

INVESTIGATION

Flaws in the "Thornberg Report"



Apple Valley Citizens for Government Accountability

APPLE VALLEY TAXPAYERS EXPOSE FATAL FLAWS IN PUBLICLY-FUNDED CAMPAIGN “THORNBERG PAPER”

Dr. Christopher Thornberg opposes Prop 13 homeowner property tax protections, and supports unlimited gas tax and vehicle license fee increases. His support for Measure F is inconsistent with Apple Valley Voters and their Values

Executive Summary

- The Town of Apple Valley paid Economist Dr. Christopher Thornberg \$25,000 to "review" the financial ramifications of the water system takeover.
- A simple review of Dr. Thornberg's public statements about important taxpayer issues suggests that his views are the opposite of Apple Valley Taxpayers. Dr. Thornberg is a vocal opponent of Proposition 13, which protects taxpayers from skyrocketing property tax increases. (Source: http://www.caltax.org/homepage/031612_split_roll.html).
- Dr. Thornberg was also a vocal public supporter of the recent gas tax and vehicle license fee increases. To a community like Apple Valley, where many residents must commute to a job, these tax and fee increases will be extremely harmful. (Source: <http://www.dailybulletin.com/opinion/20170428/road-tax-battle-not-over-state-needs-new-ways-to-close-funding-gap-guest-commentary>)
- After reviewing his paper, it appears that Dr. Thornberg was simply asked to comment on the analysis provided by Assistant Town Manager Marc Puckett, including Puckett's criticism of an independent report issued by the Inland Empire's, and high desert's most respected economist, Dr. John Husing.
- As a result, Dr. Thornberg merely repeats, sometimes with little embellishment, long-discredited Town talking points on this issue, and gives credence to statements and allegations by the Town and its representatives. For unknown reasons, Dr. Thornberg discounts or ignores completely any information to the contrary, regardless of how knowledgeable and credible the source.
- Dr. Thornberg concedes (and demonstrates) that he does not understand water operations, the eminent domain valuation process, accounting differences between public and private sector organizations.
- While Dr. Thornberg may be accomplished and well-intentioned, his analysis is nothing more than a desperate attempt to confuse taxpayers into believing that borrowing \$150 million in long term debt and repaying it with interest, while at the same time maintaining reliable quality water service, will not increase water bills.
- There has never been a case where a takeover has resulted in lower water bills as Puckett and Dr. Thornberg suggest.

- The studies by Dr. John Husing, Dr. Rodney T. Smith, and the Apple Valley Blue Ribbon Water Committee have all concluded that water bills will increase substantially should the Town, through Measure F, takeover the water system. These projections are validated by the experience in Felton, CA where residents voted for a takeover. They are repaying \$500 annually to retire the debt, and their water rates have increased by 67 percent.

Introduction

Among other valuable lessons, a classical study of Medieval English literature teaches us that the wisdom of the past easily beats the latest expert opinion. Water ratepayers in Apple Valley can benefit from this insight even if the Town Council, Town staff, and the Town's consultants do not.

Case in point is the recent report to the Town Council by Dr. Christopher Thornberg ("Town of Apple Valley Water Utility Purchase Plan Reviewing the Evidence," May 26, 2017). The Town Council paid Dr. Thornberg for his input because a previous report by economist and consultant Dr. John Husing ("Review of Apple Valley Water Measure," April 12, 2017) showed that water rates could go up by at least \$500 per year if the Town, through Measure F, were to take over the water system.

Dr. Husing reviewed not only the Town's current financial models surrounding this issue, but also the 2011 report to the Town Council by the Blue Ribbon Water Committee, the 2014 report to the Town Council by Urban Futures, the 2017 Analysis by the Analysis Group, and Liberty Utilities annual reports and public financial disclosures made as part of federal and state regulatory mandates. Each of these reports contains dire warnings to the Town Council about the risks of taking over the water system and the costs to residents.

Dr. Thornberg, on the other hand, discounts or ignores completely information from expert sources. Instead, he relies mainly on the Town's current financial model, which is found in a PowerPoint presentation by the Assistant Town Manager for Finance Marc Puckett. Mr. Puckett's career includes many examples of multi-million dollar errors, but Dr. Thornberg makes no mention of this track record. He not only fails to identify the multi-million dollar errors in Mr. Puckett's most recent financial model, he endorses them.

To his credit, Dr. Thornberg acknowledges the severe limitations of the scope of his report, as he writes, "I have been asked to review both the financial models of the Town along with the criticisms leveled at these plans." Without going beyond the work of Mr. Puckett and the Town's financial models, there is no way accurately to assess their validity. Instead, Dr. Thornberg writes that the Town's models appear well done, and are intuitive. This scarcely provides the basis for speculating with tens of millions of taxpayer dollars, let alone hundreds of millions of ratepayer dollars, nor with risking the health of the water system in Apple Valley.

Valuation

In attempting to establish the value of Liberty Utilities, Dr. Thornberg first focuses on the "rate base," by which he comes up with a valuation of around \$50 million. However, he overlooks two critical assets components: Water rights and contributed assets. Thus, the actual rate base valuation should be much higher. Moreover, in an eminent domain proceeding, a court will determine and award the highest value it believes will be paid by a willing seller. A May, 2017 eminent domain judgment for a water system in Ojai, CA set a price of \$11,500 per customer connection. Given this precedent, the price of the Apple Valley water system would be approximately \$237 million, which is consistent with the projection of the Apple Valley Blue Ribbon Water Committee.

Dr. Thornberg ignores the law and precedent and instead attempts to justify a low value based on the number of connections compared to other Park Water systems. This is not a valid approach. Apple Valley has 143 more miles of water mains than Missoula, the overall condition of the Apple Valley system is superior to that of the Missoula system and California valuations are more applicable than a valuation in Montana.

Dr. Thornberg ends the valuation section by criticizing the Blue Ribbon Water Committee's 2011 valuation of \$200 million and states that he doesn't know, "[h]ow such a panel derived this number, and who was on the committee that would actually be qualified to make such an assessment is completely unknown, and as such this hardly seems credible evidence." In fact, the Chair of the Finance Committee of the BRWC is a CPA with a Bachelors from Stanford and a PhD in Applied Economics from UCLA. If Thornberg had read the BRWC report he would have found it to comprehensive and very well searched.

Dr. Thornberg's conclusion is that the court's valuation of the Apple Valley water system will be far below \$150 million, but fails either to explain why the Town is asking for bonding up to that amount, or what the ramifications would be if that amount is needed.

Interest Rates

As with the maximum purchase price, Dr. Thornberg likewise does not go into any of the ramifications of interest rates approaching 12 percent. Yet, this is the maximum interest rate for which the Town requests approval. Should voters pass Measure F, it is the language of the Measure that will control the Town's actions, not the assurances of unaccountable experts. Put another way, if the Town will never need to seek a bond at 12 percent interest, what was the point of asking for voter approval?

The reality is that Measure F specifies that the debt will be issued when an eminent domain trial is concluded, a verdict is reached and a final price is established. Even if Measure F passes, the legal process, as was the case in Claremont, CA, took an additional two years simply for the right to take phase of the trial (where the court rejected arguments identical to those made by Mr. Puckett and Dr. Thornberg). Even if Measure F passes, the soonest bonds would be issued would be in 2019 or 2020. The

suggestion that interest rates will remain the same at that time is either a significant error or a deliberate attempt to mislead voters.

Net Revenues

Net revenues are important because they are an indicator of how much money would be available for capital financing and debt service expenses. Dr. Thornberg notes, "While I am not a CPA, I do have some knowledge in financial statements." It clear, however, that he does not understand the differences in financial reporting between governmental entities and state-regulated private utilities. Thus Dr. Thornberg makes the same basic mistakes previously made by Mr. Puckett misinterpreting Liberty's annual report. He equates net income with positive cash flow, which is a fundamental error that neither should have made. Furthermore, Dr. Thornberg seems not to realize that capital spending made by governments is accounted for as an expense -- unlike in state-regulated private utility -- and attempts to explain away Liberty's explanation to the Town as if Liberty doesn't understand the terminology. In fact, throughout his report Thornberg interchanges government and private utility terminology, never distinguishing between them, and reaches conclusions based on unrelated statements.

Dr. Thornberg also accepts the Town's claims of "up to \$4 million in potential cost savings the Town anticipates from reducing costs for outside vendors and from cutting overhead and executive costs out of the budget," and indicates that even if the Town can save half of the estimate they will simply add to reserves. As proven conclusively in the letter sent by Liberty Utilities to correct this misrepresentation, the Town is claiming cost savings against costs that do not exist.

Dr. Thornberg then echoes the Town's claims that he can't tell if Liberty actually made the capital improvements that they claim. Later, though, Thornberg refers to the very schedules in Liberty's report that show these capital expenditures. Further he questions if capital dollars were actually spent because he sees only a corresponding increase in inter-company liabilities. Debt, and cash reserves for that matter, is carried at the corporate level and that inter-company debt is the same number Mr. Puckett has referred to as inter-company expense.

Dr. Thornberg then claims that depreciation -- a paper expense -- could be used to fund half of the capital spending, and then follows that up without dealing with the other half. An accountant would have started by adding back depreciation, which was apparently done neither by Dr. Thornberg nor Mr. Puckett.

Dr. Thornberg then infers that Liberty Utilities is under-reporting earnings in some manner because if the company was earning as little as Liberty's reports reflect, "they should be absolutely thrilled to part with such a low return asset for such a handsome price." He also comments that Liberty's reports are "are not audited by accounting professionals -- and as such aren't necessarily completely correct." In reality Liberty's financial statements are independently audited every year, unlike the Town's.

Dr. Thornberg even reiterates the Town's false claim that the Town will provide "local control since ratepayers will be electing those who will be overseeing the operation of the utility." In reality, once the Town seizes the water company, there will be no control - local or otherwise -- afforded to voters and ratepayers because the damage will already have been done. Voting out the Town Council doesn't reverse the harm, and there is no evidence that those running the water system for the Town will be subject to a vote.

Dr. Thornberg ends by repeating a simplistic water rate comparison between Liberty and local municipalities with no reference or understanding of the differences in the financing models. If this is, as claimed by Dr. Thornberg, to be the "best evidence" to support the takeover of the water company, then the Town has no evidence to support its quest. This has been explained to the Town Council and staff, but should have been clear to anyone familiar with the issues. Overall, the impression is that Dr. Thornberg has little to no knowledge of the utility industry and did little to no research before writing his report.

Omissions

Neither Mr. Puckett nor Dr. Thornberg include in their financial models the millions in legal, transition, and other costs that exist atop the purchase price. The full costs will be known only in the event that a court awards control of the water company to the Town, but even a loss by the Town will result in tens of millions of dollars of obligations, which somehow must be paid without being able to resort to siphoning off proceeds from the water bond. Taxpayers in Claremont, CA are responsible for \$14 million in legal fees following a judge's rejection of their eminent domain lawsuit. The City of Claremont is appealing this decision, which will add more legal fees and interest on the existing debt. Should their appeal be rejected, taxpayers will likely be on the hook for upwards of \$18-20 million. The City says it will issue Judgement Obligation Bonds to repay this debt, adding even more interest to the cost.

Whether the Town Council does not know about these additional millions or simply does not care, ratepayers and taxpayers alike in Apple Valley should be very concerned about the risks of an already-strained Town budget being overwhelmed by these costs.

Conclusion

As was stated at the beginning of this paper, facts matter and so does historical evidence. Voters will be wise to take the position of four independent research projects, including the Apple Valley Blue Ribbon Water Committee, which conclude that passage of Measure F and an eminent domain takeover will cost residents at least \$500 more every year in new water fees.