



**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).<sup>1</sup> 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);

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<sup>1</sup> 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."<sup>2</sup> 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.<sup>3</sup>

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.<sup>4</sup> Member agencies, in turn, deliver water to their customers.

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<sup>2</sup> 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.

<sup>2</sup> DTX-090 at AR2012-000001 (capitalization omitted).

<sup>3</sup> PTX-237A\*\* (Resps. to RFA Nos. 44-47).

<sup>4</sup> 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."<sup>5</sup> Pursuant to this contract, DWR makes SWP water available to Met at delivery structures established in accordance with the contract.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup>

The DWR contract gives Met the right to use the SWP transportation facilities to transport water that does not come from SWP facilities.<sup>9</sup> 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.<sup>10</sup> 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

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<sup>5</sup> DTX-090 at AR2012-000001 (capitalization omitted).

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

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

<sup>8</sup> 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).

<sup>9</sup> DTX-055 at AR2012-000153 (Art. 55(a)).

<sup>10</sup> *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.<sup>11</sup> 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.<sup>12</sup>

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.<sup>13</sup>

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.<sup>14</sup>

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

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<sup>11</sup> DTX-045 at AR2012-006471, 006496.

<sup>12</sup> DTX-132\* at AR2012-006462\_01; DTX-034 at AR2012-005545-46.

<sup>13</sup> DTX-090 at AR2010-011443; DTX-110\* at AR2012-016594.

<sup>14</sup> DTX-090 at AR2010-0011443; DTX-110\* at AR2012-016594.

<sup>15</sup> 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.

<sup>16</sup> *Id.*

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

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.<sup>19</sup> The relevant classification categories include: fixed demand costs, fixed commodity costs, fixed standby costs, and variable commodity costs.<sup>20</sup> 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.<sup>21</sup> 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

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<sup>17</sup> 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.

<sup>18</sup> DTX-090 at AR2010-011474-011475; DTX-110\* at AR2012-016681-016682.

<sup>19</sup> DTX-090 at AR2010-011472, 011483-011489; DTX-110\* at AR2012-016679, 016688-016694.

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

<sup>21</sup> 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.<sup>22</sup>

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-foot<sup>23</sup> of water Met delivers to the member agencies), and fixed charges (*i.e.*, charges which do not vary with sales in the current year).<sup>24</sup> Among the unbundled volumetric rates in Met's rate structure are the Supply Rates (Tiers 1 and 2) and the Transportation Rates.<sup>25</sup> Met's fixed charges included a Readiness-to-Serve Charge and a Capacity Charge.<sup>26</sup>

#### **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.<sup>27</sup> These costs include capital financing, operating,

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<sup>22</sup> *Id.*

<sup>23</sup> An acre-foot of water covers one acre one foot deep.

<sup>24</sup> 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.

<sup>25</sup> DTX-090 at AR2010-011490-011500; DTX-110\* at AR2012-016695-016700.

<sup>26</sup> *Id.*

<sup>27</sup> DTX-090 at AR2010-011474-011475, 011499-011500; DTX-110\* at AR2012-016681, 016700.

maintenance and overhead costs for storage in Met's reservoirs.<sup>28</sup> 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.<sup>29</sup> 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.<sup>30</sup>

## 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.<sup>31</sup> 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).<sup>32</sup> The System Access Rate also includes regulatory storage costs, which are associated with maintaining additional distribution capacity and help meet peak demands.<sup>33</sup>

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<sup>28</sup> *Id.*

<sup>29</sup> DTX-045 at AR2012-006535-006536; DTX-090 at AR2010-011499; DTX-110\* at AR2012-016700.

<sup>30</sup> *Id.*

<sup>31</sup> DTX-045 at AR2012-006518; DTX-090 at AR2010-011492; DTX-110\* at AR2012-016697.

<sup>32</sup> DTX-045 at AR2012-006518.

<sup>33</sup> 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.<sup>34</sup>

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.<sup>35</sup>

### **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).<sup>36</sup> 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.<sup>37</sup> Each member agency's Readiness-to-Serve

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<sup>34</sup> DTX-045 at AR2012-006520; DTX-090 at AR2010-011492; DTX-110\* at AR2012-016697.

<sup>35</sup> DTX-090 at AR2010-011488, 011490; DTX-110\* at AR2012-016693, 016695.

<sup>36</sup> DTX-045 at AR2012-006519; DTX-090 at AR2010-011492; DTX-110\* at AR2012-016697.

<sup>37</sup> 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.<sup>38</sup>

**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.<sup>39</sup> 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.<sup>40</sup>

**e. Treatment Surcharge**

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

**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.<sup>42</sup>

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

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<sup>38</sup> DTX-090 at AR2010-011495; DTX-110\* at AR2012-016699.

<sup>39</sup> DTX-090 at AR2010-011492-011493; DTX-110\* at AR2012-016697-016698.

<sup>40</sup> DTX-090 at AR2010-011492; DTX-110\* at AR2012-016697.

<sup>41</sup> DTX-045 at AR2012-006520.

<sup>42</sup> *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 588:24-589:1<sup>43</sup> ("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

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<sup>43</sup> 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,<sup>44</sup> 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.<sup>45</sup> 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.<sup>46</sup> 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

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

<sup>45</sup> DTX-018\*\*; DTX-019 at AR2012-001406-001519; DTX-020 at AR2012-001520-001657.

<sup>46</sup> 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.<sup>47</sup> 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").<sup>48</sup> 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.<sup>49</sup> The IRP concludes that a 5% increase/decrease of demand had a correlative effect on when Met would need to incur capital infrastructure costs.<sup>50</sup> 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.<sup>51</sup> 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.<sup>52</sup>

## **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

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

<sup>48</sup> DTX-020 at AR2012-001520-001657.

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

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

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

<sup>52</sup> 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.”<sup>53</sup> 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.”<sup>54</sup>

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.”<sup>55</sup>

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.<sup>56</sup> 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).

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<sup>53</sup> AR2010-001406 at 001450, 001452, 001466, 001491, 001493, 001509-10, 001591.

<sup>54</sup> 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).

<sup>55</sup> AR2012-16288\_2114 at 2189-92\*.

<sup>56</sup> 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,<sup>57</sup> 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

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<sup>57</sup> 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).<sup>58</sup> 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.

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<sup>58</sup> *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.<sup>59</sup> 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,

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<sup>59</sup> 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.<sup>60</sup> 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.

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<sup>60</sup> AR2012\_016288\_1723 at 1744\*.

## 2. 1993 Raftelis Textbook

The 2012 administrative record includes an excerpt on classifying “O&M”<sup>61</sup> 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-

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<sup>61</sup> 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),<sup>62</sup> 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

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<sup>62</sup> 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.<sup>63</sup>

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.

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<sup>63</sup> *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.<sup>64</sup>

#### **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

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<sup>64</sup> 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-1<sup>65</sup> 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.

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<sup>65</sup> 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.<sup>66</sup>

#### **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

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<sup>66</sup> 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;<sup>67</sup> (2) Met uses SWP facilities as an extension of its own system;<sup>68</sup> (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.<sup>69</sup> 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.

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<sup>67</sup> 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.

<sup>68</sup> 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.

<sup>69</sup> 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.<sup>70</sup> 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;<sup>71</sup> (2) annual variation in demand has a number of causes; (3) there are only minor differences in member agency demand fluctuations;<sup>72</sup> (4) Met's rates recover the costs of variations in water purchases from year to year and within a single year;<sup>73</sup> 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

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<sup>70</sup> 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.

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

<sup>72</sup> 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.

<sup>73</sup> 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;<sup>74</sup> and (3) it is reasonable to charge the Water Stewardship Rate in connection with wheeling transactions.<sup>75</sup> 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.

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<sup>74</sup> 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.

<sup>75</sup> 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.*<sup>76</sup>

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).

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<sup>76</sup> 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.<sup>77</sup>

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

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<sup>77</sup> 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.<sup>78</sup> Previously, Met allocated SWP costs to supply, and none to transportation (including the SWP costs that DWR bills as its own transportation costs).<sup>79</sup> 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,<sup>80</sup> 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 useful<sup>81</sup> 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

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<sup>78</sup> 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).

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

<sup>80</sup> 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.

<sup>81</sup> 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.<sup>82</sup> 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,<sup>83</sup> 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

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<sup>82</sup> Transcript of closing argument at 918-19 (January 23, 2014)\*\*.

<sup>83</sup> Met Closing Brief at 75-76.

from other sources.<sup>84</sup> 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*.”<sup>85</sup> The 1999 Raftelis Report also notes that at least some of the programs’ costs should be associated with supply.<sup>86</sup>

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\*.<sup>87</sup>

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

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

<sup>85</sup> 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.

<sup>86</sup> AR2012-16288\_2179\*.

<sup>87</sup> 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.<sup>88</sup> 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;<sup>89</sup> 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

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<sup>88</sup> The 1996 IRP (DTX -019)(Met slide 28).

<sup>89</sup> 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.”<sup>90</sup>

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 chart<sup>91</sup> 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 graph<sup>92</sup> 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.

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<sup>90</sup> Order on MILS, December 10, 2013 at 4.

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

<sup>92</sup> 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.<sup>93</sup>

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.

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<sup>93</sup> 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



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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)

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IN RE: SAN DIEGO COUNTY WATER  
AUTHORITY

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

**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 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