meeting, the Board considered a number of questions raised by the Subcommittee (see [Attachment 2](#)), as well as the Board, and directed staff to agendize the Proposal for Board action at the October 16, 2001, Board meeting.

The proposed rate structure is consistent with the Board's Strategic Plan Policy Principles, which were adopted in December 1999. The Proposal furthers Metropolitan's strategic objectives, supports and encourages sound water resource management, accommodates a water transfer market, enhances fiscal stability and is based on cost-of-service principles. An analysis of the Proposal and its consistency with the Board's Principles from December 1999 is shown in [Attachment 3](#).

Summary of Proposal

Tiered Rate Structure. The Proposal retains the two-tiered pricing structure included in the Rate Structure Implementation Plan from December 2000. Such a pricing structure encourages efficient water resource management and conservation. The amount of water supply that a member agency may purchase in any one year at the lower Tier 1 rate is determined by two factors – the amount of firm water (basic and shift) purchased since fiscal year 1989/90 and the member agency's election to submit a voluntary purchase order for a ten-year supply of water.

A base level of consumption will be established for each member agency equal to the member agency's highest fiscal year firm demand since 1989/90. Member agencies will be able to submit a voluntary purchase order to purchase a minimum amount of water over the next ten years equal to 60 percent of this base times 10. The member agency has ten years to purchase this minimum quantity and can vary its purchase amounts from year to year. But, the member agency would be obligated to pay for the full purchase order, even if it did not use the full amount at the end of the ten-year period. In exchange for this minimum commitment, the member agency will be able to purchase an amount of water supply equal to ninety-percent of the base in any given year at the lower Tier 1 rate. Agencies that determined that a purchase order was not in their interest would be able to purchase up to 60 percent of their base at the lower Tier 1 rate.

Unbundled Rates and Charges. As described in the December Action Plan, rates and charges would be unbundled to reflect the different services provided by Metropolitan. Specifically, the following rate elements would be part of the Proposal:

- a. **Tier 2 supply rate.** The Tier 2 Supply Rate would be charged on a dollar per acre-foot basis for system supply delivered in excess of 90 percent of a member agency's base for member agencies with purchase orders. The Tier 2 Supply Rate would be charged for system supply delivered in excess of 60 percent of a member agency's base for member agencies without purchase orders. The Tier 2 Supply Rate would be set at a level that reflects Metropolitan's cost of acquiring new supplies.
- b. **Tier 1 supply rate.** The Tier 1 Supply Rate would be charged on a dollar per acre-foot basis for system supply delivered to meet firm demands that are less than 90 percent of a member agency's base for member agencies with purchase orders. The Tier 1 Supply Rate would be charged to system supply deliveries that are less than 60 percent of a member agency's base for member agencies without purchase orders. The Tier 1 Supply Rate would be set to recover all of Metropolitan's supply costs, except those paid through the Tier 2 Supply Rate and a portion of the long-term storage and agricultural water sales.
- c. **System Access Rate.** The System Access Rate would be charged on a dollar per acre-foot basis and collect the costs associated with the conveyance and distribution system, including capital, operating and maintenance costs. The System Access Rate would be charged for every acre-foot of water conveyed by Metropolitan. All users (including member agencies and third-party wheeling entities) of the Metropolitan system would pay the same rate for conveyance).
- d. **Water Stewardship Rate.** A Water Stewardship Rate would be charged on a dollar per acre-foot basis to collect revenues in support of Metropolitan's financial commitment to conservation, water recycling, groundwater recovery and other water management programs approved by the Board. The Water Stewardship Rate would be charged for every acre-foot of water conveyed by Metropolitan.
- e. **System Power Rate.** The System Power Rate would be charged on a dollar per acre-foot basis to recover the cost of power necessary to pump water from the State Water Project and Colorado River through the conveyance and distribution system for Metropolitan's member agencies. The System Power Rate will be charged for all Metropolitan supplies. Entities wheeling water would continue to pay the actual cost of power to wheel water on the State Water Project, the Colorado River Aqueduct or the Metropolitan distribution system, whichever is applicable.
- f. **Treatment Rate.** Metropolitan would continue to charge a treatment rate on a dollar per acre-foot basis for treated deliveries. The treatment rate would be set to recover the cost of providing treated water service, including capital and operating cost.
- g. **Capacity Reservation Charge and Peaking Surcharge.** Member agencies would pay a Capacity Reservation Charge (set in dollars per cubic feet per second of the peak day capacity they reserved). The Capacity Reservation Charge is a fixed charge levied on an amount of capacity reserved by the member agency. The Capacity Reservation Charge recovers the cost of providing peak capacity within the distribution system. Peak-day deliveries in excess of the reserved amount of capacity chosen by the member agency would be assessed a Peaking Surcharge. Peaking Surcharge revenue collected by Metropolitan for the three fiscal years ending on June 30, 2005, would be refunded to that member agency to implement specific capital projects and programs to avoid peaking charges in the future. The Capacity Reservation Charge and Peaking Surcharge are designed to encourage member agencies to continue to shift monthly demands into the winter months and avoid placing large daily peaks on the Metropolitan system. Daily flow measured between May 1 and September 30 for purposes of billing the Capacity Reservation Charge and Peaking Surcharge will include all deliveries made by Metropolitan to a member agency or member agency customer including water transfers and agricultural deliveries.
- h. **Readiness-to-Serve Charge.** Metropolitan's Readiness-to-Serve Charge would recover costs associated with standby and peak conveyance capacity and system emergency storage capacity. The Readiness-to-Serve Charge would be allocated among the member agencies on the basis of each agency's ten-year rolling average

of firm demands (including water transfers wheeled through system capacity). This allocation would be revised each year. At the request of the member agency, revenues equal to the amount of Standby Charges would continue to be credited against the member agency's Readiness-to-Serve Charge obligation.

- i. **Long-term storage service program.** The current long-term storage service program used by the member agencies for storage replenishment purposes would continue as is. The long-term storage rate would also remain a bundled rate. The long-term rate would be reviewed annually by the Board as part of the regular rate cycle. Although the Proposal recommends that the long-term storage service program remain in place for at least the next ten years, the Board retains the ability to reexamine this program as needed.
- j. **Agricultural water program.** The current surplus water agricultural service program used by the member agencies for agricultural purposes would remain in place. The agricultural rate would also remain a bundled rate. The agricultural rate will be reviewed annually by the Board as part of the regular rate cycle. Although the Proposal recommends that the current agricultural program remain in place for at least the next ten years, the Board retains the ability to reexamine this program as needed.

Addressing New Demands. The Proposal addresses the impact of new demands on the cost of water supply through the tiered rate structure. Agencies that have increasing demands on Metropolitan would pay more, since they would purchase a greater share of the water sold at the higher Tier 2 rate. In addition, the Proposal provides that a mechanism to recover costs for Metropolitan's infrastructure associated with increasing system demands will be developed and in place by 2006.

Financial Impact

Financial Impact to Member Agencies. While the Proposal includes a number of changes to Metropolitan's existing structure, the initial financial impacts as a result of the change are estimated to be less than three percent (plus or minus), on any one member agency when compared to the existing rate structure. These impacts are estimated in fiscal year 2002/03 and assume normal demand conditions. Over time, it is expected that agencies using more Metropolitan supplies will purchase a greater share of water at the higher Tier 2 rate and would pay more.

Financial Impact to Metropolitan. The total amount of revenue generated under the Proposal would be the same as that under the proposed structure. The introduction of the purchase order helps to provide additional certainty regarding Metropolitan's base supply. But, the purchase order is flexible enough that member agencies do not take on undue financial risk. In addition, the Capacity Reservation Charge adds to fixed revenues.

Impact on Water Transfers. The Proposal provides clear price signals that reflect Metropolitan's costs (both to develop new supplies and to transport water). As such, cost-effective water transfers by Metropolitan and others would be facilitated by this rate structure.

Implementation Plan

If the Board approves the Proposal, a report would be prepared describing each of the above rate design elements in detail, including the cost of service used to develop the rates and charges. The Chief Executive Officer would recommend the rates and charges to the Board in January of 2002. A public hearing on the rates and charges implementing the Proposal would be held at the February 2002 Board meeting. The Board would take action to adopt the rates and charges in March of 2002. The rates and charges as described in the report and recommended by the Chief Executive Officer would be effective January 1, 2003. A Resolution to Adopt the Rate Structure Proposal is provided as [Attachment 4](#).

Policy

The Proposal is consistent with the Board's Strategic Plan Policy Principles and addresses concerns raised by the Board regarding the December 2000 Rate Structure Action Plan.

CEQA

The proposed action, i.e., approval of the Proposal, is not defined as a project under the California Environmental Quality Act (CEQA), because it involves continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed action is not subject to CEQA because it involves the creation of government funding mechanisms or other government fiscal activities, which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed action is not subject to CEQA per Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

Board Options/Fiscal Impacts

Option #1

Adopt the CEQA determination and Resolution approving the Proposal and direct staff to take the necessary steps to implement rates and charges as defined by the Proposal to be effective January 1, 2003.

Fiscal Impact: Increased fixed revenue and financial commitment from member agencies. Total amount of revenue recovered from the member agencies will be the same.

Option #2

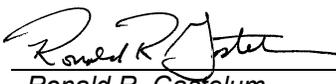
Defer consideration of the Proposal until further discussion by the Board.

Fiscal Impact: None

Staff Recommendation

Option #1

	10/9/2001
_____ Brian G. Thomas Chief Financial Officer	Date

	10/9/2001
_____ Ronald R. Gastelum Chief Executive Officer	Date

Attachment 1 - Member Agency Managers' Proposal MWD Rate Structure

Attachment 2 - Subcommittee on Rate Structure Implementation Responses to Subcommittee Questions

Attachment 3 - Comparison between Member Agency Managers' Rate Structure Proposal and Metropolitan's Board Principles

Attachment 4 - Resolution to Adopt Rate Structure Proposal

**MEMBER AGENCY MANAGERS' PROPOSAL
MWD RATE STRUCTURE
(PROPOSAL)**

(AS SUBMITTED TO THE BOARD SEPTEMBER 25, 2001)

OVERVIEW

Objectives

The proposed rate structure is a pricing mechanism to achieve the following objectives:

- Maintain MWD as the regional provider of imported water – MWD, working collaboratively with its member agencies, will secure necessary water supplies and build appropriate infrastructure to meet current and future needs of its member agencies.
- Support cost-effective local resources development and water conservation – MWD will continue to help fund cost-effective water recycling, groundwater recovery, and water conservation.
- Accommodate a water market – By unbundling its water rate, MWD will accommodate a water market.

Proposed Rate Structure

In order to support MWD's strategic vision, member agencies have developed a rate structure proposal, which is consistent with MWD's Board's December 2000 action plan. This rate structure has the following components:

1. Unbundles water rate into five separate commodity rates: (1) supply; (2) system access, for conveyance and distribution; (3) water stewardship; (4) power; and (5) treatment.
2. Supply rate has two tiers.
3. Two fixed charges: (1) Readiness to Serve Charge (RTS), to help pay for emergency storage and standby for conveyance; and (2) Capacity Reservation Charge, to help pay for peaking for distribution.
4. Voluntary Purchase Order requests for firm water deliveries.
5. Surplus water, when available, for local long-term storage replenishment and agricultural deliveries.

Benefits of Rate Structure

The proposed rate structure offers the following benefits:

- ***Unbundled rates charge all users for system access on same basis.*** Separating supply costs enables MWD to treat everyone on equal basis (member agencies, retail providers, third parties), and is the first step in accommodating a water market.
- ***Tiered supply rates provides pricing signals for water users with increasing demands and incentives to maintain existing local supplies.*** Tiered water supply rates: (1) reflect higher costs of new MWD supply development; (2) signals users when local resources development and conservation might be more cost-effective; and (3) passes appropriate costs of new supply development to those member agencies that rely on MWD for growing demands.
- ***Voluntary Purchase Orders provide for commitment while protecting regional reliability to all.*** Purchase Orders are: (1) voluntary; (2) offer price incentives to member agencies by allowing more water deliveries to be purchased in lower-priced supply tier rate; (3) offer an additional level of financial

commitment to MWD; and (4) are not tied to reliability (i.e., supply reliability for all member agencies is the same).

- ***Framework for future water management while avoiding significant cost impacts in the near term.***
The proposed rate structure offers a framework for future water management of imported and local water supplies without creating significant cost impacts to member agencies in the near-term.

Implementation

- The proposed rate structure will be implemented on January 1, 2003.
- The rate structure is a pricing mechanism designed to support a continued collaborative planning effort between MWD and member agencies used to determine MWD's future water supply and infrastructure needs.

DETAILS

General Overview

- Proposed rate structure is consistent with: (1) MWD Board Strategic Plan Policy Principles (adopted in December 1999); and (2) the intent and elements of MWD Board Action Plan for the rate structure (adopted in December 2000).
- Supply reliability is the same for all member agencies, i.e., not tied to contracts.
- Rates and charges unbundled, allowing for choice in services and providing the basis for a wheeling rate.
- Areas with increasing demands on MWD will pay proportionately more for their water through second tier of the water supply rate.
- Member agencies may request Purchase Orders for firm water supplies, offering pricing benefits for member agencies and more financial security for MWD.

Specific Elements

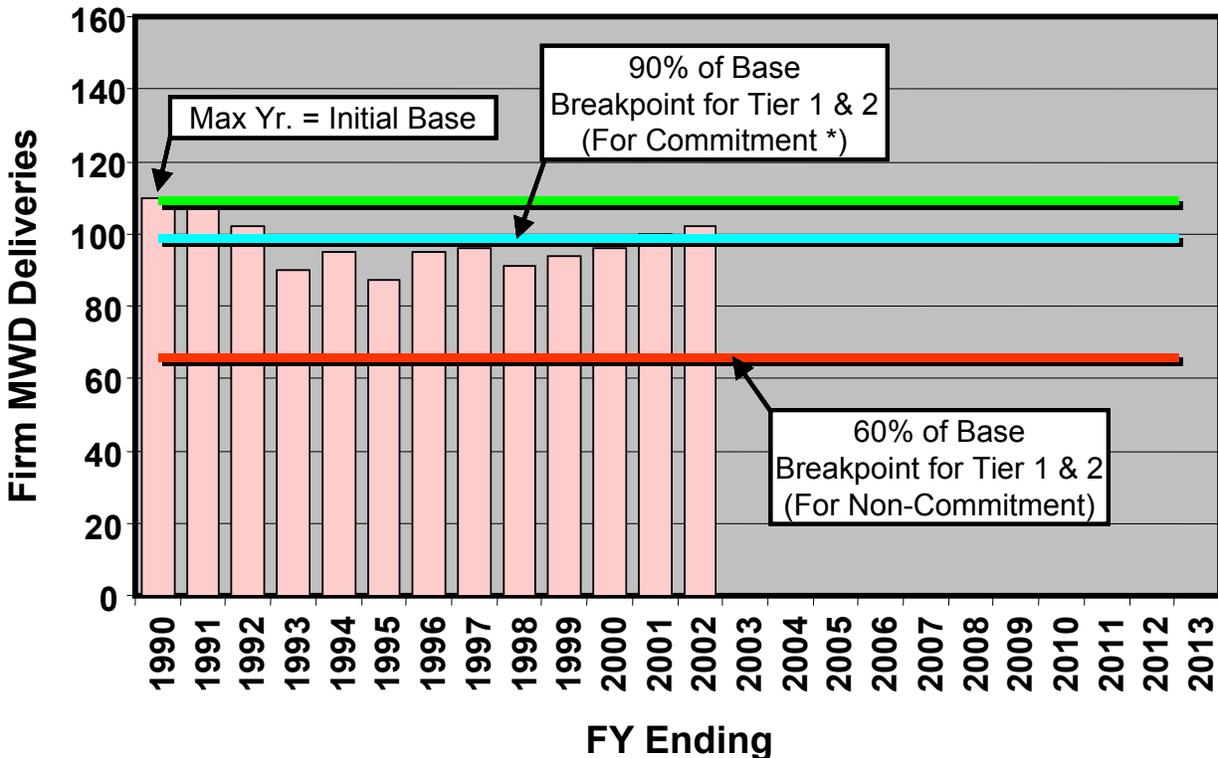
Unbundled Commodity Rates

- A. Current commodity rate for water will be unbundled into five separate commodity rates:
 - Supply Rate – two tiers, and recovers costs associated with water supply (discussed in more detail in following section)
 - System Access Rate – recovers costs associated with system capacity for conveyance and distribution
 - Water Stewardship Rate – is used to help fund local water recycling, groundwater, and conservation programs
 - Power Rate – recovers MWD's melded power cost for pumping SWP and Colorado River supplies
 - Water Treatment Rate – recovers costs for treatment.

Water Supply Rate

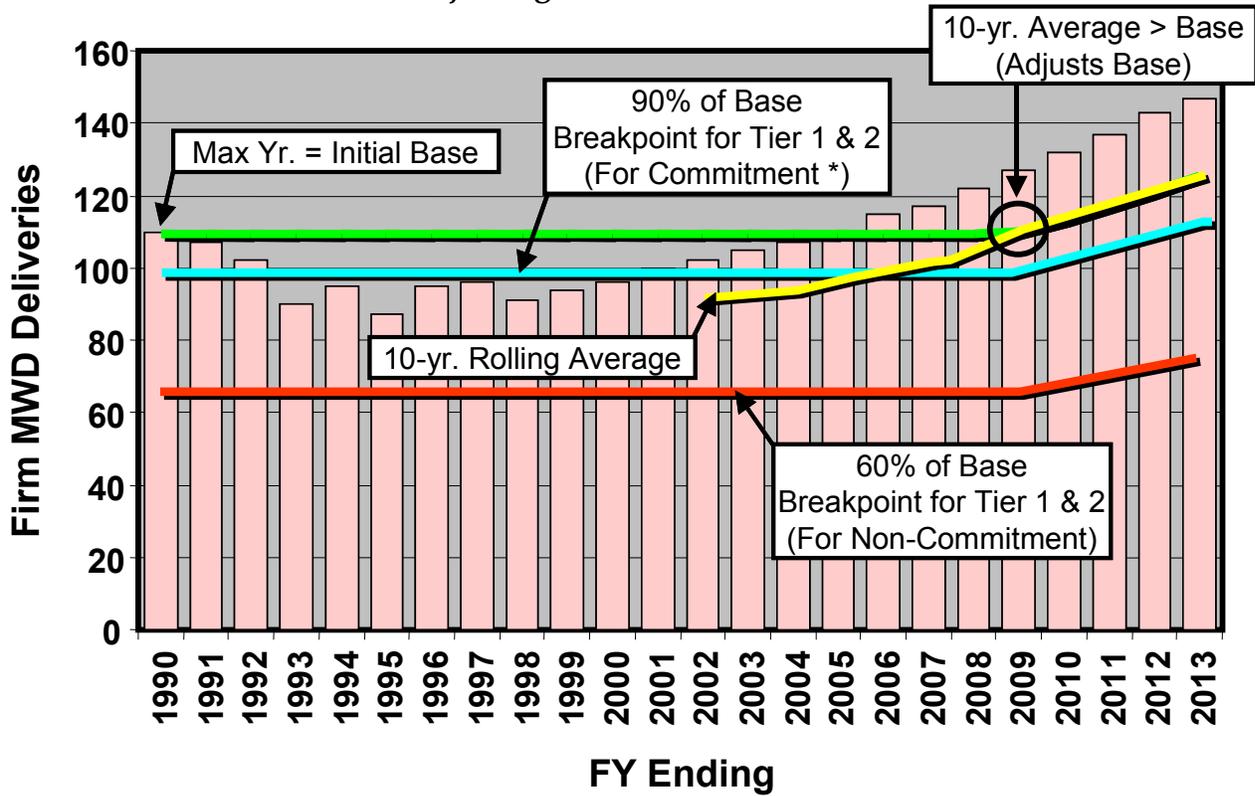
- A. The water supply rate will have two tiers, which reflect MWD’s existing and future costs for acquiring and storing supplies.
- B. Tier 2 rate will be set by MWD’s Board each year, to reflect MWD’s incremental cost of providing water supply to its member agencies. Tier 1 rate will be set to recover remaining supply costs.
- C. Tier 2 rate is currently estimated to be about \$100 to \$125/AF greater than the Tier 1 rate. Tier 2 rate will provide a pricing signal for local water management and water marketing.
- D. A two-tier water supply rate will also address increasing demands placed on MWD.
- E. An initial base (Base) for each member agency is established using that agency’s highest firm water delivery from MWD from FY 1990 to FY 2002 (see Figure 1).
- F. If a member agency chooses not to submit a Purchase Order request, then the Tier 1 rate would apply to firm water deliveries up to 60 percent of the Base, and the Tier 2 rate would apply to firm water deliveries above 60 percent of the Base, on an annual basis (see Figure 1).
- G. If a member agency chooses to submit a Purchase Order request, then that agency agrees to purchase a minimum of 60 percent of its Base times 10, over the ten-year period.
- H. Upon execution of the Purchase Order, the member agency is eligible to purchase up to 90 percent of its Base at the Tier 1 rate, and the Tier 2 rate would apply to firm deliveries above 90 percent of its Base, on an annual basis (see Figure 1).
- I. In the future, the Base will be the greater of a member agency’s historical maximum firm delivery from FY 1990 to FY 2002, or the ten year rolling average of firm deliveries (Figure 2).

**Figure 1.
Two-Tiered Water Supply Rate:
Establishing the Initial Base**



* Member agency agrees to purchase at least 60% of Initial Base times 10, over next ten years.

Figure 2.
Two-Tiered Water Supply Rate:
Adjusting Base in the Future



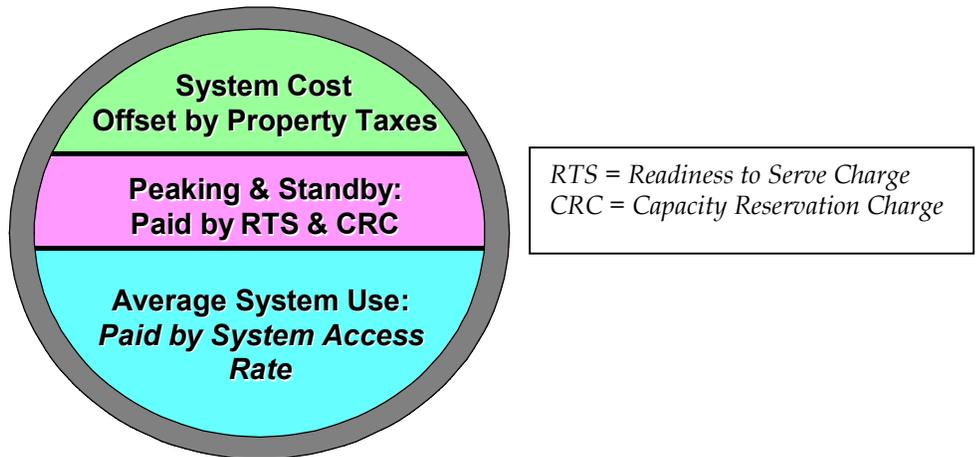
* Member agency agrees to purchase at least 60% of Initial Base times 10, over next ten years.

Fixed Charges

- A. In addition to the commodity rates, member agencies would also pay the following fixed charges:
 - o RTS Charge – covers costs for MWD’s emergency storage and conveyance standby, which is allocated to each member agency based on its 10-year rolling average of firm demands
 - o Capacity Reservation Charge – recovers costs for peak capacity on MWD’s distribution system. Each member agency reserves summer (May through September) peak capacity and pays the charge based on capacity reserved on a cfs basis.
- B. Standby charges, for those member agencies that elect to have MWD continue to assess the MWD Standby charge, will be deducted from member agencies’ allocated RTS charges—as is currently done.
- C. Property taxes will be used to offset capital costs for conveyance on the SWP and MWD’s distribution system—as is currently done.

Figure 3 illustrates how the property taxes, fixed charges, and the System Access Rate will be used to recover costs for conveyance and distribution.

**Figure 3.
MWD System Cost Allocation and Recovery**



Local Storage Replenishment and Agricultural Deliveries

- A. Surplus water supply, when available, can be purchased for long-term local storage replenishment and agricultural deliveries.
- B. The current operating rules for surplus water purchases under the long-term seasonal storage and interim agricultural programs will continue.

Wheeling Services

Wheeling pays the following commodity charges:

- o System Access Rate
- o Water Stewardship Rate
- o Power at actual (not melder) cost
- o Water Treatment Rate (if necessary)
- o Appropriate member agency costs

Implementation

This rate structure, with the elements described above, will be implemented on January 1, 2003. The rate structure is a pricing mechanism designed to support good water management and continued collaborative planning efforts between MWD and member agencies.

Addressing New Demands

- A. The rate structure addresses the water supply portion of new demands on MWD, by including these costs in the Tier 2 Water Supply Rate.
- B. MWD will utilize year 2005 Urban Water Management Plans from the member agencies and retail providers to identify MWD’s new supply and infrastructure needs.
- C. A mechanism to recover costs for MWD’s infrastructure associated with increasing system demands will be developed and in place by 2006.

**Subcommittee on Rate Structure Implementation
Responses to Subcommittee Questions**

On September 18, 2001 staff presented the Member Agency Managers' rate structure proposal (Proposal) to the Subcommittee on Rate Structure Implementation (Subcommittee). The Subcommittee had several questions and asked staff, in consultation with the member agency managers, to respond prior to the September 25, 2001 Board workshop on the rate structure.

Question 1: What is the impact of reducing the maximum amount of Tier 1 water that a member agency with a purchase order can buy from 90 percent of its Base down to 80 percent of its Base?

Response: The 90 percent limit on supply purchases at the lower Tier 1 rate was chosen to minimize the initial financial impact and risk to all member agencies resulting from the Proposal and to encourage conservation and investments in local resources. If the limit on the amount of supply that can be purchased at the lower Tier 1 Supply Rate is reduced from 90 percent to 80 percent of a member agency's Base, more member agencies will immediately purchase a greater amount of their supply at the higher Tier 2 Supply Rate. This is particularly true during dry years when member agencies need more supply from the system. Lowering the amount of supply that can be purchased at the lower Tier 1 supply rate from 90 to 80 percent of a member agency's Base will result in substantial impacts during dry years and higher degrees of volatility in the average rate paid by the member agencies. Figure 1 illustrates the difference in the total amount of supply sold at the higher Tier 2 Supply Rate if 80 rather than 90 percent is used to define the amount of supply sold at the lower Tier 1 Supply Rate. The increase in the number of member agencies that would purchase supply at the higher rate is shown in Figure 2.

Figure 1. Total Amount of Supply Purchased At Higher Tier 2 Rate

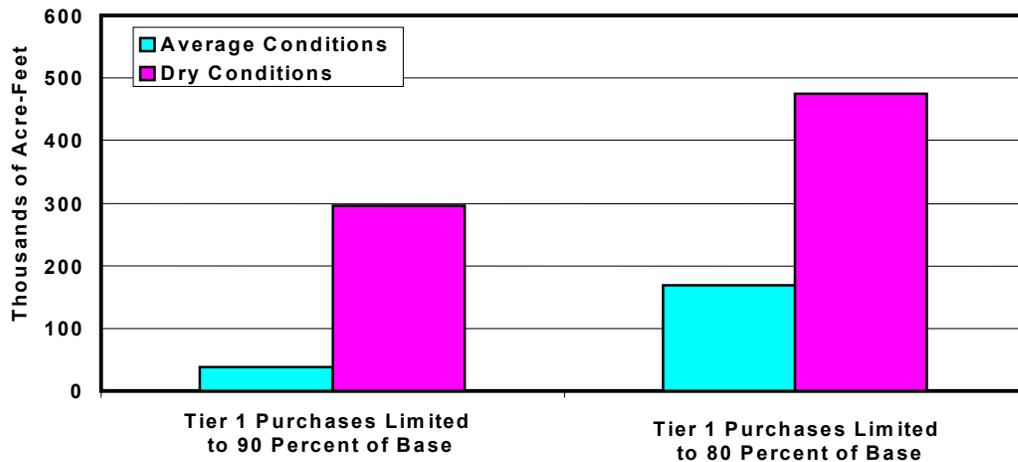
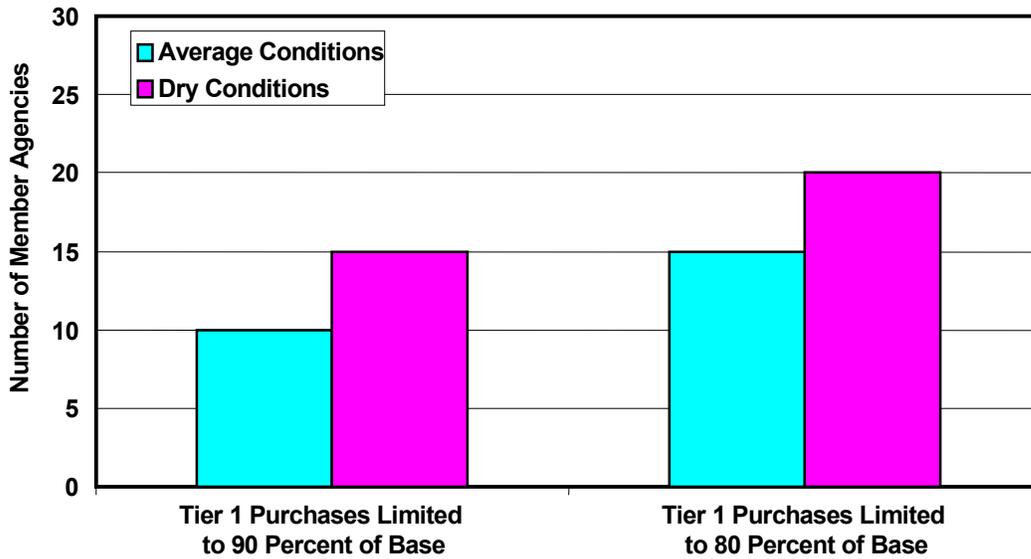


Figure 2. Number of Member Agencies that Purchase Supply At Higher Tier 2 Rate



Question 2: What is the impact of a cap on the differential between the Tier 1 and Tier 2 supply rates?

Response: The purpose of the Tier 2 Supply Rate is to reflect Metropolitan's cost of acquiring additional supply and encourage water conservation and investments in local resources. A cap on the differential between the Tier 1 and Tier 2 Supply Rates may result in a cap on the Tier 2 Supply Rate and potentially distort the price signal and its desired outcomes. However, each year as part of the annual rate setting process, the Board will review the supply conditions and the cost to set the Tier 1 and Tier 2 Supply Rates.

Question 3: Assuming that surplus water is available, how long will the current Long-term Seasonal Storage Service Program and Interim Agricultural Water Program be continued?

Response: The Proposal retains these programs to mitigate the initial financial impacts to the member agencies and their customers due to the change in the Metropolitan rate structure. The Proposal contemplates these programs would remain in place for the next ten years. As is the case today, the Board would set the rates for the Long-term Storage Service Program and Interim Agricultural Water Program.

Question 4: If a member agency increases its use of local supplies and decreases its use of Metropolitan system water, is its Base reduced?

Response: Under the Proposal, a member agency's Base would not be adjusted downward in order to avoid exposure to purchasing additional supplies at the higher rate. If the Base were adjusted downward member agencies that implemented conservation and more efficiently managed local resources would be penalized because they may have to purchase more water at the higher Tier 2 rate in the future.

Question 5: Does a member agency that unexpectedly loses local supply (e.g., groundwater contamination) have to pay the higher Tier 2 supply rate?

Response: A member agency that loses local supply production due to a system outage or a regulatory event may have to purchase supply at the higher Tier 2 rate. Over time, if the member agency is not able to reclaim its local supply and its use of Metropolitan supplies continues to increase, its Base will eventually increase as its ten-year rolling average of firm demand increases. As a result, the member agency would not continue to purchase more supply at the higher Tier 2 rate.

Question 6: How is the SDCWA/IID Transfer accounted for in the Base calculated for the San Diego County Water Authority?

Response: The initial Base used for purposes of determining the annual limit on Tier 1 purchases is defined as the maximum annual purchase since fiscal year 1990 and does not include the SDCWA/IID transfer. Under the Proposal, the calculation of the ten-year rolling average used to reset the Base in the future does not include the SDCWA/IID Transfer because the supply cost for this water would be paid by SDCWA. The SDCWA/IID Transfer is expected to begin in fiscal year 2003 at 20,000 acre-feet and increase by 20,000 acre-feet per year until reaching 200,000 acre-feet in 2012.

Question 7: Should there be a discounted rate (similar to the long-term replenishment rate) for deliveries used for seawater barrier purposes?

Response: Deliveries used for seawater barrier purposes cannot be interrupted during a drought or for any other reason. Metropolitan charges the full service rate for seawater barrier deliveries. Under the Proposal this practice would continue.

Question 8: If a member agency that has used less than its purchase order commitment requests more water from Metropolitan in the final year of the purchase order that Metropolitan cannot supply, is the member agency still obligated to pay for the entire purchase order commitment?

Response: The member agencies are obligated to pay for the entire purchase order commitment.

Question 9: What happens if not all of the supply available to the member agencies at the lower Tier 1 supply rate is purchased in a single year?

Response: The purchase order is a pricing tool only. If all of the supply that may be purchased at the lower Tier 1 rate is not used in a given year then that supply may be sold at the higher Tier 2 supply rate, available as surplus, stored for future use, or lost from the system.

Question 10: Can member agencies pool their purchase orders together or sell their purchase order to another member agency that wants to avoid the higher Tier 2 supply rate?

Response: The purchase order is a pricing tool. It does not confer a contractual right to system supply to a member agency. The Proposal does not accommodate the exchange or sale of purchase order quantities between member agencies.

Question 11: Can a member agency enter into a purchase order at any time?

Response: Under the Proposal, all member agency purchase orders would extend over the same ten-year period. Member agencies would execute purchase orders so that they would be effective January 1, 2003.

Question 12: What are the rules and formulas used to calculate the rates and charges?

Response: In January 2002, as part of the annual rate cycle and prior to adopting any rates and charges associated with the Proposal, the Board will receive a report on the Proposal. The report will include a detailed cost of service study, which will discuss the cost of service process.

An industry standard embedded cost of service process has been used to identify Metropolitan's revenue requirements by the various service functions (e.g. supply, conveyance, distribution, etc.) and to determine how much cost should be classified as being for peak, average and standby purposes. The classified service function costs are

then allocated to the rate design elements. The following provides a brief description of each of the rate design elements.

- Tier 2 Supply Rate (\$/af) - cost of acquiring additional supply.
- Tier 1 Supply Rate (\$/af)- total supply revenue requirement less Tier 2 supply rate revenues and other revenue offsets, divided by projected Tier 1 deliveries.
- System Access Rate (\$/af) - capital costs incurred to meet average demands and operations maintenance and overhead costs for the conveyance and distribution service functions divided by projected total deliveries.
- System Power Rate (\$/af) - power costs for pumping on the State Water Project and Colorado River Aqueduct divided by the projected Metropolitan deliveries in acre-feet.
- Water Stewardship Rate (\$/af) - Local Resources Program and Conservation Credits Program costs as well as other water management costs as determined by the Board divided by projected total deliveries.
- Treatment Rate (\$/af) - cost of providing treated water service divided by projected treated water deliveries.
- Readiness-to-Serve Charge (RTS) - system emergency storage and conveyance and distribution standby costs not paid by property taxes. The RTS is allocated among the member agencies based on a ten-year rolling average of firm demands.
- Capacity Reservation Charge (CRC) (\$/cfs)- distribution capital costs incurred to meet peak day demands divided by the total amount of capacity requested by the member agencies in cubic feet per second (cfs).

Question 13: Can Metropolitan implement the alternative rate structure in July of 2002?

Response: At the request of many of its member agencies, Metropolitan's rates currently become effective in January of each year. The January effective date provides enough time for the member agencies and their customers that typically budget on a July - June fiscal year basis to set their own rates and charges and prepare their own budgets. Even though the new rates and charges in the Proposal would not be effective until January of 2003, consistent with Metropolitan's current rate cycle, the Board would consider the new rates and charges recommended by the Chief Executive Officer in January of 2002, hold a public hearing on these rates and charges in February and then adopt the rates and charges in March of 2002.

A January effective date provides sufficient time for the member agencies and their customers to deal with implementation issues, including how to pass the Tier 1 and Tier 2 pricing on to their customers.

**Comparison Between Member Agency Managers Rate Structure Proposal
and Metropolitan’s Board Principles
(Prepared by Metropolitan Staff)**

Board Principles	Member Agency Managers Rate Structure Alternative
Strategic Plan Policy Principles (Adopted in December 1999)	
<p>Regional Provider Metropolitan is a regional provider of water for its service area. In this capacity, Metropolitan is the steward of regional infrastructure and the regional planner responsible for drought management and the coordination of supply and facility investments. Regional water services should be provided to meet the needs of the member agencies. Accordingly, the equitable allocation of water supplies during droughts will be based on water needs and adhere to the principles established by the Water Surplus and Drought Management Plan.</p>	<p>Supports the Regional Provider Principle</p> <ul style="list-style-type: none"> Metropolitan, working collaboratively with its member agencies, will secure necessary water supplies and build appropriate infrastructure to meet existing and future needs of its member agencies. There would be no difference in reliability for firm supplies purchased at Tier 1 and Tier 2 rates.
<p>Financial Integrity The Metropolitan Water District Board will take all necessary steps to assure the financial integrity of the agency in all aspects of operations.</p>	<p>Supports the Financial Integrity Principle</p> <ul style="list-style-type: none"> Through voluntary purchase orders, Metropolitan could have an assured level of firm water purchases up to 1.2 mafy (60% of maximum annual firm water sales) over ten years. Through voluntary purchase orders, Metropolitan provides a pricing incentive for member agencies to purchase up to 1.7 mafy of firm water in 2003 (90% of maximum annual firm water sales). <p>Compared to the current rate structure, fixed revenue is estimated to increase.</p>
<p>Local Resources Development Metropolitan supports local resources development in partnership with its member agencies and by providing its member agencies with financial incentives for conservation and local projects.</p>	<p>Supports the Local Resources Development Principle</p> <ul style="list-style-type: none"> Financial incentives for conservation and local projects are provided in two ways: (1) Tier 2 price is set at Metropolitan’s cost of securing new supply and sends a price signal for alternative supply development and (2) water stewardship charge is established to help fund existing and future local water recycling, groundwater, desalination, and conservation programs.

**Comparison Between Member Agency Managers Rate Structure Proposal
and Metropolitan’s Board Principles
(Prepared by Metropolitan Staff)**

Board Principles	Member Agency Managers Rate Structure Alternative
Strategic Plan Policy Principles - Continued	
<p>Imported Water Service Metropolitan is responsible for providing the region with imported water, meeting the committed demands of its member agencies.</p>	<p>Clarifies the Imported Water Service Principle</p> <ul style="list-style-type: none"> Based on collaborative planning with member agencies, Metropolitan would secure and deliver imported water to meet existing and future supply needs.
<p>Choice and Competition Beyond the committed demands, the member agencies may choose the most cost-effective additional supplies from either Metropolitan, local resources development and/or market transfers. These additional supplies can be developed through a collaborative process between Metropolitan and the member agencies, effectively balancing local, imported, and market opportunities with affordability.</p>	<p>Supports the Choice and Competition Principle</p> <ul style="list-style-type: none"> Member agencies may choose the most cost-effective additional supplies from among Metropolitan, local resources development and/or market transfers. In addition, the unbundling of rates and charges allows choice in services.
<p>Responsibility for Water Quality Metropolitan is responsible for advocating source water quality and implementing in-basin water quality for imported supplies provided by Metropolitan to assure full compliance with existing and future primary drinking water standards and to meet the water quality requirements for water recycling and groundwater replenishment.</p>	<p>Supports the Water Quality Principle</p> <ul style="list-style-type: none"> Metropolitan’s responsibilities for source quality and in-basin water quality for imported supplies are unchanged. The cost of source quality is recovered through the tiered supply rates. The cost for in-basin water quality is recovered through the treatment surcharge, which is the same as status quo.

**Comparison Between Member Agency Managers Rate Structure Proposal
and Metropolitan’s Board Principles
(Prepared by Metropolitan Staff)**

Board Principles	Member Agency Managers Rate Structure Alternative
<p>Cost Allocation and Rate Structure The fair allocation of costs and financial commitments for Metropolitan’s current and future investments in supplies and infrastructure may not be reflected in status quo conditions and will be addressed in a revised rate structure:</p> <p>(a) The committed demand, met by Metropolitan’s imported supply and local resources program, has yet to be determined.</p> <p>(b) The framework for a revised rate structure will be established to address allocation of costs, financial commitment, unbundling of services, and fair compensation for services including wheeling, peaking, growth, and others.</p>	<p>Supports the Cost Allocation and Rate Structure Principle</p> <ul style="list-style-type: none"> • Committed demand by member agencies is established by voluntary purchase orders. • The allocation of cost and unbundling of services are based on standard cost-of-service methodology. • The existing full service rate is unbundled into: <ul style="list-style-type: none"> ➢ Tiered supply rates (reflecting Metropolitan’s existing and future costs of supplies), ➢ System access rate (wheeling), ➢ Capacity reservation charge (peaking), ➢ RTS (standby), ➢ Water stewardship rate (local resources management), ➢ System power rate, and ➢ Treatment surcharge.
Steering Committee Guidelines (Approved in January 2000)	
<p>“Needs-Based” Allocation</p> <ul style="list-style-type: none"> • Dry-year allocation should be based on need 	<p>Supports the guideline</p> <ul style="list-style-type: none"> • There would be no difference in reliability for firm supplies purchased at Tier 1 and Tier 2 rates.

**Comparison Between Member Agency Managers Rate Structure Proposal
and Metropolitan’s Board Principles
(Prepared by Metropolitan Staff)**

Board Principles	Member Agency Managers Rate Structure Alternative
<p>No Significant Disadvantage and Fair</p> <ul style="list-style-type: none"> • Rate structure should not place any class of people in the position of significant disadvantage. • Rate Structure should be fair. 	<p>Supports the guidelines</p> <ul style="list-style-type: none"> • Member agencies are treated equally. • All supplies would be allocated during droughts based on the water needs of member agencies. • Financial impacts to the member agencies in year 2003 are estimated to be minimal. The financial impacts henceforth are dependent on the collaborative planning between Metropolitan and member agencies and the ability of member agencies to develop cost-effective alternative supplies and manage peak deliveries.
<p>Simple</p> <ul style="list-style-type: none"> • Rate structure should be reasonably simple and easy to understand. 	<p>Meets the guideline</p> <ul style="list-style-type: none"> • The proposal is easy to understand and is based on uniform rates and charges that recover costs of services.
<p>Metropolitan Revenue Stability</p> <ul style="list-style-type: none"> • Rate structure should be based on stability of Metropolitan’s revenue and coverage of costs. 	<p>Supports the guideline</p> <ul style="list-style-type: none"> • Compared to status quo, fixed revenue is estimated to increase by 50%. Fixed revenues are collected through property taxes, voluntary purchase orders, capacity reservation charge, and readiness-to-serve charge.

THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

RESOLUTION _____

**RESOLUTION OF THE BOARD OF DIRECTORS
OF THE METROPOLITAN WATER DISTRICT OF
SOUTHERN CALIFORNIA
TO APPROVE RATE STRUCTURE PROPOSAL AND TO DIRECT
FURTHER ACTIONS IN CONNECTION THEREWITH**

WHEREAS, the Board of Directors (“Board”) of The Metropolitan Water District of Southern California (“Metropolitan”), pursuant to Sections 133 and 134 of the Metropolitan Water District Act (the “Act”), is authorized to fix such rate or rates for water as will result in revenue which, together with revenue from any water stand-by or availability service charge or assessment, will pay the operating expenses of Metropolitan, provide for repairs and maintenance, provide for payment of the purchase price or other charges for property or services or other rights acquired by Metropolitan, and provide for the payment of the interest and principal of its bonded debt; and

WHEREAS, in July 1998 the Board commenced a strategic planning process to review the management of its assets, revenues and costs in order to determine whether it could conduct its business in a more efficient manner to better serve residents within its service area; and

WHEREAS, after conducting interviews with its directors, member agencies, business and community leaders, legislators and other interested stakeholders, and having public meetings to solicit public input, the Board developed and adopted Strategic Plan Policy Principles on December 14, 1999 (the “Strategic Plan Policy Principles” which document is on file with the Board Secretary) to guide staff and the member agencies in developing a revised rate structure; and

WHEREAS, the Board has received and reviewed several rate structure proposals developed during the strategic planning process and after thorough deliberation adopted a Composite Rate Structure Framework on April 11, 2000 (the “Rate Structure Framework” which document is on file with the Board Secretary); and

WHEREAS, the Board adopted a Rate Structure Action Plan on December 12, 2000 (the “Action Plan” which document is on file with the Board Secretary) and endorsed in concept a detailed rate design proposal (the “December 2000 Proposal” which document is on file with the Board Secretary) developed from the Rate Structure Framework and directed staff to work with

the Board and member agencies to resolve outstanding issues identified during the implementation of this rate design; and

WHEREAS, on September 10, 2001 an alternative Rate Structure Proposal was originally presented to the Board's Subcommittee on Rate Structure Implementation (the "Subcommittee") for its review and consideration; and

WHEREAS, on September 18, 2001 the Subcommittee evaluated and considered the alternative Rate Structure Proposal (see Attachment 1 to Board Letter 9-6, dated the date hereof and hereinafter referred to as the "Proposal"), together with staff analysis of the Proposal and other information and comments received from member agencies; and

WHEREAS, on September 25, 2001, the Proposal, together with a staff review thereof, was further discussed and considered by the Board of Directors; and

WHEREAS, each of said meetings of the Board were conducted in accordance with the Brown Act (commencing at 54950 of the Government Code), at which due notice was provided and quorums were present and acting throughout; and

WHEREAS, the Proposal is consistent with the Board's Strategic Plan Policy Principles, supports efficient water resources management, encourages water conservation and facilitates a water transfer market;

NOW, THEREFORE, the Board of Directors of The Metropolitan Water District of Southern California does hereby resolve, determine and order as follows:

1. The Board finds that the Proposal is consistent with the Board's Strategic Plan Policy Principles, addresses the issues raised during the consideration of the December 2000 Proposal, furthers Metropolitan's strategic objectives to ensure the region's long term water supply reliability, supports and encourages sound and efficient water resources management, supports and encourages water conservation, facilitates a water transfer market and enhances the fiscal stability of Metropolitan.

2. The Board hereby directs the Chief Executive Officer, in consultation with the General Counsel, to take all actions necessary in order to further implement the Proposal in accordance with the terms set forth in this Resolution.

3. The Board approves the Proposal and directs the Chief Executive Officer, in consultation with the General Counsel, to (i) prepare a report on the Proposal describing each of the rates and charges and the supporting cost of service process and (ii) utilize the Proposal as the basis for determining Metropolitan's revenue requirements and recommending rates to become effective January 1, 2003, in Metropolitan's annual rate-setting procedure pursuant to Section 4304 of the Administrative Code. Under the procedure set forth under Section 4304, a public hearing on the rates and charges implementing the Proposal shall be held at the February

2002 Board meeting (or such other date as the Board shall determine) and the Board will take final action to adopt the rates and charges in March of 2002 (or such other date as the Board shall determine).

4. The Chief Executive Officer, the Chief Financial Officer and the General Counsel are hereby authorized to do all things necessary and desirable to accomplish the purposes of this Resolution, including, without limitation, the commencement or defense of litigation.

5. This Board finds that approval of the Proposal as provided in this Resolution is not defined as a Project under the California Environmental Quality Act (CEQA), because the proposed action involves the creation of government funding mechanisms or other government fiscal activities which do not involve commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the CEQA Guidelines).

6. If any provision of this is held invalid, that invalidity shall not affect other provisions of this Resolution which can be given effect without the invalid portion or application, and to that end the provisions of this Resolution are severable.

I HEREBY CERTIFY, that the foregoing is a full, true and correct copy of a Resolution adopted by the Board of Directors of The Metropolitan Water District of Southern California, at its meeting held on October 16, 2001.

Executive Secretary
The Metropolitan Water District
of Southern California