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SUPERIOR COURT OF THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF SAN FRANCISCO

SAN DIEGO COUNTY WATER AUTHORITY,

Petitioner and Plaintiff,

v.

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA; ALL PERSONS INTERESTED IN THE VALIDITY OF THE RATES ADOPTED BY THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA ON APRIL 13, 2010 TO BE EFFECTIVE JANUARY 2011; and DOES 1-10,

Respondents and Defendants.

Case No. CPF-10-510830
Case No. CPF-12-512466

SAN DIEGO'S FIRST PRETRIAL BRIEF

Date: November 4, 2013
Time: 9:00 a.m.
Dept.: 304
Judge: Hon. Curtis E.A. Karnow

Dates Filed: June 11, 2010
June 8, 2012
Trial Date: December 17, 2013

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I. INTRODUCTION

This brief addresses the applicable standards of review, burden of proof, and evidence the Court should consider in resolving these cases in favor of San Diego and against MWD. Under any legal standard, MWD's rates violate California law.

First, with respect to the standard of review, this lawsuit fundamentally turns on the legal question of whether or not MWD's rates violate substantive legal limits on charges imposed by government agencies.[1] In particular, the Court must decide whether MWD's rates are limited to the costs of providing the services at issue and are fairly allocated to the ratepayers that caused MWD to incur those costs. This "cost of service" standard is expressly set forth, in various formulations, in the California constitution as amended by Propositions 13, 218, and 26; sections 1810-1814 of the California Water Code (the "Wheeling Statutes"); sections 50076, 54999.7 and 66013 of the Government Code; the MWD Act; and historical California common law. MWD's rate for "wheeling"—a term of art that refers to the transportation, distribution, conveyance, or exchange of third-party water—violates these standards because it not only exceeds MWD's costs, but includes costs that are entirely ***unrelated*** to the service of wheeling. California voters, the State Legislature, and the California Supreme Court have repeatedly prohibited such charges "imposed for unrelated revenue purposes." *Cal. Farm Bureau Fed'n v. SWRCB*, 51 Cal. 4th 421, 437 (2011). Furthermore, section 1813 of the Wheeling Statutes requires MWD to act reasonably to facilitate the "exchange of water," and expressly directs the Court to independently "give due consideration to the purposes and policies" of the law to encourage wheeling. Water Code § 1813. Whether MWD's rates further the purpose and policy of encouraging wheeling, and whether MWD is entitled to exempt itself from constitutional and statutory cost-of-service requirements, are legal questions for the Court to decide *de novo*, based on its independent judgment, because the courts are the "ultimate arbiters" of constitutional and statutory interpretation. *Cal. Assn. of Psychology Providers v. Rank*, 51 Cal. 3d 1, 11 (1990). MWD's

[1] A "rate" is a type of "fee" or "charge" that is imposed on a consumption, or volumetric, basis—*i.e.*, in the case of water rates, based on the amount of water delivered. The terms "rate," "fee" and "charge" are treated synonymously for the purposes of applicable constitutional limitations. *See Bighorn-Desert View Water Agency v. Verjil*, 39 Cal. 4th 205, 213-17 & n.4 (2006).

misinterpretations and violations of the law are not entitled to deference.

Second, the burden of proving compliance with these legal standards is on MWD. With respect to Proposition 26, this is indisputable—that constitutional provision explicitly gives MWD the burden of proving its compliance by a preponderance of the evidence. But even as to San Diego's other claims, pre-existing California law made clear the burden was on MWD to justify its rates, because MWD is the only party in a position to prove what its costs are, how it allocates those costs, and the consistency (or lack thereof) between its costs and its rates. Prior to the enactment of Proposition 26, courts evaluating challenges under Proposition 13 and statutes governing rates held that, where evidence justifying ratemaking is uniquely within the possession of an agency, that agency bears the burden of validating its rates. In any event, the legal questions presented here—whether and to what extent MWD is bound by cost-of-service requirements and whether its rates further the policies of the law—do not turn on the burden of proof. This Court decides what the law requires, regardless of who asserts a claim.

Third, the Court's review is not limited to MWD's self-selected "administrative record." Instead, the Court may review all relevant evidence. Under Proposition 26, the burden is on MWD to establish by a preponderance of the evidence that its rates do not exceed its costs and that they are fairly apportioned to its member agencies according to their burdens on, and the benefits they receive from, MWD. MWD cannot carry its burden by suppressing the evidence that undercuts it. Likewise, the Wheeling Statutes expressly direct the Court to consider "all relevant evidence." Water Code § 1813. MWD has tried to short-circuit this review by submitting an incomplete set of documents it considered, omitting other documents that it considered yet now disavows because they do not support its litigation positions. Even in a traditional "administrative record" case (which this is not) an agency cannot make Swiss cheese of the actual record of its decision-making process by excluding documents in its possession at the time of its decision that it does not want the Court to see.

Fourth, MWD's rates are illegal on any record and any standard of review:

- MWD has illegally allocated ***to its transportation rates*** an ***admitted water-supply cost***: charges MWD pays the Department of Water Resources ("DWR") for a water supply from DWR's State Water Project ("SWP").

Long before any dispute over wheeling rates, MWD's experts unambiguously accounted for SWP costs as ***supply*** costs. MWD's only purported justification for deviating from its own, and industry, practice—aside from the bare and illegal desire to discourage wheeling—is that DWR charges MWD for ***DWR's*** transportation costs within ***DWR's*** system and itemizes those costs on its invoices to MWD. But that has always been the case. As MWD previously recognized, ***DWR's*** transportation costs are not ***MWD's*** transportation costs because, as MWD admits, and the California Supreme Court has held, MWD neither owns nor operates the SWP.

- MWD ***imposes an illegal tax on its member agencies in the form of a so-called "Water Stewardship Rate"*** on every acre-foot[2] of water transported through MWD's system (other than water MWD sells at a discount to select member agencies without charging the Water Stewardship Rate). MWD then uses the proceeds of this tax to fill a slush fund that it disburses to favored agencies in the form of subsidies for local water-supply and conservation projects. The Water Stewardship Rate is illegal because MWD assesses it as a ***transportation*** charge even though its admitted purpose and effect is to develop additional water ***supplies***. It is also illegal because MWD imposes the Water Stewardship Rate without regard to which agency is causing MWD to incur the project-funding expense. And MWD terminated San Diego's eligibility for project funding in retaliation for filing this lawsuit, so San Diego pays tens of millions of dollars each year in Water Stewardship Rate charges yet is barred from receiving any subsidy-program benefits.

- MWD admittedly (and illegally) ***fails to account for the costs it incurs to meet the standby (or "dry-year peaking") demands of its member agencies***. MWD is, by its own definition, a "supplemental water supplier," delivering, in most cases, only the extra water that its member agencies need over and above their local water supplies. During dry years, many agencies "roll on" to MWD's facilities and substantially increase the amount of water they purchase. During wet or average years, these agencies "roll off" MWD's system to use their local water supplies, yet MWD pays hundreds of millions of dollars to acquire and store extra water—including SWP water—and maintains capacity in its facilities to convey it when these agencies roll back on again. MWD has admitted it does not account for these costs or attempt to apportion them fairly to the member agencies that cause them, instead illegally forcing many agencies, including San Diego, to subsidize hundreds of millions of dollars of standby water supply and facility costs caused by other member agencies.

Most of the facts related to these issues are undisputed. In particular, MWD admits:

- MWD does not "separately identify costs, expenditures, or sales volumes for each rate component." Ex. 70 (MWD Resp. to Interrog.) No. 1.[3]

- Similarly, MWD does not identify, and does not know, how the revenue it collects from any of its rates compares to its actual costs. Ex. 71 (MWD

[2] An acre-foot of water is 325,851 gallons, enough water to cover one acre, one foot deep.

[3] Unless otherwise noted, exhibit references are to the exhibits attached to San Diego's Appendix, Memorandum of Points and Authorities in Support of Motion to Augment the Record, and Request for Judicial Notice ("Appendix"), filed herewith.

Resp. to Req. for Admis.) Nos. 1-16. In fact, MWD admitted it has no idea whether it is over- or under-collecting on any of its rates by tens of millions of dollars annually. *See* Declaration of Warren A. Braunig ("Braunig Decl.") Ex. A (Van den Berg Depo.-Confidential) at 248:22-251:19.

- MWD believes its only obligation is to set rates that, in the aggregate, "result in revenue [that] will pay the operating expenses of the district." MWD Demurrer Reply (Mar. 18, 2013) at 6. In other words, MWD believes it has the right to allocate its costs among its various rates however it sees fit, and to collect more than the costs of the services it provides.

- MWD admits that the Water Stewardship Rate is an illegal tax: that it is used to collect "general revenues" that MWD uses to fund its pet projects, without regard to the burdens on, or benefits to, its member agencies—proportionally or collectively—and without seeking, much less obtaining, the vote of two thirds of the electorate. *See* Ex. 76 (Upadhyay Depo.) at 53:4-19, 85:9-13, 109:16-110:13; 133:9-135:24; Ex. 71 Nos. 17-43; Ex. 73; Cal. Const. art. 13A, § 4; art. 13C, § 1.

Thus, pursuant to San Diego's first three causes of action in both cases, the Court should issue a writ of mandate and declare MWD's rates invalid.[4]

Further, the Court should grant San Diego declaratory relief on its claims for invalidation of (1) MWD's so-called "Rate Structure Integrity" clause; and (2) MWD's unlawful calculation of San Diego's preferential rights. As San Diego argued in its pending summary-adjudication motion, the RSI clause—which purports to give MWD the right to deny San Diego any program funding from Water Stewardship Rate payments in retaliation for filing any lawsuit—is both (1) an invalid unconstitutional condition on San Diego's rights to free speech and petitioning the courts; and (2) an unlawful attempt by MWD to immunize itself in advance from challenges to its unlawful rate-setting. MWD further miscalculates San Diego's preferential rights by treating MWD's charges for conveyance of water purchased by San Diego from third parties as payments for the "purchase of water."

For all these reasons, as further outlined below, and as San Diego will prove at trial, the Court should invalidate MWD's unlawful rates, RSI Clause, and preferential-rights calculation.

II. BACKGROUND

A. MWD and its annexation of San Diego at FDR's directive

MWD was established in 1928 pursuant to the Metropolitan Water District Act. *See* Ex.

[4] This brief does not address San Diego's fourth cause of action for breach of contract, which will be the subject of a later phase, pursuant to the Court's July 22, 2013 Order.

25 at 12. Soon thereafter, MWD began work on the Colorado River Aqueduct, which brings water from the Colorado River at Lake Havasu to Lake Matthews in Riverside County. *See id.* at 13, 159. In 1941, the aqueduct was completed, and the first Colorado River water was delivered to the coastal plain of Southern California. *Id.* at 13.

At that time, San Diego was not yet connected to MWD's system. But in 1944, at the height of World War II, President Franklin D. Roosevelt recognized an "impending emergency in the water supply of San Diego," which was of "emergency importance to the Federal Government" because of the naval and other military installations in the area. Ex. 22, Attachment 1 (Nov. 29, 1944 Presidential Commc'n) at 1-2. Roosevelt directed the Navy to construct the San Diego Aqueduct, connecting the Colorado River Aqueduct to the newly completed San Vicente Reservoir in San Diego County. *See id.* And he directed San Diego "to press negotiations with the Metropolitan Water District of Southern California in order that an equitable arrangement may be completed for the permanent operation of the works, which will have continued value and utility." *Id.* at 2. Those negotiations resulted in MWD's annexation of San Diego in 1946. Among other terms, San Diego assigned to MWD its entitlement to 112,000 annual acre-feet of Colorado River water, and paid MWD an annexation fee of over $13 million to account for San Diego's share of the cost of the Colorado River Aqueduct. *See* Ex. 25 at 23, 43, 51.

Ever since it was pressed to join MWD during World War II, San Diego has been unique among MWD's member agencies. For example, most of MWD's other member agencies have significant local water supplies—groundwater, or in the case of Los Angeles, its water supply from the Owens Valley imported via the Los Angeles Aqueduct—and "use Metropolitan as a supplemental source of supply during periods in which local water supplies are depleted." Ex. 36 at 25. But San Diego does not have that luxury. Due to the same dearth of local water that led President Roosevelt to declare an emergency and order the Navy to connect San Diego to MWD, San Diego subsequently became, and remains, highly dependent on MWD for imported water—whether San Diego purchases it from MWD or from third-parties, such as the conserved water from the Imperial Valley that MWD wheels to San Diego. Indeed, San Diego has purchased more MWD water, more steadily, than any other MWD member agency. *See id.* at 25, 27. For

example, as MWD's expert found in the study on which MWD's rates are based, in 1998 San Diego alone purchased nearly 30% of the water MWD sold—more than the three next-largest purchasers (the Municipal Water District of Orange County ("MWDOC"), West Basin, and Los Angeles) combined, and far more than the even smaller amounts purchased by the remaining member agencies. *See id.* at 25. San Diego is also the only member agency that pays MWD to wheel a significant amount of non-MWD water each and every year. *See, e.g.*, Ex. 50 at 9. As discussed below, the wheeling rate MWD charges San Diego for that service is grossly disproportionate to MWD's costs, not only because MWD illegally inflates the rate itself, but also because the entire wheeling transaction is not a cost to MWD, but a great benefit: if not for San Diego's water from the Imperial Valley, MWD's Colorado River Aqueduct would be "over half empty," and MWD would have to spend its own money to fill it. *In re Quantification Settlement Agreement Cases*, 201 Cal. App. 4th 758, 785 (2011) ("*QSA*") (quotation marks omitted); *see also* Ex. 32 (July 10, 1997 MWD Mem.).

Although MWD has asserted in this case that San Diego could simply choose not to purchase water or wheeling services from MWD, that is incorrect and MWD knows it. MWD has a monopoly on the facilities necessary to transport water from the Imperial Valley to San Diego. In 1952, MWD adopted what is known as the "Laguna Declaration," which is now codified in MWD's Administrative Code. *See* Ex. 84 (MWD Admin. Code) § 4202(b). MWD's Laguna Declaration was designed to preclude member agencies, including San Diego, from establishing competing water distribution facilities. *See id.* Thus, by MWD's own design and decree, it has a monopoly on "water distribution facilities to service Southern California areas." *Id.*

B. The SWP, MWD's 1969 Study accounting for SWP charges as *supply* costs, and MWD's failure to properly account for the costs of dry-year peaking

In 1960, MWD entered into a contract with DWR for a water supply from the SWP. Ex. 1. Although MWD now mischaracterizes the majority of its SWP costs as water ***transportation*** costs, rather than ***supply*** costs, the very title of the contract states that it is "***FOR A WATER SUPPLY***." *Id.* at 3 (emphasis added, capitalization in original). The contract also specifies that DWR, not MWD, is responsible for the transportation of water up to the point of delivery into

MWD's system; MWD is only responsible for transportation "after such water has passed the delivery structures." *Id.* at 33, § 13. And the contract is "take or pay," meaning that MWD must pay the contracted amount regardless of how much water MWD actually takes from the SWP in a given year. *See id.* at 26, § 9.

From the beginning, the SWP contract led to disputes among MWD member agencies, which resulted, in turn, in hearings before the State Assembly Committee on Water. *See* Ex. 25 at 2-7. In 1968, that Committee found that MWD lacked the data and analysis necessary to support its water pricing policies, leaving "little basis for the District's constituent members to evaluate pricing problems except in terms of seeking the greatest individual advantage for each member." *Id.* at 7. On the Committee's recommendation, MWD commissioned a Water Pricing Policy Study, which was published in 1969. *See id.*

The 1969 Study allocated MWD's costs into "appropriate functional components," distinguishing supply costs from distribution (*i.e.*, transportation) costs. Crucially, it accounted for SWP costs, except for MWD's terminal reservoirs, as water ***supply*** costs:

> l. Supply System. The supply system includes all facilities involved in the function of making water available to the initial regulating reservoirs of the MWD distribution system. This includes the Colorado River Aqueduct up to the inlet works of Lake Mathews, the proposed Bolsa Island desalination plant and its treated water transmission system, ***and the State Water Project facilities excluding the terminal reservoirs of that system***. In sum, this category includes facilities whose function is the delivery of water from the sources of supply to the MWD distribution system but whose operation is essentially unrelated to the problems of meeting short term fluctuations in demand of the individual customer agencies of MWD.
>
> 2. Distribution System. For purposes of this study, the distribution system includes all of the MWD facilities which convey water, upon demand, from supply works to the member agencies. This includes feeder pipelines and other distribution conduits, metering facilities, distribution system maintenance facilities, and the distribution reservoirs, including Lake Mathews, which provide storage for regulating purposes and emergency supply. Costs arising from construction and operation of terminal storage reservoirs of the State Water Project are included in the distribution component. Thus, this group includes all facilities involved in distribution of water received from the supply system and in meeting the fluctuating demands imposed on the MWD system by requirements of individual member agencies and purveyors who take water from the system.

Id. at 159 (emphasis added). For fiscal year 1989-90, the 1969 Study projected that ***only 25.81% of MWD system costs would have been accounted for as distribution costs, whereas 66.26%***

would rightly have been accounted for as supply costs (the remainder being treatment costs). *See id.* at 161. Then, as now, DWR described the bulk of its charges as "Transportation charge[s]" on invoices sent to SWP contractors. *See id.* As the 1969 Study recognized, however, after the water passed from the SWP into MWD's system at the terminal reservoirs, those charges became supply costs for MWD and its member agencies. *See id.* at 159-61.

The 1969 Study also identified problems with MWD's finances that continue to this day. Perhaps MWD's most fundamental problem is the mismatch between its fixed costs and variable revenues. Most of MWD's costs are fixed, particularly because it pays a fixed charge for its water supply from SWP. But because MWD chooses to recover most of its revenue through water rates, rather than fixed charges, MWD's revenues can swing wildly depending on the amount of water that its member agencies purchase in any given year. Thus, "MWD does not have the stable market enjoyed by most water supplying agencies nor does it have the assurance of income that it would have if member agencies were bound by contract or by conditions of service to guarantee minimum annual payment to MWD, such as [MWD has] guaranteed to the state." *Id.* at 246.

This problem is exacerbated by "the supplemental nature of the supply furnished by MWD." *Id.* at 19. Member agencies with significant supplies of non-MWD water tend to utilize those supplies as long as they are available, and use "the MWD system principally to accommodate peak demands." *Id.* This imposes "substantially greater peaking demand on the MWD system than is imposed on the purveyor's system by seasonal variations in demand of its customers," particularly in dry years when local water supplies are diminished further than the normal seasonal low. *Id.*; *see also id.* at 62, 67-68. As the Study noted, "MWD policies have not been adequately responsive to those consequences." *Id.* at 146.

C. The 1987-1992 drought and its aftermath

MWD's failure to properly plan and account for dry-year peaking costs was nearly catastrophic for San Diego in the 1987-1992 drought. *See* Ex. 26 at I-1, S-14-15. As predicted by the 1969 Study that MWD commissioned but ignored, member agencies that normally relied on their local water supplies were unable to do so during the drought and instead placed demands

on MWD supplies that it could not meet, resulting in 31% supply cutbacks to San Diego for more than a year. Even deeper cutbacks in MWD's supply of water to San Diego were only averted by the "March Miracle" rains of 1991. *See* Ex.35 at 4. San Diego was not helped by the fact that it had paid more in water rates, more dependably, than any other member agency, because it made those payments "without receiving any recognition in the form of preferential rights." Ex. 25 (1969 Study) at 248.

Recognizing that MWD not only failed to plan for the drought, but exacerbated its effects, the Legislature again pushed MWD to reevaluate its rates and charges, and MWD commissioned another study in 1992. Ex. 26 at I-1. That study made clear that MWD's rates are "inequitable" because they "do not distinguish variations in cost of service to individual customers"—specifically, variations between agencies that cause high "peaking" costs and agencies (like San Diego) that do not. *Id.* at S-14. Further, MWD's rates are "inherently unstable, in that revenue produced is a function of sales." *Id.* The authors recommended that MWD conduct a detailed "cost allocation study," and implement rates and charges accounting for "both the volume of water purchased and the peak demand placed on its system by member agencies," which "would enhance overall equity and improve revenue stability." *Id.* at S-15-16. Like the 1969 Study, however, those recommendations went nowhere.

D. The Quantification Settlement Agreement and the conserved water San Diego obtains from the Imperial Valley—*to MWD's benefit,* as well as San Diego's

In 1996, the Secretary of the Interior declared that California must implement a strategy to restrict its use of Colorado River water to the 4.4 million acre-feet per year the United States Supreme Court had limited it to in *Arizona v. California*, 373 U.S. 546 (1963). For years after that decision, "California was nonetheless able to use much more than that because Arizona and Nevada were not yet able to use their full entitlements." *QSA*, 201 Cal. App. 4th at 773. As those states began to use more water, however, California was required to cease its chronic overuse of Colorado River water. In particular, the Imperial Irrigation District ("IID") was required to reduce its water consumption through conservation measures. *See id.* at 788.

Because IID needed funds for its conservation program, and because the drought had left

San Diego in need of an alternative and more reliable supply of water, in 1998 San Diego and IID entered into the Transfer Agreement, "the largest agricultural-to-urban water transfer in United States history." *Id.* Under that agreement, San Diego ultimately would receive 200,000 acre-feet per year of conserved water from the Imperial Valley. *See id.*; Ex. 34. Five years later, pursuant to another agreement between San Diego, MWD, IID, the United States, and other parties (the Allocation Agreement), San Diego obtained approximately 80,000 additional acre-feet per year of conserved water in return for replacing two earthen canals in the Imperial Valley desert—the All American and Coachella canals—with modern, concrete-lined canals. *See* Ex. 42. Pursuant to the Exchange Agreement between MWD and San Diego, discussed below, MWD wheels the conserved water from the Imperial Valley to San Diego. *See* Section II.H, *infra*.

The Transfer and Allocation Agreements were the cornerstones of the Quantification Settlement Agreement ("QSA"), a multi-party agreement intended to "end a long-running series of disputes over Colorado River water." *QSA*, 201 Cal. App. 4th at 772. In fact, an express term of the QSA is that it terminates if the Transfer Agreement does. Ex. 43 § 1.1(62). The QSA, Transfer Agreement, and Allocation Agreement are "critical components" of California's efforts to limit its water consumption and comply with the constitutional requirement "that water be put to reasonable and beneficial use." *QSA*, 201 Cal. App. 4th at 789 & n.10 (citations and quotation marks omitted); *see also* Ex.38 (Sept. 23, 2003 MWD Board Action).

Nevertheless, as discussed below, MWD ***penalizes*** San Diego for performing these critical contracts and obtaining additional water supplies. MWD claims it must do so in order to prevent "harm" to its other member agencies, despite admitting internally (then attempting to conceal) that when San Diego obtains those additional supplies, it creates a clear supply benefit to MWD and all MWD member agencies, on San Diego's dime. *See*, *e.g.*, Ex. 32. In 1997, MWD calculated that "without a California Plan for Colorado River supplies Metropolitan may have to raise its water rates by as much as $65 per acre-foot in order to maintain a full Colorado River Aqueduct." *Id.* MWD suppressed that fact because it did not want to be "in a position where SDCWA can say, 'See the SDCWA/IID Transfer is worth $1.41/mo to $2.82/mo for Southern Californians.'" *Id.* But the fact that MWD—and all of Southern California—benefits from the

water supplies that San Diego pays for is undeniable. If not for these additional water supplies, "Metropolitan would feel the brunt of the shortfall" in California's allotment of Colorado River Water, leaving MWD's Colorado River Aqueduct "over half empty," and forcing MWD itself to spend hundreds of millions of dollars to purchase more water. *See QSA*, 201 Cal. App. 4th at 785. It is completely irrational for MWD to punish San Diego for obtaining and paying for third-party water supplies that benefit MWD as a whole.

MWD's irrational behavior is further highlighted by the fact that MWD continues to this day to ***subsidize*** other member agencies' local water-supply projects in order to avoid "having to spend money on other imported supplies." Ex. 76 (Upadhyay Depo.) at 109:21-110:1. MWD claims that the benefits of those projects "accrue to the region because it's freeing up supplies that are able to be provided elsewhere." *Id.* at 106:1-108:1. But if that is true of the water supplies generated by other MWD member agencies, it is indisputably also true of the conserved water San Diego obtains from the Transfer and Allocation Agreements, which helps to keep water in the Colorado River Aqueduct. *See QSA*, 201 Cal. App. 4th at 785; Ex. 32. MWD's imposition of unrelated and unjustified costs onto San Diego for purchasing these additional water supplies, at the same time it is subsidizing local water supply development by its other member agencies, is arbitrary and capricious, serving no purpose except to illegally force San Diego to subsidize MWD's other member agencies.

E. MWD's admittedly invalid "equivalent margin" wheeling rate

When MWD learned of San Diego's efforts to acquire additional water supplies from the Imperial Valley, it recognized that it would be required, under the Wheeling Statutes, to wheel that water to San Diego for no more than "fair compensation." Water Code § 1810. This brought new urgency to MWD's effort to set an explicit wheeling policy, where before it had addressed such transactions on a case-by-case basis. *See* Ex. 2 at 2; Ex. 4 at 1-3; Ex. 28 at MWDPRA010099. From the beginning, "perhaps the single most important constraint on the pricing of wheeling services" has been MWD's self-imposed policy that wheeling must "not adversely affect the rates and charges of Metropolitan or any non-wheeling member public agency now or into the future." Ex. 5 at 3-2; Ex. 2 at 4; *see also* Ex. 4; Ex. 6.

MWD's policy is pure protectionism. It has no basis in the facts of any given transaction and is directly contrary to law. In general terms, San Diego's transfer of water from the Imperial Valley benefits MWD and all of its member agencies. *See, e.g.*, Ex. 32. And with respect to cost allocations among member agencies, MWD admitted internally that any increase in rates and charges for other member agencies would ***not*** be an unfair redistribution of wheeling costs that should be allocated to San Diego, but would simply reflect the long-overdue and legally-required adjustment of rates and charges to require each member agency to "pay for fixed costs commensurate with their use of the system." Ex. 31 at 2. Indeed, a November 1995 memorandum by one of MWD's own experts emphatically states that "***it is virtually unthinkable that there is any remotely acceptable wheeling rate that could in fact be imposed that would hold MWD and the other agencies harmless"—i.e., that would "avoid any rate escalation for 'non-wheeling' member agencies***." Ex. 28 at MWDPRA010104 (emphasis added).

But MWD was more concerned with preventing any increase in rates or fixed charges to non-wheeling members resulting from a proper allocation of its costs than with developing a "remotely acceptable wheeling rate." *Id.* Instead, MWD decided to use what it called the "equivalent margin method," under which it charged almost the same amount for wheeling alone as it would charge for wheeling plus the water supply itself, so as to preserve "the same level of revenues" regardless of whether a member agency purchases water from MWD or from a third party. Ex. 2 at 9. To justify this approach, MWD counterfactually claimed that "the cost of water to Metropolitan is essentially zero," and then asserted the same thing of the water San Diego obtains from the Imperial Valley at great expense. *Id.* But MWD itself has calculated that the conserved water from the Imperial Valley, which, again, ***San Diego*** pays for, is worth $65 per acre foot ***to MWD's other member agencies***, not to mention San Diego. *See* Ex. 32. And MWD's own 1969 Study and water-stewardship subsidy program—as well as history, economics, and common sense—belies its contention that the cost of its own water supplies is "essentially zero." In fact, ***water supply accounts for at least two thirds of MWD's costs***. *See* Ex. 25 (1969 Study) at 159-61. And MWD collects millions of dollars every year from all of its member agencies (including San Diego), and pays subsidies to those agencies (except for San Diego) to

generate local water supplies precisely because water is ***not*** free. *See* Ex. 76 (Upadhyay Depo.) at 109:21-110:1.

Resource Management International, Inc. ("RMI"), which MWD hired to evaluate its proposed wheeling rate, also concluded that the wheeling rate MWD ultimately adopted "could be perceived as excessive" because it "includes costs not incurred to provide wheeling service," such as "fixed SWP costs." Ex. 5 (Dec. 1995 RMI Assessment) at 5-6. RMI concurred with the 1969 Study, and every other pertinent industry standard, that SWP costs are "supply costs" that cannot reasonably be included in a wheeling rate. *Id.* at 5-2-3; *see also* Ex. 3 (Oct. 1995 RMI Study) at 1-1 (cost of water "purchased from other sources such as the State Water Project" should be allocated to "Water Supply and Purchases of Water"); Ex. 25 (1969 Study) at 159. It is similarly unreasonable to impose the costs of water conservation programs on the wheeling rate where the "primary benefit of certain of these efforts is to 'produce' additional supply sources by freeing up water supplies that would otherwise be consumed." Ex. 3 (Oct. 1995 RMI Study) at 4-9; *see also id.* at 3-6 ("incentives … paid by Metropolitan for the purpose of encouraging the use of reclaimed water and to maximize … groundwater resources … provide benefits in the form of increased water supplies. For this reason, [they] should be treated as supply related costs.").

RMI further warned that MWD's equivalent margin method "could be criticized as an obstacle to efforts to easing water shortages by water transfers," and because it "will distort the market for water transfers and discourage the transfer of water from low value to high value uses." Ex. 5 (Dec. 1995 RMI Assessment) at 5-6. Indeed, those are precisely the criticisms leveled by ***experts hired by MWDOC and Los Angeles***: "Based upon our legal analysis, we do not believe the equivalent margin method conforms to the [Wheeling Statutes] legally." Ex. 29 (Feb. 1996 NBS/Lowry Analysis) at 1, 6-5. Under the Wheeling Statutes, a wheeling rate must be "consistent with the requirements of law to facilitate the voluntary sale, lease, or exchange of water." Water Code § 1813. As MWDOC's and Los Angeles's experts rightly concluded, and informed MWD, the equivalent margin method would violate that requirement because it would "have an adverse impact on water transfers and an adverse impact on Southern California water resource efficiency," and is therefore "probably illegal and incorrectable." Ex. 29 at 7-4. MWD

itself reached much the same conclusion in its own internal analysis. *See* Ex. 31.

MWD was well aware that its equivalent margin method would violate the Wheeling Statutes and other legal requirements. *See id.* And it was aware of a lawful solution: to require member agencies to "make commitments to pay for fixed costs commensurate with their use of the system," which it referred to as the "Commitments" strategy. *Id.* at 2. This was San Diego's proposal, consistent with industry standards—including those set forth in MWD's own 1969 Study: "if alternative sources are available to [wholesale customers], some form of guaranteed income agreement is often required by the wholesaling agency." Ex. 25 at 130; *see also* Ex. 37 (AWWA Principles of Water Rates, Fees & Charges) at 237 ("Where the wholesale purchaser has other supply options, a minimum-purchase (take-or-pay) requirement may be added to the wholesale customer's rate structure. The purpose of such a requirement is to discourage a customer from using the utility system as a supplemental source of supply to meet peak requirements."); *id.* at 239 ("To the extent that costs of providing service are related to peak demand, a uniform volume rate by itself may be less equitable than one with a demand rate or a seasonal rate."); Ex. 30 (April 22, 1996 SDCWA Ltr.) at I-D, p. 2 ("SDCWA believes it is in the interests of MWD and all its member agencies that MWD obtain such commitments from all its customers so that it can plan realistically.").

As MWD admitted internally, San Diego's "Commitments" strategy would allow MWD to wheel water at a rate that recovers "only the additional costs incurred with providing that service," thereby encouraging wheeling as required by the Wheeling Statutes and California public policy, while still recovering MWD's fixed costs and treating each of its member agencies equitably. Ex. 31 at 4. Indeed, MWD's own "Evaluation Matrix" showed that San Diego's "Commitments" strategy was the ***only*** one on the table that would satisfy all the criteria for a valid wheeling rate:

Evaluation Matrix

Strategy:	Encourages Wheeling?	Cost Shifting?	Same Treatment?	SWP Cost Recovery?	Others?
Equivalent Margin Method	-	+	+	+	
Commitments	+, at incremental cost	+	+	+	
Infrastructure Bank	maybe	+	+	+	
MWDOC Proposal	+	-	-	-	
Fully Distributed Cost	-	maybe (storage issue)	+	+	
Point-to-Point	+	-	-	-	
Bidding	?	?	?	?	
Incremental Cost	+	-	-	-	
Others?					

+ = meets criteria, - = does not meet criteria

Id. at 7.

F. The prior wheeling-rate case

Disregarding its own "Evaluation Matrix" and the advice of its experts as well as those of MWDOC and Los Angeles (not to mention San Diego), MWD implemented its equivalent margin method in 1997 and sued to validate the resulting wheeling rate. *See MWD v. IID*, 80 Cal. App. 4th 1403 (2000). The trial court found MWD's rates invalid as a matter of law without holding a hearing pursuant to section 1813 of the Wheeling Statutes. *See id.* at 1422. The Court of Appeal held that the trial court erred in holding that the Wheeling Statutes "as a matter of law preclude under any and all circumstances including system-wide costs in a wheeling rate calculation," *id.* at 1428, and remanded for the trial court to conduct a section 1813 hearing to determine "[w]hether the Metropolitan Water District properly included specific costs in its wheeling rate calculation or has adopted a rate that violates the statutory mandate to facilitate wheeling." *Id.* at 1436. But that hearing never took place, because MWD dismissed the case in anticipation of "unbundling" its formerly "bundled" rate. *See id.* at 1417.

G. MWD's adoption of Los Angeles's proposed rate structure and wheeling rate

MWD's unbundled "rate structure," however, had the same fatal defects as the "equivalent margin method." Indeed, MWD admits in its Answer that the wheeling rate it adopted along with its "new" rate structure only "slightly modified the wheeling rate adopted in

1997." Answer ¶ 4. As MWD's "person most knowledgeable," its former Chief Financial Officer Brian Thomas, testified, MWD's unbundled rate structure corresponded (and still corresponds) to what MWD called the "fully distributed cost" strategy in its "Evaluation Matrix." *See* Ex. 75 (Thomas Depo.) at 176:7-8. Like the "equivalent margin method," the "fully distributed cost" strategy embodied in MWD's new rate structure admittedly failed to "Encourage[] Wheeling." Ex. 31 at 7. And it still improperly accounted for the majority of SWP charges as transportation, rather than supply, costs. *See* Ex. 36 at 104.

MWD hired a new consultant, George A. Raftelis, to bless this approach. Like RMI before him, however, Raftelis had already conceded—in his textbook on water rates—that costs "associated with the source of water supply," including "water right purchases," should be attributed to supply rather than transportation. Ex. 68 at 168-69. This approach is dictated not only by Raftelis's textbook, the 1969 and RMI studies, and common sense, but also by the National Association of Regulatory Utility Commissioners' ("NARUC") Uniform System of Accounts. The NARUC system, which Raftelis cites as authoritative, *see id.*, provides that "the cost at the point of delivery of water purchased for resale" must be accounted for as a supply cost. Ex. 69 at 140.[5] Faced with these contrary authorities, including his own, Raftelis offered no justification for MWD's categorization of SWP costs as transportation costs other than the conclusory statement that this is necessary "so that the true costs of moving water to the Southern California region and Metropolitan's internal distribution system may be properly measured." Ex. 36 (1999 Raftelis Cost of Service Study) at 104. But that just begs the question what a "proper" measurement would be; it provides no supporting facts or reasoning.

Further, Raftelis's analysis shows that MWD's rates fail to account for the true costs of "dry-year peaking," or standby. Raftelis calculated each member agency's "need for system

[5] MWD has expressly represented that it follows the NARUC guidelines, even though MWD did not even possess a copy of those guidelines. *See* Ex. 15, Attachment 2 at 8; Ex. 59. MWD did possess a copy of the similar guidelines of the California Public Utilities Commission ("CPUC," a member of NARUC), *see* Ex. 59, which, if anything, even more explicitly contradict MWD's approach: the "Purchased Water" account "shall include the cost at the point of delivery of water purchased for resale. This includes charges for readiness to serve and the portion applicable to each accounting period of annual or more frequent payments for the right to divert water at the source of supply." Ex. 24 at 96.

capacity." *Id.* at 26. This includes costs imposed by member agencies that are not necessarily captured by their water purchases—*i.e.*, the costs of standby capacity and storage for member agencies that "use Metropolitan as a supplemental source of supply during periods in which local water supplies are depleted." *Id.* at 25-26. As Raftelis's analysis makes clear, while San Diego accounts for more of MWD's water sales than any other agency, it does not have the greatest "need for system capacity." *See id.* at 26-27. Other member agencies—in particular, Los Angeles and MWDOC—regularly purchase less water from MWD than San Diego does, yet require greater proportional capacity because their usage has higher peaks during dry years. *See id.* Because MWD collects the great majority of its revenues through water rates, steady customers like San Diego end up subsidizing member agencies whose use is more sporadic—which is inequitable, as MWD's own experts have admitted. *See* Ex. 26 (1992 Study) at S-14.

Raftelis also recognized that "all or at least a portion of" the costs of subsidizing local water conservation efforts should be accounted for "as supply costs because these investments have been made to forego or defer other more expensive investments in the development of additional imported water supplies." Ex. 36 at 14. Yet Raftelis arbitrarily assigned half of these costs to the "Transmission" function, while conceding that a true cost-of-service analysis would analyze each conservation project "to determine how the local project defers or eliminates investments in additional transmission and or treatment capacity or supply yield." *Id.* at 104. In the end, MWD neither adopted Raftelis's arbitrary "50/50" approach, nor conducted a cost-of-service analysis for each specific project; instead, it illegally includes ***100%*** of the Water Stewardship Rate in its wheeling rate.[6]

[6] Neither does MWD's vaunted "Rate Model" add anything to Raftelis's 1999 report. Far from providing an independent justification for MWD's rates, MWD admits the Rate Model simply provides Microsoft Excel macros using Raftelis's misallocation of MWD costs, for which he, in turn, had no basis other than MWD's erroneous instructions. *See* Ex. 57. As MWD confessed, it designed the Rate Model without consulting industry standards or guidelines for the development of a rate model, and the Rate Model has never been audited, peer-reviewed or shared outside of MWD, other than possibly to Raftelis. Ex. 74 (Van den Berg Depo.) at 48:3-49:9, 59:4-17, 60:9-19, 72:7-12. The Rate Model purports to accomplish the same four cost-of-service steps (determine revenue requirement; functionalize costs; classify costs; allocate costs to specific rates) discussed by Raftelis. But the Rate Model does this simply by applying either the arbitrary numerical formulas set by Raftelis in 1999, s*ee id.* (Van den Berg Depo.) at 35:7-39:18; Braunig Decl., Ex. A (Van den Berg Depo. – Confidential) at 232:4-23; *id.* Ex. B (Kostopoulos Depo.) at 19:3-20:22, 51:20-52:19, or alternative formulas subsequently set by an informal "committee" of

On October 16, 2001—over San Diego's objections—the MWD Board adopted a "rate structure" proposed by Los Angeles and four other member agencies. *See* Exs. 8-9. MWD's rates were "unbundled" into the following components:

- Supply Rate, with two tiers, supposedly recovering the costs associated with water supply, but improperly excluding more than two thirds of MWD's supply costs, including the bulk of the supply costs from the SWP;
- System Access Rate, supposedly recovering water transportation costs, but improperly including most SWP supply costs, contrary to the 1969 Study and the industry standards MWD claims it follows;
- Water Stewardship Rate, which is used to increase water supplies by subsidizing local water recycling, groundwater and conservation projects, and thus, as noted above, cannot reasonably be charged in its entirety to wheeling, even under Raftelis's analysis, *see* Ex. 36 at 14;
- System Power Rate—which also improperly includes SWP costs that are supply costs to MWD under the 1969 Study and industry standards; and
- Water Treatment Rate.[7]

The wheeling rate is comprised of the System Access Rate, Water Stewardship Rate, Water Treatment Rate (if necessary), and power at actual cost. *See* Ex. 8, Attachment 1 at 3-6.

H. The Exchange Agreement

Meanwhile, in 1998, MWD and San Diego entered into a contract whereby MWD would take delivery of water that San Diego obtained from the Imperial Valley through the Transfer and

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MWD staff that does not even document, much less explain, what changes it has made, or why. *See id.* Ex. A (Van den Berg Depo.) at 231:18-238:13; Ex. B (Kostopoulos Depo.) at 22:6-27:25.

Although the Rate Model provides no explanation for why MWD made the cost allocations it did and, indeed, demonstrates the absence of a cost-of-service basis for MWD's rates, MWD's Rate Model should be part of the record in this case. MWD's Person Most Qualified witness conceded that "[t]he rate model is used to determine the revenue requirements and rates and charges," and is "an important part of how MWD sets its rates." Ex. 74 (Van den Berg Depo.) at 64:1-7, 64:16-65:7. And MWD provided at least portions of the Rate Model to Raftelis when Raftelis was evaluating MWD's proposed 2011 and 2012 rates. Ex. 14 at 12; Ex. 55. The current Protective Order covering the Rate Model does not allow San Diego to submit it with the Appendix to this Trial Brief; once the parties complete a modification of the Protective Order, San Diego will file a copy, and ask the Court to include it in whatever record the Court considers.

[7] In addition to these rates, member agencies pay certain fixed charges: a Readiness to Serve Charge; a Capacity Reservation Charge; and Standby Charges. *See* Ex. 8, Attachment 1 at 5. Despite its names for these charges, MWD admits that these fixed charges do not recover its full standby (or dry-year peaking) costs, as discussed below. *See* Section II.J, *infra*; Ex. 20, Attachment 9 at 8-14; Ex. 51. MWD also collects property taxes. *See* Ex. 8, Attachment 1 at 5.

Allocation Agreements and deliver the same quantity of water to San Diego. That agreement was amended and superseded by the parties' October 10, 2003 Exchange Agreement. Ex. 41 (Exchange Agreement). The price for the water delivered by MWD under the Exchange Agreement "shall be equal to the charge or charges set by Metropolitan's Board of Directors pursuant to applicable law and regulation and generally applicable to the conveyance of water by Metropolitan on behalf of its member agencies." *Id.* § 5.2.

As MWD's General Manager, Jeffrey Kightlinger, explained, "we charge SD our regular wheeling rate and regular power rate that we would [charge] any other wheeling party – the Exchange Agreement sets out [the first] year's rate as $253 for instance." Ex. 45. For its own convenience, MWD elected to charge San Diego the System Power Rate rather than the actual cost of power as it would under its general wheeling rate, but the price under the Exchange Agreement is admittedly a "wheeling rate" nonetheless. *See id.*; Ex. 39 ("It's now official—San Diego … will … pay MWD's full wheeling rate on all water."); Ex. 40 ("In exchange, San Diego will pay Metropolitan's full wheeling rate on all its water from both the canal lining project as well as from the IID/SDCWA Transfer."); Ex. 44; Ex. 75 (Thomas Depo.) at 90:11-116:6.

The Exchange Agreement put the parties' disputes over MWD's wheeling rate on hold, precluding San Diego from challenging it until January 2008. Ex. 41 (Exchange Agreement) §§ 5.2, 11.1. But San Diego made clear at the time that—as the Exchange Agreement expressly permitted—San Diego would sue to invalidate MWD's wheeling rate after the end of the five-year litigation standstill unless MWD changed it to comply with California law. *See id.*; Ex. 75 (Thomas Depo.) at 135:25-136:10, 143:13-144:5.

I. The "Rate Structure Integrity" Clause

Just a few months after the Exchange Agreement was signed, MWD began work on a contractual provision—the so-called "Rate Structure Integrity" or "RSI" Clause—designed to prevent San Diego from exercising its contractual and constitutional right to challenge MWD's rates. Ex. 46; Ex. 77 (Arakawa Depo.) at 84:25-85:8. In a memorandum introducing the RSI Clause to MWD's member agencies in June 2004, its then-CEO Ron Gastelum explicitly called out San Diego's reservation of rights in the Exchange Agreement and the risk that San Diego

might exercise those rights. Ex. 46; *see also* Ex. 77 (Arakawa Depo.) at 88:18-24. Gastelum admitted that the RSI Clause is designed to avoid "potentially significant cost shifting onto other member agencies" that might occur if MWD was forced to adopt rates that apportion costs fairly and legally. Ex. 47 at MWD2010-00520695; *see also* Ex. 77 (Arakawa Depo.) at 68:11-69:6, 73:5-74:11; Ex. 48 at 3-4. Gastelum's supposed justification for the RSI Clause proves that MWD has no justification for it: it is "usually bad business and not healthy for long term relationships to 'bite the hand that feeds you.'" Ex. 46 at 3.

The RSI Clause allows MWD to terminate financial benefits provided under any subsidy agreement "if the recipient participates in litigation or supports legislation challenging Metropolitan's rate structure." Answer ¶ 15. As discussed in San Diego's pending summary-adjudication motion, MWD invoked the RSI Clause against San Diego in 2011, after San Diego filed this action. *See* Ex. 65. Yet San Diego still must pay the "Water Stewardship Rate" that MWD uses to fund the subsidies it now refuses to provide to San Diego. This so-called "rate" is actually a ***tax*** that is imposed on every acre-foot of water delivered through MWD's distribution facilities (except discounted water that MWD makes available to some member agencies without charging the Water Stewardship Rate). The funds from the Water Stewardship Rate go into MWD's general fund to distribute to its members as it sees fit. *See* Ex. 76 (Upadhyay Depo.) at 85:9-13. San Diego has paid from $15 million to $20 million every year in these unlawful "Water Stewardship" taxes, from 2003 to the present—even though MWD has now barred San Diego from receiving any benefit from these taxes because San Diego filed this action.

J. MWD's invalid rates for 2011 and 2012

In 2009, MWD began the process of setting the rates it would adopt at the beginning of 2010, to apply in 2011 and 2012. As part of that process, MWD facilitated a series of Cost of Service workshops to identify potential changes to MWD's cost allocations, including changes to the allocation of SWP costs. *See* Ex. 12; Ex. 50; Ex. 52. Internally, MWD recognized that, among other defects, its existing rate structure failed to properly account for standby (or dry-year peaking) costs. *See* Ex. 51. Although MWD imposes a Readiness to Serve charge, which ostensibly recovers the costs of providing standby capacity, that charge does not recover the true

costs of "peak system use," even under MWD's own analysis. *See id.* In fact, MWD admits that the Readiness to Serve charge only recovers "a portion of the total potential benefit" of standby capacity. Ex. 20, Attachment 9 at 8-14. Just by itself, "not recovering full cost of service … could be viewed by courts as demonstrating that rates are arbitrary." Ex. 54 at MWD2010-00221548. Nevertheless, MWD decided to maintain the same cost-allocations, continuing to under-collect for standby costs and continuing to account for the majority of SWP supply costs as water transportation costs in order to charge them to wheelers, along with 100% of the Water Stewardship Rate. *See* Ex. 15.

MWD rehired Raftelis to try to justify this approach in what he tellingly called the "Cost of Service Validation Project." Ex. 56 at 1. Raftelis reached his foregone conclusions in a fifteen-page report dated April 6, 2010. Ex. 14. Raftelis did not even attempt to justify MWD's decision to include its entire Water Stewardship Rate in the wheeling rate, despite Raftelis's previous conclusion that "all or at least a portion of" such charges should be accounted for "as supply costs." Ex. 36 (1999 Raftelis Cost of Service Study) at 14. He did, however, purport to defend MWD's allocation of most SWP supply costs to its transportation rate, but offered only the conclusory assertion that this is "appropriate" because "DWR invoices in a very detailed manner that allows MWD staff to functionalize costs." Ex. 14 at 7.

But documents MWD recently produced pursuant to the Court's October 10, 2013 Order show that this language was drafted—or at the very least heavily edited—***by MWD itself***. *See* Ex. 57.[8] While Raftelis characterized his cost-of-service study as "Independent," MWD has admitted, and its recent production conclusively proves, that Raftelis is an MWD partisan—in MWD's own words, the "functional equivalent[] of staff" (Oct. 13, 2013 Joint Statement at 7:16-20)—who simply parroted language from MWD. *See* Ex. 57. Even as MWD was feeding Raftelis the language quoted above about DWR's invoices allowing MWD to "functionalize

[8] MWD drafted this "language for RFC report" on Mar. 29, 2010. Ex. 57. Notably, up to that point, the Raftelis Report did not include any explanation or justification for why SWP costs were allocated to transportation rates instead of the Supply Rate. *See* Ex. 58. Raftelis simply inserted ***MWD's*** litigation position into the Raftelis Report, almost verbatim, passing off MWD's self-serving explanation as Raftelis's "independent" conclusion. *See* Ex. 14 at 7.

costs," MWD admitted that Raftelis and his staff "***have not reviewed our methodology***." *Id.* (emphasis added).

In any event, mischaracterizing DWR's transportation costs as MWD's own transportation costs—which they are not, as MWD admits—violates standard industry practice. *See* Ex. 13A at MWDRECORD011209; Ex. 14A at MWDRECORD011375-82; Ex. 18 at MWDRECORD2012_016161; Ex. 71 Nos. 44-47. The cost of water at the point of delivery is a supply cost to the buyer, regardless of what it cost the seller to get it there, or the amount of detail the seller provides on its invoice. *See* Ex. 69 (NARUC) at 140; Ex. 68 (Raftelis Textbook) at 168-69. Raftelis's—or, more accurately, MWD's—contrary opinion is litigation-driven nonsense. *See* Ex. 57. The 1969 Study further confirms that Raftelis was simply a mouthpiece for MWD's litigation position. Before wheeling was on the horizon—*i.e.*, before MWD saw a need for its counterfactual SWP-cost accounting—the 1969 Study made clear that what DWR invoices as a "Transportation charge" is a ***supply*** cost to MWD, aside from the costs of MWD's terminal reservoirs. Ex. 25 at 159-61. That remains as true today as it was in 1969. *See id.*; Ex. 69 at 140.

San Diego objected to MWD's proposed rates and charges, and submitted the findings of Bartle Wells Associates, which showed that MWD's misallocation of SWP supply costs and Water Stewardship Rate costs to its revenue category for conveyance and distribution violates standard industry practice and is both inequitable and illogical. *See* Ex. 13A. MWD's only response was a one-page letter contending, without support, that MWD's rates comply with the American Water Works Association ("AWWA") Manual. *See* Ex. 14A at MWDRECORD011346. As Bartle Wells pointed out, however, the "basic premise" of the AWWA Manual is that costs must "be allocated among the customers commensurate with their service requirements." *Id.* at MWDRECORD011377; *see also* Ex. 37 (AWWA Principles of Water Rates, Fees & Charges) at 49. MWD's rates violate that premise by illegally requiring "cross-subsidization among customer classes." Ex. 14A at MWDRECORD011378. "In particular, by improperly allocating certain SWP, local water supply development projects, conservation, and other supply costs to its conveyance service function, MET undercharges most

of its member agencies for supply services and overcharges other agencies for transportation services." *Id.* Indeed, MWD now ***admits*** that it made no effort to ensure that its rates recover no more than the reasonable cost of the services provided, and made no effort to ensure that its rates apportion costs fairly to the member agencies that caused them to be incurred. *See* Exs. 70-73. Nevertheless, relying on Raftelis's conclusory, self-contradictory, and admittedly lawsuit-driven cost-of-service study, MWD adopted new rates and charges on April 13, 2010, effective January 1, 2011 and January 1, 2012. *See* Ex. 15 at 7; Ex. 16. As MWD admits, San Diego took "the steps necessary to exhaust its remedies" with respect to MWD's rates. Ex. 61. On June 11, 2010, San Diego filed a timely challenge to those rates: Case No. CPF-10-510830 ("2010 case").

K. MWD's invalid rates for 2013 and 2014

MWD's rate-setting process for 2013 and 2014 was even more cursory. MWD did not even pretend to obtain an "independent" analysis of its rates. Notably, during this process, MWD did recognize that it should try to increase its fixed revenues, over Los Angeles's longstanding objections. *See* Ex. 66. Indeed, one of MWD's experts observed that "[i]t is a wonder sometimes how MWD has gotten by with this structure for so long.…" Ex. 67 (Oct. 12, 2011 email to Skillman). Yet MWD did not attempt to develop a system of rates and charges that would equitably account for the costs imposed by, for example, Los Angeles rolling off of the system "due to high flows off the LA Aqueduct." *Id.* Instead, it bowed to pressure from Los Angeles and eighteen other member agencies, who complained that to allocate SWP costs to the supply rate "would result in a savings to the Water Authority of over $26 million in Calendar Year (CY) 2010 (and over $800 million dollars over the next 20 years) and a corresponding increase in cost shared by Metropolitan's other member agencies." Ex. 60. Again, however, MWD ***admits*** that it never conducted any cost-of-service analysis to support its imposition of those costs onto San Diego. *See* Exs. 70-73.

As before, San Diego objected to MWD's proposed 2013-2014 rates. *See* Ex. 18. Bartle Wells again found that MWD's proposed rates did not comply with industry standards. *See id.*, Attachment 3. And San Diego also submitted an analysis from the FCS Group showing "that MWD's 2013 and 2014 water rates deviate from well-established cost of service principles; and

unfairly discriminate against the Water Authority and against the transportation, or wheeling, of third-party sources of water through MWD's system." *Id.*, Attachment 1 at 2. MWD's only response was to reassert its litigation position—this time, it did not even go through the motions of hiring a supposedly "independent" expert. *See* Ex. 19; *see also* Ex. 21. On June 8, 2012, San Diego filed a timely challenge to MWD's 2013-2014 rates: Case No. CPF-12-512466 ("2012 case").

III. STANDARDS, BURDENS, AND EVIDENCE

A. Proposition 26 (Cal. Const. art. 13C)

As San Diego alleges in its first three causes of action in the 2012 case, MWD's rates and charges violate Proposition 26 because they are higher than necessary to cover the reasonable costs of the services provided.[9] In fact, MWD's violation of the law goes beyond mere overcharges because the SWP costs and Water Stewardship taxes that MWD includes in its wheeling rate ***have nothing to do with wheeling***. Further, MWD's rates violate Proposition 26 because they do not bear a fair or reasonable relationship to the member agencies' disparate burdens on, and benefits received from, the MWD system. *See* Cal. Const. art. 13C, § 1.

1. The standard of review under Proposition 26 is *de novo*.

San Diego's claim that MWD's rates violate the constitutional requirements imposed by Proposition 26 is "subject to a de novo or independent standard of review." *Griffith v. City of Santa Cruz*, 207 Cal. App. 4th 982, 990 (2012). This follows from Proposition 26's burden-of-proof provision, as discussed below. *See Silicon Valley Taxpayers Ass'n, Inc. v. Santa Clara Cnty. Open Space Auth.*, 44 Cal. 4th 431, 443-50 (2008) (interpreting similar provision in Proposition 218). It also follows from the rule—echoed in, but well established long before Proposition 26—that fees "may not be imposed for unrelated revenue purposes," compliance with which is subject to *de novo* review. *See Cal. Farm Bureau*, 51 Cal. 4th at 436-37.

[9] The same should be true of the rates San Diego challenges in the 2010 case. But on March 29, 2013, this Court granted MWD's motion to strike the Proposition 26 allegations from the 2010 case. San Diego preserves its right to challenge that ruling on appeal, if necessary.

2. Proposition 26 gives MWD the burden of proof by a preponderance of the evidence, eliminating any deference to MWD, as it concedes.

Under Proposition 26, MWD "bears the burden of proving by a preponderance of the evidence" that its challenged rates and charges are not taxes, "that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity." Cal. Const. art. 13C, § 1. Taxes are defined to include "any levy, charge, or exaction of any kind imposed by a local government," with enumerated exceptions, the relevant one excluding charges "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." *Id.* § 1(e)(2).

As MWD has admitted, Proposition 26 "eliminates the presumption of validity ordinarily afforded legislative enactments." MWD Mot. to Strike (filed Feb. 22, 2013). The same conclusion follows from *Silicon Valley*, where the California Supreme Court analyzed Proposition 218's similar burden-of-proof provision. Before Proposition 218, courts often employed a deferential standard of review in evaluating "quasi-legislative acts of local governmental agencies." *Silicon Valley*, 44 Cal. 4th at 443. By placing the burden of proof on the agencies instead, voters "specifically targeted this deferential standard of review for change." *Id.* at 444. As the *Silicon Valley* Court recognized, Proposition 218 effectively codified the holding of *Beaumont Investors v. Beaumont-Cherry Valley Water Dist.*, 165 Cal. App. 3d 227 (1985), which placed the burden on a defendant water district to prove that its charges do not exceed the reasonable cost of the service provided, and "that the charge allocated to plaintiff bore a fair or reasonable relation to plaintiff's burden on, and benefits from, the system." *Id.* at 235; *see Silicon Valley*, 44 Cal. 4th at 446.

Notably, the Court of Appeal in *Silicon Valley*—like MWD here—had erroneously "maintained that courts should continue to give deference to the local agency's" decision, even though it "recognized that the voters intended to change the deferential standard of review."

Silicon Valley, 44 Cal. 4th at 446-47. Its reasons for this incorrect conclusion were "'the constitutional separation of powers,'" and its view that to hold otherwise would "'frustrate the will'" of the majority of voters supporting the agency's decision. *Id.* The Supreme Court rejected those arguments.

Proposition 218—like Proposition 26—put in place "constitutional provisions of dignity at least equal to the constitutional separation of powers." *Id.* at 448. While the separation of powers "served as a foundation for a more deferential standard of review" with respect to statutory provisions, it is no basis for deference as to constitutional requirements. *Id.* "Thus, a local agency acting in a legislative capacity has no authority to exercise its discretion in a way that violates constitutional provisions or undermines their effect." *Id.* Likewise, "voter consent cannot convert an unconstitutional legislative assessment into a constitutional one." *Id.* at 449. Because neither the separation of powers nor the consent of the voters allows an agency "to usurp the judicial function of interpreting and applying the constitutional provisions" at issue, courts must "exercise their independent judgment," without deference to the agency's decision. *Id.* at 449-50.

In *City of Palmdale v. Palmdale Water Dist.*, 198 Cal. App. 4th 926 (2011), the court applied the burden of proof and standard of review established in *Silicon Valley* in a case quite similar to this one. The Palmdale Water District ("PWD"), like MWD, hired Raftelis "to prepare a rate study and recommend a new rate structure." *Id.* at 928. Raftelis outlined two options, the "Cost of Service" option and the "Fixed Cost" option. *See id.* at 929. Raftelis noted that the Cost of Service option was more consistent with both Proposition 218 and industry standards, but that it would result in greater revenue fluctuations. *See id.* The Fixed Cost option, on the other hand, had the advantage of "'rate stability.'" *Id.* PWD opted for rate stability over compliance with the governing legal standard. *See id.* at 929-30. The City of Palmdale sued to invalidate the resulting rates, arguing that "PWD failed to demonstrate that its water rates are proportional to the cost of providing water service to each parcel." *Id.* at 933. The trial court disagreed, and validated the rates, but the Court of Appeal reversed.

Following *Silicon Valley*, the Court of Appeal exercised its independent judgment to hold

that PWD failed to carry its burden of proof. PWD's rates imposed disproportionate burdens on some customers "without any showing by PWD of a corresponding disparity in the cost of providing water" to them. *Id.* at 937. Raftelis inadvertently put the nail in PWD's coffin because his report was an admission that "the option PWD did ***not*** choose" was the one that complied with Proposition 218 and industry standards. *Id.* at 937 (emphasis in original). Yet PWD improperly rejected that option in favor of rate stability. *See id.* "It follows that PWD has failed to carry its burden to demonstrate compliance with the requirements of article XIII D, and the [trial court's] judgment [to the contrary] must be reversed." *Id.* at 938.

Likewise here, the evidence proves that MWD has failed to carry its burden to prove that its rates are no more than necessary to cover its reasonable costs, and are fairly allocated to its member agencies according to the burdens they impose on, and benefits they receive from, MWD.

3. The evidence the Court should consider under Proposition 26.

Before discussing the evidence itself, a brief discussion of what evidence is admissible is in order. From the outset of this case, MWD has argued that this Court should not consider any evidence other than MWD's self-serving "administrative record," relying heavily on *Western States Petroleum Assn. v. Superior Court*, 9 Cal. 4th 559 (1995) ("*Western States I*"). But the *Western States I* Court's partial exclusion of extra-record evidence from the review of quasi-legislative acts was expressly based on "the constitutional separation of powers." *Id.* at 572. And that doctrine does not limit the standard or scope of the Court's review where, as here, the issue is MWD's compliance with constitutional requirements that are entitled to "dignity at least equal to the constitutional separation of powers." *Silicon Valley*, 44 Cal. 4th at 448. *Silicon Valley* rejected separation of powers as a basis for deference of even quasi-legislative agency action. *See id.* at 449-50. Thus, the Court must exercise its independent judgment, under the *de novo* standard of review, in deciding whether MWD violated Proposition 26. *See id.*; *see also, e.g.*, *Hensler v. City of Glendale*, 8 Cal. 4th 1, 16 (1994) (in takings context, court may consider "additional evidence" where the agency's purported "administrative record is not an adequate basis on which to determine," *de novo*, whether it violated the constitution).

There is no way to square Proposition 26's constitutional requirement that MWD carry its burden "by a preponderance of the evidence" with limiting the Court to a deferential review of only the evidence MWD has chosen for its so-called "record." Cal. Const. art. 13C, § 1. In quantifying the burden an agency must meet, Proposition 26 goes beyond the less precise burden provision in Proposition 218, which already was sufficient to eliminate deference and mandate *de novo* review under *Silicon Valley*. *See Silicon Valley*, 44 Cal. 4th at 445 (noting that Proposition 218 "does not specify the scope" of the agency's burden, citing Cal. Const. art. 13D, § 4(f)). To determine whether MWD has carried its burden by the "preponderance of the evidence," the Court must "independently weigh conflicting evidence." *Western States I*, 9 Cal. 4th at 576. MWD cannot limit the Court's review to evidence MWD has selected—that would leave one side of the scales empty and make the "preponderance" standard meaningless. *See* Cal. Const. art. 13C, § 1; *Western States I*, 9 Cal. 4th at 576; *Silicon Valley*, 44 Cal. 4th at 443-50.

In any event, the evidence San Diego asks the Court to consider would be admissible under any standard, because it consists of information in MWD's possession when it made the challenged rate decision. Indeed, even if *Western States I* applied, which it does not, *see Silicon Valley*, 44 Cal. 4th at 448-50, the evidence at issue here is not "extra-record evidence," but evidence that properly should be included in a traditional administrative record. For example, an agency's "earlier studies, reviews and reports, made at the expense of time and money in response to the [agency's] mandate" are considered to be part of the record, even if the agency attempts to exclude such materials from its supposed record. *City of Santa Cruz v. Local Agency Formation Com.*, 76 Cal. App. 3d 381, 392 (1978); *see also, e.g., Town of Tiburon v. Bonander*, 180 Cal. App. 4th 1057, 1076 (2009) (earlier materials concerning the same issue are properly considered part of the record); *Rivera v. Div. of Indus. Welfare*, 265 Cal. App. 2d 576, 589 (1968) (where, as here, an agency conducts "substantial 'off-record' investigations," their incorporation into the record is "an indispensable condition of fairness"); *accord Cal. Assn. of Nursing Homes etc., Inc. v. Williams*, 4 Cal. App. 3d 800, 811 (1970). Most of the evidence at issue here—aside from what MWD admits should be in the record—is of this nature. *See* Exs. 24-69. The 1969 Study, for example, is among the "earlier studies" that MWD commissioned, at the Legislature's

insistence, to address the cost-of-service issues presented in this case. *See Santa Cruz*, 76 Cal. App. 3d at 392; Ex. 25 at 7; *see also* Ex. 26 (1992 Study). And the 1999 Raftelis Cost of Service Study was not only commissioned by MWD, it forms the "core" of the "financial planning model" that MWD uses to set its rates, and thus lies at the heart of this case. *See* Ex. 74 (Van Den Berg Depo.) at 35:14-65:7. MWD's exclusion of these and similar documents from its so-called "record" is "patently without merit." *Santa Cruz*, 76 Cal. App. 3d at 392. Like the defendant agency in *Santa Cruz*, MWD "must in reason be presumed to have considered its earlier studies, reviews and reports," which, therefore, do not even need to fit within a *Western States I* exception for "extra-record evidence." *See id.*

Further, the Court in *Western States I* held that "evidence that could not be produced at the administrative level in the exercise of reasonable diligence should be admitted." 9 Cal. 4th at 578 (quotation marks omitted). Evidence that MWD had in its possession at the time, but hid from San Diego, falls into this category. For example, an internal MWD memorandum calculated that, far from imposing a burden on MWD's system as it contends, San Diego's purchase of water from IID benefits MWD and the rest of Southern California "by as much as $65 per acre-foot." Ex. 32. Yet MWD buried this document precisely because it would put MWD "in a position where SDCWA can say, 'See the SDCWA/IID Transfer is worth $1.41/mo to $2.82/mo for Southern Californians.'" *Id.* Because San Diego could not, "in the exercise of reasonable diligence," force MWD to include in its record evidence that MWD hid in its own files, such evidence "should be admitted" under *Western States I*. 9 Cal. 4th at 578. Likewise, MWD's discovery responses and testimony, which admit the true basis of MWD's rates and the limitations of MWD's purported support for those rates, convey information that was exclusively within MWD's possession at the time it enacted those rates. *See, e.g.*, *Nasha L.L.C. v. City of Los Angeles*, 125 Cal. App. 4th 470, 485 (2004) (deposition testimony was properly admitted and considered in a mandamus proceeding because it could not have been introduced at the administrative hearing "in the exercise of reasonable diligence").

Finally, any evidence at issue that is not already accounted for by the foregoing principles falls within the exceptions recognized in *Western States I* "for background information,"

information that is useful in "ascertaining whether the agency considered all the relevant factors or fully explicated its course of conduct or grounds of decision," and information bearing on "the accuracy of the administrative record, … procedural unfairness, and … agency misconduct." 9 Cal. 4th at 575 n.5, 579; *accord Outfitter Properties, LLC v. Wildlife Conservation Bd.*, 207 Cal. App. 4th 237, 251 (2012) (trial court properly considered extra-record evidence in deciding whether agency violated statutory spending limit). MWD's discovery responses and deposition testimony, as well as the potential testimony of witnesses at trial, are admissible under these exceptions as well because this additional evidence establishes MWD's failure to consider the costs of its services and which customers or classes of customers caused those costs to be incurred, and the inadequacy of its explanation of the bases of its rate decisions. Even before Proposition 26, this sort of evidence has been admitted to resolve such issues. *See, e.g., Pajaro Valley Water Mgmt. Agency v. Amrhein*, 150 Cal. App. 4th 1364, 1375 (2007) (trial court heard, and Court of Appeal considered, "testimony from witnesses for the Agency and Objectors" in deciding whether a water management agency violated Propositions 218 and 62); *County of Orange v. Barratt Am., Inc.*, 150 Cal. App. 4th 420, 427-30 (2007) (opinion of an expert appointed to assist the court "in its determination of the propriety, reasonableness and necessity of the costs incurred" was substantial evidence in support of the trial court's order that the agency must reduce its fees).

a. The documentary evidence proves that MWD's rates violate Proposition 26.

The documentary evidence in this case establishes that MWD has not carried and cannot carry its burden to prove that its rates satisfy the requirements of Proposition 26. MWD ***admits*** that it has never even attempted to reconcile its wheeling rate with the costs it incurs in providing that service. *See* Exs. 70-73. Thus, MWD admits it cannot satisfy Proposition 26's requirements that it prove, by a preponderance of the evidence, that its wheeling rate is "no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity." Cal. Const. art. 13C, § 1.

MWD cannot carry its burden because its inclusion of SWP costs and the Water Stewardship Rate in its wheeling rate directly contravenes Proposition 26. As discussed above, MWD's own 1969 Study proves that its inclusion of SWP costs in its wheeling rate is indefensible. "The supply system includes all facilities involved in the function of making water available to the initial regulating reservoirs of the MWD distribution system," which includes "***the State Water Project facilities excluding the terminal reservoirs of that system***." Ex. 25 at 159 (emphasis added). The studies MWD commissioned from RMI, the authoritative NARUC system, the similar system employed by the California Public Utilities Commission, and Raftelis's textbook all compel the same conclusion. *See* Ex.3 (Oct. 1995 RMI Study) at 1-1; Ex. 5 (Dec. 1995 RMI Assessment) at 5-2-3; Ex. 69 (NARUC) at 140; Ex. 24 (Cal. Pub. Util. Comm'n Sys.) at 96; Ex. 68 (Raftelis Textbook) at 168-69.

MWD ***admits*** that it "does not own the State Water Project;" "does not operate the State Water Project;" "does not transport State Water Project water from Northern California to DWR's terminal reservoirs at Castaic Lake and Lake Perris;" and "does not pump State Water Project water from Northern California to DWR's terminal reservoirs at Castaic Lake and Lake Perris." Ex. 71 Nos. 44-47. Indeed, this has been well established for decades, at least since the Court in *MWD v. Marquardt*, 59 Cal. 2d 159 (1963), rejected the idea that MWD could "obtain ownership of any [SWP] facilities" by virtue of its water-supply contract with SWP. *Id.* at 201. "[N]othing in the contract indicates that the state shall hold title as a trustee or that the district shall be an equitable owner." *Id.* at 202. It is, therefore, beyond dispute that the SWP costs that MWD characterizes as its own transportation costs are nothing of the kind—they are supply costs that ***admittedly*** are "not incurred to provide wheeling service." Ex. 5 at 5-2-3, 5-6. Because MWD includes these non-wheeling costs in its wheeling rate, that rate violates Proposition 26's requirement that it be "no more than necessary to recover the reasonable costs" of that service, Cal. Const. art. 13C, § 1, as well as the long-established principle that "[a] valid fee may not be imposed for unrelated revenue purposes." *Cal. Farm Bureau*, 51 Cal. 4th at 437.

Indeed, MWD disregards cost-of-service requirements even when MWD staff recommends otherwise, as illustrated by MWD's knowing misallocation of so-called "flexible

storage" costs associated with the reservoirs at Castaic Lake and Lake Perris. In addition to the standard supply of water provided by DWR, the water in those reservoirs includes "flexible storage" water that Met can utilize to meet demands in dry years, and then "refill" within five years thereafter. Ex. 12. MWD's only reason for allocating these costs to its System Access Rate is that DWR includes the reservoirs within ***DWR's*** transportation system and bills MWD accordingly. Ex. 11 at MWDRECORD2012_010758. But even MWD's own staff has acknowledged the error of that approach. Because flexible-storage water "provides a dry-year supply benefit to Metropolitan," MWD staff recommended that, starting with the 2011 rates, 48% of the reservoir costs be shifted to MWD's Supply Rate. *Id*. at MWDRECORD2012_010756, 59. The staff memo further noted that this re-allocation would be "consistent with how Metropolitan allocates the cost of its [own] reservoirs." Ex. 12. Yet the MWD Board rejected this reallocation—without discussion—by ordering no change to the cost-of-service methodology and tabling the staff recommendation indefinitely. *See* Ex. 13 at MWDRECORD2012_010786; Ex. 20.[10]

Proposition 26 also requires MWD to allocate its rates and charges to its member agencies in a manner that bears "a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity." Cal. Const. art. 13C, § 1. But MWD's inclusion of SWP costs in its wheeling rate has exactly the opposite purpose and effect. From the beginning, MWD's reason for including SWP costs in its wheeling rate has been to maintain artificially low water-supply rates for its non-wheeling member agencies. *See*, *e.g.*, Ex. 28 at MWDPRA010104. As discussed above, MWD never had any factual or legal basis for this. On the contrary, MWD has admitted that all of its member agencies benefit from the water that is transferred into MWD's system from the Imperial Valley at San Diego's expense, *see* Ex. 32; that any increase in rates and charges to non-wheeling member agencies would reflect the requirement that each

[10] San Diego later learned, via Public Records Act requests, that the idea to permanently defer a proper cost-allocation approach for flexible-storage costs originated with a group of member agency managers, including representatives from Los Angeles, MWDOC, and more than a dozen other member agencies, who met in secret between 2009 and at least 2011 to influence MWD policy. Ex. 53 at GLENDALE-PRA00001274.

agency must "pay for fixed costs commensurate with their use of the system," Ex. 31 at 2; and that "it is virtually unthinkable that there is any remotely acceptable wheeling rate that could in fact be imposed that would hold MWD and the other agencies harmless"—i.e., that would "avoid any rate escalation for 'non-wheeling' member agencies." Ex. 28 at MWDPRA010104. MWD's wheeling rate violates Proposition 26 because it not only exceeds the cost of wheeling, but forces San Diego and other wheelers to subsidize MWD's non-wheeling member agencies. *See* Cal. Const. art. 13C, § 1. MWD certainly has never proffered any evidence that wheelers—in particular, wheelers that are transporting water through the Colorado River Aqueduct, which is not part of the SWP—place a burden on MWD's system that would justify treating them as though they caused MWD to incur SWP costs.

Further, MWD's own record also shows that it is illegal for MWD to include its entire Water Stewardship Rate in its wheeling rate because it has no basis for attributing any of those costs—much less all of them—to wheeling. *See* Ex. 3 at 4-9. As MWD's experts at RMI conceded, the "primary benefit of certain of these efforts is to 'produce' additional supply sources by freeing up water supplies that would otherwise be consumed." *Id.*; *see also id.* at 3-6; Ex. 5 at 5-6 (wheeling rate "could be perceived as excessive" because it "includes costs not incurred to provide wheeling service"). Likewise, Raftelis conceded that "all or at least a portion of" the costs of MWD's Water Stewardship programs should be accounted for "as supply costs." Ex. 36 at 14. Indeed, at least since the 1969 Study, MWD has known that projects such as desalination plants should be accounted for as part of the "supply system." Ex. 25 at 159. Numerous MWD witnesses and other documents produced in discovery further confirm that the primary benefit of the conservation and local water development programs funded by the Water Stewardship Rate is a ***supply benefit***. *See* Ex. 49; Ex. 62-64; Ex. 76 (Upadhyay Depo.) at 109:16-110:1; Ex. 77 (Arakawa Depo.) at 91:2-13; Braunig Decl. Ex. B (Kostopoulos Depo.) at 42:14-42:23; Ex.75 (Thomas Depo.) at 79:3-22. Indeed, the only "benefit" that MWD ever calculates or tracks from its Water Stewardship programs is the amount of water supply (in total acre-feet) they generate. Ex. 76 (Upadhyay Depo.) at 52:11-53:19; 104:17-105:25, 110:2-13, 116:1-117:14; Ex. 49; Ex. 62; Ex. 64. MWD has admitted that it does not even monitor the financial benefits to MWD or its

member agencies from these programs, much less ensure that the benefits to member agencies are proportional to the rate dollars they are contributing, because, in the words of MWD's designated witness, "[t]here hasn't really been a business need to do that." Ex. 76 (Upadhyay Depo.) at 52:11-53:19; 104:17-105:25, 110:2-13, 116:1-117:14, 134:17-135:24; *see also* Ex. 71 Nos. 17-43. Yet MWD improperly includes ***all*** of its Water Stewardship Rate in its wheeling rate in the name of "rate stability," and thus cannot "demonstrate that its water rates are proportional to the cost of providing water service." *Palmdale,* 198 Cal. App. 4th at 933; *see* Cal. Const. art. 13C, § 1.

As in the *Palmdale* case, Raftelis has effectively conceded the invalidity of MWD's rates in his attempt to justify them. Not only did he concede that all or at least some of the Water Stewardship costs should be allocated to supply and thus excluded from the wheeling rate, he further indicated that a proper cost-of-service approach would "determine how the local project defers or eliminates investments in additional transmission and or treatment capacity or supply yield." Ex. 36 at 104. But MWD ***admits*** that it has ***never*** attempted to determine "***any*** additional transportation or conveyance capacity or water supply created by ***any*** such projects or programs." Ex. 71 No. 26 (emphases added); *see also id.* Nos. 27-31; Ex. 72. MWD further admits that:

- "MWD does not provide MWD member agencies funds for existing and future investments in local water supply projects, seawater desalination projects, and conservation programs in an amount proportional to each member agency's contribution of revenue through the Water Stewardship Rate." Ex. 71 No. 17; *see also id.* Nos. 18-19;
- "MWD does not calculate the proportional benefit to each of its member agencies from each individual local water supply project, seawater desalination project, or conservation program funded or subsidized with revenue collected through the Water Stewardship Rate." *Id.* No. 20; *see also id.* Nos. 21-25;
- "MWD has never calculated the proportional benefit to each of its member agencies from the aggregate group of local water supply projects, seawater desalination projects, or conservation programs funded or subsidized with revenue collected through the Water Stewardship Rate in a particular calendar year." *Id.* No. 32; *see also id.* Nos. 33-37;
- "MWD has never calculated the regional benefit to MWD created by the aggregate group of local water supply projects, seawater desalination projects, or conservation programs funded or subsidized with revenue collected through the Water Stewardship Rate in a given calendar year." *Id.* No. 38; *see also id.* Nos. 39-43.

MWD's rates and charges also fail to properly account for the costs of dry-year peaking

and thus, for this independent reason, violate Proposition 26's requirement that they "bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity." Cal. Const. art. 13C, § 1. In fact, Raftelis demonstrated that MWD's charges to San Diego are disproportionately high, and its charges to Los Angeles and MWDOC are disproportionately low, compared to these agencies' respective "need for system capacity." Ex. 36 at 26. More recently, MWD has acknowledged that its rate structure does not properly allocate the costs imposed by its member agencies' need for standby capacity. *See* Ex. 20, Attachment 9 at 8-14; Ex. 51. MWD has long known that one way it could properly address this problem would be to obtain commitments from its members, as San Diego suggested more than seventeen years ago, consistent with industry standards in place long before that. *See* Ex. 30 (April 22, 1996 SDCWA Ltr.) at I-D, p. 2; Ex. 31; Ex. 37 (AWWA Principles of Water Rates, Fees & Charges) at 237-39; Ex. 25 (1969 Study) at 130. Like the defendant in *Palmdale*, however, MWD rejected this lawful option in order to maintain "rate stability" for its most powerful member agencies. *See Palmdale*, 198 Cal. App. 4th at 929-30. MWD's rates, therefore, violate Proposition 26. *See id.*; Cal. Const. art. 13C, § 1.

In deciding whether MWD violated Proposition 26, the Court should consider all of the evidence described above and attached to San Diego's Appendix, as well as other relevant evidence that may be introduced at trial and/or in response to MWD's contentions. The evidence overwhelmingly compels the conclusion that MWD's rates are invalid.

b. Percipient and expert witness testimony will further establish that MWD's rates violate Proposition 26.

At trial, San Diego intends to call 3-5 witnesses to establish that MWD's rates are unlawful and have caused harm to San Diego and its ratepayers. Specifically, San Diego plans to call expert[11] or percipient witnesses to testify about:

- The various facilities—including DWR's, MWD's, and member agencies' facilities—that enable transportation of water to MWD's service area and to San Diego;
- The particular charges imposed by MWD on San Diego;

[11] The parties will be exchanging expert witness disclosures on October 28, 2013.

- The cost-of-service standards that prevail in the utility industry, and MWD's violation of those standards in its recovery of SWP charges, imposition of the Water Stewardship Rate, and failure to account for standby costs; and

- The financial impact of MWD's unlawful rates in the form of overcharges on San Diego and subsidies to other MWD member agencies.

In addition, San Diego expects to present deposition testimony from three or four MWD witnesses who were designated as Persons Most Qualified on various issues in this case. For the same reasons discussed above, the Court can and should consider deposition testimony in deciding whether MWD's 2013 and 2014 rates violate Proposition 26, as well as the other Constitutional and statutory grounds. *See*, *e.g.*, *Pajaro*, 150 Cal. App. 4th at 1375 (trial court considered percipient and expert testimony in deciding whether agency violated Proposition 218); *Barratt*, 150 Cal. App. 4th at 427-28 (upholding trial court, which relied on expert opinion about "'the propriety, reasonableness and necessity'" of county's costs).

B. Proposition 13 and Government Code Section 50076

Proposition 13 applies in both the 2010 and 2012 cases, and prohibits MWD from imposing rates that exceed the reasonable cost of providing the service, or are levied for unrelated or general-revenue purposes. *See* Cal. Const. art. 13A, § 4; Gov't Code § 50076. The court in *Beaumont* held that Proposition 13 applies to charges imposed by a water district, and gave the water district the burden to prove that those charges did not exceed its reasonable costs:

> The purpose of Proposition 13 being to impose a broad constitutional restriction on the power of local agencies to impose "special taxes," subject to the limited statutory exception contained in Government Code section 50076, it rightfully follows that the local agency which seeks to avoid the general rule should have the burden of establishing that it fits the exception. Still another reason for placing the burden on the local agency is to ensure an adequate record of governmental compliance with the statute. ***Otherwise, if the taxpayer were forced to prove that the fee is not reasonably related to the service for which it was imposed, local agencies would gain a litigational advantage by not undertaking, or at least not recording, any effort to relate the cost of the service to the fee charged. Such a perversion of process was surely not intended by the voters or the Legislature.*** In sum, the burden of establishing that it satisfied the requirements of Government Code section 50076 properly rested with defendant.

Beaumont, 165 Cal. App. 3d at 235-36 (emphasis added).

MWD has argued that Proposition 13 does not apply here based on *Brydon v. E. Bay Mun. Util. Dist.*, 24 Cal. App. 4th 178, 191 (1994), and *Rincon Del Diablo Mun. Water Dist. v.*

SDCWA, 121 Cal. App. 4th 813, 821-22 (2004), which followed *Brydon*. MWD's reliance on those cases is misplaced; as the Supreme Court has made clear, a charge or rate that collects revenue exceeding or unrelated to service costs may be invalidated under Proposition 13. *See Cal. Farm Bureau*, 51 Cal. 4th at 440-442; *Sinclair Paint Co. v. State Bd. of Equalization*, 15 Cal. 4th 866, 881 (1997). Further, on the question of standard of review, *Brydon* declined to follow *Beaumont* because *Knox v. City of Orland*, 4 Cal. 4th 132 (1992), "cast substantial doubt" on *Beaumont*. *Brydon*, 24 Cal. App. 4th at 191. As the California Supreme Court subsequently held in *Silicon Valley*, however, and has reiterated since, Proposition 218 "was intended to overturn the line of cases," specifically including *Knox*, "that held a deferential review of local government assessments was required." *Greene v. Marin Cnty. Flood Control & Water Conservation Dist.*, 49 Cal. 4th 277, 298 (2010) (citing *Silicon Valley*, 44 Cal. 4th at 445-46). Because it has been "overturn[ed]," *Knox* and its progeny—including *Brydon* and *Rincon*—no longer state the applicable standard of review, and there is no longer any "substantial doubt" about the ruling in *Beaumont*. *See Brydon*, 24 Cal. App. 4th at 191; *Silicon Valley*, 44 Cal. 4th at 445-46.

In any event, neither *Brydon* nor *Rincon* addressed the question of the misallocation of costs for one service function to charge for another; instead, they involved water rates that were undisputedly for the services of supplying or transporting water (tiered water rates in *Brydon* and transportation rates in *Rincon*). Thus, even on their own terms, *Brydon* and *Rincon* do not apply to MWD's Water Stewardship Rate, which is invalid because it is "imposed for unrelated revenue purposes." *Cal. Farm Bureau*, 51 Cal. 4th at 437. As discussed above, that so-called "rate" is not a water rate at all, but a ***tax*** under Government Code section 50076. MWD admits that the subsidies funded by its Water Stewardship Rate "are actually paid for through Metropolitan general revenues." Ex. 76 (Upadhyay Depo.) at 85:9-13. MWD levies this so-called "rate" for "general revenue purposes," and distributes that revenue in the form of subsidies for select conservation and local water supply development projects—which MWD makes available to all member agencies ***except*** San Diego—with admitted disregard for "the reasonable cost of providing the service." Gov't Code § 50076; *see* Ex. 71 Nos. 17-43. Thus, Proposition 13 applies to MWD's Water Stewardship Rate, even under *Brydon* and *Rincon*. Proposition 13 also

applies to MWD's wheeling rate generally, because it recovers revenue for unrelated SWP supply costs. *See Cal. Farm Bureau*, 51 Cal. 4th at 437. And, again, Proposition 13 applies to all of MWD's challenged rates under *Beaumont*, which, unlike *Brydon* and *Rincon*, accurately states current law. *See Silicon Valley*, 44 Cal. 4th at 445-46; *Beaumont*, 165 Cal. App. 3d at 235-36.

The standard of review, burden of proof, and relevant evidence under Proposition 13 are the same as described above for Proposition 26. ***First***, because Proposition 13 established constitutional requirements, this Court evaluates MWD's compliance with it independently, on *de novo* review, without deference to MWD. *See Silicon Valley*, 44 Cal. 4th at 443-50. ***Second***, under *Beaumont*, MWD has the burden to prove that its rates do "not exceed the reasonable cost of providing the service." Gov't Code § 50076; *see Beaumont*, 165 Cal. App. 3d at 235-36; *see also Morris v. Williams*, 67 Cal. 2d 733, 760 (1967); *Oildale Mut. Wat. Co. v. N. of the River Mun. Wat. Dist.*, 215 Cal. App. 3d 1628, 1633-34 (1989); *Barratt*, 150 Cal. App. 4th at 437-38. ***Third***, the Court can and should consider the evidence described in the preceding section and attached to San Diego's Appendix.

C. The Wheeling Statutes

In its first three causes of action in both cases, San Diego also alleges that MWD violates the Wheeling Statutes because (a) the price MWD charges San Diego under the Exchange Agreement is an illegal wheeling rate, and (b) the general wheeling rate set forth in section 4405 of MWD's Administrative Code, which it imposes on San Diego in other transactions, is likewise illegal. *See, e.g.*, Ex. 10 ("SDCWA's water [from other wheeling transactions] will be conveyed consistent with Section 4405 of Metropolitan's Administrative Code and California Water Code Sections 1810-1814 (the 'wheeling law').").

The Wheeling Statutes declare that it "is the policy of the state to facilitate the voluntary sale, lease, or exchange of water or water rights in order to promote efficient use." Stats. 1986, ch. 918, § 1(d). As noted in the introduction to the legislation, this confirms and expands upon preexisting law, which "directs the Department of Water Resources, the State Water Resources Control Board, and all other appropriate state agencies to encourage voluntary transfers of water and water rights." Stats. 1986, ch. 918; *see also* Water Code § 109 ("It is hereby declared to be

the established policy of this state to facilitate the voluntary transfer of water and water rights," and the "Legislature hereby directs the Department of Water Resources, the State Water Resources Control Board, and all other appropriate state agencies to encourage voluntary transfers of water and water rights.").

The Wheeling Statutes advance these policies by providing that, "[n]otwithstanding any other provision of law, neither the state, nor any regional or local public agency may deny a bona fide transferor of water the use of a water conveyance facility which has unused capacity, for the period of time for which that capacity is available, if fair compensation is paid for that use…." Water Code § 1810. "'Fair compensation' means the reasonable charges incurred by the owner of the conveyance system, including capital, operation, maintenance, and replacement costs, increased costs from any necessitated purchase of supplemental power, and including reasonable credit for any offsetting benefits for the use of the conveyance system." *Id.* § 1811(c). The Wheeling Statutes apply to 70% of unused capacity. *Id.* § 1814. The public agency that owns the water conveyance facility "shall in a timely manner determine" (a) the "amount and availability of unused capacity," (b) the "terms and conditions, including operation and maintenance requirements and scheduling, quality requirements, term or use, priorities, and fair compensation." *Id.* § 1812.

In making the factual determinations required under the Wheeling Statutes, the "***public agency shall act in a reasonable manner consistent with the requirements of law to facilitate the voluntary sale, lease, or exchange of water and shall support its determinations by written findings***." *Id.* § 1813 (emphasis added). Independently, in any judicial action, "***the court shall consider all relevant evidence, and the court shall give due consideration to the purposes and policies of this article***." *Id.* (emphasis added). The "court shall sustain the determination of the public agency"—*i.e.*, any factual determination as to unused capacity, fair compensation, and so on—"if it finds that the determination is supported by substantial evidence." *Id.*

The legislative history of the Wheeling Statutes further informs the issues the Court asked the parties to address. Assemblyman Richard Katz introduced the original draft of the Wheeling Statutes (AB 2746) in January 1986. *See* Ex. 79 (Legislative History).

> This bill is intended to make it easier for a water agency to use another agency's canals or other conveyance facilities for transferring water to a third agency. In the past, water agencies have had difficulty in gaining permission to use another agency's canals or pipelines. In some situations, the owner has simply refused to allow others to use its facilities. In other situations negotiations have been long a drawn out. This bill seeks to solve the problem by requiring the unused capacity to be made available and by providing a way for determining the fair market value of the use.

Id. at LH00121. Under Assemblyman Katz's original proposal, if the parties to a proposed wheeling transaction could not agree on fair market value, DWR was to make a recommendation as to fair market value to the State Water Resources Control Board ("SWRCB"), which "shall, after notice and opportunity for hearing, determine the fair market value for use of the water conveyance facility." *Id.* at LH00055. That determination could be challenged by writ proceedings, in which the "court shall affirm the determination of the board if the determination is found to be supported by substantial evidence in the record before the board." *Id.*

San Diego supported the legislation because, among other things, it would require MWD to provide wheeling services "if the Water Authority were to negotiate a separate agreement with the Imperial Irrigation District (IID) to purchase conserved waters.…" *Id.* at LH00151. But MWD, Los Angeles, and others "oppose[d] giving the SWRCB any role in determining fair market value for the use of facilities." *Id*. at LH00122; *see also id*. at LH00089-90, 145. In response, the bill was amended in June 1986 to require "fair compensation," rather than fair market value, and to provide that the agency would determine fair compensation, in addition to other factual determinations, subject to judicial review based on "all relevant evidence." *Id.* a LH00063-64. Notably, the phrase "in the record before the board" was deleted. *Id*. at LH00064; *cf. id.* at LH00055. Because the initial fair compensation determination now would be made by the wheeling agency, rather than the SWRCB, the Court "shall consider ***all*** relevant evidence," not just the evidence selected by the interested agency itself. *Id.* (emphasis added). Given this amendment, MWD abandoned its opposition and supported the revised bill. *See id*. at LH00156.

But other agencies were still unsatisfied. In particular, Inyo County opposed the revised bill because it did not provide sufficient protection for a water transfer's area of origin. Inyo County objected that the Owens Valley "is an example of the undesirable consequences that can

result from a water transfer from an area of origin." *Id*. at LH00307. To address this and related concerns, the bill was amended again in July 1986 to provide that the "use of a water conveyance facility is to be made without injuring any legal user of water and without unreasonably affecting fish, wildlife, or other instream beneficial uses and without unreasonably affecting the overall economy or the environment of the county from which the water is being transferred." That amendment secured the support of Inyo County. *See id*. at LH00314.

The Wheeling Statutes' reference to not "injuring any legal user of water" does not protect the water rates paid by non-wheeling agencies, as MWD has contended. *See, e.g.*, Ex. 7 at 2. On the contrary—as MWDOC's and Los Angeles's own experts explained—this language "***refers to the loss of appropriation rights owned by the transferor by reason of the transfer***." Ex. 29 (Feb. 1996 NBS/Lowry Analysis) at 5-18 (emphasis added); *see also id.* at 5-29-32. That this language has nothing to do with preserving the water rates of non-wheeling customers is confirmed by the fact that after it was added, opponents such as the California Chamber of Commerce argued that the "bill will potentially reduce the customer base within specific service areas. ***The remaining service area customers who do not benefit from an involuntary water transfer will pay higher rates for the District's fixed costs***." Ex. 79 at LH00315 (Aug. 6, 1986) (emphasis added). Likewise, after the bill was in its final form as enacted, opponents such as the Association of California Water Agencies and the California Municipal Utilities Association continued to argue that "***[l]ess customers on which to spread the cost of services would ultimately mean higher charges to those remaining customers***." *Id*. at LH00353-354 (Enrolled Bill Report) (emphasis added). These opponents rightly perceived that the caveat against "injuring any legal user of water" would not, and was never intended to, prevent increases in the rates and charges to non-wheeling customers. *See also San Luis Coastal Unified Sch. Dist. v. City of Morro Bay*, 81 Cal. App. 4th 1044, 1050 (2000) (rate increases for non-wheeling customers are not "the sort of injury to a legal user of water the Legislature had in mind"). As discussed above, MWD's wheeling of water to San Diego from the Imperial Valley would not be the cause of any such higher charges in any event, because the transaction benefits all of MWD's member agencies, as MWD admits. *See* Ex. 32. But, in any event, MWD's purported desire to avoid higher charges is no basis for its

illegal efforts to discourage wheeling. *See Morro Bay*, 81 Cal. App. 4th at 1050.

1. Standards of review under the Wheeling Statutes

a. The Court should decide the questions presented here *de novo*.

As discussed above, the Wheeling Statutes provide that the wheeling agency's factual determinations regarding available capacity and fair compensation must be supported by written findings, which are subject to the "substantial evidence" standard of review. *See* Water Code §§ 1812, 1813. MWD has never made such factual determinations, much less supported them with the requisite written findings. Thus, there is nothing to review for "substantial evidence" under section 1813.

Rather, the questions presented here under the Wheeling Statutes are predominantly legal, and therefore subject to *de novo* review. *See, e.g., W. States Petroleum Assn. v. Bd. of Equalization*, 57 Cal. 4th 401, 415-16 (2013) ("*Western States II*"); *Yamaha Corp. of Am. v. State Bd. of Equalization*, 19 Cal. 4th 1, 8 (1998); *20th Century Ins. Co. v. Garamendi*, 8 Cal. 4th 216, 271 (1994); *Rank*, 51 Cal. 3d at 11-12. For example, a central question here is whether "fair compensation" for wheeling includes SWP supply costs and the Water Stewardship Rate, neither of which has anything to do with wheeling. The Court must "apply independent judgment" to this question of statutory interpretation. *Western States II*, 57 Cal. 4th at 416.

Moreover, the Wheeling Statutes expressly provide that "***the court*** shall give due consideration to the purposes and policies of this article," which are "to facilitate the voluntary sale, lease, or exchange of water or water rights in order to promote efficient use." Water Code § 1813 (emphasis added); Stats. 1986, ch. 918, § 1(d). This requirement of independent judicial consideration of whether MWD's wheeling rates are consistent with "the purposes and policies" of the Wheeling Statutes cannot be satisfied by deferring to MWD. On the contrary, it is well established that the Court must decide such questions *de novo*. As the California Supreme Court held in *Garamendi*, whether "rate regulations" are consistent with the authorizing statute "and with the law generally" is "examined independently." 8 Cal. 4th at 271-72; *see also Western States II*, 57 Cal. 4th at 415 ("[W]hen an implementing regulation is challenged on the ground that it is in conflict with the statute or does not lay within the lawmaking authority delegated by

the Legislature, the issue of statutory construction is a question of law on which a court exercises independent judgment.") (citations and quotation marks omitted); *accord Yamaha*, 19 Cal. 4th at 11 n.2 (the standard is "respectful nondeference") (citation and quotation marks omitted).[12]

The prior wheeling case further confirms that the Court should decide the issues presented here independently because MWD neither made the factual determinations required under section 1812, nor supported them with written findings as required under section 1813. In the previous case, the Court of Appeal held that MWD may establish "a fixed rate for wheeling by member agencies in advance of a particular transaction," but "***need only modify the fixed rate as applied to a proposed wheeling transaction after considering any necessitated power costs, treatment costs, replacement costs, or offsetting benefits***." *MWD v. IID*, 80 Cal. App. 4th at 1434 (emphasis added). In other words, nothing prevents MWD from interpreting the Wheeling Statutes in advance, but the validity of MWD's interpretation "presents a question of law" for the Court to decide independently. *Id.* at 1423. The "substantial evidence" standard then comes into play only to the extent MWD has made factual determinations "as applied to a proposed wheeling transaction"—which it never has. *See id.* at 1434; Water Code §§ 1812, 1813. In particular, MWD has never made written findings regarding the "offsetting benefits" of wheeling water to San Diego from Imperial Valley, other than the one it attempted to conceal—that all of its member agencies benefit from that transaction by at least $65 per acre-foot. *See* Ex. 32.

MWD likewise is not entitled to "quasi-legislative" deference under the Wheeling Statutes because those statutes do not grant MWD the authority to make new law—only to interpret the law and make factual determinations about particular transactions. *See id.*; *Western States II*, 57 Cal. 4th at 415. Agencies act in a "quasi-legislative" capacity where they are "granted such

[12] Numerous cases have invalidated regulations and other agency actions as inconsistent with California law, based on non-deferential *de novo* review. *See, e.g.*, *Morris v. Williams*, 67 Cal. 2d 733, 737, 748 (1967); *Rank*, 51 Cal. 3d at 21; *Matteo v. California State Dep't of Motor Vehicles*, 209 Cal. App. 4th 624, 631 (2012); *Aguiar v. Super. Ct.*, 170 Cal. App. 4th 313, 331 (2009); *Slocum v. State Bd. of Equalization*, 134 Cal. App. 4th 969, 976 (2005); *Kaiser Found. Health Plan, Inc. v. Zingale*, 99 Cal. App. 4th 1018, 1028 (2002); *Communities for a Better Env't v. California Res. Agency*, 103 Cal. App. 4th 98, 109-14 (2002); *State Farm Mut. Auto. Ins. Co. v. Quackenbush*, 77 Cal. App. 4th 65, 71 n.2 (1999); *Home Depot, U.S.A., Inc. v. Contractors' State License Bd.*, 41 Cal. App. 4th 1592, 1559-1607 (1996).

substantive rulemaking power" that they "are truly 'making law.'" *Yamaha*, 19 Cal. 4th at 10. But where an agency is interpreting existing law, as MWD has done here, that "does not implicate the exercise of a delegated lawmaking power," and is therefore "not binding or necessarily even authoritative"—particularly where (as here) the interpretation is simply the agency's "litigating position." *Id.* at 8-11 (citations and quotation marks omitted). Again, MWD has no authority to "make law" with respect to wheeling; it is only given the authority to make initial factual determinations, as an interested party to a particular wheeling transaction, subject to review by this Court for substantial evidence and, independently, for consistency with the purposes and policies of the Wheeling Statutes. Water Code §§ 1812, 1813; *see also, e.g.*, *Envtl. Prot. Info. Ctr. v. Dep't of Forestry & Fire Prot.*, 43 Cal. App. 4th 1011, 1023 (1996) ("When the Legislature has so directly and in such detail dealt with the subject of what [an agency] may do," the agency cannot "materially broaden" its authority "by regulation.").

MWD never exercised the limited authority it was granted by the Legislature to make specific factual determinations supported by written findings. Instead, it continues to rely on decisions it made "in advance of a particular transaction." *MWD v. IID*, 80 Cal. App. 4th at 1434. Lacking any authority to make its own wheeling laws, MWD's "advance" decisions are necessarily either interpretive or *ultra vires*—MWD is either interpreting the Wheeling Statutes, or purporting to make its own wheeling laws without the authority to do so. Either way, MWD is not entitled to deference. *See Western States II*, 57 Cal. 4th at 415-16; *Yamaha*, 19 Cal. 4th at 6-15. The Court should decide San Diego's claims under the Wheeling Statutes *de novo*. *See id.*

b. MWD mischaracterizes the "substantial evidence" standard because it has no truly substantial evidence for its invalid rates.

To the extent the "substantial evidence" standard of section 1813 applies, despite MWD's failure to make factual determinations supported by written findings, that standard is not nearly as deferential as MWD contends. MWD has suggested that the "substantial evidence" standard is the same as the "arbitrary and capricious" standard that applies to quasi-legislative acts establishing a rule for "all future cases." *Mountain Def. League v. Bd. of Supervisors*, 65 Cal. App. 3d 723, 729 (1977). MWD is wrong.

"Substantial evidence" is a "more stringent standard" that typically applies to "quasi-judicial action"—*i.e.*, "the determination of specific rights under existing law with regard to a specific fact situation." *Id.* It is unsurprising that the Wheeling Statutes incorporate this standard because when the words "substantial evidence" first appeared in the legislative history, the "fair market value" of wheeling services was to be set by the SWRCB in a quasi-judicial proceeding. *See* Ex. 79 at LH00055. And under the Wheeling Statutes as ultimately enacted, the agency is supposed to make the initial determination of "fair compensation" on a case-by-case, quasi-judicial, basis. *See* Water Code §§ 1812, 1813. This is true even if the agency makes some decisions in advance, because it still must "modify the fixed rate as applied to a proposed wheeling transaction after considering any necessitated power costs, treatment costs, replacement costs, or offsetting benefits." *MWD v. IID*, 80 Cal. App. 4th at 1434. Even if, as MWD contends, it may simply ignore this crucial second step—which it cannot, *see id.*—MWD admits that proceedings under section 1813 are often quasi-judicial in nature. *See* Ex. 81 (MWD Writ Reply) at 23. Indeed, its Administrative Code expressly provides that it will make the determination of whether there is unused capacity "on a case-by-case basis in response to particular requests for wheeling." Ex. 84 (MWD Admin. Code) § 4405(a).

There is no indication that "substantial evidence" means one thing for supposed quasi-legislative wheeling decisions and another for the quasi-judicial wheeling determinations MWD is actually authorized to make. On the contrary, the "substantial evidence" standard is the same "regardless of whether those findings are quasi-adjudicative or quasi-legislative." *Sierra Club v. Contra Costa Cnty.*, 10 Cal. App. 4th 1212, 1223 (1992);[13] *see also Mountain Def. League*, 65 Cal. App. 3d at 729 (where more than one standard may apply to an agency's determination, "review of that determination must be by the more stringent standard"); *accord City of Carmel-By-The-Sea v. Bd. of Supervisors*, 183 Cal. App. 3d 229, 239 (1986); *William S. Hart Union High Sch. Dist. v. Reg'l Planning Com.*, 226 Cal. App. 3d 1612, 1626 (1991).

Indeed, to the extent "substantial evidence" may have a unique interpretation under the

[13] This case was partly disapproved on other grounds not relevant here by *Voices of the Wetlands v. State Water Res. Control Bd.*, 52 Cal. 4th 499, 529 (2011).

Wheeling Statutes, the legislative history shows that this standard should be applied more stringently than usual—not less so, as MWD erroneously contends. As discussed above, the Legislature originally proposed that wheeling rates should be set by the impartial SWRCB. At MWD's insistence, however, the Wheeling Statutes were amended to allow MWD to determine "fair compensation" for itself in the first instance. It is, therefore, particularly inappropriate for MWD to ask for "complete deference," because its own "self-interest is at stake." *Valdes v. Cory*, 139 Cal. App. 3d 773, 790 (1983) (citation and quotation marks omitted). Further, as the California Supreme Court recognized in *California Hotel & Motel Assn. v. Indus. Welfare Com.*, 25 Cal. 3d 200, 213 (1979), "good judges customarily tread lightly when they are impressed with the care, conscientiousness, and balance of the administrators, but they penetrate more deeply, sometimes even substituting judgment, when the administrative performance seems to them to have been slovenly." *Id.* at 213 n.28 (citation and quotation marks omitted). An agency certainly is not entitled to deference where, as here, it is both self-interested ***and*** fails to make the written findings that are prerequisite to the Court's review for "substantial evidence." *See id.* at 209-16.

In any case, it is well established that the "substantial evidence" test is not a rubber stamp, as MWD has argued. Evidence is not "substantial" unless it is "of ponderable legal significance ... reasonable in nature, credible, and of solid value." *Ofsevit v. Trustees of Cal. State Univ. & Colleges*, 21 Cal. 3d 763, 773 (1978) (citations omitted); *accord, e.g.*,; *Lucas Valley Homeowners Assn. v. Cnty. of Marin*, 233 Cal. App. 3d 130, 142 (1991). "Substantial evidence is not synonymous with 'any' evidence. Instead, it is 'substantial' proof of the essentials which the law requires." *Roddenberry v. Roddenberry*, 44 Cal. App. 4th 634, 651 (1996) (citations and ellipses omitted). For example, the opinion of an expert "constitutes substantial evidence only if based on conclusions or assumptions supported by evidence in the record. Opinion testimony which is conjectural or speculative cannot rise to the dignity of substantial evidence." *Id.* (quotation marks omitted); *see also, e.g., Hongsathavij v. Queen of Angels/Hollywood Presbyterian Med. Ctr.*, 62 Cal. App. 4th 1123, 1137 (1998).

Whether the evidence on which an agency decision was based is "substantial" can only be determined in light of other relevant evidence, "including evidence that fairly detracts from the

evidence supporting the agency's decision." *Cnty. of San Diego v. Assessment Appeals Bd. No. 2*, 148 Cal. App. 3d 548, 554 (1983). Cases suggesting otherwise are "outmoded," and have been disapproved by the California Supreme Court. *Id.* at 554 n.4 (citing *LeVesque v. Workmen's Comp. App. Bd.*, 1 Cal. 3d 627, 637 (1970)); *see also, e.g., Cal. Youth Auth. v. State Pers. Bd.*, 104 Cal. App. 4th 575, 586 (2002). Deciding whether evidence is "substantial" thus necessarily "involves some weighing of the evidence to fairly estimate its worth." *Cnty. of San Diego*, 148 Cal. App. 3d at 555; *accord San Diego Unified Sch. Dist. v. Comm'n on Prof'l Competence*, 214 Cal. App. 4th 1120, 1146 (2013); *Cate v. California State Pers. Bd.*, 204 Cal. App. 4th 270, 281 (2012).[14]

2. MWD has the burden of proof under the Wheeling Statutes.

Because, as discussed above, this case presents legal questions for the Court to decide based on its independent judgment, the concept of "burden of proof" is of limited relevance. *See, e.g., Universal Elecs. Inc. v. United States*, 112 F.3d 488, 492 n.3 (Fed. Cir. 1997) ("Strictly speaking, it may not be proper to refer to 'burden of proof' in reference to the resolution of a question of law.") (citation and quotation marks omitted). To the extent the burden of proof is relevant, however, it should be assigned to MWD.

As discussed above, *Beaumont* stated the generally applicable rule that a water district has the burden of proof that its charges are fairly allocated and do not exceed the reasonable cost of the service provided because, otherwise, the agency "would gain a litigational advantage by ***not*** undertaking, or at least not recording, any effort to relate the cost of the service to the fee charged.

[14] *Western States I*, on which MWD has relied as its mantra, is not to the contrary. There, the Court observed that, in reviewing agency determinations about environmental impacts, a "court's task is not to weigh conflicting evidence and determine who has the better argument." 9 Cal. 4th at 574 (quotation marks omitted). But that does not imply that the Court does not weigh the evidence at all. On the contrary, part of the "established legal meaning" of "substantial evidence," which *Western States I* incorporated, *id.* at 574, is that there must be "some weighing of the evidence" or the word "substantial" would be meaningless. *Cnty. of San Diego*, 148 Cal. App. 3d at 555. The point in *Western States I* was simply that if an agency decision is supported by substantial evidence, the court should not discard that evidence in favor of extra-record evidence that the agency did not have. The question in *Western States I*—whether the Court may consider extra-record evidence—has already been decided here ***against MWD***. Indeed, MWD admitted long ago, in seeking writ relief of this Court's order granting discovery, that "[a]ll further trial court proceedings will assume the inapplicability of *Western States [I]* to the Wheeling Statute." Ex. 81 (MWD Writ Reply) at 2-3.

Such a perversion of process was surely not intended by the voters or the Legislature." *Beaumont*, 165 Cal. App. 3d at 235-36 (emphasis in original). Likewise, the court in *Oildale* held that "policy and fairness" dictate that the water district must carry the burden of proving that its charges do not exceed the reasonable cost of the service provided. *Oildale*, 215 Cal. App. 3d at 1634. And the court in *Barratt* held that this rule is not limited to the constitutional requirements at issue in *Beamont* and *Oildale*, but applies to statutory requirements as well. *See Barratt*, 150 Cal. App. 4th at 437-38. These cases follow the well-established rule that "[w]here the evidence necessary to establish a fact essential to a claim lies peculiarly within the knowledge and competence of one of the parties, that party has the burden of going forward with the evidence on the issue although it is not the party asserting the claim." *Morris*, 67 Cal. 2d at 760. The defendants have the burden where, as here, "only defendants could explain" how their action allegedly complies with statutory requirements. *Id.*

This rule applies with at least as much force in the context of the Wheeling Statutes, which not only limit "fair compensation" to the "the reasonable charges incurred," but place the burden on MWD to establish that amount "in a reasonable manner consistent with the requirements of law to facilitate the voluntary sale, lease, or exchange of water and … support its determinations by written findings." Water Code §§ 1811, 1813. The result of MWD's failure to provide such findings cannot be to transfer the burden of proof to San Diego. On the contrary, only MWD could explain how its rates recover no more than fair compensation and facilitate wheeling. Thus, the burden on this issue is MWD's. *See Morris*, 67 Cal. 2d at 760.

3. The evidence the Court should consider under the Wheeling Statutes.

The Wheeling Statutes mandate that "the court shall consider all relevant evidence, and the court shall give due consideration to the purposes and policies of this article." Water Code § 1813. MWD argued at the outset of this case that "all relevant evidence" means only what it has unilaterally selected for its purported "administrative record." This Court rejected that argument, MWD filed a writ petition, and the Court of Appeal denied it. *See* Ex.80 (Jan. 6, 2012 Tr.) at 5:16-28; Ex. 82. It should now be well beyond dispute that when the Legislature directed that "the court ***shall*** consider ***all*** relevant evidence," it meant exactly that. Water Code § 1813

(emphases added). All of the evidence San Diego summarizes here and includes in its Appendix is relevant. Thus, the Wheeling Statutes mandate that the Court consider it, giving due consideration to the express public policy of encouraging wheeling. *See id.*

As MWD's own record shows, its decision to include in its wheeling rate SWP charges and other costs that are unrelated to wheeling has its roots in MWD's misunderstanding of section 1810(d), which provides that "use of a water conveyance facility is to be made without injuring any legal user of water." Water Code § 1810(d). MWD interpreted this to prohibit increases in rates and charges to its non-wheeling member agencies that might result if MWD charged only for the actual cost of wheeling—admittedly not because of the wheeling itself, but because non-wheeling member agencies would, as the law requires, be required to pay "costs commensurate with their use of the system." Ex. 31 at 2, 7; *see also*, *e.g.*, Ex. 7 at 2. As shown above, however, that language was never intended to preclude increases to the rates and charges paid by non-wheeling customers, and certainly does not preclude allocating costs commensurate with member agencies' use of MWD's system. Rather, it "refers to the loss of appropriation rights owned by the transferor by reason of the transfer," Ex. 29 at 5-18, and was added to address Inyo County's concerns that it might lose its water rights and suffer damages as a result of water transfers. *See* Ex. 79 at LH00307, LH00314. Furthermore, the court in *Morro Bay* held that increases in the rates and charges paid by non-wheeling customers are ***not*** "injuries" within the meaning of section 1810(d). There, the defendant city attempted to justify its refusal to wheel water for the plaintiff "based on the rate increase it claims its other customers will have to bear if it loses the school district as a customer." *Morro Bay*, 81 Cal. App. 4th at 1050. But the court rejected that argument: "we do not believe the loss of income from a customer is the sort of injury to a legal user of water the Legislature had in mind.… Although loss of a customer can cause financial difficulties, it does not amount to an injury." *Id.* Because "erroneous legal advice" lies at the root of MWD's wheeling rate, it is invalid. *William S. Hart Union High Sch. Dist. v. Reg'l Planning Com.*, 226 Cal. App. 3d 1612, 1627 (1991).

Further, MWD's experts, and those hired by Los Angeles and MWDOC, have repeatedly put it on notice that "it is virtually unthinkable that there is any remotely acceptable wheeling rate

that could in fact be imposed that would hold MWD and the other agencies harmless"—i.e., that would "avoid any rate escalation for 'non-wheeling' member agencies." Ex. 28 at MWDPRA10104; *see also* Ex. 5 at 5-2-3, 5-6; Ex. 29 at 6-5, 7-4. MWD's own "Evaluation Matrix" showed that San Diego's "Commitments" proposal was the only one that would facilitate wheeling while also satisfying all of the other criteria for a valid wheeling rate. *See* Ex. 31 at 7. This was not true, however, of either the "equivalent margin method" or the "fully distributed cost" method—which MWD admits is "probably closest to what is done now." *Id.*; Ex. 75 (Thomas Depo.) at 176:7-8; *see also* Answer ¶ 4 (current rate structure is only "slightly modified" from the "equivalent margin method"). Like the defendant in *Palmdale*, MWD rejected what was admittedly the legal option—San Diego's proposal to obtain commitments from each member agency "to pay for fixed costs commensurate with their use of the system" (Ex. 31 at 2, 7)—in order to preserve "rate stability" for the majority of its members. *Palmdale*, 198 Cal. App. 4th at 938. MWD's wheeling rate, therefore, is invalid. *See id.*

MWD cannot defend its current rates by arguing that it no longer employs the "equivalent margin method" and does not exactly use the "fully distributed cost" method. It has conceded that its current rate structure is admittedly "close" to the latter and only "slightly modified" from the former. *See* Ex. 75 (Thomas Depo.) at 176:7-8; Answer ¶ 4. Moreover, MWD still purports to justify its rates on the basis that "[i]f Metropolitan's rate structure were reorganized in the manner SDCWA now claims it should be—in other words, to exempt all SWP costs, as well as the Water Stewardship Rate, from the rates charged on all water conveyed through Metropolitan's system – other rates and charges would have been higher in the future for all member agencies." Answer ¶ 8. That is exactly the reasoning the court rejected as inconsistent with the Wheeling Statutes in *Morro Bay*, and is equivalent to the "rate stability" justification the court rejected in *Palmdale*. *See Morro Bay*, 81 Cal. App. 4th at 1050 (defendant cannot avoid setting a wheeling rate that facilitates wheeling "based on the rate increase it claims its other customers will have to bear"); *Palmdale*, 198 Cal. App. 4th at 938 ("rate stability" is not a justification for rates that exceed cost of service). The bottom line is that MWD could have rate stability ***and*** a lawful wheeling rate but it chooses not to do so in order to continue illegally shifting the burden of the

costs it incurs for some other member agencies onto San Diego. *See, e.g.*, Ex. 31 at 2, 7.

Raftelis also opined—because MWD expressly told him to—that it is appropriate to allocate SWP costs to transportation because "DWR invoices in a very detailed manner that allows MWD staff to functionalize costs." Ex. 14 at 7; Ex. 57. As discussed above, this contradicts Raftelis's own textbook, the NARUC accounting system he purports to follow, the 1969 and RMI studies, and established industry practice. *See* Ex. 3 at 1-1; Ex. 5 at 5-2-3, 5-6; Ex. 14A at MWDRECORD011375-82; Ex. 17 at 3; Ex. 18 at MWDRECORD2012_016161; Ex. 24 at 96; Ex. 25 at 159; Ex. 68 at 168-69; Ex. 69 at 140; Ex. 71 Nos. 44-47. It also goes against common sense. The nature of a buyer's costs does not change with the amount of detail the seller provides on an invoice. A bill from a car mechanic, for example, might simply give the total, or might provide more detailed entries for parts and labor. But the nature of the expense from the car owner's perspective is the same either way—the mechanic's labor certainly does not become the car owner's labor simply because it is listed as labor on the invoice. Raftelis's unsupported and conclusory assertion to the contrary "cannot rise to the dignity of substantial evidence," *Roddenberry*, 44 Cal. App. 4th at 651, especially given that, as MWD ***admits***, it is nothing more than MWD's own "litigating position." *Yamaha*, 19 Cal. 4th at 9; *see* Ex. 57; Oct. 13, 2013 Joint Statement at 1-7.

All of the evidence summarized in Section III.A.3.a, above, and attached to San Diego's Appendix, is relevant and therefore admissible under the Wheeling Statutes. *See* Water Code § 1813. The Court also should consider the testimony indicated in Section III.A.3.b, above. *See id.* Based on all of the evidence, as well as the Wheeling Statutes' requirement that MWD's wheeling rate must facilitate wheeling, which it admittedly does not, the Court should invalidate MWD's wheeling rate.

D. Government Code Sections 54999.7(a) and 66013

Government Code section 54999.7 provides that the rates and charges one public agency imposes on another for public utility service "shall not exceed the reasonable cost of providing the public utility service." Gov't Code § 54999.7(a). While MWD has suggested in the past that it might dispute the applicability of this provision, it has never actually done so in any of its many

challenges to San Diego's pleadings—neither by demurrer, nor motion for judgment on the pleadings, nor motion to strike, nor motion for summary adjudication. MWD had good reason to abandon its argument that section 54999.7(a) does not apply here—on its face, it does apply. MWD and San Diego are both public agencies. MWD charges San Diego rates and charges for a "public utility service." It may not, therefore, impose fees that "exceed the reasonable cost" of providing that service. *Id.*

Similarly, Government Code section 66013 provides, "[n]otwithstanding any other provision of law, when a local agency imposes fees for water connections or sewer connections, or imposes capacity charges, those fees or charges shall not exceed the estimated reasonable cost of providing the service for which the fee or charge is imposed," unless approved by a popular two-thirds vote. Gov't Code § 66013. As with section 54999.7, MWD has never demurred or filed any other motion on the basis that section 66013 does not apply here. Moreover, the court in *Regents of University of California v. East Bay Municipal Utility District*, 130 Cal. App. 4th 1361 (2005), held that fees subject to Government Code section 54999 *et seq.* are also "subject to section 66013." *Id.* at 1379 (declining to follow *Rincon*'s reasoning that section 66013 does not apply to water rates). MWD cannot avoid the requirements of section 66013 simply because it has "'buried' as ordinary user charges what should have been designated as capital facilities fees." *Id.* (quoting *Utility Cost Management v. Indian Wells County Water Dist.*, 26 Cal. 4th 1185, 1198 (2001)). That is what MWD has done—in particular with respect to its Water Stewardship Rate, which is a tax for capital improvements improperly disguised as a water transportation rate, as discussed above.

Government Code sections 54999.7 and 66013 are both intended to limit the fees and charges that agencies such as MWD can impose. *See Indian Wells*, 26 Cal. 4th at 1191. As the court held in *Barratt*, the burden is on MWD to prove that its fees and charges fall within these statutory limits. The issue in *Barratt* was whether fees charged by Orange County complied with the Mitigation Fee Act, which includes section 66013. The trial court held that Orange County had the burden of proof and appointed an expert to assist in determining "'the propriety, reasonableness and necessity" of the costs and fees at issue. 150 Cal. App. 4th at 427-28. The

expert found that the County did not provide sufficient support for some of its costs. The trial court agreed; held that the County did not carry its burden of proof; and ordered the County to reduce its fees. *See id.* at 428-30. On appeal, the County argued that the trial court violated the separation of powers, but the Court of Appeal disagreed: "judicial inquiry into the 'reasonableness and necessity' of fee expenditures is legislatively sanctioned and does not violate the separation of powers doctrine." *Id.* at 437. The trial court rightly placed the burden of proof on the County because it was in a better position to know what its costs were and how to defend them as reasonable. *Id.* at 437-38. Because the County failed to do so, the trial court properly ordered it to reduce its fees. *See id.*

Likewise, here, MWD has the burden to prove that its fees and charges do not exceed the cost of the services provided. *See id.* at 437-38; Gov't Code §§ 54999.7(a), 66013. The Court should apply the *de novo* standard of review in deciding whether MWD carried that burden—particularly because, as discussed above, this case is not about factual findings MWD has made that might be entitled to deference, but broader legal questions such as whether MWD may include unrelated SWP costs and Water Stewardship taxes in its wheeling rate. These questions must be "examined independently." *Garamendi*, 8 Cal. 4th at 271-72. In exercising its independent judgment, this Court is not bound by MWD's inadequate and self-serving record, any more than the trial court was in *Barratt*. *See* 150 Cal. App. 4th at 427-29, 436-38.

E. The MWD Act

Under MWD's enabling statute, the MWD Act, it must set rates that "shall be uniform for like classes of service throughout the district." Water Code § 109-134. MWD admits that its Exchange Agreement with San Diego created a "new class of service." Ex. 27; *see also* Ex. 33 at 1. MWD, therefore, cannot simply impose the same rates on San Diego in the name of "uniformity," but must adopt rates that are "reasonable and nondiscriminatory," *id.*, and take the new class of service fairly into account. *See* Water Code § 109-134. Instead, MWD discriminates against San Diego (and other wheelers) by including in its wheeling rate SWP costs and Water Stewardship costs that have nothing to do with wheeling. MWD's goal, as always, is to charge San Diego a wheeling rate that is as close as possible to the full rate it charges its other

member agencies for water supply as well as transportation—even though San Diego has separately purchased a water supply from the Imperial Valley, and MWD is only providing wheeling services. The result is the opposite of uniformity and fairness: San Diego pays disproportionately and unjustifiably high rates, subsidizing the water-supply rates of MWD's other member agencies.

Here, again, whether MWD's rates "are consistent with" the requirement of uniformity for like classes of service is "examined independently." *Garamendi*, 8 Cal. 4th at 271. Because the Court decides this legal question *de novo*, the concept of burden of proof is inapposite. But to the extent the burden of proof is relevant, it should be MWD's. *See*, *e.g.*, *Morris*, 67 Cal. 2d at 760. And even if the standard of review were whether MWD's rates are "arbitrary and capricious," and even if San Diego had the burden of proof, MWD cannot limit the Court's review to its purported "administrative record." MWD's self-serving "record" improperly excludes "earlier studies, reviews and reports, made at the expense of time and money in response to the [agency's] mandate." *Santa Cruz*, 76 Cal. App. 3d at 392; *see also Tiburon*, 180 Cal. App. 4th at 1076; *Rivera*, 265 Cal. App. 2d at 589; *Williams*, 4 Cal. App. 3d at 811. For example, MWD excludes from its purported "record" the 1999 Raftelis report that supposedly provided the justification for its rates. That report undoubtedly should be part of the administrative record for both cases. *See id.*; Ex. 74 (Van Den Berg Depo.) at 35:14-65:7. Yet is clear why MWD has omitted it: far from justifying MWD's rates, it shows that they are arbitrary and capricious.

Raftelis states that "all or at least a portion of" the costs of subsidizing local water conservation efforts should be accounted for "as supply costs because these investments have been made to forego or defer other more expensive investments in the development of additional imported water supplies." Ex. 36 at 14. Nevertheless, he recommended assigning half of these costs to "transportation" charges, but conceded that the proper approach would be to conduct a cost-of-service analysis "to determine how the local project defers or eliminates investments in additional transmission and or treatment capacity or supply yield." *Id.* at 104. Raftelis's proposal to allocate half of the water-stewardship costs to transportation was arbitrary and capricious because it admittedly was "taken without reference to relevant information." *Apte v. Regents of*

Univ. of Cal., 198 Cal. App. 3d 1084, 1099 (1988); *see also, e.g.*, *Madonna v. Cnty. of San Luis Obispo*, 39 Cal. App. 3d 57, 61 (1974) (simply splitting the difference between two possibilities is arbitrary and capricious). But MWD's approach is even worse—indeed, it is aptly described as ***arbitrary and malicious***. In order to maximize its wheeling rate, MWD includes ***100%*** of its Water Stewardship Rate, ignoring Raftelis's admission that all, or at least some, of those costs should be allocated to supply and thus left out of the wheeling rate.

The fact that MWD has excluded the 1999 Raftelis Report—which is the purported basis for its "rate structure," Ex. 74 (Van Den Berg Depo.) at 35:14-65:7—from its so-called "administrative record" is proof that MWD's record contravenes the "indispensable condition of fairness." *Rivera*, 265 Cal. App. 2d at 589. Accordingly, the Court should disregard MWD's effort to hide the true record of its decisions and should consider all of the documentary evidence described above and attached to the Appendix, as well as witness testimony as outlined above. *See* III.A.3.b, *supra*.

F. California Common Law

Under California common law, MWD cannot charge rates that unreasonably discriminate against a customer or class of customers. *See Hansen v. City of San Buenaventura*, 42 Cal. 3d 1172, 1181 (1986); *Cnty. of Inyo v. Pub. Utilities Com.*, 26 Cal. 3d 154, 159 n.4 (1980); *Elliott v. City of Pac. Grove*, 54 Cal. App. 3d 53, 59 (1975). The common law generally gave the plaintiff the burden to "show that the discrimination is not based on 'cost of service or some other reasonable basis.'" *Hansen*, 42 Cal. 3d at 1181 (quoting *Inyo*, 26 Cal. 3d at 159 n.4). As discussed above, however, the burden can and should be shifted to MWD here. *See, e.g.*, *Morris*, 67 Cal. 2d at 760. And, as demonstrated above, MWD cannot limit the Court's review to its self-serving and incomplete "administrative record." *See, e.g.*, *Western States I*, 9 Cal. 4th at 575 n.5; *Santa Cruz*, 76 Cal. App. 3d at 392; *Tiburon*, 180 Cal. App. 4th at 1076; *Rivera*, 265 Cal. App. 2d at 589; *Williams*, 4 Cal. App. 3d at 811.

In any event, even if San Diego has the burden of proof, and even if the Court were to look no further than MWD's supposed "administrative record" and its binding admissions about that record, the Court should invalidate MWD's rates. MWD has admitted that its record does

not contain, and MWD has never tried to develop, any cost-of-service basis for its discriminatory inclusion of non-wheeling costs in its wheeling rate. *See* Exs. 71-73; Answer ¶ 8. What MWD's record does contain is MWD's admission that its wheeling rate is "excessive" because it "includes costs not incurred to provide wheeling service," including "fixed SWP costs." Ex. 5 at 5-2-3, 5-6. Those costs should be allocated to "Water Supply and Purchases of Water," not to transportation and the wheeling rate. Ex.3 at 1-2, 3-3. Likewise, the Water Stewardship Rate should not be charged to the wheeling rate because, according to MWD itself, the programs it funds "provide benefits in the form of increased water supplies," and thus "should be treated as supply related costs." *Id.* at 3-6; *see also id.* at 4-9. That is San Diego's case in a nutshell, and it is right there in MWD's so-called record, in statements by MWD's own experts. *See* Exs. 3, 5. MWD's unreasonably discriminatory rates violate California common law and should be invalidated. *See, e.g., Inyo,* 26 Cal. 3d at 159 n.4.

G. MWD's "Rate Structure Integrity" Clause

MWD's so-called "Rate Structure Integrity" or "RSI" Clause is illegal and unenforceable as a matter of law, as San Diego demonstrated in its pending motion for summary adjudication of its fifth cause of action. The RSI Clause allows MWD to cut off access to subsidy benefits that MWD funds with its illegal "Water Stewardship Rate" tax if a member agency challenges MWD's illegal rates. Since San Diego filed the 2010 Case challenging MWD's rates, MWD has enforced the RSI Clause against San Diego to deny it subsidies funded by the Water Stewardship Rate. The RSI Clause is illegal on the undisputed facts both because it is an unconstitutional condition on public benefits that MWD provides, and because it violates California Civil Code section 1668 by seeking to prospectively immunize MWD from liability for illegal rate-making.

San Diego's RSI Clause claims are subject to the default rules under the California Evidence Code, with all relevant evidence admissible at trial. The Court should evaluate San Diego's challenges to the RSI Clause *de novo* because they present constitutional and statutory questions over which MWD can claim no administrative authority, and no right to any deference from the courts. The courts are the "ultimate arbiters" of constitutional and statutory interpretation. *Rank,* 51 Cal. 3d at 11. Accordingly, although challenges to unconstitutional

conditions on government benefits naturally require review of public agencies' actions, courts decide the constitutional merits of such claims using their own independent judgment, with no deference to the agencies' decisions (and no limitation to any administrative record). *See, e.g.*, *Parrish v. Civil Serv. Comm'n of Alameda Cty.*, 66 Cal. 2d 260, 265 (1967); *Bagley v. Wash. Twp. Hosp. Dist.*, 65 Cal. 2d 499, 505 (1966).

Far from receiving any deference, MWD bears a "heavy burden" of justifying the RSI clause's burden on San Diego's rights to free speech and petition the courts. *See Parrish*, 66 Cal. 2d at 265. MWD must prove that "(1) the condition reasonably relates to the purposes of the legislation which confers the benefit; (2) the value accruing to the public from imposition of the condition manifestly outweighs any resulting impairment of the constitutional right; and (3) there are no available alternative means that could maintain the integrity of the benefits program without severely restricting a constitutional right." *Robbins v. Superior Court*, 38 Cal. 3d 199, 213 (1985). As explained in San Diego's motion for summary adjudication, MWD cannot carry this burden, because the undisputed facts make clear that the RSI Clause's purpose and function was to burden San Diego's petitioning and free-speech rights by penalizing challenges to MWD's rates. The material facts relevant to San Diego's challenge under Civil Code § 1668 are equally undisputed, and the Court can and should decide that claim as a matter of law as well.

San Diego's summary adjudication motion sets forth the key evidence relevant to the RSI Clause claims. That evidence includes MWD documents reflecting the RSI Clause's history, its illegal purpose and scope, and its enforcement against San Diego, as well as testimony by MWD and San Diego witnesses on those issues. If the Court grants San Diego's motion, of course, no evidence on this issue will be necessary at trial. Otherwise, San Diego will present the types of evidence submitted with its summary adjudication motion (which San Diego incorporates here by reference). If it is necessary to present evidence on the RSI Clause issues, San Diego intends to call one witness to testify as to MWD's imposition and enforcement of the Rate Structure integrity clause, and the impact on San Diego of MWD's cancellation of local water-supply and conservation projects in San Diego's service area, and may present the testimony of MWD witnesses, as appropriate.

H. Preferential Rights

Even MWD concedes that San Diego's claim for declaratory relief regarding calculation of its preferential rights is subject to the default rules under the California Evidence Code, with all relevant evidence admissible at trial. The relevant standard is section 135 of the MWD Act, which gives each MWD member agency preferential rights calculated according to

> the same ratio to all of the water supply of the district as the total accumulation of amounts paid by such agency to the district on tax assessments and otherwise, ***excepting purchase of water***, toward the capital cost and operating expense of the district's works shall bear to the total payments received by the district on account of tax assessments and otherwise, ***excepting purchase of water***, toward such capital cost and operating expense.

MWD Act § 135 (emphases added). MWD miscalculates San Diego's preferential rights by treating MWD's admitted charges for conveyance of water purchased by San Diego from third parties as payments for the "purchase of water." *Id.*

MWD has a pending summary adjudication motion on this claim, which is baseless and which San Diego will oppose next month. As the Court will hear in San Diego's opposition, nothing in the prior lawsuit between MWD and San Diego addressed MWD's unbundled wheeling rate or San Diego's payments under the Exchange Agreement. Moreover, MWD and its member agencies routinely "invoke" agencies' preferential rights by relying on and referring to preferential rights allotments in setting water policy, including conservation targets and imported water purchases.

San Diego intends to call one witness to testify about how San Diego and other member agencies rely on their preferential rights to water and how they are relevant to other policies within, and actions by MWD. The same witness will testify about the extent of MWD's miscalculation of San Diego's preferential rights—*i.e.*, how San Diego's allocation of water would increase if MWD were to lawfully calculate San Diego's preferential rights—and how that miscalculation affects San Diego's policy decisions and other expenditures.

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IV. CONCLUSION

For the foregoing reasons, and as San Diego will prove at trial, the Court should invalidate MWD's unlawful rates, RSI Clause, and preferential-rights calculation.

Dated: October 18, 2013

KEKER & VAN NEST LLP

/s/ Dan Jackson

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SAN DIEGO COUNTY WATER AUTHORITY

PROOF OF SERVICE BY ELECTRONIC TRANSMISSION AND EMAIL VIA PDF FILE

I am employed in the City and County of San Francisco, State of California in the office of a member of the bar of this court at whose direction the following service was made. I am over the age of eighteen years and not a party to the within action. My business address is Keker & Van Nest LLP, 633 Battery Street, San Francisco, CA 94111-1809.

On October 18, 2013, I served the following documents described as:

SAN DIEGO'S FIRST PRETRIAL BRIEF

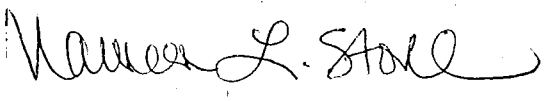
by serving a true copy of the above-described documents in the following manner:

BY LEXIS NEXIS® FILE & SERVE

On the date executed below, I electronically served the documents via Lexis Nexis® File & Serve described as on the recipients designated on the Transaction Receipt located on the via Lexis Nexis® File & Serve website.

Executed on October 18, 2013, at San Francisco, California.

I declare under penalty of perjury under the laws of the State of California that the above is true and correct.



Maureen L. Stone