

**City of Modesto
Grand Jury Case # 06-26
2005-2006**

SUMMARY

A complaint was received by the 2005/2006 Stanislaus County Civil Grand Jury (CGJ) from a resident of the unincorporated neighborhood known as the Del Rio community. The complaint concerned alleged violations of Proposition 218, "Right to Vote on Taxes Act" Article XIII C and XIII D, which occurred when the Modesto City Water District (District) established its current water rates implemented in January 2005. The alleged violations included:

1. The notice informing the public of the new rate schedule was inadequate because it did not contain proper notification of the time for a public hearing or a justification for the new rates.
2. The water rate policy of Proposition 218 violated the provision requiring that a parcel be charged only its proportional costs.
3. There was a misuse of funds by using monies collected for uses other than water.
4. The process was not only illegal but unfair to the Del Rio community as that community pays more than other customers in the District.

The CGJ sought to understand the provisions of the law, compare the costs between Del Rio and the rest of the District, and determine, if possible, what was fair and equitable. The CGJ obtained many documents, including a sample comparison between similar-sized lots within the City of Modesto (City) and Del Rio and a table containing all the flat rate and metered customers in the District. The CGJ conducted several interviews.

The CGJ found no evidence that the notification letter was improper with respect to either the time of a public hearing or a justification for the new rates. The CGJ determined that there were many opinions as to how Proposition 218 should be interpreted. The CGJ took no stand on these opinions but left those interpretations to the courts. The CGJ found that since September 19, 1999, all water funds are placed in separate accounts called Enterprise Funds and used exclusively for water.

The CGJ concluded that there is no difference in the rate structure between Del Rio and the rest of the District's customers which are billed on a metered rate. Del Rio does, however, pay more than most customers due to (1) being exclusively metered, (2) having large lots (most of which are greater than 17,000 square feet) and (3) having extensively landscaped properties. The other area that is exclusively metered is the unincorporated area of Grayson, which has comparatively small lots.

The CGJ obtained from the City of Modesto a comparison of ten similar-sized lots (greater than 17,000 square feet) within the City limits and Del Rio. This City report compared the charges of both areas as to the actual metered costs in 2004 and 2005 as well as what the costs would have been in 2004 and 2005 if billed at a flat rate. The City report included the total number of customers in all its jurisdictions, which are on both flat and metered rates.

The sampling of costs with similar-sized lots within the city limits indicate that more than half the bills in the City are lower than they would have been, billed at a flat rate. Most of the City lots are not of the same type of extensively landscaped residential property as Del Rio. The single property, located in the Fleur de Ville subdivision, that matches Del Rio in landscaping also matches in costs. Eight out of the ten city properties are located within areas of the lowest socio-economic sections in Modesto. The amount of landscaping in these areas is generally limited, compared to other areas in Modesto. Based on the small sample obtained, it's possible that with average usage the charges for metered water would be higher than that of a flat rate.

The CGJ made no recommendations for issues concerning the Notification, Proportionality and Use of Funds.

Concerning the issue of Fairness to Del Rio, the CGJ recommends that the Modesto Public Works Department shall:

- Conduct an extensive evaluation of the actual customer cost between metered and flat rates. The study is to compare like properties, including such variables as lot size, similar landscapes, and house size.
- Compare the charges of all presently metered residential parcels as to what the charge would be under a flat rate for the year 2005.

The CGJ recommends that the Modesto City Council:

- Develop an equitable rate schedule including the data obtained in the two comparison studies recommended in the above (1) and (2) with other information gathered from other rate studies. Until such time as all properties are under the same rate plan, an effort should be made to make the present system as equivalent as possible.
- Develop a schedule as to when each area not yet billed as metered will be converted and read as metered. Those customers already metered but not yet read as such shall be converted to metered bills as quickly as possible.

INTRODUCTION

A complaint was received by the 2005-06 CGJ concerning the revised water rates implemented in January 2005 for the District. The complaint asserted that the District violated Proposition 218 when establishing these rates. Alleged violations of the Proposition included:

1. The notice informing the public of the new rate schedule was inadequate because it did not contain proper notification of the time for a public hearing or provide a justification for the new rates.
2. The water rate policy violated the Proposition's provision requiring that a parcel be charged only its proportional costs.
3. There was a misuse of funds by using monies collected for uses other than water.
4. The unincorporated Del Rio community, by being metered, was being charged more than other areas within the District and, in effect, was subsidizing other users. (The District encompasses the City of Modesto and several outlying areas.)

The CGJ attempted to understand Proposition 218, received interpretations from public and private sources, and viewed an opinion of the Supreme Court of California. The CGJ did not attempt to create its own interpretation.

Two issues limit the scope of this investigation:

1. Many of the parties involved in developing the initial report and recommendations that came from that report are no longer involved with the City of Modesto. These include Foresight Consulting, the firm that compiled the water rate study for the City, and former City employees responsible for input into the issue. These former employees include the Public Works Director, City Attorney and Financial Director.
2. The water rates imposed in January 2005 are now under review by the City. A reported shortfall of monies collected under the rate schedule is being investigated by the City of Modesto.

The CGJ investigated the following:

1. Notification of water rates and justification for rates
2. Proportional costs
3. Use of water funds
4. Access to information
5. Flat and metered rate schedules
6. A Comparison of similar-sized lots between Del Rio and Modesto City customers
7. Fairness of Rates to Del Rio
8. Ownership of water system

METHOD OF INVESTIGATION

The CGJ obtained the following documents:

1. Text of Proposition 218 "Right to Vote on Taxes Act"
2. Coupal, Jonathan. "Proposition 218: The Drafter's Statement of Intent." Cal-Tax Digest , February 1997
3. Doering, John P., Assistant County Counsel, Stanislaus County "Proposition 218 Overview," March 14, 2002
4. Reports authorized and prepared for the City of Modesto by Foresight Consulting Services:
 - Final Report, "Water Utility Cost of Service Rate Study," September 3, 2004
 - Appendix E Water Rate Mode Tables, September 3, 2004
5. West & Yost Associates Engineer's Report, "Justification and Cost Allocation for Proposed Water System Improvements," September 2, 2004
6. Letter of notification of the new water rate schedule, (September 2004)
7. List of current number and areas of customers now on metered rate and flat rate schedules
8. Sampling of charges between similar lots within Modesto city limits and Del Rio during 2004 and 2005 calendar years
9. Information regarding lawsuits
 - *Richmond v. Shasta Community Services District* (2004) 32 Cal 4th 409
 - *Bighorn Desert View Water Agency v. Beringson* (July 20, 2004) 120 Cal. App 4th 890 (Supreme Court docket S127525)
10. Letter from Morrison & Foerster, a law firm representing the Del Rio Homeowners Association, November 22, 2004
11. Copies of water bills from a Del Rio customer for 2005
12. State of California " Accounting Standards and Procedures For Counties" section 1.08, b (1)
13. Minutes of the Modesto City Council, March 7, 2006

Persons interviewed:

1. Complainant
2. Director of Public Works Department, City of Modesto
3. Director of Finance Department, City of Modesto
4. Interim attorney for City of Modesto
5. Former attorney for City of Modesto
6. Official from City of Waterford

Meetings attended:

1. Modesto City Council meeting, February 28, 2006
2. Public Rate Review workshop on April 11, 2006, convened by the direction of the Modesto City Council

FINDINGS

Since Proposition 218 was adopted by the voters of California in 1997, issues concerning the breadth and detailed application of Proposition 218 have been questioned. Some public corporations and private citizen organizations (and their attorneys) have chosen how they will apply, understand, and advocate for their interpretation of the Proposition. California courts have reviewed some aspects and legal issues created by Proposition 218. The Supreme Court of California has published at least one decision regarding certain types of charges and water rates that must be developed and approved pursuant to procedures of Proposition 218. As recently as June 7, 2006, the Supreme Court heard oral arguments in another case based on the interpretation of some aspects and application of Proposition 218. The Court will publish its opinion within ninety days. The CGJ did not attempt to create its own interpretation.

1) Notification of Water Rates and Justification for Rates

Del Rio alleged that the notice did not contain proper notification of the time for a public hearing and a justification for the new rates. The CGJ found that the notice contained the following information:

- The District mailed the notice, "Proposed Water Rate Increase and of Public Hearing" to all property owners in the District.
- A public hearing was scheduled for November 23, 2004, for "hearing" public testimony and receiving written protests on the proposed "Water Rate Increase."
- The rate schedule for 2005 and ensuing years was included for both flat rate (by lot size) and metered rates (by size of pipe and usage.)
- The notification stated that the proposed rates would take effect January 1, 2005.
- The notice stated that the increase was needed to fund operation, maintenance, and replacement costs. The improvements were necessary to rehabilitate, upgrade, and replace the existing water distribution system.
- A protest form was included with the notice which gave instructions on where and when to return it.

2) Proportional Costs

Del Rio alleged that the water rate policy violated the Proposition's provision requiring that a parcel be charged only its proportional costs.

Fees collected under the proportional cost provision of Proposition 218, fall into four areas. They include:

- Revenues derived from fees *shall not exceed the funds required to provide the property-related service.* (Article XIII D, §6 (b)(1).)
- Revenues shall not be used for any purpose other than that for which the fee was imposed. (Article XIII D §6 (b)(2).) (b)(3).)
- The amount of a fee imposed may not exceed the proportional cost of the service attributed to the service. (Article XIII D §6 (b)(4).)
- The fee imposed must be for a service used by, or immediately available to the owner in question and not based upon potential or future use of a service. (Article XIII D §6 (b)(4).)

Under sworn testimony, the CGJ determined that it would be impossible to develop any rate schedule if each parcel were charged just what it costs for individual water delivery. As one of Modesto's legal experts testified: "If you had fifty-thousand customers, you'd have fifty-thousand rates, and we don't think the law meant that. It would be impractical and impossible to calculate rates that way."

- The Modesto legal counsel stated the issue of proportionality in the following way: "It's just like getting car insurance or life insurance. It is cheaper for everybody if we are all in a pool. You can spread out the cost. I do not think when they drafted (Proposition) 218 that they thought about that. If you take the argument that Del Rio is entitled to a different rate than Modesto or Grayson, it's the same thing. Then it is a slippery slope and you are going to slide all the way to the bottom where water rates are calculated house by house, street by street."
- The CGJ determined through extensive investigation that there was considerable disagreement between Del Rio's legal council and the City of Modesto's legal counsel as to how each of these sections of the law is to be interpreted and applied. The CGJ did not take a position on these opinions of law. It is up to the courts to make these determinations.

3) Use of Water Funds

As a result of the 1999/2000 Civil Grand Jury Report, water and other funds are no longer being transferred into the general fund. As of September 1999 funds are kept within the Modesto City Water District in separate accounts known as Enterprise Funds. (Enterprise Funds are funds designed for specific uses and are established for accounting purposes. Defined in section 1.08, b. (1) of the State of California "Accounting Standards and Procedures for Counties," May 2003.) According to sworn testimony, these funds are used to provide service to the entire system and designated for the projects as they occur. There is an accumulation of reserve funds within the

Enterprise Fund to pay for capital projects. According to the Foresight Report, the rates should “generate revenue adequate to meet the utility’s operating costs as well as projecting new capital and sources of supply costs.”

- The CGJ determined that the District is accounting for water costs and revenues separately from other non-water related accounts.

4) Access to Information

- The CGJ found that obtaining specific information concerning actual costs of water delivery and cost of usage to specific geographic areas is extremely difficult to obtain from the City. The Del Rio community tried repeatedly to get such information so they could analyze what it cost Modesto to provide water to its area and the rest of the District.
- The CGJ attended one public forum and a City Council meeting and found that, in both instances, specific water delivery cost information justifying the rates is non-existent or vague. Decisions on how to “fix” the schedule or even to determine if there is or is not enough money to run the system cannot be done with any validity when it is so difficult to get detailed financial information. Under sworn testimony, the Chief Financial Officer stated that the city’s financial computer system is not readily able to produce reports that provide detailed financial information on specific costs.
- The City Public Works Department did supply the CGJ with the information requested regarding a list of metered and flat rate properties and a comparison sample of metered customers in Del Rio and the City. The information arrived almost two months after the request was made (one month after due). This delay could be the result of a lack of ease within the system to retrieve such data. An upgraded system would serve the city and the public well, so that essential data from which to determine water rates and other utilities can be readily available.

5) Flat and Metered Rate schedules

The former rate schedule was a three zone system in which residential customers differed in the amount paid, dependent upon which geographical area the customer resided. Zone 3 had the lowest rate, followed by the other two zones. Under the new water rate system, the former three zone system with different rates was replaced by three different rate classifications:

- Residential
- Industrial
- Commercial

All residential areas are billed under one of two rates, depending if their area is metered or on a flat rate. The “blending” of rates, from the previous three zones, equalizes the burden of any one area having to pay more than another area.

- Flat rate schedules are based upon lot size, regardless where the property lies within the District (Appendix 1 for details.)
- A metered rate schedule is based upon the amount of water consumed and is the same for all residential areas within the District (Appendix 1 for details.)
- In December 2005 there were 55,185 customers within the Modesto jurisdiction (City limits) that were either on a flat rate schedule or were metered but billed at a flat rate. In the Modesto jurisdiction 9998 were metered and billed as such.
- Within the areas of the following cities that are served by the Modesto Water District including Ceres, Turlock, and Waterford, as well as the unincorporated areas of Salida, Del Rio, Grayson and Empire, 8103 customers were on flat rate schedule or were metered but billed at a flat rate. Except for Del Rio and Grayson (the only two areas fully metered and billed as such) 2009 customers were metered and billed as such.
- The total number of customers within and outside Modesto which have meters but not currently being read is 17,117. (Appendix 3 for detailed table)

6) A Comparison Of Similar-Sized Lots Between Del Rio and Modesto City Customers (Appendix 4, for details.)

The CGJ obtained from the City of Modesto a comparison of ten similar sized lots (greater than 17, 000 square feet) within the City limits and ten within Del Rio. This City report compared the charges of both areas as to the actual metered costs in 2004 and 2005 as well as what the costs would have been if billed at a flat rate.

- In 2005, for the sampled lots, the yearly range of charges for Del Rio over a flat rate charge was between \$47.88 and \$633.12 with an average difference of \$287.90.
- In 2005, for the sampled lots within the City, the difference compared with flat rates ranged between negative \$248.36 and \$556.17 with an average difference of \$8.12. This was due to six of the ten customers using less water than the average flat rate charge. In viewing the lots, it was noticed that seven lots were not extensively landscaped or watered.

- The one lot comparable to the landscaping of Del Rio was in the Fleur de Ville subdivision and had an increase of \$499.65 more than a flat rate charge in 2005. The consumption of water for the ten Del Rio properties dropped in seven out of ten cases from 2004 to 2005. This drop is consistent with an expert's testimony that overall, when parcels are switched from flat rates to metered rates consumption also drops.
- The average consumption for the ten Del Rio properties in 2005 was 5880 ccf (consumption cubic feet) which translates into 43,392.4 gallons per month or 1466 gallons per day (one cubic foot of water equal 7.48 gallons.)
- The average consumption for the ten Modesto properties in 2005 was 3396.7 ccf which translates into 25,407.4 gallons per month or 846.9 gallons per day.
- In order for the cost of metered water and flat rate to be equivalent, a customer with a lot size greater than 17,000 square feet would consume just over 25,000 gallons per month or an average of 840 gallons per day (2005.)
- Costs were compared for 2005 as the rates were converted in June 2004 from flat rate to metered in the Del Rio area. This resulted in part of the year being on different rate schedules.

7) Fairness of Rates to Del Rio

Del Rio is the only discrete area besides Grayson that is billed as all metered rates. Since Grayson generally has a much smaller lot size resulting in less water usage, the impact for Del Rio being metered is greater than any other single area. As the change from flat rate to metered rate in Del Rio occurred about the same time as an increase in rates it is difficult to separate the effect that each change had upon the charges for water.

- Another issue that impacted Del Rio more than other areas is that Del Rio was in the previous Zone 3 which historically paid less than Zones 1 or 2. The increased costs for Del Rio was exacerbated by being one of the few areas changed to meters, which has a greater impact on larger landscaped lot sizes as more water is consumed.
- The CGJ found no evidence to show that Del Rio was singled out to pay a different rate than any other area with the same parameters (metered large lots.) The claim by Del Rio that they pay up to ten times the cost of someone living in the City does not hold up with the evidence presented by the City. Without a comparison of all properties, both metered and flat rate, this assertion cannot be verified. It is possible that a person could pay ten times more than another if one compared the smallest lot size or least amount of water used with a metered rate on a large lot with an excessive amount of water use. This would appear to be an exception, not the rule. Del Rio does, in general, pay more than most customers due to large lot sizes,

usage and being exclusively metered.

- With the small sample reviewed, it is not possible to accurately predict which system costs the consumers more overall. After looking at most of the properties listed in the sample, the CGJ predicts that a parcel with a well landscaped yard, with normal grass and plants, would cost more under a metered plan. The public has been given no data from the City as to the comparability of the two rates when translated into actual monthly charges.
- In the sample of similar-sized lots, four were in the Modesto High or Mark Twain area, two in the Airport district, one in South Modesto, one in a middle class property, and one in Fleur de Ville. This sample can hardly be representative for all of Modesto. It may well reflect what areas within the City are on metered water with lot sizes of approximately one half acre in size.
- The conversion to metered water as quickly as possible for all areas that have meters but not read would be more equitable for all customers. The conversion would probably be more expensive for most customers, but more reflective of their water usage. There are now over 17,000 customers with unread meters. The City's plan to convert to meters (outside in) (outlying areas first and gradually include inside the city limits) can be seen as unfair to the outlying areas already converted (Del Rio and Grayson.) The evidence comparing the number of meters read between 2004 and 2005 showed very little effort to convert flat rate users to metered users either within the city or in the outlying areas. In Salida, for instance, 59 parcels are on a flat rate, 819 on a metered rate, and 3516 are metered but billed at a flat rate.
- At the March 7, 2006, City Council meeting the Board passed a resolution authorizing \$5,000,000 per year for the installation of water meters. This resolution was passed, without a plan stating which area would have meters installed and when such areas would be read as metered.
- While impractical, considering that all properties within a water district must be eventually metered under state law, the fairest solution is that all residential areas remain on a flat rate until all are converted to a metered rate.
- There is no way to make water rates and charges totally fair. Under a flat rate plan, there is no way to control the amount of usage nor is there an incentive to conserve. Those customers paying under a metered rate appear to be paying more than flat rate customers with similar, well landscaped properties. Those properties with very little landscape or outside watering generally pay less under a metered rate. Paying for usage seems to be the most equitable solution. Ultimately, as previously stated, all properties in California within a water district must be metered.

8) Ownership of Water System

Del Rio and Waterford were offered the opportunity to obtain part of the Del Estes water system from Modesto that previously serviced their area. Waterford, thus far, has been satisfied with Modesto handling the system, but a new subdivision in Waterford has set up its own district which is not associated with Modesto. Del Rio elected not to obtain its own water district from the City. The complainant stated that Del Rio probably could not get the votes from its own residents necessary to obtain the district from Modesto. This was primarily due to the fear of potential costs for future repairs. The former attorney for the City of Modesto testified that the City would have been willing to “give it to them.”

RECOMMENDATIONS

1. Notification of Water Rates and Justification for Rates

No recommendation.

2. Proportional Costs

No recommendation.

3. Use of Water Funds

No recommendation.

4. Access to Information

No recommendation.

5. Flat and Metered Rate Schedules

No recommendation.

6. A Comparison Of Similar-Sized Lots Between Del Rio and Modesto City Customers

No recommendation.

7. Fairness of Rates to Del Rio

The CGJ recommends that the Modesto Public Works Department:

- Conduct an extensive evaluation of the actual customer cost between metered and flat rates. The study is to compare like properties, including such variables as lot size, similar landscapes, and house size.

- Compare the charges of all presently metered residential parcels as to what the charge would be under a flat rate for the year 2005.

The CGJ recommends that the Modesto City Council:

- Develop an equitable rate schedule including the data obtained in the two comparison studies recommended in the above (1) and (2) with other information gathered from other rate studies. Until such time as all properties are under the same rate plan, an effort should be made to make the present system as equivalent as possible.
- Develop a schedule as to when each area not yet billed as metered will be converted and read as metered. Those customers already metered but not yet read as such shall be converted to metered bills as quickly as possible.

8. Ownership of Water System

No recommendation.

This report of the City of Modesto is issued by the 2005-2006 Civil Grand Jury with the exception of two members of this Civil Grand Jury who are residents of Del Rio. These Grand Jurors were excluded from all parts of the investigation, which included interviews, deliberations, and the making and acceptance of this report. This report is based on the information obtained from outside sources with none of the information being obtained from the excluded Grand Jurors.

APPENDIX

1. Notification of Proposed Water Rate Increase
2. Proposition 218, "Right to Vote on Taxes Act" Article XIIC and XIID
3. City of Modesto: List of Jurisdictions and Metered vs Flat Rate Summary
4. City of Modesto "Del Rio Comparison"