

Cap Fees and Developer Fund clarifications

Thu, Feb 18, 9:51 PM

February 18, 2021

Mr. Glenn Pruim, General Manager
Vallecitos Water District

Hello Mr. Pruim:

Gayle Martin has forwarded some of your comments and replies to my attention for verification/clarification. As a courtesy, to be fair and open, I am replying directly to you with a copy to Ms. Martin regarding clarifications or corrections to certain statements you have made in email responses and in public meetings. The purpose of this communication is not to perpetuate an adversarial relationship with the District, but hopefully to work cooperatively to resolve issues to the benefit of ratepayers, particularly since we have some new faces on the Board. Please share this communication with the Board and feel free to respond and correct me if necessary.

Capital Facility Fees

At the January 21, 2021, Board meeting you stated “The Board recently raised the [capital facility] fees.” The Board accommodated requests by the BIA and developers to defer the effective date several times, ultimately making the fees effective in January of 2020. The District originally anticipated an effective date in 2015. The cap fee study online is not dated, but was completed before cap fees were adopted in October of 2019.

In a September 30, 2020, email to Ms. Martin you stated, “The recent Capacity Fee Model calculated the required amount and calculated a Fee to be charged to each Equivalent Dwelling Unit of future development.” In a February 16, 2021, email to Ms. Martin you stated “The Replacement Fund will be made whole.” The “required amount” includes repayment to the Replacement Fund (public money accumulated through water and sewer rates) that has been paying for development for the last nine years while the developer fund has had a deficit balance – no money to pay current developer obligations.

The Capacity Fee Model divides up the “required amount” among a growth projection that is unattainable. Your model assumed water EDU additions of 4,400 and sewer EDU additions of 4,800 during Phase 1, 2015 through 2020. The error is detailed in the Protest Letter you received on February 3, 2020, and included at the end of this communication. The overstatement of projected EDUs diluted the fee per EDU, and was never corrected.

Actual EDU additions for Phase 1 were 1,807 for water and 2,318 for sewer. The Capacity Fee Model assumed total capacity fee revenue during Phase 1 of \$93.6 million while actual Phase 1 capacity fee revenue was \$39.9 million. Although most of the Phase 1 \$53.7 million revenue shortfall occurred at the time the fees were adopted, no provision was made in the fee to make up the shortfall, essentially guaranteeing that without a new cap fee calculation, ratepayers (“the Replacement Fund”) will never be paid back (“made whole”) for the unauthorized and unconstitutional loan of public money to developers.

Issuing Bonds

Intent to issue bonds can be discerned by actions and inactions.

In the February 16, 2021, email to Ms. Martin you state “Issuing debt in the Capacity Fund is in the District’s 5-year plan.” Issuing \$13.4 million in bonds was also in the District’s 5-year plan included in the 2017/18 budget, but was never executed. Had bonds been issued, most of the deficit would be restored and bond proceeds could have supplanted the “Transfer to Capital Reserve” included in our water rates. In other words, not issuing bonds to pay for development has negatively impacted our water rates. Just showing debt proceeds in the current 5-year plan is no assurance that bonds will actually be issued and the increasing deficit will ever be curtailed or that water rates will no longer be used to subsidize development.

At the April 15, 2019, Finance Committee meeting, staff relayed a request from developers to Committee members Directors Mike Sannella and Hal Martin: “Developers asked ‘Can we continue to borrow from the ratepayers?’” The consensus at the meeting was to not issue bonds, but continue to use ratepayer reserves to fund development because “instead of paying our ratepayers back at 2% developers would be paying 5%” if you issued bonds. Director Sannella acknowledged “We [developers] are making money on ratepayer money.” No item was taken to the full board to authorize borrowing from ratepayers. Using ratepayers’ money for any purpose other than to provide service is a violation of the California Constitution.

Reimbursement resolutions, also known as resolutions of intent, have not been brought to the Board with each budget ever since I resigned. A resolution of intent is not a commitment to issue bonds, but enables the district to draw from restricted debt proceeds to reimburse construction costs incurred prior to an issuance of bonds. Resolutions of intent are a common, fundamental, and prudent practice. Without resolutions of intent you can only recover costs from the issue date and only curtail future increases in the deficit. Resolutions of intent allow for an instant cash infusion that can supplant amounts included in our water rates to “Transfer to Capital Reserve,” the reserves that have been used to pay developer obligations for the last nine years. In other words, not adopting resolutions of intent negatively impacts our water rates.

5 Year Plan to recover the deficit

Ms. Martin also inquired about presentations and statements made at the October 7, 2020, Board meeting indicating that the deficit will be restored in ten years and showing the deficit balance after five years at \$6.8 million.

Your current five year plan includes tax-exempt debt that is ineligible. Tax-exempt borrowings can only be used to fund projects that benefit the public. You show debt that exceeds your projected capital expenditures. And it is unlikely that any financial institution will initiate a taxable borrowing to bring your \$22 million deficit to a \$12 million deficit as you show in 2022.

If the District borrows the maximum eligible debt in the capacity funds, the deficit, per your 5-year plan, will increase to \$20.9 million in five years. But as stated previously, the consensus of the Finance Committee and the fact that you have not adopted resolutions of intent for the last three years indicates that you will not be issuing bonds. If no bonds are issued, you project a \$54.1 million deficit in five years.

Your projection also includes assumptions of peak building activity (cap fee revenue) throughout the projection period, more than recently projected at the January 2021 Engineering Committee meeting based on an analysis of ongoing and potential development projects. Budgeting should include conservative assumptions, not aggressive assumptions like unattainable revenue projections and debt proceeds beyond the legal limit.

At the October 7, 2020, Board meeting you stated “Capacity fees will be sufficient to pay for growth.” Given the previous discussion under Capital Facility Fees and your own projection, capacity fees will not be sufficient to pay for growth.

If Developers (Cap Fees) are not paying for growth, who is?

Vallecitos is a sole purpose special district – a political subdivision of the State of California – a publicly-owned utility. There are only two sources of controllable revenue and funds – one from developers and the other from ratepayers (controllable because you can set rates). When one fund is negative (revenue is not enough to cover expenses) the other pays. It’s that simple. Vallecitos is not a city – it has no general fund, or any other fund to draw from to cover a deficit.

During the October 7, 2020, Board meeting, a slide was presented stating, “Are ratepayers funding development? No. Growth pays for growth.” This is not true of Vallecitos. Growth has only paid a portion of growth. Ratepayers have paid the rest.

Fourteen and one-half percent of our current water rates are paid as a “Transfer to Capital Reserve.” This is the ratepayers’ money from which developers requested to continue to “borrow.” If bonds had been issued, this \$6.8 million, or 14.5%, of our rates would not be necessary. In fact, our water rates could be even lower with our rate study showing “Transfer *from* Capital Reserve” given that our total ratepayer reserve balance is now \$102.2 million, more than any other San Diego County retail water district, and our capital replacement costs, net of property tax revenue, have been between \$0.7 million and \$4.6 million for the last five years, and no draws on our operating reserves. You do not need to accumulate so much reserves for replacement costs.

Proactive Steps to Address the Deficit

In your February 16, 2021, email to Ms. Martin you stated, “the District has taken proactive steps to address the shortfall over time. The Replacement Fund will be made whole and is being paid interest for any funds currently being earmarked to backstop the Capacity Fund Shortfall. Issuing debt in the Capacity Fund is in the District’s 5-year plan.”

In a September 17, 2020, email to Ms. Martin you stated, “We did realize our cap fees were too low, and that’s why the Board directed us to prepare a new study and develop new cap fees to ensure development pays its own way. Those new cap fees became effective this calendar year.”

The “new” study you referred to was requested by staff in early 2013 in the 2013/14 budget. Because of the deficiencies discussed under Capital Facility Fees and in the Protest Letter appended hereto, the study actually ensures development will never pay it’s own way unless the District is proactive in addressing the deficit and future development obligations.

Proactive steps to payback ratepayers and ensure growth pays for growth should have included:

1. Adopt reimbursement resolutions,
2. Authorize and execute debt issuances,
3. Calculate a Buy-In component to add to the Capital Facility Fee,
4. Revise the Cap Fee Study and Cap Fees,
5. Prepare and adopt a new reserve policy consistent with industry guidelines and best practices,
6. Commission a new Master Plan study.

None of these steps have been taken by the District in recent years. The District has not been proactive in addressing the developer fund deficit and ensuring ratepayer equity. More detailed discussion of these steps follow.

Adopt reimbursement resolutions immediately, identifying all capital improvement projects, both for replacement and capacity (growth). You can group projects into one resolution to reduce paperwork.

Authorize and execute debt issuances with specific strategies to maximize debt proceeds:

- Improve credit worthiness - stop paying down the 50+ year pension obligation with current position at least until sufficient debt is issued,
- Induce a premium on the bond price,
- Debt finance all developer projects, debt finance 75% of replacement projects, then trade debt for cash among funds to replace unauthorized, unconstitutional borrowing with compliant bonded indebtedness. Don't plan on incurring debt for your total capital improvement plan – provide a cushion to ensure arbitrage compliance.

Calculate a Buy-In component to add to the Capital Facility Fee – AWWA's Principle of Water Rates, Fees and Charges, M1 Manual, provides generally accepted guidance for determining legally defensible fees, and defines three common methods to calculating capital facility fees as follows:

1. “The *buy-in method* is based on the value of an existing system’s capacity. This method is typically used when the existing system has sufficient capacity to serve new development now and into the future.
2. The *incremental cost method* is based on the value or cost to expand the existing system’s capacity. This is typically used when the existing system has limited or no capacity to serve new development and new or incremental facilities are needed to serve new development now and into the future.
3. The *Combined [Hybrid] Approach* is based on a blended value of both the existing and expanded system’s capacity. This method is typically used where some capacity is available in parts of the existing system ..., but new or incremental capacity will need to be built ... to serve new development at some point in the future.”

Vallecitos falls into the third category. Developers have argued that our system has the capacity to serve new development in an effort to reduce fees Vallecitos assesses currently using the *incremental cost method*.

Relevant law (The Mitigation Fee Act) allows for Vallecitos to charge capacity for “public facilities in existence at the time a charge is imposed.” The buy-in puts new connections on par with existing customers who have paid for replacement and maintenance of existing systems and funded capital reserves. Under the *buy-in method*, revenue is unrestricted and may be deposited directly in capital replacement reserves and used to offset water rates (“Transfer *from* Capital Reserves”). Revenue from a Buy-In component of the Cap Fee rate will not help reduce the developer deficit, but it is a direct benefit to existing ratepayers and should have been added to the Cap Fee long ago. A new or revised Master Plan is not needed to calculate the Buy-In since it is based on the value of existing assets.

Revise the Cap Fee Study and Cap Fees to correct errors noted earlier and in the appended Protest Letter and add a buy-in component.

Prepare and adopt a new reserve policy consistent with industry guidelines and best practices. Your current investment policy is horrible. I should know, I wrote it thirteen years ago. It worked well through the recession and drought back then, but now needs to be scrapped and replaced with more current industry standards. No reserve policy should allow such a run up of ratepayer money and not specifically address restricted reserve deficit balances and how to remedy them.

As I mentioned in the beginning, I hope we can work cooperatively to resolve these issues. I am offering, through my consulting firm, to calculate the Buy-In component for Vallecitos consistent with relevant law and industry guidance, standards, and practices. I require a depreciation schedule downloaded to an Excel file. The schedule must agree to your audited financial statements and provide for each asset: acquisition date, original cost, useful life, accumulated depreciation, and asset category. I will also need your last meter count provided to the San Diego County Water Authority for their IAC determination, and a printout from your customer database for paid capacity in addition to base meter capacity.

I can also draft a proposed Reserve Policy that is consistent with current industry standards and specifically appropriate for Vallecitos.

I will not charge the District for these services, but ask in return that the objective be for the benefit of ratepayers, and that we be open and honest regarding the developer fund deficit and its impact to ratepayers.

Paid consultants work for the Board, not ratepayers, and will do whatever you want them to do, and justify whatever outcome you desire. If paid consultants are used to provide the proactive tasks mentioned, the Board and management need to articulate to any consultant hired that the focus is to make ratepayers whole, use conservative assumptions in projections, and not to be influenced by fee comparisons. Cap fees need to cover all costs of development and recover the deficit in a timely manner.

Please feel free to respond with corrections and/or a date/time to meet and discuss how I can be of service to Vallecitos and its customers.

Sincerely,

Tom Scaglione
Ratepayer

~

Tom Scaglione
790 Rose Ranch Road
San Marcos, CA 92069

February 3, 2020

Vallecitos Water District
ATTN: Rate Hearing
201 Vallecitos de Oro
San Marcos, CA 92069

I am the property owner of 790 Rose Ranch Road, San Marcos, CA. I oppose the proposed water rate increases. I oppose subsidizing development. Subsidizing development is not a cost of service. Vallecitos' water rates are not in compliance with Article XIII D Section 6(b) of the California Constitution.

I request postponement of any consideration of water rate increases until deficiencies in the current Capital Facility Fees (Cap Fees) and the developer fund deficit are adequately addressed.

Indications of Errors in the Adopted Cap Fees

The Board and Management should have been aware that there were errors in calculating the recently adopted Cap Fees for the following reasons:

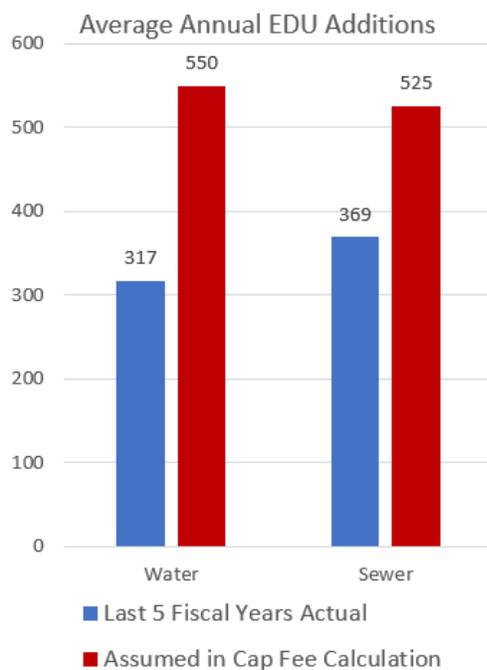
1. The Cap Fee calculations assume average annual EDUs far above the actual addition of EDUs during the last peak in building in San Marcos (2015 – 2019),
2. Correcting the reserve projection included in Vallecitos' 2019/20 adopted budget for the actual Cap Fees adopted results in a \$49.4 million developer fund deficit, subsidized by ratepayers, in 5 years (without the phantom debt proceeds), and
3. The adopted Cap Fees provide for the repayment to ratepayers of the current \$14.6 million developer fund deficit (or subsidy) only after 8,400 water EDUs are added and 8,800 sewer EDUs are added. During the last five years (Fiscal Years 2015 through 2019), a peak of building activity, only 1,583 water EDUs were added, and 1,847 sewer EDUs were added. This should have been obvious to all involved that the estimate for EDUs added before 2035, the end of the planning period, was grossly overstated.

How can the District make an assumption of such a large number of EDUs to absorb the revenue requirement? This is in an obvious understatement of the Cap Fees required for developers to pay their impacts, and results, by your own numbers, in an escalation of current ratepayer subsidies for development from \$14.6 million to \$49.4 million. The impact to ratepayers, the additional \$34.8 million to be paid over the next five years by ratepayers, was disclosed in the staff report accompanying the Board action to adopt the Cap Fees as ***"... the determined Cap Fees should have no fiscal impact to ratepayers."***

Understating Current System Capacity

Cap Fees are calculated as a fraction with the revenue requirement in the numerator and the projected EDU additions during the planning period in the denominator. Projected EDUs are the estimated system capacity at the end of the planning period less the current or starting system capacity.

In the previous Cap Fee Study, 2012, both the starting and end-of-planning-period system capacity were calculated from SanDAG population projections and duty factors. In the current Cap Fee study, the end-of-planning-period system capacity was calculated from SanDAG population projections and duty factors, but the calculation methodology for the starting system capacity was changed and not consistent with the 2012 calculation.



The starting water system capacity for the current Cap Fees assumes system capacity is equal to 2014 water sales of 16,581 acre feet (or 14.8 MGD), which were far below system capacity because of extraordinary conservation efforts at that time. In 2007 water sales were 20,528 acre feet (or 18.3 MGD). The water system capacity in 2007 was more than 18.3 MGD since you were not operating at capacity. And since 2007 significant projects added to the capacity of the system.

How can you assume system capacity decreased by more than 19%?! The same error was made in the starting capacity for sewer. How did this error go undetected through so many layers of review? This error grossly overstates the number of EDUs to divide into the revenue requirement, grossly understating the Cap Fee needed to recover costs of development.

An appropriate assumption for rate setting is a conservative assumption. Less than peak building activity should be assumed, not 74% more. That’s not just aggressive, but impossible. With assumptions like this, ratepayers will never be paid back for the development we paid for, and subsidies will continue until these issues are adequately addressed.

Shifting \$22.3 Million in Developer Debt to Ratepayers

When the new Cap Fees were first considered, the assumed effective date was January 1, 2016. The debt service and developer fund deficit were included with their balances as of January 1, 2016. The total revenue requirement was divided by the assumed EDU additions from 2014 through 2035 (for water, 38,400 EDUs as of 2035, less 29,600 EDUs as of 2014, or 8,800 water EDUs added, with a similar calculation for sewer).

As the proposed Cap Fees were delayed for several years, a revised calculation of the new Cap Fees moved the assumed effective date to July 1, 2018. The debt service and developer fund deficit were included in the calculation with their balances as of July 1, 2018. Notes in the Excel file by the District's Financial Analyst indicated the intent to move the starting point of EDU accumulation from 2014 to 2018, but an apparent formula error left the accumulation from 2014 – the same 8,800 EDUs - divided into a smaller revenue requirement, resulting in an understatement in the Cap Fees needed to recover developer costs. I pointed out the error in a letter to the General Manager.

After proposed Cap Fees were on the agenda at the August Board Meeting and Workshop, the error was addressed by leaving the start date of the accumulation at 2014 and moving the CIP start date to 2015 to match. But the debt service and developer fund deficit were left at the lower 2018 balances. ***The Cap Fee as adopted does not cover \$22.3 million in developer debt, effectively shifting that burden to ratepayers.*** Why wasn't the error addressed by simply moving the start date of the EDU accumulation to 2018? That would have been a more reasonable assumption resulting in a more reasonable amount of EDU additions.

Revenue Shortfall from Delay in Cap Fee Increase not Included in the Cap Fee

With the assumed effective date back to 2014 or 2015, but the actual Fee increase not going into effect until 2020, much less revenue was collected than assumed in the Fee calculation. This difference in the Fee that went into effect in 2020 and the actual Fees assessed from 2015 through 2019, times the EDUs added during that period, should have been added to the revenue requirement. This omission also contributed to the understatement of Cap Fees and the projection of a \$49.4 million developer fund deficit in five years.

Sewer Treatment Capacity Burden Shifted to Ratepayers

Ten years ago, Black and Veatch completed a nexus study that provided a clear connection to densified development (more dense than planned for at that time) and the need for additional sewer treatment facilities (capacity). The previous Board of Directors adopted the Sewer Density Impact Fee assessed on those EDUs that are driving the need for the additional sewer treatment capacity.

In 2015, this Board eliminated the Sewer Density Impact Fee, and refunded fees already paid, back to the developers. Developers building these additional EDUs that contributed to the need for the additional treatment did not pay for their impacts. At that same meeting in 2015, the Board explicitly made a promise to the public that the costs of the additional sewer treatment that were supposed to be covered by the Sewer Density Impact Fee would be added to the Cap Fees scheduled to be increased that same year – 2015. Those Cap Fee increases were delayed for more than four years. And sometime between the August Workshop and the October 2nd adoption, the \$55.1 million cost for the additional sewer treatment capacity was eliminated from the Cap Fee.

Vallecitos Water District Rate Hearing
February 3, 2020

Ratepayers have no confidence that developers will ever pay these impacts. These last-minute adjustments to the Cap Fees (manipulating the assumed effective date and eliminating the sewer treatment from the developers' burden) effectively **shifted \$77.4 million of cost burden from developer fees to water and sewer rates.**

Incremental Approach vs Hybrid Approach to Cap Fee Determination

At the current level of build-out of the Vallecitos Water District service boundaries, it is more appropriate for Vallecitos to use a hybrid approach (incremental and buy-in), not just incremental, as this current Cap Fee was calculated. The Cap Fee just adopted should have also included a buy-in component – another omission contributing to the inadequacy of the Cap Fees and the continually increasing burden on ratepayers and upward pressure on our water and sewer rates.

Debt – Inappropriate Use of Ratepayer Funds

I wrote to the General Manager on more than one occasion advising him that the deficit can only be eliminated by adopting adequate Cap Fees and issuing bonds instead of continuing to “borrow” from ratepayers. The “benefit” (interest accrued) to ratepayers, will never be realized because with the adopted Cap Fees as low as they are, the developer fund deficit will continue to grow - \$49.4 million in five years per your own calculations. Using revenue from water and sewer bills to lend to, or subsidize, development is not in compliance with the California Constitution. **Stop borrowing from ratepayers and issue bonds.**

Please postpone consideration of any water or sewer rate increases until all the ratepayer concerns mentioned in this protest letter are adequately addressed.

Sincerely,

Tom Scaglione
Property Owner, 790 Rose Ranch Rd, San Marcos, CA 92069
February 3, 2020