



PRIVILEGED AND CONFIDENTIAL DOCUMENT

MEMORANDUM

To: Dolores Salgado, Ardurra
From: PARIS KINCAID WASIEWSKI, LLP
Issue: **Sheep Creek Water Company Water Rights**
Date: February 2, 2022

I. Background

The Sheep Creek Water Company (SCWC) is a mutual benefit water company organized on January 7, 1914. SCWC currently provides municipal water supply to over 3,300 people through approximately 1,200 active connections. Due to drought conditions and water elevation declines, SCWC has experienced falling water production in the recent years. On August 30, 2018, the State Water Resources Control Board (State Board) Division of Drinking Water issued Compliance Order No. 05-13-18R-002 finding that SCWC violated title 22 of the California Code of Regulations section 64554, which requires public water systems to have adequate source capacity to meet the system's highest demand. In an effort to comply with the source capacity requirements and compliance Order No. 05-13-18R-002, SCWC is considering consolidating its system with Phelan Piñon Hills Community Services District (PPHCSD). In light of the consolidation effort, the SCWC system will be subsumed by PPHCSD. This legal memo will discuss the water rights held by SCWC, the ability to market or sell these rights, and whether the SCWC system can be sold in part.

II. Sheep Creek Water Rights

a. SCWC Water System

The SCWC system includes six wells that extract water from Sheep Creek, one supply tunnel located within the El Mirage Basin, two storage tanks, a system of conveyance infrastructure and 43 pressure reducing stations throughout the service area. The supply tunnel, wells, and storage tanks are located on the southeastern slope of the San Gabriel mountains and the system is entirely gravity fed.

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b. Surface Water Rights
Application No. 12-718

On June 12, 1917, SCWC filed application No. 12-718 with the State Water Resources Control Board (State Board) to appropriate 13,300 acre feet per year. The State Board granted certificate 12-5 on September 19, 1918, allowing SCWC until 1921 to put the water to full beneficial use. (D-3383, at 2.) SCWC was not able to complete its system construction and received another extension from the State Board until September 1, 1923. After it was unable to complete construction within this extended time, the State Board required SCWC to file a new application. On March 3, 1924, SCWC filed application 3883 for the diversion of 4,000 acre feet from Sheep Creek. (*Ibid.*)

State Water Board Decision 3883 (D-3883)

On August 24, 1926, the State Board issued SCWC a surface water right to allow the diversion of 3,000 acre feet from Sheep Creek. D-3883 allows SCWC the right to divert surface and sub-surface flows at a maximum rate of 40 cubic feet per second (cfs) to be stored in Horse Canyon Reservoir. The purpose of use is for irrigation from March 1 to September 30. The place of use is the 1,920 acres of the SCWC service area.

1931 Stipulation for Judgment

D-3883 was challenged in *Pacific Southwest Trust and Savings Bank, et al. v. Sheep Creek Water Company*, Riverside Superior Court Case No. 195605. A temporary injunction was granted against SCWC preventing them from constructing or driving a tunnel to a certain point across Sheep Creek Canyon. However, the matter was settled with an agreement between Security-First National Bank of Los Angeles, the County Los Angeles and SCWC (1931 Stipulation).

The 1931 Stipulation generally divided the right to use water and build conveyance systems by location. The 1931 Stipulation allowed SCWC to build conveyance and divert water in the Sheep Creek Valley, stating SCWC was allowed to: construct shafts, drifts, tunnels, ditches, and dams and “do such things as it may deem convenient, necessary, or expedient in the promises to take any all water it may desire from the lands lying and being in San Bernadino County ... and lying generally within that portion of the area of Sheep Creek Valley lying below the point on Sheep Creek designated in the temporary injunction.”

The Security-First National Bank (Bank) agreed to not bore any wells or sink any shafts, tunnels, or other excavations in the specific area around Sheep Creek that would interfere with the flow of any underground waters. Through the 1931 Stipulation, the Bank granted and conveyed an easement and right-of-way to SCWC to construct, operate, and maintain a submerged dam and bulkhead across the channel of Sheep Creek and Sheep Creek Valley. This easement is granted “to have and to hold unto [SCWC], its successors or assigns forever.”

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In turn, the SCWC agreed to waive any and all claims against the Bank and County for any and all use of water by them in the Swarthout Valley and recognized the full ownership of each party's respective water rights within the Swarthout Valley.

SCWC has the "perpetual right to take, divert and use all surface water flowing in Sheep Creek below the confluence of said Sheep Creek with Swarthout Creek and may construct such diversion dams and barriers as shall be necessary to divert the same into a ditch or conduit, and may maintain such ditches and conduits as shall be necessary to divert and carry away such water for use by [SCWC]." However, this right to divert surface water in Sheep Creek is "subsequent and subordinate" to the rights of the Bank and the County.

c. Surface Water Through Subsurface Extractions

Although SCWC extracts water through wells, the extraction amounts to the diversion of surface water, not groundwater. D-3883 specifically recognizes that SCWC has the authority to divert subsurface flows of Sheep Creek through well extraction. It is well-established that water in subterranean streams that flow through known and defined channels is legally categorized as surface water. (*City of Los Angeles v. Pomeroy* (1899) 124 Cal. 597; *North Gualala Water Co. State Water Resources Control Bd.* (2006) 139 Cal.App.4th 1577.) In addition, the State Board only has authority to issue permits and licenses for surface water; it does not have the authority to permit the use of groundwater. For these reasons, D-3883 provides SCWC with a right to divert the surface waters of Sheep Creek.

d. Exposure to Forfeiture

In order to maintain and defend an existing water right, the water right holder must divert water and put it to beneficial use. (Water Code, § 1240.) The failure to put water to its full and beneficial use may subject unexercised water rights to forfeiture. When the person entitled to the use of water fails to use beneficially for a period of five years all or any part of that water, for which a right of use has vested, for the purpose for which it was appropriated or adjudicated, the unused water may revert to the public and will be regarded as unappropriated public water. Forfeiture, however, is not automatic. Rather, forfeiture requires a finding by the State Board following notice to the permittee and a public hearing if one is requested by the permittee. (Water Code, § 1241.)

If failure to put water to use due to water transfers, conservation, or lack of supply will not affect any determination of forfeiture applicable to appropriated water. (Water Code, § 1244.) Therefore, any water that is transferred, conserved or not served due to drought or lack of supply will be counted as fully put to use for the purpose of forfeiture.

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e. Groundwater Rights
Mojave Basin Area Adjudication

In January 2016, Sheep Creek entered into a Stipulation for Intervention and Entry of Judgment with the Mojave Water Agency. SCWC agreed to the 1996 Judgment (Mojave Adjudication) a Base Annual Production Right for SCWC of 0 acre-feet.

This Mojave Adjudication appoints Mojave Water Agency (MWA) as Watermaster of a physical solution to solve groundwater overdraft in the Mojave Basin Area. The physical solution is intended to provide for delivery and equitable distribution of supplemental water, for which MWA must construct conveyance facilities. MWA must exercise its authority to pursue all reasonable sources to secure supplemental water as necessary to fully implement the provisions of the Judgement. MWA must establish fair and equitable prices for the supplemental water.

The Mojave Adjudication is divided into subareas and each party is enjoined and restrained from producing water from the Basin Area except pursuant to the provisions of the physical solution, from recapturing water that has been recharged in the Basin Area, from transporting water outside the Basin Area, and from diverting storm flows.

Antelope Valley Adjudication 28, 2015 Notice of Entry of Judgment

The judgment in the Antelope Valley Area adjudicates the groundwater rights in the Antelope Valley. The judgment decrees a physical solution with a five-member board serving as the Watermaster. Parties listed in Exhibit 4 to the Judgment have overlying production rights. These parties have the right to extract groundwater, on an annual basis, up to their overlying production right. SCWC is listed in Exhibit 4 but is shown to have an overlying production right of zero.

SCWC only has a single well, Well No. 10 in the Antelope Basin Area. Well No. 10 has a pumping right of 0 afy. The judgment also states that nothing in the judgment affects preexisting banking projects and lists SCWC as having one of those projects. However, SCWC has never developed a banking project in the Antelope Basin Area.

III. Water Rights are Vested Property Rights

a. Background

California has long recognized the right to divert water as a vested property right, subject to ownership and disposition, similar to other private property. (*Eddy v. Simpson* (1853) 3 Cal. 251; *Irwin v. Phillips* (1855) 5 Cal. 140, 146; *Tartar v. Spring Creek Co.* (1855) 5 Cal. 395, 398; *Conger v. Weaver* (1856) 6 Cal. 548, 557; *Hoffman v. Stone*, 7 Cal. 49; *Maeris v. Bicknell*, 7

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Cal. 262; *Hill v. King*, 8 Cal. 336; *Kimball v. Gearhart*, 12 Cal. 47; *Ortman v. Dixon*, 13 Cal. 38; *Kidd v. Laird*, 15 Cal. 180; *Rupley v. Welch*, 23 Cal. 455.) Therefore, water rights may be characterized as real or personal property for purposes of its sale. Water, in its natural state, whether in streams, lakes, or ponds, or in percolation through the soil, is part of the land. Water becomes personal property only when severed from the realty. This means that once the right to divert water is exercised, the water becomes saleable personal property. (*Copeland v. Fairview Land Etc. Co.* (1913) 165 Cal. 148, 154.)

b. Water Transfers

A water right holder has the right to sell water diverted pursuant its own right without affecting the underlying right to divert water. Such a sale of water, but not rights, is often referred to as a water transfer. The transfer must be within the confines of the existing right or (for post-1914 rights) parties must obtain a change petition from the State Board to allow transferred water to be used outside the confines of the existing right. For example, if the water transferred were to be used outside the defined place of use of the existing right and the water being transferred was post-1914 water, the State Board would need to approve a change petition to allow the use of the water outside the place of use. For pre-1914 rights, no State Board permission is needed, but such a transfer must not injure legal users to water.

c. Sale of a Water System

The sale of a water rights as part of a water system is different than the transfer of water. The transfer of water under an existing right does not change ownership of the right, only of the corpus of water. By contrast, the sale of a water rights system changes ownership of the right to divert water, along with the supporting conveyance and infrastructure. In addition, this sale may include land that includes the point of diversion and storage and conveyance structures.

There are cases that involve the purchase or condemnation of a private or mutually held water company. These cases hold that the water rights and the system used to serve the rights are connected and cannot be separated for purposes of acquisition. For example, in *San Bernardino Valley Municipal Water Dist. V. Meeks & Daley Water Co.* (1964) 226 Cal.App.2d 216, the court reviewed the condemnation of a privately held water company by a municipal water district. There were several issues in this matter, including whether notice of condemnation was properly provided. The water company facilities were located in more than one county and the court had to determine what the condemnation included. In so doing, the court held that a water right and the system used to exercise the right must be considered parts of the same property. Specifically, the court held that “in condemning the water rights of defendants, is required to also condemn the distribution system” and that a “water right is more than right to divert water” but instead

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the “right does not exist without the use.” (*San Bernardino*, at 220.) This suggests that any acquisition of SCWC would need to include all parts of the whole system and cannot be broken out into to allow the purchase of only selected pieces.

Further, to the extent that acquisition of one component of a water system would render another component without utility or value, any condemnation proceeding would require payment for both the components acquired and those rendered without use. For example, in *City of San Jose v. Great Oaks Water Co.* (1987) 192 Cal.App.3d 1005, the court held that when the City of San Jose built out a water system that rendered a portion of the Great Oaks water system useless, Great Oaks was “entitled to all the compensation and benefits appropriate” from the “diminution of value and damage to these preexisting facilities caused by the City’s duplication of water service.” (*Id.*, at 1013.) Therefore, even if it were possible to purchase only components or portions of the SCWC water system, any component of the system that such an acquisition rendered useless would be subject to compensation.

d. Continued Service

Several cases discuss the responsibility to continue to provide water after the acquisition of a water system. These cases are clear: when a municipal system takes over a mutual or privately held water system, the obligation to provide service to the shareholders remains. (*San Bernardino*, at 222.) However, the service of providing water would be in the context of water provided to a municipal customer – after the acquisition of the water system, the water service would not longer be through rights as a shareholder. *San Bernardino* states that the interests of the shareholder and the water system are different and should not be confused. (*Id.*, at 223.) Continuing to provide water service to the shareholder/customer, does not affect the need to acquire the assets of the water system or water company. (*Id.*; *Stratford Irrigation Dist. v. Empire Water Co.* (1943) 58 Cal.App.2d 616; *Lindsay-Strathmore Irr Dist. v. Wutchumma Water Co.* 111 Cal.App. 688; *Bent v. Second Extension Water Co.* (1921) 51 Cal.App. 648.) Therefore, in these cases, the acquisition of the water system was not discounted or otherwise changed due to the obligation for continued service.

IV. Conclusion

SCWC has a valid surface water right to divert 3,000 acre feet from Sheep Creek. This right has been tested through litigation and affirmed. The right is not likely vulnerable to forfeiture, due to any reductions have been due to transfer, reduced supply, and/or conservation.

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SCWC has existing options to access groundwater through two adjudications, but it does not have an adjudicated groundwater right apart from these options to purchase groundwater. Existing infrastructure to exercise these options includes Well No. 10 and Well No. 11.

SCWC may transfer water while continuing to hold the water right.

SCWC may sell its water rights, along with its system of supporting conveyance and infrastructure system, lands, and other real property. Acquisition of a water system includes all parts of the system and acquisition of only a portion or certain parts of the system is not likely to survive scrutiny, because the parts are not severable. There may be an obligation of continued service of water to SCWC shareholders. However, this obligation does not affect the acquisition of the water system and/or water rights.