LESLIE E. DEVANEY
ANITA M. NOONE
LESLIE J. GIRARD
SUSAN M. HEATH
GAEL B. STRACK
ASSISTANT CITY ATTORNEYS

KELLY J. SALT
DEPUTY CITY ATTORNEY

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

Casey Gwinn
CITY ATTORNEY

CIVIL DIVISION
1200 THIRD AVENUE, SUITE 1100
SAN DIEGO, CALIFORNIA 92101-4100
TELEPHONE (619) 533-5800
FAX (619) 533-5856

MEMORANDUM OF LAW

DATE: January 18, 2001

TO: William Hanley, Deputy Director, Metropolitan Wastewater Department, Contracts and Services Division

FROM: City Attorney

SUBJECT: Potable Water Capacity Charges for Blending Water for South Bay Water Reclamation Plant

QUESTION PRESENTED

Is the Metropolitan Wastewater Department [MWWD] required to pay the Water Department a capacity charge for a new potable water connection at the South Bay Water Reclamation Plant [SBWRP]?

SHORT ANSWER

Yes. State law, the San Diego Municipal Code, and bond covenants require that the MWWD pay a capacity charge to the Water Department for a new or an additional potable water connection at the SBWRP.

BACKGROUND

In July 1988, the United States of America, acting through the Department of Justice and the United States Environmental Agency [EPA], and the State of California filed suit against the City. The suit alleged: (1) violations of the Clean Water Act, the City's National Pollutant Discharge Elimination System [NPDES] permit; (2) sewer overflows; and (3) alleged irregularities in the City's industrial waste pretreatment program. After years of litigation, the City, the EPA, and the Sierra Club (an intervenor in the litigation) settled all outstanding disputes and claims regarding the alleged violations. In September 1996, the parties presented a Final Order to the United States District Court that resolved all of the outstanding disputes and claims for relief. The United States District Court approved and entered the Final Order on June 6, 1997.

During the period in which the City was in litigation on these issues, the City sought legislative relief pertaining to alleged violations of the Clean Water Act and the City's NPDES permit. In October 1994, the Clean Water Act was amended to specifically permit the City to apply for a waiver of secondary treatment requirements from the EPA under certain conditions. One of the conditions is that the City implement a wastewater reclamation program that would achieve a system capacity of forty-five million gallons a day [MGD] of reclaimed wastewater by January 1, 2010. 33 U.S.C. § 1311(j)(5)(B)(i). The MWWD constructed the SBWRP in order to meet a portion of this obligation.

In the course of constructing the SBWRP, the MWWD determined that a demineralization facility would not be necessary at the plant in order to produce a saleable reclaimed water product.[1] Instead, the department decided to have a three MGD potable water connection made at the SBWRP. The purpose of this connection would be to deliver potable water to the plant to blend with the tertiary effluent and thereby dilute the TDS level of the tertiary effluent.

When the MWWD requested the new potable water connection at the SBWRP, the department was informed that a water capacity charge would have to be paid for the new connection. This memorandum addresses the legal requirements for the payment of the water capacity charge.

ANALYSIS

I

San Diego Municipal Code and State Law Provisions

A capacity charge is a one-time charge for a new, additional, or larger connection to the City's water or sewer systems.[2] The charge is imposed for both the right to connect to the existing systems as well as the need to provide for existing and new facilities that will benefit the property being connected.

San Diego Municipal Code section 67.72 provides that a capacity charge "shall be paid when any person, firm, corporation or other entity shall request a new water connection or in any way cause an increase in the water usage by the addition of any type of dwelling, commercial or industrial unit." This charge is due and payable at the time the building permit fees or water connection fees are paid. This code section fully comports with the California statutory provisions governing capacity charges.

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[1]In order for the reclaimed water to be a saleable product, the total dissolved solids [TDS] level of the reclaimed water must be less than 1,000 mg/l. A demineralization facility is used to reduce the TDS of tertiary effluent to the requisite levels.

[2]This memorandum will only address water capacity charges.

California Government Code section 66013 authorizes local agencies to impose capacity charges and establishes the parameters for setting the rates. California Government Code section 66013 provides:

> (a) Notwithstanding 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 . . . .
>
> . . .
>
> (b)(3) "Capacity charge" means a charge for facilities in existence at the time a charge is imposed or charges for new facilities to be constructed in the future that are of benefit to the person or property being charged.

This and other related provisions of the Government Code (*see* Cal. Gov't Code § 66001) ensure that capacity charges are reasonably related to the cost of constructing the capital improvements directly benefitting a property connecting to the system. In the City, capacity charges are established from time to time, taking into account the capital improvement projects necessary for the system to meet the demands of all users of the water system. Each property connecting to the water system receives the direct benefit of those system improvements. Payment of capacity charges guarantees that the property will have a certain amount of capacity in and use of the water conveyance, treatment, and delivery systems. *Dawson v. Town of Los Altos Hills*, 16 Cal. 3d 676, 689 (1976).

By accepting a capacity charge, the Water Department has reserved capacity in and has made a legal commitment to provide the necessary facilities for conveyance, treatment, and delivery to the property. Inherent in this commitment are the necessary preparatory tasks of engineering, designing, and constructing the facilities required to make the capacity available. *Carlton Santee Corp. v. Padre Dam Mun. Water Dist.*, 120 Cal. App. 3d 14, 25 (1981). The costs of these preparatory tasks are then used to determine the capacity charge rates to ensure that the capacity charges are reasonably related to the benefits accruing to the property for which a capacity charge is paid.

To the extent the Water Department waives a capacity charge for the MWWD, the water capacity charges of other ratepayers are vulnerable to challenge. In such an instance, the ratepayers are paying for the incremental engineering, design, and construction costs necessary for providing capacity in the water system for the MWWD. Arguably, their capacity charges therefore are not reasonably related to the cost of providing them water service.

Representatives of the MWWD have suggested that since the SBWRP will be producing reclaimed water there will be, in effect, a concomitant reduction in demand for potable or raw water. The potable water used for blending at the SBWRP, they argue, actually results in a net reduction in demand for potable water. They further argue that since the SBWRP potable water connection

does not impact the water system, existing facilities will not be affected nor will new facilities need to be constructed in order to meet the capacity needs of the SBWRP connection. Thus, they conclude, they should not have to pay a capacity charge.

This argument fails on several grounds. First, the initial customer base being pursued for the sale of the reclaimed water from the SBWRP is the Otay Water District. The City does not provide potable water to the Otay Water District. Consequently there is potentially very little potable water being replaced in the City's potable water system by the reclaimed water being produced at the plant.

Second, as discussed above, capacity charges are based upon the incremental engineering, design, and construction costs necessary to provide the service to the water customer's property. The potable water distribution system in the planning area of the SBWRP was not designed to deliver an additional three MGD of potable water to the SBWRP. An additional distribution system will need to be designed and constructed to provide this capacity of potable water. That is precisely the purpose for which capacity charges are collected.

Finally, based upon discussions between the Water Department and the MWWD, it would appear that as the amount of reclaimed water produced at the SBWRP increases, there will be a commensurate increase in the delivery of potable water to the plant. The potable water delivery system must be designed based on peak flows to the plant and cannot take into account a potential reduction for potable water elsewhere in the system. This would suggest that the entire engineering, design, and construction costs are reasonably related to the capacity charge for the three MGD in conformance with state law.

II

Bond Covenants

In addition to the San Diego Municipal Code and state law mandates, a waiver of capacity charges is prohibited under existing bond covenants. In 1998 the San Diego Facilities and Equipment Leasing Corporation [Corporation] issued $385,000,000 in certificates of participation denominated Certificates of Undivided Interest (In Installment Payments Payable from Net System Revenues of the Water Utility Fund of the City of San Diego, California) Series 1998 [the Bonds]. In conjunction with the issuance of the Bonds, the City and the Corporation entered into a Master Installment Purchase Agreement. Pursuant to the Master Installment Purchase Agreement, the Corporation agreed to sell components of the project financed with the Bonds to the City. In turn, the City agreed to purchase the project components by making periodic payments ("installments"). The payments are designed to be sufficient to pay debt service on the Bonds.

In order to assure there are sufficient revenues to pay the debt service on the Bonds, the Master Installment Purchase Agreement contains express restrictions on the use of all Water

Department revenues. Foremost of these bond covenants is Section 6.15 of the Master Installment Purchase Agreement, which mandates that no part of the water system may be provided free of charge. Specifically, Section 6.15 provides:

> To the extent permitted by law, the City will not permit any part of the Water System or any facility thereof to be used or taken advantage of free of charge by any authority, firm or person, or by any public agency (including the United States of America, the State of California and any city, county, district, political subdivision, public authority or agency thereof).

Master Installment Purchase Agreement by and between the City of San Diego and the San Diego Facilities and Equipment Leasing Corporation, § 6.15 (August 1, 1998).

The import of this provision is that the Water Department does not have the discretion to determine when it may or may not collect a fee or charge from a water customer for the use of its system. It has covenanted to do so in all instances, regardless of who the customer is or the purpose for which the water will be used. The failure of the department to protect the interests of the bondholders in assuring that there are sufficient revenues to make the debt service on the Bonds constitutes a breach of this covenant and may have serious legal implications for the department.

In the instant case, the MWWD is no different than any other water customer. The MWWD desires to have an additional three MGD of potable water capacity in the water system. In order to order to connect to the water system and receive this additional capacity, San Diego Municipal Code section 67.72 requires that the MWWD pay a capacity charge. Section 6.15 of the Master Installment Purchase Agreement mandates that the Water Department collect the capacity charge from the MWWD.

CONCLUSION

The MWWD must pay the required capacity charge. Pursuant to San Diego Municipal Code section 67.72, any person who desires to make a new connection or enlarge their current potable water connection must pay a capacity charge. In addition, capacity charges must be reasonably related to the cost of providing the service to the water customer. To the extent that the Water Department waives capacity charges for customers, such as the MWWD, the City's capacity charge rate structure is vulnerable to challenge as not being reasonably related to the cost of providing the service to other customers.

Finally, the Water Department is required to collect the charge pursuant to bond covenants. Section 6.15 of the Master Installment Purchase Agreement for the Bonds requires that the City collect all rates and charges and prohibits the use of the water system free of charge.

The Water Department does not have any discretion in waiving this bond covenant as it applies to the collection of a capacity charge from the MWWD.

CASEY GWINN, City Attorney

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By
Kelly J. Salt
Deputy City Attorney

KJS:mb:pev:(x043.2)
cc: Larry Gardner, Director, Water Department
Ted Bromfield, Deputy City Attorney
Marsi Steirer, Deputy Director, Water Policy, Finance and Planning Division
Mary Vattimo, Deputy Director, Financing Services
Dennis Kahlie, Utilities Finance Administrator
Christine Ruess, Senior Financial Analyst
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