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Fitch: Mixed Outcome in Southern California Water Rate Litigation.

Fitch Ratings-Austin-26 June 2017: On June 21, in a decision that Fitch Ratings found to be credit-neutral, the California Court of Appeal gave both parties reason to claim victory in its decision on litigation between the Metropolitan Water District of Southern California (Metropolitan, rated 'AA+' /Stable) and the largest of its 26 member agencies, the San Diego County Water Authority (CWA, rated 'AA+' /Stable). The court ruled in favor of the CWA on most points, but the ruling favored Metropolitan on the core financial aspect of the case. The appellate court affirmed the legality of the aspect of Metropolitan's rate-setting methodology that includes State Water Projects (SWP) costs, reversing the trial court decision of Nov. 2015. We believe the most recent appellate court ruling is credit-neutral for Metropolitan in that the bulk of its transportation rate was found to be appropriate, and credit-neutral for San Diego CWA, since it could receive some relief in the transportation rate that would be credited back to its members. The case is expected to be appealed to the State Supreme Court.

Water Transportation Rate at Heart of the Case

CWA pays water transportation rates to Metropolitan for the movement of imported water CWA purchases from the Imperial Irrigation District. Metropolitan's transportation rate-setting methodology includes SWP charges (charges associated with the 444-mile California aqueduct that moves water from northern California to southern California), which CWA has contested as costs that are more appropriately characterized as water supply costs and not allocable to transportation costs. Based on the 2010 legal filing, CWA asserted that the inclusion of SWP costs resulted in an overcharge of at least \$24.5 million per year and inclusion of the water stewardship rate resulted in a further overcharge of \$5.4 million per year, in comparison to CWA's full payments to Metropolitan of approximately \$328 million in recent typical years.

The trial court, in its 2015 decision, had awarded San Diego CWA \$188.3 million in breach of contract claims to San Diego CWA for rate overcharges (both SWP and water stewardship rate) during the years 2011-2014 plus additional amounts for interest and legal costs. While there is legal precedent that affirms water transportation rate methodology can include system costs broader than just the facilities used to convey specific water supplies in an individual contract, the trial court found Metropolitan's inclusion of the SWP charges improper because the SWP is not directly owned by Metropolitan. However, the appellate court's recent ruling reversed the trial court's determination, finding that the SWP, while not owned by Metropolitan, is an integral component of its water supply system and can be included in the transportation rate.

The remaining points in the litigation on which the appellate court found in favor of the CWA are 1) in regard to the exclusion of Metropolitan's water stewardship rate in its water transportation charge methodology (in agreement with the Nov. 2015 trial court decision); 2) the more generous calculation methodology of CWA's rights to preferential water during a shortage (also in agreement with the trial court decision); and 3) a finding that CWA has standing to challenge an unconstitutional component of Metropolitan's water conservation program contracts that allowed

Metropolitan to cut off conservation program funding to a member that is in active litigation to challenge the Water Stewardship Rate. The trial court had found this aspect of the conservation program to be unconstitutional but determined that CWA lacked the standing to challenge the provision.

Credit Rating Outcomes Expected to be Relatively Neutral

Fitch believes the current credit ratings of Metropolitan and CWA provide sufficient room to incorporate any potential outcomes in the case pending ultimate resolution. Fitch believes Metropolitan is positioned to absorb the costs and required rate restructuring required by the appellate court ruling if it were upheld. This outcome would allow Metropolitan to include SWP costs but exclude the water stewardship rate in its transportation rates and pay certain damages to CWA, assumed to be substantially less than those awarded by the Nov. 2015 trial court decision. The appellate court's decision would lower the transportation rates charged to CWA in the future by removing the water stewardship rate but Metropolitan could recover those lost revenues through an incremental rate increase to other members. Metropolitan's revenue stability will depend on the timeliness of rate restructuring to recover the revenues at issue from other members. Metropolitan's cash reserves were spent down in fiscal 2016 related to the state drought but should recover to more typical robust levels prior to a final decision by the Supreme Court. Reserves could be necessary to provide financial cushion until rate restructuring could be put into place. If a final ruling is instead consistent with the original trial court decision, resulting in a more urgent need for rate restructuring among Metropolitan's members, strong reserves and rapid Board action will become more critical credit considerations.

San Diego CWA's credit quality is unlikely to shift regardless of the outcome, given the upside potential of receiving financial damages and the intent to return any funds directly to customers. If the appellate court ruling is upheld, CWA would receive a smaller portion of the damages being sought but the higher rates have already been paid to Metropolitan and recovered in CWA's own rates charged to its customers. CWA has committed to returning any funds received from the litigation to its customers (net of legal costs). Fitch believes the credit impact would be neutral for San Diego regardless of whether the final ruling includes the large \$188.3 million settlement awarded by the trial court or the smaller amount related only to the water stewardship rate component implied by recent appellate ruling. Future water rates may be higher than what CWA had hoped, but CWA has cautiously assumed a continuation of current rates in its conservative forecast planning and rate methodology.

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