

Vallecitos Water District Hidden Subsidies A case study in the need for transparency and accountability

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The roles of elected officials include setting the general direction of the agency and making policies consistent with the vision and mission of the agency. Executive management is responsible to implement policies and make the elected officials and the public aware of the impacts of policies considered. When policies are not in the public's interest, and executive management fails to disclose the true impact of adopted policies, consumer advocates take on the role of ensuring that the public's interest is at the fore-front of decision making.

Draft

Background

Vallecitos Water District (VWD) is a publicly-owned, sole purpose, special district (political subdivision of the State of California), serving water and sewer service to most of San Marcos, and parts of Escondido, Vista, Carlsbad, and unincorporated areas in North San Diego County. Being a sole purpose special district, there is no General Fund.

There are only two sources of controllable revenue – controllable because the Board of Directors can raise and lower rates and influence the respective fund balances. One source of revenue is from developers who are charged Capital Facility Fees (Cap Fees) to pay for their impacts – infrastructure and assets necessary to accommodate growth, as well as the debt service for financing growth facilities. What's left over, Cap Fees less growth-related expenditures, is the developers' money – restricted for future growth projects.

The other source of revenue is from water and sewer customers' payments for service. What's left after paying for operating costs and asset replacements is unrestricted operating and replacement reserves – the ratepayers' money.



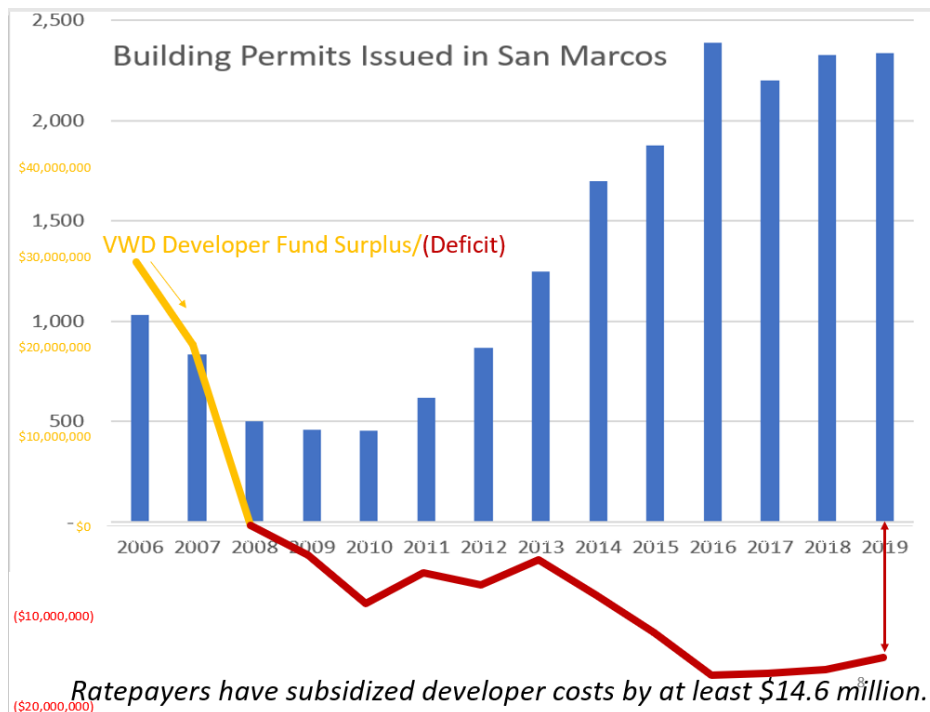
There are two distinct areas of the California Constitution related to these revenue sources. The Mitigation Fee Act says developers can't be charged more than their impacts. Proposition 218 (Article XIII D 6b) says ratepayers can't be charged more than the cost to provide the service. With no other source of controllable revenue or funds, publicly-owned utilities have to walk this fine line. Otherwise, one fund would be subsidizing the other and not be in compliance with California law.

Article XIII D Section 6(b) of the California Constitution provides that, "Revenues derived from the fee or charge shall not be used for any purpose other than that for which the fee or charge was imposed." As of June 30, 2020, VWD's developer fund is at a deficit of \$15.5 million, a deficit funded by revenues derived from water and sewer charges to fund urban development.

The Deficit

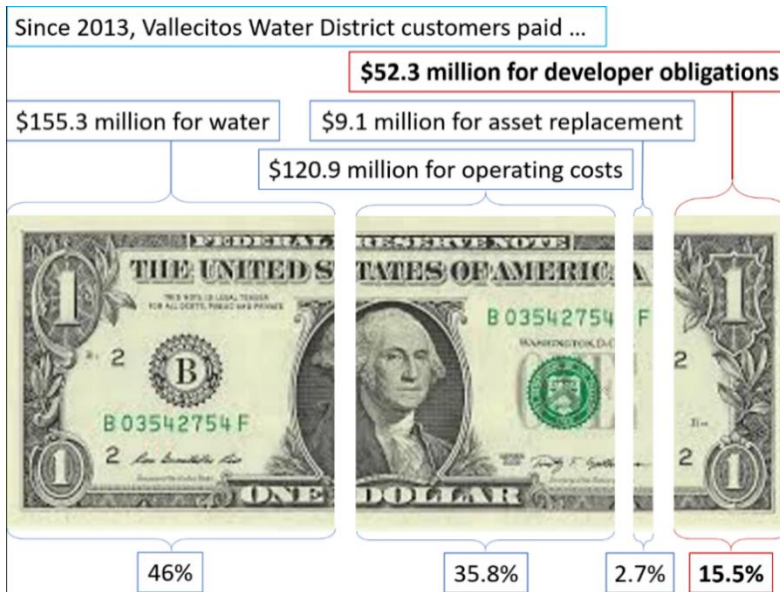
A developer fund deficit works like a "due to" balance, payable to the ratepayer fund. When the deficit is restored, the ratepayer fund is paid back.

When the economy is good and building is occurring, there is a surplus in the developer funds. When the economy is not so good and building slows or stops, there may be a deficit in developer funds. During the last building peak in San Marcos, instead of coming out of a deficit with a significant surplus, the developer fund balance plummeted to record lows.

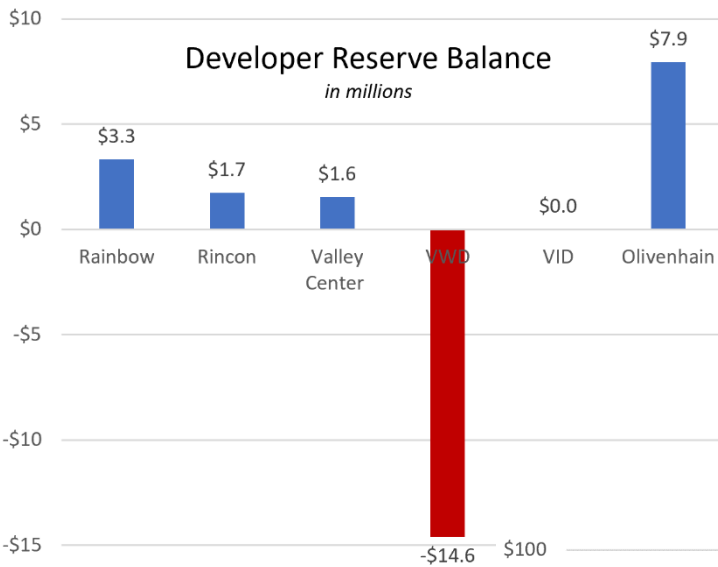


In addition to directly funding the developer fund deficit, ratepayer money has been accumulated as reserves beyond the extent that is reasonable for unanticipated capital replacement and operating emergencies. No other water agency in San Diego County has accumulated more ratepayer money than VWD. VWD has publicly stated its intention to "borrow" from ratepayers to pay for development instead of issuing bonds.

From July 1, 2013, through June 30, 2019, VWD received \$337 million from water and sewer customers. Of the \$337 million collected, \$52.3 million, or 15.5%, paid for urban development (i.e., funded the developer deficit) and increased reserves sufficient to continue to cash fund developer obligations, rather than issue bonds.

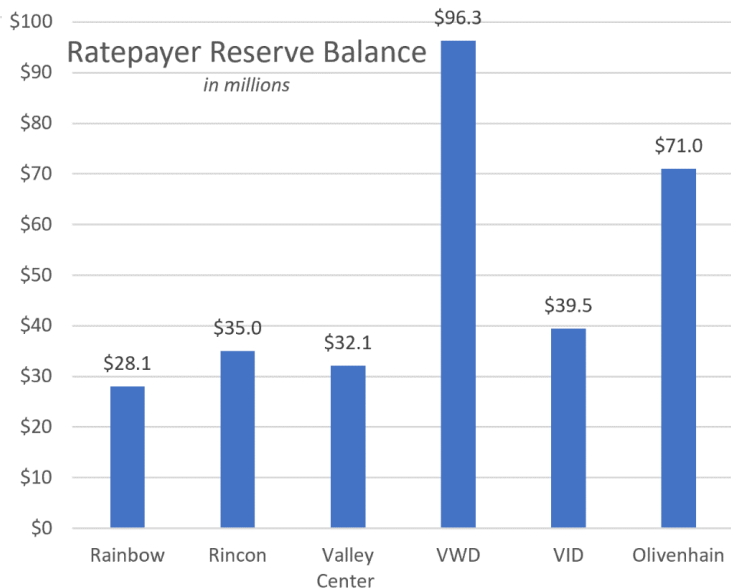


Amounts noted in the illustration above are accumulated from audited statements of cash flows, audited statements of revenue, expenses, and changes in net position, and reserve reports prepared by VWD.



VWD is the only water agency in San Diego County (possibly all of California) with a deficit in its developer funds. VWD is the only water agency in San Diego County (possibly all of California) that subsidizes development with ratepayer money. Illustrated Developer Reserve Balances are from VWD's most recent MD&A, and neighboring agencies' most recent audited statements of net position (net position restricted for future construction or capital projects).

No other water agency in San Diego County has accumulated more ratepayer money than VWD. Illustrated Ratepayers Reserve Balances are from VWD's June 30, 2019 reserve report, and neighboring agencies' most recent audited statements of net position (unrestricted cash and investments). The reserve balances illustrated do not include all of San Diego County water agencies – only those agencies whose service boundaries touch VWD's service boundaries.



The Subsidy

A subsidy is “a sum of money granted by the government or a public body to assist an industry or business so that the price of a commodity or service may remain low or competitive.” *Dictionary.com*.

“I want to be competitive,” *Hal Martin, VWD Board Member and Finance Committee Chair*. At the time of this admonishment to staff by Director Martin to keep developers’ Cap Fees competitive, Cap Fees were anticipated to be \$8,994 for water and \$18,253 for sewer per home (or equivalent dwelling unit) at the next hearing to modify the fees. After private discussions with developers, Cap Fees of \$7,896 for water and \$12,986 for sewer were adopted by the VWD Board.

VWD’s calculation of the Cap Fees adopted include assumptions that are overly aggressive and some that are impossible. A letter to the General Manager detailing deficiencies in the Cap Fee calculations is appended hereto. No response was ever provided.

Cap Fees as adopted are not sufficient to restore the deficit (repay ratepayers). VWD’s reserve projection included in their adopted FY 2020/2021 budget estimates the developer fund deficit will be reduced to \$7.2 million.

VWD included \$50 million in debt proceeds in the developer fund deficit projection with only \$35 million in debt-eligible capital expenditures. After correcting the projection to maximize debt proceeds to legal allowable limits, the deficit increases to \$20.4 million in five years.

VWD has no intention to issue debt. They have not adopted reimbursement resolutions (or resolutions of intent to incur debt) for the last three years. They have been foregoing current position to pay down their pension liability, diminishing their debt capacity. At a public Finance Committee meeting, staff articulated a request to Board members from developers, “Can we continue to borrow from ratepayers?” The Finance Manager called it a “win-win” because of the 2% interest they were accruing for ratepayers and developers only paying the 2% rather than 5% if they issued bonds.



The Master Plan Study that supports the Cap Fee calculations is typically done every five years. The Study that supports the current rates is based on data from 2007 through 2014, and was started in 2014 with an estimated completion date in 2015. No new Master Plan Study has been identified in the capital improvement plan through at least 2025. Without a new study and a rate adjustment, and even with the maximum allowable debt issuance, ratepayers will likely never recover the millions they have paid for urban development.

Accountability and Ethics

Special Districts have a special purpose and provide specific services to customers. Those customers receiving the services elect officials to represent their interests. Under common law, elected officials have a fiduciary responsibility to use their powers of office to set policy for the benefit of their customers and are not permitted to use those powers for the benefit of private interests. Developers are not customers receiving the services for which the Special District was formed. Developers are private interests.

While elected officials (the Board), are accountable to the customers who elected them, executive management is accountable to the Board to put the policies they set in place, regardless of if they agree with the policies or not. Executive management also has the responsibility to serve customers and make the Board and public aware of the consequences of policy actions under consideration.

Naturally, elected officials have some degree of loyalty to private or special interests that provide them with financial support. Loyalty and responsibility are both bona fide ethical values. Since 2013, VWD Board members, the majority of whom receive financial support from developers, have been faced with the ethical dilemma of loyalty versus responsibility every time the development community requested an accommodation, particularly when the developer funds were at a deficit and accommodations were to be funded by ratepayers. Guidance in ethics training required by California Assembly Bill 1234 (AB 1234) dictates that the ethical value of responsibility to customers trumps the ethical value of loyalty to private interests.

In addition to these ethical departures, the Board, and executive and financial management have failed to embrace ethical values mandated by AB 1234 (transparency, responsibility, trustworthiness, public's confidence) and codified by the AICPA (integrity and objectivity) and the Institute of Management Accounting (competence and credibility). At public meetings and in public staff reports, the Board and management made the following misrepresentations:

- ◇ "... the determined Cap Fees should have no fiscal impact to ratepayers."
- ◇ "... it is the District's policy that 'growth pays for growth'..."
- ◇ "... rate payer funds do not help subsidize development in the Vallecitos service area. There is currently a deficit in the developer fund; however, the recently approved capital facility fees were increased which will erase that deficit."
- ◇ "I hate the word deficit for many reasons. It gives credibility to detractors to start with. ... There's no deficit. ... Deficit is a bad word. For the naysayers, it's very easy to say 'deficit!'. ... We need to change that terminology somehow ... You can't use the word 'deficit.' Change that terminology!" *Hal Martin, Board Member.* "[How about] 'Capital Facility Revenue Shortfall.'" *Glenn Pruim, General Manager.* [No member of the public was present during this meeting].

Impacts of ethics, whether embraced or disregarded, transcends pervasively through an organization, customers served, and potentially the industry and economy. In 2011, workshops at VWD were held with employees to establish a set of organizational values to be incorporated in a Strategic Plan that was adopted by the Board in 2012. Ethical values most important to staff and embraced by the then Board were Integrity, Respect, Trust, Loyalty, Responsibility and Professionalism. At that time VWD was "the Golden Standard" of water agencies, the employer of choice with a customer focus.

Within five years of the election after the Strategic Plan was adopted, only one of the five Board members remained, the adopted ethical values were disregarded, and all but one of the District's managers resigned. The most dedicated, loyal, and ethical employees do not want to work for an agency that neglects its responsibilities and accountability to the public.

VWD has gone from being "the Golden Standard" of water agencies, to no longer being able to attract or retain talent in the industry – a critical attribute for an entity whose mission is to provide a population of more than 100,000 with reliable and safe drinking water.

Organizational Values	
Board of Directors, management and staff are guided by the following values:	
Integrity	
Honest and ethical policies, communication and actions without bias	
Respect	
Appreciate differences in background, opinion and approach, and acknowledge with high regard.	
Trust	
Our actions and words inspire fairness and support.	
Loyalty	
Dedicated to the Public, the District and its employees.	
Responsibility	
Demonstrate prudent use of all public and environmental resources.	
Professionalism	
Conduct interactions in a courteous and respectful manner and be accountable for personal actions and decisions.	

VWD Strategic Plan 2012 Page 3

Advocacy

Advocacy is defined as the act of pleading or arguing in favor of something, such as a cause, idea or policy. Advocacy can be a lonely endeavor unless significant and positive change can be realized from the efforts, and enough of the impacted public become aware of the need and the possibility for positive change. Had it not been for advocacy efforts in the case of VWD, no would know or even believe that such departures from ethics and subsidies unknowingly paid by ratepayers were possible.

A website called *Friendship of Vallecitos Customers* (FVC) was created as a resource of factual information regarding the development subsidies and a call for VWD customers to become a members. There is no formal organization – no dues, no committees - just an email list created from the member sign-ups, members of the media, and other contacts. Advocacy efforts have included:

- ◇ Letters and emails to the Board and General Manager specifying deficiencies in Cap Fees and providing solutions to recover the deficit
- ◇ Lectures and presentations
- ◇ Press releases
- ◇ Nominations of VWD for San Diego County Taxpayer Association's Golden Fleece Award
- ◇ Consumer complaint filed with the California Attorney General
- ◇ VWD public meeting attendance
- ◇ Proposition 218 (consumer rate increase) protest letters
- ◇ Frequent emails to FVC Members and Friends with information and calls to action

VWD's response to advocacy has been to refute, deny, and cover up, rather than take the steps required to restore the deficit and effectively pay back ratepayers. The obvious steps are to increase developers' Cap Fees and issue bonds. VWD has no intention of doing either. Aside from VWD's defiance, other obstacles and challenges to initiate positive change, emphasizing the need for advocacy, include:

- ◇ *Lack of Media Coverage* – Only two news articles were released about the subsidies, and both by freelance journalists before California Senate Bill 5 was approved. SB 5 reclasses freelance journalists to employees rather than independent contractors if they have fewer than 35 content submissions per year, effectively eliminating freelance journalism in California. The reasons other news outlets have not picked up the stories are unknown – perhaps lack of understanding of the financial issues and impacts, not affording credibility to the advocate, or developer influence.
- ◇ *Community social media* pages want to stay out of politics and delete posts believed to be politically motivated.
- ◇ *No Watch Dog Agency* – Non publicly-owned California utilities are accountable to the California Public Utilities Commission. Publicly-owned California utilities, like VWD, are accountable to an elected board of directors. The complaint filed with the Attorney General stated clearly that the deficit was caused by policy adopted by the Board, detailed every effort to persuade the Board to change policy to favor consumers, and the Board's response of refute, deny, and cover up. The response from the Attorney General was to “address your complaint to the board of directors and/or manager of the special district. If this does not lead to a satisfactory resolution, we suggest that you contact your representatives on the County Board of Supervisors and/or City Council for assistance.” The majority of both the Board of Supervisors and City Council are supported by developers. Other nonprofit organizations that claim to be “watchdogs” are also supported financially by developers.
- ◇ *Entrenched Politicians and Special Interests* – Deceptive mailers and false campaign advertising reaches every voter because special interests, like developers, have the resources to fund this expensive outreach. Well intended challengers who do not accept money from corporate or special interests for small local races, like VWD's board, can afford to get their message out effectively only to a subset of voters. Well-funded incumbents rarely lose their seats. VWD has no term limits and California does not mandate term limits for special districts.
- ◇ *Limited Benefits from Successful Legal Challenges* – VWD can be challenged on violations of Article XIII D Section 6(b) as well as other constitutional provisions (Gift of Public Funds, Open Meeting Act, mandated ethics, etc.). Initiating legislation is expensive. A judgement to refund money to ratepayers is not practical because of statutes of limitation and the fact that there is no developer money – the refund to ratepayers would have to come from ratepayers.

Conclusion

A special district with a strong ethical culture will respond to advocacy positively and productively, and be motivated to put the public's interest at the fore-front of decision making. Unfortunately, this Case Study does not yet have a happy ending, but does emphasize the need for grass-roots advocacy to bring awareness and understanding about the role of special districts, the rights of those served, and to promote accountability and responsible government.

[Appendix](https://friendshipvallecitoswater.files.wordpress.com/2019/08/vwd-letter-to-glenn.pdf) – Letter to VWD General Manager detailing deficiencies in Cap Fee calculations
<https://friendshipvallecitoswater.files.wordpress.com/2019/08/vwd-letter-to-glenn.pdf>

Note from the Author

I often tell my students that the most important letter in CPA is “P.” As a CPA and public servant, my responsibility was to serve the public. As an executive manager, my duty was to implement the will of the Board, which is to use public funds to subsidize development and not for the benefit of the VWD customers they serve. My resignation as the Assistant General Manager and CFO of VWD was a resolution of an ethical dilemma. But I still have a responsibility to serve the public as a CPA and not keep what I know to myself. Through my advocacy efforts, more and more of the over 100,000 population served by VWD are aware of the depths of the ethical departures and the magnitude of the fiscal impact to them. I was advised before taking on the role of an advocate to be factual and present data fairly, which I have done. I have a long way to go, against many odds, but the truth is more meaningful than political rhetoric and more powerful than special interest money. Wish me luck.

Thank you,
Tom Scaglione

Author Bio

Tom Scaglione, MBA, CPA

Tom Scaglione is the Managing Director of *ATS Financial Services*. ATS serves publicly-owned utilities with interim executive and financial management, rate structure and cost of service studies, and financial modeling and analysis. Prior to forming ATS, Tom worked for the Vallecitos Water District for eighteen years, ending his water management career as the Assistant General Manager and CFO.

Tom served as the Association of California Water Agencies (ACWA) Finance Committee Chair, on the Executive Committee, and on the Board of Directors. ACWA is a non-profit statewide association of public water agencies whose 450 members are responsible for about 90% of the water deliveries in California. Tom also chaired of the ACWA Joint Powers Insurance Authority Audit and Finance Committee.

He is a frequent speaker for professional organizations at various conferences. Tom is recognized throughout the State as an expert in public water utility finance.

Tom teaches various accounting, finance, and business classes, including finance, organizational development, and leadership for water managers, and upper-division cost accounting. He currently teaches at California State University San Marcos and has taught at Palomar College since 1994.

As co-founder of the *Friendship of Vallecitos Customers*, Tom advocates against water ratepayers subsidizing urban development in San Marcos, California.

Tom maintains an active CPA license, earned a Master of Business Administration degree with an emphasis on government leadership from California State University San Marcos, and his Bachelor of Science degree in Business Administration with an emphasis on accounting from SDSU.

In his leisure, Tom enjoys accounting and finance.