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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

May 17, 1993

To: Board of Directors (Finance and Insurance Committee--Information) (Water Problems Committee--Information)

From: General Counsel

Subject: Payment of Capital Costs from Water Sales Revenue

Report

At the Finance and Insurance Committee and Water Problems Committee meetings on February 8, 1993, Director Reed questioned the legal authority under Section 134 of the Metropolitan Water District Act for payments of costs of capital improvements generally and pay-as-you-go construction costs in particular by The Metropolitan Water District of Southern California (District) from water revenues. The Committee requested that the General Counsel review Metropolitan's Act regarding pay-as-you-go financing.

California courts have long recognized the discretion of boards of directors of water utilities to set rates which will operate to the best advantage of such utility. The U.S. Supreme Court ruled in 1899 that courts will not interfere with water rates determined under legislative sanction, unless the rates are plainly and palpably unreasonable such that they constitute the taking of property without just compensation. (San Diego Land & Town Co. v. City of National City (1899) 74 U.S. 739, 43 Ed. 1154.)

The setting of water rates by the lawful rate-fixing body is a legislative act and may not be second-guessed on judicial review when such rates are challenged. In Durant v. City of Beverly Hills (1940) 39 Cal.App.2d 133, customers outside the city limits sought to impose a requirement that their water rates be uniform with the rates of customers within the city. The court declined, stating:

> "In short, the respondent has sought to substitute the court for the city council and have the court fix the charges which he should pay. The universal rule is that in these circumstances the court is not a rate-fixing body, that the matter of fixing water rates is not judicial, but is legislative in character, and that the

> limit of its function and jurisdiction is to find, upon a proper showing, that the rates fixed are unreasonable and unfair."

A similar fact situation existed in Hansen v. City of San Buenaventura (1986) 42 Cal.3d 1172, where nonresidents of the city challenged a 70 percent nonresident surcharge for water service. The California Supreme Court declared, "Rates established by the lawful rate-fixing body are presumed reasonable, fair and lawful" and stated that plaintiffs bore the burden of establishing that the rates were unreasonable or unfair. (42 Cal.3d at 1180). Reasonableness is "the beginning and end of judicial inquiry." (42 Cal.3d at 1181, citing Kennedy v. City of Ukiah (1977) 69 Cal.App.3d 545, 552.)

Metropolitan's Rate-Setting Authority

Under Section 130 of the Act Metropolitan's Board of Directors is empowered to fix the District's rates for water. Section 134 of the Act further provides:

> "The Board, so far as practicable, shall fix such rate or rates for water as will result in revenue which, together with revenue from any water stand-by or availability service charge or assessment, will pay the operating expenses of the district, provide for repairs and maintenance, provide for payment of the purchase price or other charges for property or services or other rights acquired by the district, and provide for the payment of the interest and principal of the bonded debt subject to the applicable provisions of this act authorizing the issuance and retirement of the bonds."

In 1938, General Counsel Howard explained to the Board the high degree of latitude given to boards of directors of utility districts in the setting of rates, as recognized in California case law. Mr. Howard cited General Engineering and Dry Dock Co. v. East Bay Municipal Utility District (1932) 126 Cal.App. 349, stating that a showing of fraud or arbitrary abuse of discretion by the board of directors of East Bay Municipal Utility District would have been necessary to invalidate the rates set by such board. Mr. Howard noted that the court reached this decision despite a statutory requirement that the board should fix rates sufficient to meet the utility's entire budget requirement "so far as possible"; and observed that "Even more latitude

is accorded by the Metropolitan Water District Act, as the phrase therein employed, 'so far as practicable,' is less restrictive in meaning and more definitely confers upon the Board of Directors the discretion to determine that rate which will operate to the best advantage of the District."

In Louisiana-Pacific Corporation v. Humboldt Bay Municipal Water District (1982) 137 Cal.App.3d 152, the court addressed the issue of whether a municipal water district had the ability to make a contract with regard to water rates as a part of its rate-setting powers under Section 71616 of the Water Code. Section 71616 stated that "A district, so far as practicable, shall fix such rates for water in the district, and in each improvement district therein, as will result in revenues" sufficient to pay operating expenses and other enumerated costs of the district." The court reviewed the history of this provision and related statutes and determined that the district's power to set rates had evolved from a mandatory duty to a discretionary power; read in harmony with the Water Code provisions permitting the district to make contracts, such provision also permitted the district to contract as to rates.

The methodology used by the Court of Appeals in Louisiana-Pacific is significant. The court reiterated the "established rule" that "statutes and codes blend into each other, and are to be regarded as constituting but a single statute. . . . One should seek to consider the statutes not as antagonistic laws but as parts of the whole system which must be harmonized and effect given to every section. . . . Even when one statute merely deals generally with a particular subject while the other legislates specially upon the same subject with greater detail and particularity, the two should be reconciled and construed so as to uphold both of them if it is reasonably possible to do so."

Under this analysis, the District's powers to set rates should be read in conjunction with its other powers granted in the Act, including the rights to make contracts, acquire property and construct facilities. The power to set rates under Section 134 is permissive, and read together with the District's other powers permits the Board to set rates sufficient to cover costs of the exercise of those powers. This was recognized in connection with the predecessor to Section 134, when on August 17, 1955, General Counsel Howard wrote to the Board, "The text [of the water rates provision] does not ear-mark revenues from the sale of water for any specific purpose nor prohibit the use of such funds for construction."

By contrast with Section 134, Section 238 of the Act, also dealing with water rates, appears to be mandatory. This Section states:

> "The board shall fix the rate or rates at which water shall be sold pursuant to Chapter 2 (commencing with Section 130) of Part 4 which, with reasonable allowances for contingencies and error in the estimates, shall be at least sufficient, together with any other revenues not derived from the levy of taxes, to provide revenues to pay the following amounts in the order set forth:
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> "(1) The necessary expenditures for operating and maintaining the properties, works, and facilities of the district, and also for such charges as may be payable by the district under a contract with this state for water which are classified as operation, maintenance, power, and replacement charges.
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> "(2) The principal and interest of the revenue bonds as the same become due and payable, including any sinking fund payments for term bonds, if any.
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> "(3) The deposits into any reserve funds that may be established to secure the revenue bonds.
>
> "(4) Any other obligations which are liens or encumbrances upon the water revenues."
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> Section 239 continues,
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> "Any excess of revenues collected over and above the amounts required to be used for specific purposes by Section 238 may be used for any lawful purpose of the district . . ."

Sections 238 and 239 were enacted as part of the District's revenue bond authority and therefore requires rates to be set at levels sufficient to pay debt service and other costs. It is evident that the rate requirement under Section 238 is a minimum, not a maximum, amount. Section 239 clearly contemplates the possibility that the District may receive water revenues in excess of the required amounts. Read in conjunction and harmonized with Sections 238 and 239, as required by Louisiana Pacific, Section 134 provides for a minimum level for water rates set by the Board, not a maximum.

Using Water Revenues to Fund Construction

California courts have upheld the ability of water districts and other utilities to include costs of future improvements in their water rate structure. In Sacramento Municipal Utility District v. Spink (1956) 145 Cal.App.2d 568 (Spink), SMUD's ability to issue revenue bonds was challenged based on the Municipal Utility District Act's provision that the board of directors is not required to set unreasonably high rates or rates sufficient to cover large expenditures required for future needs. The court stated, "While [such provision] does not compel the district to pay for large expenditures for future needs from rates, it does not so forbid."

A municipal water district's financing in part of a construction project through an increase in water rates was upheld in Kahn v. East Bay Municipal Utility District (1974) 41 Cal.App.3d 397. A municipal water district's right to set water rates sufficient to pay expenses and provide a "reasonable surplus for improvements, extensions and enlargements" was upheld in Pacific Corp. v. Humboldt Bay Municipal Water District (1982) 137 Cal.App.3d 152, 157. Under these cases, the Board's discretion to set water rates at levels high enough to construct capital projects on a pay-as-you-go basis, instead of financing such projects through the issuance of revenue bonds or other long-term obligations, should withstand judicial challenge, absent a showing of fraud or abuse of discretion.

Resolution 5821, adopted by the Board September 27, 1960, required at least half of all capital charges to the District which remain after application of annexation charges to be borne by proceeds of sales of water. Resolution 7446, adopted on August 18, 1972, specifically factors pay-as-you-go construction into the Resolution 5821 formula. Resolution 7446 states that, "for purposes of interpretation of Section 5821, where construction is financed on a pay-as-you-go basis, only the annual debt service on hypothetical bonds required for such construction cost shall be considered a capital cost", provided that there are excess reserves to finance pay-as-you-go construction. This Resolution limited the District's ability to fund pay-as-you-go construction from current revenues, at least while reserves were available for that purpose, but did not prohibit such payment or require that such construction be financed only through the issuance of bonds.

The current formula for allocating capital costs to water sales revenues is contained in Section 4301(a) of the Code, which requires the District to fix rates sufficient to pay all of operating and maintenance costs plus "that portion of its annual capital costs as the ratio of the quantity of water it has sold annually to its member public agencies bears to its total ultimate annual contractual entitlements to water." However, as discussed above, this constrains only the minimum level of water revenues which may be set by the District.

Section 5109 of the Code states that the Board's objective shall be to fund 20 percent of Metropolitan's capital program expenditures on a pay-as-you-go basis, to preserve Metropolitan's debt capacity for evolving or unexpected financial needs. The Board has ample discretion to set rates at levels sufficient to fund the pay-as-you-go program and cover other costs of the District.

Board Committee Assignments

This letter is referred for information to:

The Finance and Insurance Committee pursuant to its authority to determine revenues to be obtained through sales of water, water standby or availability of service charges, and the levying of taxes; and

The Water Problems Committee pursuant to its authority to study, revise, and make recommendations with regard to the selling prices of water and conditions governing sales and exchanges of water.

Recommendation

For information only.

N. Gregory Taylor

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