

PAUL E. COOPER
EXECUTIVE ASSISTANT CITY ATTORNEY

MARY T. NUESCA
ASSISTANT CITY ATTORNEY

THOMAS C. ZELENY
CHIEF DEPUTY CITY ATTORNEY

OFFICE OF

THE CITY ATTORNEY

CITY OF SAN DIEGO

JAN I. GOLDSMITH

CITY ATTORNEY

CIVIL DIVISION

1200 THIRD AVENUE, SUITE 1100

SAN DIEGO, CALIFORNIA 92101

TELEPHONE (619) 533-5800

FAX (619) 533-5856

MEMORANDUM OF LAW

DATE: September 4, 2015
TO: Honorable Mayor and City Council
FROM: City Attorney
SUBJECT: Recycled Water Rates

INTRODUCTION

Later this year, the Mayor and City Council will consider proposed adjustments to the City's water rates. The proposed water rate adjustments include an increase in the rate the City charges for recycled water. The current rate for recycled water was set in 2001 at \$0.80 per hundred cubic feet (hcf). This rate has not been increased since then. Prior to 2001, the recycled water rate was \$1.34 per hcf based on a calculation of 90% of the City's potable water rate for commercial customers. The proposed adjustment will increase the recycled water rate from \$0.80 to \$1.73 per hcf, which is approximately 34% of the proposed commercial potable water rate.

A question has been raised by the Otay Water District, which receives recycled water from the City's South Bay Water Reclamation Plant. The Otay Water District questions whether the City can charge the same rate for recycled water city-wide (as the City currently does), when the City's recycled water system consists of two distinct treatment plants and distribution systems which are not connected. The Otay Water District asks the City to adopt two different recycled water rates, one for the area served by the South Bay Water Reclamation Plant and another rate for the area served by the North City Water Reclamation Plant. The effect of implementing two different rate "zones" would be to reduce the proposed rate increase for the Otay Water District and other customers in the south, and increase the proposed rate adjustment for City customers in the north.

A question has also been raised about the timing of the proposed rate increase for recycled water. Recycled water customers have asked whether the City can gradually implement the proposed rate increase over a number of years, rather than increasing the rate all at once.

QUESTIONS PRESENTED

1. Is the City required to adopt two different recycled water rates, one for each area served by its two water reclamation plants?

2. Can the City phase in the recommended recycled water rate over time?

SHORT ANSWERS

1. No, it is not legally required but the City has the discretion to adopt two different recycled water rates. If the City is inclined to pursue zone rates for recycled water, we recommend that the City first study the model through its rate consultant to identify any possible issues or conflicts with the current city-wide rates for potable water and wastewater or with the cost of service study.

2. Probably not. Courts will exercise their independent judgment when reviewing water rates adopted by local agencies for compliance with Proposition 218. Based on the facts described in this memorandum, there is a significant risk that a court would determine that delaying full implementation of the proposed recycled water rate violates Proposition 218.

BACKGROUND

The City operates two water reclamation plants. They are located about 26 miles apart with distribution systems that are not physically connected to each other. Therefore, customers can receive recycled water from only one plant or the other, not both. The plants were constructed and are operated by the City's wastewater utility as a condition of receiving a waiver from full secondary treatment at the Point Loma Wastewater Treatment Plant. 33 U.S.C. § 1311(j)(5).

The North City Water Reclamation Plant started operating in 1997 and is capable of converting up to 30 million gallons per day of wastewater into irrigation quality water. The North City Water Reclamation Plant serves Mira Mesa, Miramar Ranch North, Scripps Ranch, University City, Torrey Pines, Santaluz and Black Mountain Ranch though about 80 miles of recycled water distribution pipes. It also provides recycled water to the City of Poway and the Olivenhain Municipal Water District for distribution to customers in their service areas.

The South Bay Water Reclamation Plant was completed in 2002, though actual sales of recycled water produced there did not occur until a few years later. It can treat up to 15 million gallons of wastewater per day. There are only a few City customers served by the South Bay Water Reclamation Plant. Most of the recycled water is used by the Otay Water District for distribution to customers in its service area, primarily in Otay Mesa and parts of Chula Vista.

The City's first recycled water rate was established in 1994 at 90% of the cost of potable water. San Diego Resolution R-285055 (Dec. 5, 1994). At the time, the City was only operating a small water reclamation plant in San Pasqual capable of producing one million gallons of recycled water per day. The San Pasqual plant has since been decommissioned. Based on the adopted formula, the recycled water rate in 1994 was \$1.21 per hcf. With increases in the cost of potable water, by 2001 the recycled water rate was \$1.34 per hcf. This rate applied city-wide,

regardless of which plant produced the recycled water. A city-wide rate for all customers is also known as a “unitary” or “postage stamp” rate.

In 2001, the City reduced the rate for recycled water to \$0.80 per hcf. San Diego Resolution R-295034 (Jun. 19, 2001). This reduced rate was not tied to the cost of potable water, but on a cost of service study designed to recover all recycled water costs to the Water Fund through recycled water rates. City Mgr. Report No. 01-071 (Apr. 13, 2001). In conjunction with the rate reduction, the City terminated all City-funded incentive programs to convert to recycled water. *Id.* The rate of \$0.80 per hcf was anticipated to increase by five to six percent annually after 2006. City Mgr. Report No. 02-287 (Nov. 25, 2002). These anticipated rate increases were not implemented, so the rate for recycled water today is still \$0.80 per hcf.

The City is currently proposing a recycled water rate of \$1.73 per hcf. This rate is about 34% of the proposed potable rate for commercial customers or about 30% of the proposed rate for potable irrigation customers. According to the City’s 2013 Recycled Water Pricing Study, most agencies in California have adopted a recycled water rate that is 75% to 90% of the potable water rate. The City’s proposed rate is a postage stamp rate, like the existing rate for recycled water.

At the request of the Independent Rates Oversight Committee, the City calculated what the recycled water rates would be if the City were to adopt different rates based on which plant produces the recycled water. Under this “zone rate” approach, the proposed rate for recycled water produced at the North City Water Reclamation Plant would increase to \$2.14 per hcf, while the proposed rate for the South Bay Water Reclamation Plant would decrease to \$1.17 per hcf. The Otay Water District prefers this zone rate approach because its contract with the City requires it to pay the same rate for recycled water as other City customers. The Otay Water District has requested a separate, lower rate for recycled water from the South Bay Water Reclamation Plant from time to time since at least 2001. Letter from Mateo R. Camarillo, Acting General Manager of Otay Water District, to Chair Madaffer, Natural Resources and Culture Committee (Apr. 17, 2001).

ANALYSIS

I. A postage stamp rate complies with Proposition 218.

Proposition 218 amended the California Constitution in 1996 by adding articles XIII C and XIII D. Section 6 of article XIII D imposed new requirements for new and existing property-related fees and charges. These requirements include a restriction that the revenue from the fee or charge cannot exceed the cost to provide the property-related service. Cal. Const. art. XIII D, § 6(b)(1). The amount of a fee or charge also cannot exceed the proportional cost of the service attributable to the parcel. Cal. Const. art. XIII D, § 6(b)(3). Charges for water delivered to property owners and residents are property-related fees subject to these restrictions. *Bighorn-Desert View Water Agency v. Verjil*, 39 Cal. 4th 205, 217 (2006).

Proposition 218 does not specify any particular method for apportioning fees or charges among utility customers, other than that the amount not exceed the proportional cost of the service attributable to the parcel. Grouping similar users together into customer classes to

determine water rates is one reasonable way to apportion the cost of service that complies with Proposition 218. *Griffith v. Pajaro Valley Water Management Agency*, 220 Cal. App. 4th 586, 601 (2013). Proposition 218 does not require a more precise apportionment of the cost of service, such as a parcel-by-parcel determination of water rates. *Id.*; see also *Capistrano Taxpayers Ass'n v. City of San Juan Capistrano*, 235 Cal. App. 4th 1493, 1515 (2015) ["This is not to say City Water must calculate a rate for 225 Elm Street and then calculate another for the house across the street at 226"]. The fact that there may be other ways to apportion the cost of service does not mean the particular method chosen by a water agency is unconstitutional. *Griffith*, 220 Cal. App. 4th at 601.

Furthermore, it is legal for potable water customers to pay for part of the cost of producing and delivering recycled water to other customers. *Capistrano Taxpayers Ass'n*, 235 Cal. App. 4th at 1502. The rationale is that potable water customers benefit from recycled water because the more recycled water that is used, the more potable water that is available for them. *Id.* Under tiered pricing, however, potable water customers who use water at a level below which a recycled water system is needed to supplement supply should not be contributing to the cost of a recycled water system. *Id.* at 1516. But Proposition 218 does not require that potable water and recycled water be treated as two separate, independent services. *Id.* at 1502.

Based on the analysis in the 2013 Recycled Water Pricing Study, the City's postage stamp rate for recycled water complies with Proposition 218. According to the study, if recycled water customers had to fully fund the construction, operation, and maintenance of the City's reclaimed water system, the recycled water rate would be over \$14 per hcf, almost three times the cost of potable water. The proposed rate of \$1.73 per hcf is much less than the actual cost of service. The difference is made up by potable water customers, and by wastewater customers who benefit from the recycled water system by receiving wastewater treatment and by avoiding billions of dollars in costs associated with converting the Point Loma Wastewater Treatment Plant to secondary treatment levels. City Mgr. Report No. 01-071 (Apr. 13, 2001). The study explains the basis for using a postage stamp rate, including the fact that the cost of construction and operation of the reclaimed water plants was also funded through postage stamp rates, and that the City's contracts with other water agencies anticipate one system-wide rate for recycled water. The study supports the decision to use a postage stamp rate as a reasonable approach to cost allocation, as required by *Griffith* and Proposition 218.

II. A postage stamp rate complies with Proposition 26 and the Government Code.

Proposition 218's restrictions on property-related fees and charges do not apply to the transfer and sale of water between water agencies.¹ Proposition 218 defines fees and charges as "any levy other than an ad valorem tax, a special tax, or an assessment, imposed by an agency upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property related service." Cal. Const. art. XIII D, § 2(e). A property related service is "a public service having a direct relationship to property ownership." Cal. Const. art. XIII D, § 2(h). Fees or charges imposed as a result of the voluntary activity of a property owner are not

¹ We recognize, however, that litigation was just filed by a ratepayer against the Otay Water District, the San Diego County Water Authority, and the Metropolitan Water District, alleging the rates charged by all three water agencies are subject to, and in violation of Proposition 218 even though only the Otay Water District provides water service directly to property owners. *Coziahr v. Otay Water District*, Sup. Ct. Case No. 37-2015-00023413-CU-MC-CTL.

“incident of property ownership” and fall outside of Proposition 218. *Richmond v. Shasta Community Services Dist.*, 32 Cal. 4th 409, 426-427 (2004) [capacity fees for new water service connections are not subject to Proposition 218]; *Apartment Ass'n of Los Angeles County, Inc. v. City of Los Angeles*, 24 Cal. 4th 830, 840 (2001) [inspection fee imposed on rental property is not a fee imposed as an incident of property ownership under Proposition 218].

Therefore, Proposition 218 does not govern the City’s sale of water to the Otay Water District. The Otay Water District voluntarily entered into a contract with the City to purchase recycled water. The City delivers water to the Otay Water District at a connection between their recycled water infrastructures. The City’s delivery of recycled water to the Otay Water District is not associated with providing service to any particular parcel. The City and the Otay Water District are engaged in a voluntary business transaction outside of the restrictions of Proposition 218.

Instead, the sale of recycled water to the Otay Water District is probably governed by similar cost of service principles in the California Government Code and Proposition 26. We say “probably” because the Superior Court in San Francisco recently held that these laws apply to rates charged by the Metropolitan Water District to member agencies for wheeling water, but the decision is likely to be appealed. *San Diego County Water Authority v. Metropolitan Water District of Southern California*, San Francisco Superior Ct. Case Nos. CPF-10-510830, CPF-12-512466; Statement of Decision on Rate Setting Challenges (Apr. 24, 2014).

Proposition 26 is a constitutional amendment adopted by the voters in 2010. Proposition 26 further tightened the restrictions on local government revenue imposed by Propositions 13, 62 and 218 by defining a tax as “any levy, charge, or exaction of any kind imposed by a local government,” with seven exceptions. Cal. Const. art. XIII C, § 1(e). One of the exceptions is for property-related fees and charges under Proposition 218 discussed above. Cal. Const. art. XIII C, §1 (e)(7). The exception relevant here is:

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

Cal. Const. art. XIII C, § 1(e)(2). Therefore, if the City is charging a fee for a service or product (like recycled water), it is not a tax subject to voter approval under Proposition 26 if the fee does not exceed the reasonable cost of providing the service or product. 2011 City Att’y MOL 46 (2011-3; Mar. 4, 2011).

Similarly, the Government Code requires a public agency providing utility services (other than gas or electricity) to another public agency to charge no more than the reasonable cost of providing the service, calculated on the same basis as non-public customers:

(a) Any public agency providing public utility service may impose a fee, including a rate, charge, or surcharge, for any product, commodity, or service provided to a public agency, and any public agency receiving service from a public agency providing public utility service shall pay that fee so imposed. Such

a fee for public utility service, other than electricity or gas, shall not exceed the reasonable cost of providing the public utility service.

(b) A fee, including a rate, charge, or surcharge, for any product, commodity, or service provided to a public agency, shall be determined on the basis of the same objective criteria and methodology applicable to comparable nonpublic users, based on customer classes established in consideration of service characteristics, demand patterns, and other relevant factors.

Cal. Gov't. Code § 54999.7. Under both Proposition 26 and the Government Code, the City's rate for recycled water charged to other water agencies cannot exceed the reasonable cost to provide the service.

Postage stamp rates have been upheld as a fair and reasonable way of allocating the cost of providing service between water agencies. In *Rincon Del Diablo Municipal Water District v. San Diego County Water Authority*, 121 Cal. App. 4th 813 (2004), water agencies in the northern part of San Diego County challenged the County Water Authority's postage stamp rate for transporting water throughout its system of pipelines and aqueducts. The water agencies argued that the transportation rate exceeded the cost to provide the service to them because they only used the northern part of the system, but the transportation rate was based on system-wide costs. In other words, they argued the transportation rate made them pay for facilities they did not use. The Court rejected the argument and upheld the postage stamp method, concluding that a determination of the reasonable cost of providing service does not require a calculation of the specific cost attributable to each user. *Id.* at 822-24; *see also Metropolitan Water District of Southern California v. Imperial Irrigation District*, 80 Cal. App. 4th 1403 (2000) [holding that the Metropolitan Water District was not limited to charging only for the portions of those facilities actually used by member agencies for wheeling water]. While both of these decisions predate Proposition 26 and Government Code section 54999.7, they analyzed the same issue of what is a reasonable allocation of the cost of providing service and should be determinative here.

Assuming Proposition 26 and the Government Code apply to the sale of recycled water to the Otay Water District, the proposed postage stamp rate complies with these laws.² As discussed above, the proposed recycled water rate is less than the actual cost to provide the service. Potable water and wastewater customers are offsetting the cost because of the benefits they receive from the recycled water system. The Otay Water District will be charged the same rate for recycled water as other recycled water customers. The courts have determined a postage stamp rate is an acceptable method of allocating costs which does not cause any particular user to pay more than the reasonable cost of providing service.

² If Proposition 26 and Government Code section 54999.7 do not apply to the sale of water to the Otay Water District, then the standard of judicial review will not be as strict. The proposed recycled water rate would only be overturned if the City's contract with the Otay Water District is unconscionable (Cal. Civ. Code § 1670.5) or if the proposed rates are "arbitrary, capricious, or entirely lacking in evidentiary support." *Brydon v. East Bay Municipal Utility District*, 24 Cal. App. 4th 178, 196 (1994).

III. Water agencies have discretion to adopt zone rates.

The City's current and longstanding practice is to establish water and wastewater rates for different customer classes, and charge them using a postage stamp rate. City water customers pay the same rate whether their potable water is produced at the Otay Water Treatment Plant, the Miramar Water Treatment Plant, the Alvarado Water Treatment Plant, or by the San Diego County Water Authority. City wastewater customers pay the same rate regardless of whether their wastewater is treated by the Point Loma Wastewater Treatment Plant, the North City Water Reclamation Plant, the South Bay Water Reclamation Plant, or the City of Escondido's Hale Avenue Plant. Both the City's water and wastewater systems consist of sub-systems that are not entirely connected with each other, just as the City's recycled water system is not connected between the north and the south.

As explained above, however, Proposition 218 does not specify any particular rate model to be used, and there may be many reasonable rate models to choose from. *Griffith*, 220 Cal. App. 4th at 601. For example, some water agencies do not use tiered rates for residential customers, while others do not use water meters and charge customers a flat fee regardless of actual water consumption. Some water agencies include a pumping surcharge for those customers who reside at higher elevations than the rest of their customers. These examples illustrate that local agencies are exercising their discretion on how to allocate costs for water and wastewater service. The City could divide its water and wastewater service areas into billing zones based on which facilities are used by which customers, arguably a more precise approach than a postage stamp rate. But such an approach is not mandated and may not be practical. If the City is inclined to pursue zone rates for recycled water, we recommend that the City first study the model through its rate consultant to identify any possible issues or conflicts with the current postage stamp rates for potable water and wastewater or with the cost of service study.

IV. The City probably cannot phase in the recycled water rate increase over time.

Some recycled water customers have asked whether the City can phase in the proposed rate increase over a number of years instead of all at once. The reasons they give are (1) to avoid the "rate shock" of an immediate increase from \$0.80 per hcf to \$1.73 per hcf, and (2) to maintain the incentive to convert from potable water to recycled water.

Proposition 218 changed the standard by which courts review fees and charges adopted by local agencies. Before Proposition 218, courts deferred to the discretion of local agencies, overturning water rates only if they were "arbitrary, capricious, or entirely lacking in evidentiary support." *Brydon v. East Bay Municipal Utility District*, 24 Cal. App. 4th 178, 196 (1994) [upholding tiered water rates for residential customers]. Courts must now "exercise their independent judgment" in deciding whether water rates comply with Proposition 218. *See Moore v. City of Lemon Grove*, 237 Cal. App. 4th 363, 368 (2015) [*de novo* review applies to wastewater rates of local agencies under Proposition 218]; *Silicon Valley Taxpayers Ass'n v. Santa Clara County Open Space Authority*, 44 Cal. 4th 431, 450 (2008) [courts should exercise their independent judgment in reviewing property assessments under Proposition 218]; City Att'y MS 2015-4 (Feb. 19, 2015). The reason why is because Proposition 218 mandates that "[i]n any legal action contesting the validity of a fee or charge, the burden shall be on the agency to demonstrate compliance with this article." Cal. Const. art. XIII D, § 6(b)(5).

There is a significant risk that a court exercising its independent judgment could conclude that phasing in the proposed recycled water rate over time violates the principles of Proposition 218. We note that this is not a situation where the phasing in of rate increases over time is accomplished by gradually ramping up a capital improvement program or drawing down a rate stabilization fund. That type of phasing in of rates benefits all ratepayers. If the City phases in the recycled water rate increase over time, it means potable water customers will continue to pay more over the same period because phasing in the rate increase does not change the City's cost of providing water service. Delaying the rate increase benefits recycled water customers to the detriment of potable water customers.

While there are no court opinions addressing "rate shock" in a cost of service environment, in the context of the City's historical recycled water rates such justification for phasing in the rate increase may not survive judicial review. Prior to 2001, the City's recycled water rate was \$1.34 per hcf compared to the current rate proposal of \$1.73 per hcf. The rate was reduced to \$0.80 per hcf in 2001 and has not been increased in 14 years, even though the intent at the time was to implement annual rate increases after 2006. Over the same 14 year period, potable water rates have tripled. Recycled water customers have enjoyed a relatively low rate for years, and to rely on a rate set in 2001 as the basis for rate shock today is unlikely to be persuasive to a court.

The better argument is that the phasing in of the rate increase is needed to maintain an incentive to convert to recycled water, but there is little in the record to support it. The proposed increase to \$1.73 per hcf is still only 30-34% of the cost of potable water (depending on which potable rate is used for comparison), which by itself is a substantial incentive. The 2013 Recycled Water Pricing Study concludes that a higher rate of \$2.24 per hcf would continue to provide an incentive to new users to convert to recycled water and does not consider whether phasing in the rate increase is necessary. Since the study was finalized, the City has reallocated, postponed, or eliminated some costs to lower the proposed rate to \$1.73 per hcf, further increasing the incentive to convert to recycled water. Another incentive is that recycled water is exempt from water use restrictions during times of drought. San Diego Municipal Code § 67.3804(d). It is also our understanding that with the City's undertaking of the Pure Water San Diego program³ and the geographical limitations of the recycled water distribution system, there are not many potential customers left to incentivize who have access to recycled water and are still using potable water for irrigation. Due to these unique circumstances, a court acting in its independent judgment could conclude that phasing in the proposed recycled water rate as a further incentive to convert to recycled water is unreasonable or unnecessarily delaying the rate increase to the detriment of potable water customers.

CONCLUSION

The City is not legally required to adopt two different recycled water rates for its two water reclamation plants. A postage stamp rate has been upheld by the courts as a reasonable

³ The Pure Water San Diego program will take the remaining capacity of the City's water reclamation plants, and build additional capacity, to produce 83 million gallons per day of potable (not irrigation) quality water by 2035.

method to apportion the cost of water service. The City has the discretion to change its rate model and it could adopt zone rates for recycled water, but before doing so we recommend the City first study the model with its rate consultant to identify any possible issues or conflicts with the current postage stamp rates for potable water and wastewater or with the cost of service study.

Courts exercise their independent judgment when reviewing fees and charges for compliance with Proposition 218, a higher standard than what applies to most legislative actions. There is a significant risk that under this standard a court could conclude that the justifications offered for phasing in the proposed recycled water rate increase are insufficient. The 2013 Recycled Water Pricing Study concludes there is still an incentive to convert to recycled water without considering phasing in the proposed increase, and the proposed recycled water rate is a small fraction of the cost of potable water.

JAN I. GOLDSMITH, City Attorney

By /s/ Thomas C. Zeleny
Thomas C. Zeleny
Chief Deputy City Attorney

TCZ:mt

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cc: Andrea Tevlin, Independent Budget Analyst
Halla Razak, Public Utilities Director