EDUCATIONAL SERIES
Release 5, July 7, 2021

WATER RATES – WHAT ARE CUSTOMERS PAYING FOR?

FVC's Educational Series serves as educational communications to Vallecitos Water District Board Members and advocates to provide information sufficient to acquire an understanding and comfort level for initiating and supporting Board actions for positive change for the benefit of ratepayers.

Board Members, please see "Caution – Open Meeting Act Compliance" at the end of this release. These communications cannot be a means to reach a consensus of the Board majority or communicate a position on an issue. That must be done at meetings posted and open to the public. These communications are strictly to educate, inform, and mitigate the current lack of transparency at the Vallecitos Water District.

Background and Summary

Vallecitos Water District (VWD) is a publicly-owned, independent special district (political subdivision of the State of California) formed by the community it serves for one purpose – to provide water and sewer service to its customers. The community (ratepayers) elects members to a governing Board who, ***collectively***, make policy, set the general direction of the District, and supervise the General Manager. Being a publicly-owned utility, VWD is not subject to California Public Utilities Commission (PUC) oversight. The PUC provides oversight to investor-owned utilities, like SDG&E. For VWD, the Board is the watchdog on behalf of the community.

The most important policy decision a Board of a public utility will make is what rates to set to recover operating and **capital**[1] replacement costs. The California Constitution limits rates to covering ***only*** the cost necessary to provide the service. The VWD Board has set water rates sufficient to pay for all operating costs, capital asset replacement, ***and to fund subsidies afforded to urban developers.***

Even though VWD water rates have already funded VWD's entire foreseeable capital needs, plus an additional $10.8 million, VWD is still requiring water customers to contribute 14.5% of their water bill towards "capital reserves". Coincidently, VWD funds developer subsidies with "capital reserves".

The 14.5% for developer subsidies is only part of the excess that customers (ratepayers) pay for water. The following sections detail and support the 19.7% that customer pay in excess of what is necessary.

Basic Rate Calculation

In the most basic terms, the water rate is how much money VWD needs to operate divided by how much water they will sell. How much VWD needs to operate is the ***Revenue Requirement***. How much they will sell, referred to as *Units of Service*, is a little complicated. Some Units of Service are fixed monthly assessments (Ready-to-Serve charges) and some Units of Service change every month (consumption). To keep it simple, the focus of this Release is on the ***Revenue Requirement – how much money VWD needs to collect from customers to provide them with water***.

[1] "Capital" refers to long-lived assets (tanks, reservoirs, pipelines, pump stations, buildings, trucks, equipment, etc.)

The Revenue Requirement

The *Revenue Requirement*, how much money a utility needs to operate, is based on budgeted annual operating expenses, less other budgeted revenues that offset the need for revenue from water rates (*Revenue Requirement Offsets*), adjustments to achieve target reserve levels (transfers to/from reserves), less transfers from rate stabilization funds. VWD's current Revenue Requirement is based on VWD's 2020 budget. The current Revenue Requirement, the current water rates, and what the Revenue Requirement would be based on the newly adopted 2022 budget and only necessary operating costs, are summarized as follows:

Revenue Requirement	Current Based on 2020 Budget		Revised Based on 2022 Budget		Overstatement of the Revenue Requirement	
Budgeted Operating Expenses	$ 44,306,000	93.6%	$ 45,581,000	119.9%		
Budgeted Revenue Offsets	(3,872,000)	-8.2%	(3,936,000)	-10.4%		
Transfer to Capital Reserve	6,882,908	14.5%	-	0.0%		
Transfer from Rate Stabilization	-	0.0%	(3,637,079)	-9.6%		
Total Revenue Requirement	$ 47,316,908	100.0%	$ 38,007,921	100.0%	$ 9,308,987	19.7%

*VWD's complete **Water Cost of Service Rate Study Report 2020** was prepared by a well-respected consulting firm and is consistent with industry guidelines. The consultant does not determine the elements of the Revenue Requirement. VWD provides these numbers to the consultant.*

Budgeted Operating Expenses for 2020 can be found on page 11 of VWD's adopted 2020 Budget, and for 2022 on page 11 of VWD's adopted 2022 budget.

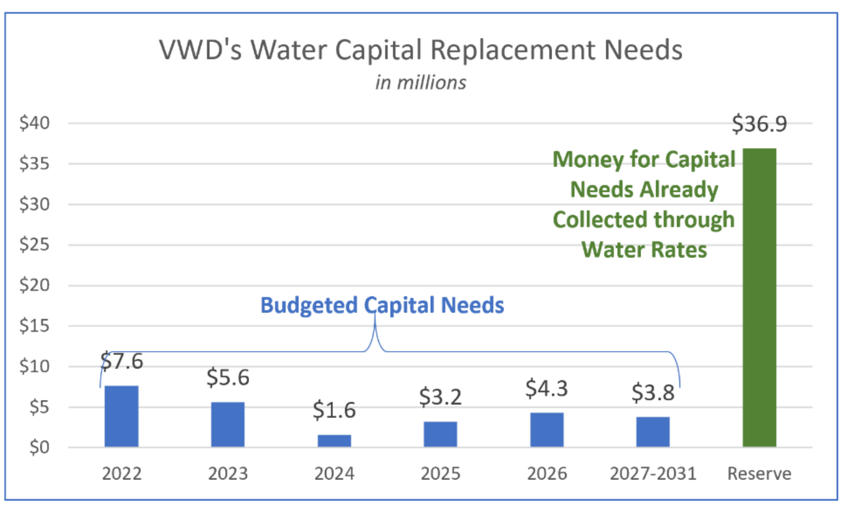
Actual 2020 operating expenses were only $40,077,184 (see page 22 of the July 15, 2020 Board packet). So is the overstatement of the Revenue Requirement, amount in excess of what ratepayers need to pay, more than 19.7%? Budgets are typically conservative, meaning expenses usually come in less, but not by 10% as it did in 2020 for VWD. This is one reason why "*at least*" is noted throughout this document in relation to the overstatement of the Revenue Requirement.

Budgeted Revenue Requirement Offsets are detailed to the right and come from pages 11 and 97 of VWD's adopted 2020 Budget, and pages 11 and 117 of VWD's adopted 2022 budget.

Budgeted Revenue Requirement Offsets	2020	2022
Pumping charges	$ 340,000	$ 415,000
Other operating revenues	700,000	601,000
Property Tax	2,072,000	2,454,000
Investment Income	760,000	466,000
Total Budgeted Revenue Requirement Offsets	$ 3,872,000	$ 3,936,000

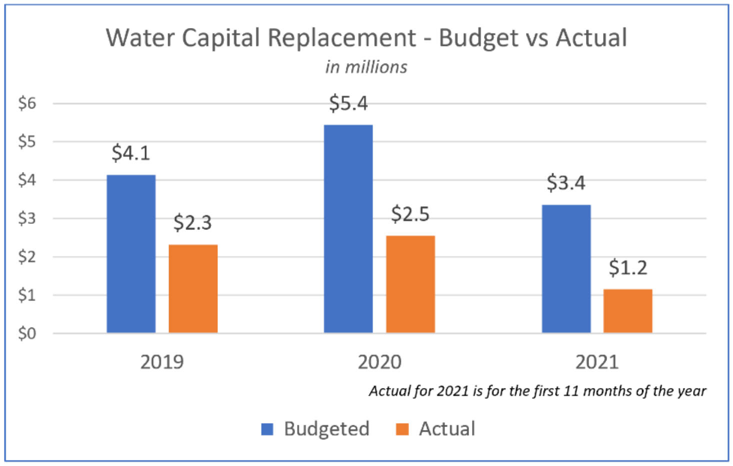
Transfer to Capital Reserve

VWD's water capital replacement reserve balance as of May 31, 2021, is $36.9 million. VWD's water replacement capital needs ***for the next ten years*** total $26.1 million per their adopted budget. ***VWD water rates already funded $10.8 million more than their entire foreseeable capital replacement needs, yet VWD is still requiring customers to contribute 14.5% of their water bill towards "capital reserves". Coincidently, VWD funds developer subsidies with "capital reserves".***



VWD has argued in favor of higher rates to support additional transfers to capital reserves because the rates are set in compliance with their reserve policy. The California Constitution provides that "Revenues derived from the fee or charge shall not exceed the funds ***required*** to provide the property related service [***emphasis added***]". VWD is not required to collect more than their capital needs and are not required to subsidize urban development. The California Constitution trumps District policy, particularly policy that does not follow industry best practices. Please see FVC Educational Series, Release 2, Reserves for more details.

Does VWD budget for their entire capital requirement? How conservative does VWD budget water capital replacement? For the last three fiscal years, VWD's actual water capital replacement cost came in, on average, 54.2% less than budgeted. Budgeted capital needs are likely far more than what is actually required.

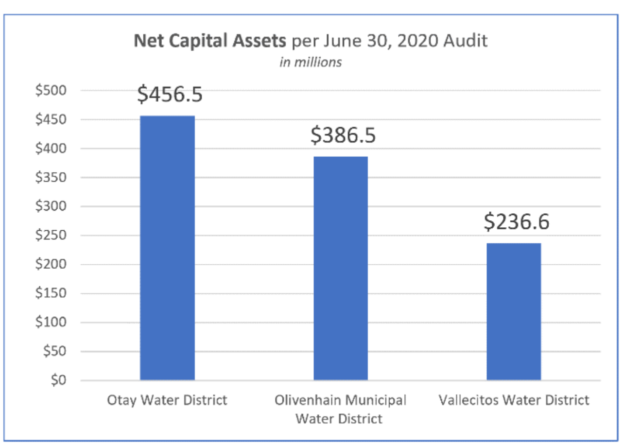


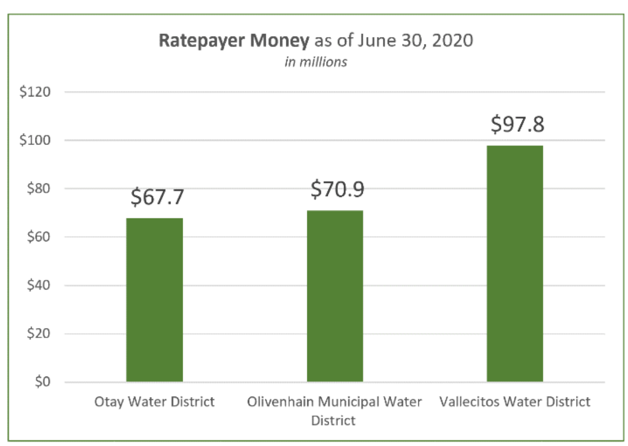
Transfer from Rate Stabilization

VWD has collected $10.8 million in excess of their 10-year capital requirement, and $14.5 million in excess of their 5-year capital requirement. A 5-year planning horizon is typical for the industry to plan for capital asset needs. A prudent reserve policy established with best industry practices would consider 1-year capital replacement the reserve floor and 5-year capital needs the reserve ceiling. Ratepayer money collected in excess of the 5-year capital requirement should go to a rate stabilization fund and used to offset the Revenue Requirement.

No other independent special water district in San Diego County has run up ratepayer reserves to the extent VWD has. There is no industry standard for how to deal with such a large sum of money that has been collected in excess of what is needed. A likely plan would be to reduce the revenue requirement by the excess over time – two, three or four years – for example, use half the sum the first year and reevaluate the remaining excess in the second year. A prudent legal strategy may be to reduce the revenue requirement immediately by the entire $14.5 million to avoid legal challenges for actual refunds of overcharges. This analysis assumes only one-fourth of the excess is used to reduce rates. So again, the Revenue Requirement is ***at least*** 19.7% more than it should be.

VWD recently argued that it is prudent to maintain excessive reserves considering they have more than $300 million in depreciable assets. There are only two independent special water districts in San Diego County with more than $300 million in capital assets net of depreciation, Otay Water District and Olivenhain Municipal Water District (OMWD). ***Both have accumulated less ratepayer money than VWD***.





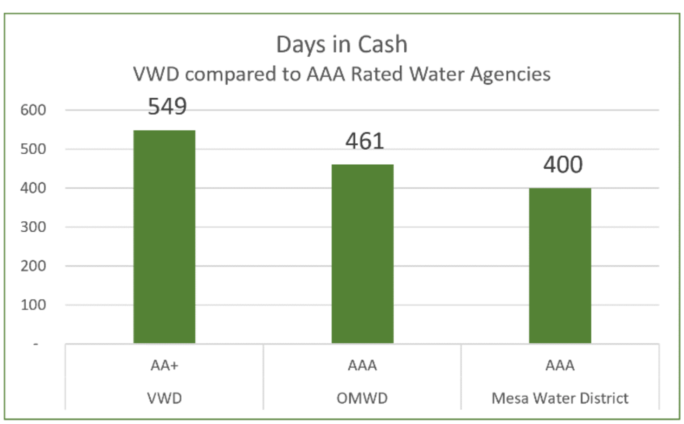
VWD has a AA+ credit rating, $236.6 million in net capital assets per their most recently audited financial statements, and limits water replacement reserves by projecting 10 years of replacement costs with a complicated formula that disregards budgeted capital needs. Per VWD's June 30, 2020, reserve activity report to the Board, VWD accumulated $97.8 million in ratepayer reserves. Their audited unrestricted cash and investments were significantly less due to ratepayers funding developer subsidies. As of May 31, 2021, ***VWD has accumulated $104.2 million in ratepayer money and continues to add $6.9 million every year assessed through their water rates***.

OMWD has a AAA credit rating, $386.5 million in net capital assets, $70.9 million in unrestricted cash and investments (ratepayer money), and limits their capital replacement reserves to their 5-year capital budget.

Otay has a AA- credit rating, $456.6 million in net capital assets, $67.7 million in unrestricted cash and investments, and limits their capital replacement reserves to 6% of the historical value of existing assets. Otay funds their replacement reserve with debt proceeds and money received from the ***Buy-In component*** of their developer capital facility fee (Cap Fee). ***The Buy-In component is assessed to developers to pay for their share of the value of existing system capacity***.

VWD is the only San Diego County independent special water district that does not require developers to pay for existing system capacity. In her report, VWD's Cap Fee consultant recommended that since VWD's service boundaries were more than 50% built out, they should add a Buy-In component to their Cap Fee. VWD responded by eliminating the recommendation from the final report and replacing it with a recommendation to consider a Buy-In component "next time". VWD responded to that recommendation by making sure there is no "next time". Although it is prudent to prepare a Master Plan Study, the basis for Cap Fees, every five years, VWD eliminated the Master Plan from their budget for at least ten years, making sure there is no "next time". ***An estimated $15.6 million that benefited developers could have instead been available to offset water and sewer rate increases had VWD added a Buy-In component to the Cap Fee.*** So again, VWD customers are paying ***at least*** 19.7% more than they should. Please see FVC Educational Series Release 4, Capital Facility Fee – Buy-In Component for more details.

VWD defended their reserve policy and excessive reserve levels by stating that lowering reserves would "weaken days in cash". "Days in cash" is a measure of how many days a business can operate without any revenue. As of May 31, 2021, VWD has 549 days of operations in cash. ***That means VWD has accumulated enough ratepayer money to operate for a year-and-a-half without any revenue.*** If VWD were to reduce cash by the $14.5 million in excessive water replacement reserves (reduce rates), their days in cash would be 460. However, if they reduce cash by the excessive reserves, ***and*** if they had never used ratepayer money to subsidize development, days in cash would be 551. The following chart compares VWD's days in cash to near-by AAA rated agencies.



The level of cash (accumulated ratepayer money) maintained by VWD exceeds rating agency criteria guidelines for a AAA rating.

Rating Agency Cash & Liquidity Metrics			
S&P[1]			
Rating	AAA	AA	A
Days' Cash Level	> 150	90-150	60-90
Actual Available Cash Reserves	> $75mm	$20-75mm	$5-20mm
Moody's Criteria			
Rating	Aaa	Aa	A
Days' Cash Level	> 250	150-250	35-150

[1] S&P's cash and liquidity assessment evaluates both days' cash and actual available cash reserves.

Days in cash was not a concern when VWD's Finance Committee consented to using ratepayer money to finance urban development and keep developers' Cap Fees as low as possible. That impact to days in cash is more than the impact if they lower the Revenue Requirement by the excess reserves. On June 28, 2021, the VWD Finance Committee decided ***not*** to change the reserve policy and ***not*** to eliminate excessive reserves to reduce water rates, in part, to preserve days in cash.

Before 2012, before VWD's board focus shifted from water customers to developers, VWD's water replacement reserves were less than their 5-year capital requirement and their credit rating was AA+. Today, VWD's water replacement reserves exceed their 5-year capital requirement by $14.5 million and their credit rating is AA+.

Are VWD Water Rates Low?

VWD recently defended their excessive reserve levels by comparing their rates to other San Diego County water agency rates. Considering only VWD's average monthly water use, without pumping charges and with no summer use, VWD's rate is below the average. However, VWD's Tier 3, or summer use, rate is the second highest of the agencies they surveyed at $9.18 per unit (100 cubic feet, or 748 gallons). The average summer rate of the ten agencies they showed above VWD's rate is about $6.60 per unit.

Not only does their rate survey not take in to account summer use, it also does not factor in property tax paid by ratepayers as part of the 1% ad valorem County assessment. None of the ten agencies shown as having rates higher than VWD collected more property tax revenue than VWD. VWD collected $5,257,7581 in property tax to offset water and sewer rates, as reported on their 2020 financial statement audit. The average property tax income of the ten higher agencies is $563,516.

Most importantly, rates for a publicly-owned utility are not set on a free-market basis. Comparing a utility to other utility rates does not justify charging more than what is necessary to operate. Prudent financial management and compliance with legal provisions and industry guidance determine the proper rate to charge.

Have VWD Customers paid for politics rather than water?

Since 2013, developer fees, known as capital facility fees (Cap Fees), assessed to mitigate impacts from development, have been too low, causing a deficit in the development fund. Ratepayers have been paying for developer obligations. The last scheduled Cap Fee adjustment (other than annual inflationary adjustments) was supposed to be in 2015. VWD delayed the Cap Fee adjustment and the VWD Finance Committee admonished staff to keep the Cap Fees "competitive". New Cap Fees were delayed for more than four years, becoming effective in 2020, and are still not sufficient to cover the fiscal impacts of urban development. The Board has no plans for a Cap Fee adjustment (other than annual inflationary adjustments) for at least the next ten years.

With no money in the developer fund, and no plans for a Cap Fee increase, VWD will continue to require ratepayers to fund urban development in violation of the California Constitution.

Additional Information

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

FVC Educational Series, Release 1, Introduction and the Deficit

FVC Educational Series, Release 2, Reserves

FVC Educational Series, Release 3, Debt

FVC Educational Series, Release 4, Capital Facility Fee – Buy-In Component

FVC Get Educated page

Caution – Open Meeting Act Compliance

Article IX of the California Constitution requires the business of the public to be conducted in open meetings. The Board can take action, arrive at consensus, and take positions only in open meetings. While two Board Members do not constitute a majority, the potential for stating a position or attempting to gain consensus could happen, either intentionally or inadvertently, with a series of replies or communications. FVC's Educational Series communications cannot be a means to reach a consensus of the Board majority or communicate a position on an issue. That must be done at meetings posted and open to the public. These communications are strictly to mitigate the current lack of transparency at VWD, educate, and inform.

Excerpt for Article IX of the California Constitution:
11122.5.
(a) As used in this article, "meeting" includes any congregation of a majority of the members of a state body at the same time and place to hear, discuss, or deliberate upon any item that is within the subject matter jurisdiction of the state body to which it pertains.
(b) (1) A majority of the members of a state body shall not, outside of a meeting authorized by this chapter, use a series of communications of any kind, directly or through intermediaries, to discuss, deliberate, or take action on any item of business that is within the subject matter of the state body.
https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=GOV&sectionNum=11122.5.