



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

December 13, 2013

Director Michael T. Hogan
Director Keith Lewinger
Director Vincent Mudd
Director Fern Steiner
San Diego County Water Authority
4677 Overland Avenue
San Diego, CA 92123

Dear Directors:

Your letter dated December 9, 2013 regarding Board Letter 8-1

This letter responds to your comments on Draft Appendix A dated November 25, 2013 of the Official Statement for Metropolitan's Water Revenue Refunding Bonds, 2011 Series A-1/A-3 and 2009 Series A-2, attached to Board Letter 8-1. Chairman Foley asked me to respond to your letter.

General Comments

Your "General Comments" find inconsistent statements between the Official Statement (in this case, the draft Remarketing Statement presented to the Board for review and authorization to finalize, execute and distribute) and court pleadings in the Water Authority's challenge of Metropolitan's rates. The documents are readily reconciled. Metropolitan's offering statements are limited to information about the bonds being offered and their security and source of payment to potential investors. As you know, Metropolitan's pleadings respond to the Water Authority's allegations and legal claims irrespective of the allegations' and claims' materiality to the bonds, their security or their repayment. Given the difference in context and purpose, one would not expect the documents to be mirror images of one another. The statements in each, however, are made in good faith and Metropolitan stands behind them.

The example from page A-54¹, disclosure that you have questioned before, states Metropolitan's expectation that rates and charges would still recover Metropolitan's cost of service if changes are required in response to court rulings. Although the components of the rate structure may change, the rates still will be set to recover anticipated costs of service and meet the revenue requirement. The Board could adjust Metropolitan's costs as well and set rates to recover reduced costs of service. Aggregate revenues still will be set to recover anticipated costs of service, a requirement that would not be affected. We will clarify this statement in Appendix A.

The destabilizing effect of the rate litigation on planning and individual projects from uncertainty about rate structure components exists because any court ruling related to Metropolitan's rates could require reconsideration and modification of rate components and costs. As correctly stated in paragraph 30 of Mr. Upadhyay's declaration that you provided as Attachment 1 to your comment letter, "Even if MWD's overall revenues would not be affected by a challenge to MWD's Existing Rate Structure, that does not mean that a challenge to MWD's Existing Rate Structure would not affect the revenues allocated to any particular program or service" Statements in Metropolitan's court pleadings that recognize this are factual and do not need to be reconciled with the Appendix A statement about Metropolitan's aggregate revenues.

You also generally criticize Metropolitan's financial policies, such as adoption of approaches other than the take-or-pay contracts advocated by the Water Authority. The Board-established financial policies are reviewed periodically and will be reviewed again as the next biennial budget is presented to the Board for consideration, beginning in January. Take-or-pay contracts are one alternative but not the one chosen by the Board in Metropolitan's current rate structure, and not the only means by which member agencies may commit to pay for Metropolitan's programs. The unfounded statement in your letter, that Metropolitan and its member agencies are going to "extraordinary lengths" to impede development of local water supplies in San Diego, disregards the cooperative efforts by Metropolitan and its member agencies to encourage local supply development within the region and ignores Metropolitan's documented support for the Carlsbad seawater desalination project.

Comments on Draft Appendix A dated November 25, 2013

A-1 Uniform rates for each of class of service. Appendix A states that, "member agencies request water from Metropolitan...and pay for such water at uniform rates established by the Board for each class of service" (emphasis added). This is the only place in Appendix A where the words, "class of service" are used. Please confirm whether the water "categories" described at A-57-58 are the "classes of service" referred to in the recital at page A-1.

¹ References to page numbers are to the marked November 25, 2013 draft, showing changes from the May 31 draft.

Yes, Page A-52 of the blackline states: “Metropolitan has provided three classes of water service: (1) full service; (2) replenishment (discontinued effective December 31, 2012); and (3) interim agricultural (discontinued effective December 31, 2012). See “—Classes of Water Service” below.”

A-6 Standby or “dry-year peaking” demands of MWD member agencies. Due to the compartmentalization of the disclosures in Appendix A, the reader might fail to associate the withdrawals from storage described in the last paragraph on page A-6 with the Water Authority’s rate litigation; specifically, the issue of MWD’s failure to account for or properly allocate the costs associated with having almost 6 million acre-feet of storage capacity and more than 3.3 million acre-feet of stored water available for withdrawal, which made possible the 300,000-500,000 acre-feet of water supply that MWD expects to draw upon to meet demands in 2013. The long-term negative impacts on MWD from its failure to identify and account for these costs are described in the Blue Ribbon Task Force Report, in the above excerpts and other portions of the Report. Appendix A should be revised to include a full discussion of this issue including potential impacts on MWD sales and rates.

The withdrawals from storage described on A-6 disclose how Metropolitan is meeting member agency demands for supplemental water supplies in 2013, under a 35% State Water Project allocation. This disclosure references the table of water storage capacity and water in storage because these withdrawals will impact the amount of water in storage as of January 1, 2014. It is not associated with the Water Authority’s rate litigation.

A-11 Area of Origin litigation. Please provide us with a copy of the settlement agreement that is “currently being circulated among the parties for signature.”

Attached. There are four settlement agreements, a separate one with each of the four plaintiffs. Appendix A will refer to settlement agreements rather than a single settlement agreement.

A-18 Second supplemental agreement with Coachella. Please provide a copy of the second supplemental agreement with CVWD referred to in the second full paragraph.

Attached.

A-28 Storage capacity and water in storage. What accounts for the reduction in the storage numbers since last reported in May 2013?

Unlike replenishment and withdrawal of water stored in a Metropolitan facility like Diamond Valley Lake, where changes may be calculated immediately, water storage in

non-Metropolitan facilities and accounts may be reconciled throughout the year. Reconciliations resulted in these adjustments.

A-30 Preferential rights and water supply allocation plan. The second full paragraph under Water Supply Allocation Plan should be revised to include disclosure that – except in a water shortage emergency declared by the MWD board under Section 350 of the Water Code (which has never happened), or any other statutory basis MWD may believe would support limitations on the exercise of preferential rights – the MWD board has no statutory authority or ability whatsoever to diminish the statutory preferential right to water held by each of its member agencies. It is highly misleading in the context of current water rates and realities to state that, “historically, these rights have not been used in allocating Metropolitan’s water.” The historical record is clear that the cities of Los Angeles and Long Beach have every intention of calling upon their respective preferential rights to water should it be advantageous for them to do so. The Water Authority does not question these rights, which have also been confirmed by legal opinions of MWD’s General Counsel and the Court of Appeal.

The statement that you question is a correct statement. To date, preferential rights have not been used in allocating Metropolitan’s water. The preferential rights disclosure is included because the statutory right exists and any member agency might exercise its preferential right to purchase water in the future.

A-32 Impact on MWD sales of Los Angeles updates reported in Appendix A. Two significant changes are made to Appendix A regarding the City of Los Angeles. First, that its “favored son” agreement executed by Ron Gastelum without the knowledge or consent of the board of directors, is expected to be completed six years sooner than previously disclosed. Second, that LADWP has reached a “major agreement” regarding future dust control on portions of Owens Lake. Please explain what has changed in the implementation of the AVEK agreement that accounts for the project now being completed before the end of next year (versus 2020 as previously reported in Appendix A). Please explain the impacts on MWD water sales as a result of each of these developments.

This section was updated in consultation with Department of Water and Power staff. Appendix A describes the Los Angeles Aqueduct and local supply sources because these sources of local water affect member agency demands for supplemental supplies from Metropolitan. This section gives DWP staff’s projections of the City’s purchases from Metropolitan under a range of conditions over the next 25 years. Impacts of these developments already are factored into the demand projections.

A-33 Local water supplies. The discussion of local water supplies generally is very confusing because it does not make clear to the reader what supplies are being developed by MWD (or with subsidies from MWD) and which are not. There should also be a discussion here that ties in to

later sections of the Appendix A disclosing the impact on MWD sales from the development of local water supplies by the member agencies (with and without subsidies from MWD).

Sources of local water affect member agency demands for supplemental supplies from Metropolitan, whether the supplies are developed by member agencies or other agencies, with or without funding from Metropolitan. Appendix A describes the factors included in Metropolitan's water sales projections under "MANAGEMENT'S DISCUSSION OF HISTORICAL AND PROJECTED REVENUES AND EXPENDITURES—Water Sales Projections."

A-34 Impact on MWD sales of Carlsbad seawater desalination project. We were unable to confirm whether MWD's future sales projections take into account the 48,000-56,000 acre feet of water supply expected to come on line in 2016. Please identify where that accounting is made.

It is assumed in our projections that SDCWA will only purchase the minimum required under its purchase contract for water from the Carlsbad project. The 48,000 acre feet projected to be purchased by SDCWA from the Carlsbad project represents less than 3% of projected water sales of 1.75MAF in FY 2016-17 and is taken into account. See "MANAGEMENT'S DISCUSSION OF HISTORICAL AND PROJECTED REVENUES AND EXPENDITURES—Water Sales Projections" in Appendix A.

A-35 MWDOC application for MWD subsidies for a seawater desalination project. Please provide us with a copy of the application. Also, please provide an analysis (facts) of the regional benefits MWD believes would support the payment of such subsidies.

This application will be analyzed using the Local Resources Program criteria after this proposed project is fully permitted, consistent with other applications for funding under the Local Resources Program. It will be submitted for Board consideration if it receives necessary permits and passes full staff review. We are providing a copy of the application to you separately. The application was submitted jointly by MWDOC and the Cities of Anaheim, Fullerton, and Santa Ana on October 3, 2013. We will revise Appendix A to state that this is a joint application from these member agencies.

A-42 Discussion of MWD's capital investment plan (CIP) illustrates the need for a long range finance plan and updated cost of service analysis. The short CIP discussion reflects the wild fluctuations as a result of poor estimations by MWD staff of capital spending and the need for pay-as-you-go funding and water rate increases. Every one of these highly inaccurate estimations results in further distortion of MWD's already improper allocation of costs to its member agencies and all MWD ratepayers. It is also unclear – except possibly for litigation purposes – why MWD is claiming that it will spend zero dollars on "supply" over the next five years. Please advise whether the words, "Cost of Service," are used in a rate setting context or, is intended to have some other meaning in this section of the Appendix A. Also, please advise why debt service

for bonds MWD did not issue and does not expect to issue is included in the financial projections.

As stated in this section, the CIP is reviewed and revised periodically and the CIP estimate is updated annually based on the factors listed in this section. Projects can be delayed, redesigned or deferred. Actual expenditures are less than projections because of lower-than-estimated bids, lower progress payments and efforts to optimize project design and scheduling, resulting in significant savings. In contrast, the cost of service study and debt service projections are updated in each budget process. The biennial budget proposal will include an updated cost of service study and revised debt service projections.

A-49 Risk management discussion is incomplete. As stated in multiple prior letters, we remain concerned with the inadequacy of MWD's overall risk disclosure. Many of the issues we have raised have not been addressed in the Appendix A. In particular, we remain concerned that MWD's long range finance plan is materially out of date (last updated in 2004). The draft Appendix A does not disclose that MWD is operating (by choice) without a long range finance plan because, after more than five years of working on it, MWD abandoned the effort (i.e., its member agencies could not agree on a long range finance plan to pay MWD's costs). Nor does MWD (by choice) have water rate projections that take into account and plan for all of MWD's projected costs and liabilities. These costs include, for example, some reasonable estimate of BDCP costs, other water supply programs included in the IRP, facility investments and retiree health. Almost 20-years has passed since the Blue Ribbon Task Force wisely cautioned MWD to develop and implement a plan for its fiscal sustainability; yet today, there remains ***no plan*** for how MWD expects to pay its costs over the long term. MWD's current ad hoc approach to financial planning is neither advisable nor sustainable and its continued spending creates a risk for all of Southern California including all of its bondholders.

This comment is inconsistent with other comments in this letter; see your immediately prior and following comments. Also see the "Risk Factors" discussion in the body of the Remarketing Statement.

Metropolitan's upcoming biennial budget will review financial policies and include a ten-year forecast, rather than the five-year forecast in prior budgets. This long-range forecast will be reviewed every two years as part of each biennial budget, compared to the less-frequent Long-Range Finance Plan updates. This will assure more frequent examination of long-range financial planning.

A-50 MWD's actions in 2013 suspending the tax limitations in the MWD Act were not factually or legally justified. It is ironic that MWD chose to increase taxes (the net economic effect of suspending the limitation) at the same time that it was awash in cash from the over-collection of revenue from Southern California's water ratepayers. In June 2013, when MWD took the action

to suspend the tax limitations, it had already collected \$314 million more than needed to pay 100% of its budgeted expenditures and caused its reserves to exceed maximum reserve level by at least \$75 million (see the Water Authority's June 5, 2013 letter RE Board Memos 8-1 and 8-2). As a matter of fact, additional tax revenue was most assuredly *not* "essential to the fiscal integrity of the district." The MWD board did not and could not make the findings necessary to support the suspension of the tax limitation, and any suggestion that the board considered in any meaningful or substantive way "factors" including the "balancing of proper mechanisms" for funding current and future State Water Project costs is unsupported by the record. If there is any document or record you believe supports this statement in the Appendix A other than the board memo, please provide copies to us in your response to this letter.

The Board's determination to suspend the tax limitation clause of the MWD Act balanced a number of factors, including long-range views of State Water Contract obligations, proper mechanisms for funding them, a balance of revenue sources and a fair distribution of costs across Metropolitan's service area, rather than a short-term view of currently-available revenues. The tax rate set by the Board in August maintained the same tax rate as in the prior fiscal year.

A-51 Wheeling revenues as an MWD "water sale." The Water Authority does not purchase its IID or canal lining water from MWD; it pays MWD to convey the water to San Diego. MWD's representation of these revenues as "water sales" are made for purposes of litigation only and are misleading bondholders, MWD's "disclosures" in the footnotes to its Summary of Receipts by Source notwithstanding.

Metropolitan consistently lists revenues from its volumetric water rate components as water sales in its Summary of Receipts by Source table, and has done so since inception of the Exchange Agreement in 2003. This is consistent with the master resolution for Metropolitan's water revenue bonds, which pledges all water rate revenues to repay the water revenue bonds. Further, the Exchange Agreement is not a wheeling agreement or a conveyance agreement. In order to provide complete disclosure, footnote 2 points out that water wheeling and exchange revenues are included in the "Water Sales" category in the table and refers to the section where wheeling and exchange revenues are separately quantified.

A-52 Member agency purchase orders. The description of member agency purchase orders is misleading because it suggests that MWD's member agencies have made firm commitments to purchase water from MWD in the future when they have not. See discussion of this issue in prior letters commenting on the Appendix A.

See responses dated May 22, 2013, February 19, 2013 and November 19, 2012 to the Water Authority's prior letters.

A-53 Rate structure. Representations that uniform rates are collected “for every acre-foot of water conveyed by Metropolitan” are inaccurate because the rates do not take into account all of the discounted and special agreements MWD affords some but not all of its member agencies. Moreover, MWD fails to comply with cost of service legal requirements and its own act because it fails to properly acknowledge or account for different classes of service it provides to its member agencies (see comment at A-1 above, the only place in the Appendix A in which MWD mentions classes of service).

See response to comment at A-1 above. As noted, interim agricultural water service and replenishment service have been discontinued. We believe that the remainder of this comment is factually and legally unsupported.

A-54 Litigation challenging rate structure. See general comments about the inconsistency between representations in the draft Appendix A and representations made to the Court.

See our response to your general comments.

A-60 Hydroelectric power recovery revenues. Why have the three paragraphs been deleted?

The initial paragraph in this section provides energy generation sales revenues from the 16 small hydroelectric plants on Metropolitan’s distribution system for the past two fiscal years and the range of annual revenues from these energy generation sales since 2000. The deleted paragraphs provided additional detail about the underlying sales contracts, which the team determined to be immaterial to an investor making an investment decision.

A-79 Tax increase to pay for additional payments under the State Water Contract. Please provide a copy of the opinion of MWD’s General Counsel referred to in the first full paragraph that the tax increase as described would be within the exemption permitted under Article XIII A of the State Constitution as a tax to pay pre-1978 voter approved indebtedness.

In *Goodman v. Riverside* (1983) 140 Cal.App.3d 900, 909-10, the court held that when California voters approved the Burns-Porter Act, they approved indebtedness in the amount necessary to build, operate, maintain and replace the State Water Project and they approved the use of local property taxes to fund water contract obligations of the water contractors (such as Metropolitan). General Counsel Robert P. Will explained in March 1980, when the Board authorized Metropolitan’s intervention as a defendant in *Goodman*, that “in order to preserve the financial integrity of the Project and to provide for its essential further development, it is of utmost importance that the taxing power of the contractors” to pay their state water contract obligations be maintained. Beginning with General Counsel Will and his successor Carl Boronkay, who represented Metropolitan as one of the intervenors in the *Goodman* case, General Counsel and their

staff attorneys have confirmed the continuing vitality of the analysis and holdings in *Goodman*.

A-86 Projected revenues and expenditures. See question above, at A-34. Do these revenue projections assume that the Carlsbad seawater desalination facility comes on line in 2016? See also the questions above, at A-32. What assumptions are made about water sales to LADWP?

See answer to A-34. The projected sales of 1.75MAF assume a normal year in terms of supply hydrology for Metropolitan and its member agencies and are conservative when compared to the long-term average water sales of 2.0MAF and the recent five-year average sales of 1.815MAF.

A-89 Long range finance plan. MWD's reserve policies are outdated, just as its 1999 Long-Range Finance Plan is. Is MWD staff relying upon and implementing all of the policies in the 1999 plan at this time?

See response to your comment on A-42.

We have carefully reviewed and considered your comments on Metropolitan's Official Statements and Remarketing Statements. Our objective in the Offering Statements is to provide complete and accurate disclosure regarding the bonds being offered and their security and source of payment to potential investors. We are confident that our responses to your comments meet that objective and we thank you for your comments.

Sincerely,



Gary Breaux
Assistant General Manager/Chief Financial Officer

cc: J. Kightlinger
MWD Board Members
SDCWA Board of Directors and Member Agencies

Attachment 1—Appendix A draft dated November 25, 2013, showing changes from the May 31, 2013 draft

Attachment 2A, 2B, 2C, 2D—Settlement Agreements for: A) Napa County Flood Control and Water Conservation District; B) Solano County Water Agency; C) City of Yuba City; and D) Butte County

Attachment 3—Second Supplemental Agreement between Metropolitan and Coachella Valley Water District, dated June 14, 3013

