



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

May 22, 2013

Director Keith Lewinger
Director Vincent Mudd
Director Fern Steiner
Director Doug Wilson
San Diego County Water Authority
4766 Overland Avenue
San Diego, CA 92123

Dear Directors:

Your letter dated May 13, 2013, regarding board letter 8-3

This letter responds to your questions and comments to the May 1, 2013, draft of Appendix A to the Official Statement for Metropolitan's Water Revenue Refunding Bonds, 2013 Series D, attached to board letter 8-3. Chairman Foley asked me to respond to your letter.

Before we address your specific comments on the May 1 draft of Appendix A, there seems to be some confusion in the central policy question you identified (whether the Board should change its investment policy to be more conservative and consistent with the primary objective of safeguarding the principal of invested funds), and Metropolitan's interest rate swap policy. Nothing in the swap portfolio affects the investment policy.

The Board considers Metropolitan's Statement of Investment Policy annually and unanimously approved the current Statement of Investment Policy on June 12, 2012. As explained in board letter 8-1 for the June 2012 meeting and in the policy itself, safety of funds is the highest of the three priorities governing public funds management. To safeguard invested funds, each investment is entered into considering the quality of the issuer, the underlying security or collateral, and diversification of the portfolio. After safety, the second and third priorities are liquidity and investment return.

The Statement of Investment Policy does not apply to interest rate swaps, which are governed by the Master Swap Policy. The Master Swap Policy was most recently amended by unanimous vote of the Board on May 11, 2010. The Board also authorized the novation of existing swaps with UBS AG to a higher-rated counterparty and amendment of swaps to permit early cancellation under the criteria presented to the Board. Since then, Metropolitan successfully novated the UBS AG swaps to Deutsche Bank and has amended and terminated \$322.2 million in interest rate swaps, achieving

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\$1.2 million in debt service savings from the swap terminations and associated refunding of water revenue bonds. A similar swap termination and refunding transaction, described in the Official Statement that was the subject of your February 11, 2013 comment letter, is pending favorable market conditions.

The agenda for the April 2013 meeting of the Finance and Insurance Committee included a review of the swap policy and current swap transactions, as requested by Director Lewinger. The presentation was deferred for lack of time at that meeting. An updated report will be presented in July, when Director Lewinger can be present and the next quarterly swaps report will be available. I can meet with you to discuss your concerns and answer your questions before that presentation, if you prefer. In the meantime, you may view the PowerPoint posted for the Finance and Insurance April committee meeting in the Board letter archive at <http://edmsidm.mwdh2o.com/idmweb/cache/MWD%20EDMS/003733006-1.pdf>.

Your most recent comments on Appendix A and our responses are set forth below.

A-49: Source of funding to pay SDCWA to the extent it prevails in the litigation. The points raised in our February 11, 2013 letter to you on this subject have not been addressed (see page 4, A-50). The Exchange Agreement requires MWD to hold the amount of disputed funds in a separate interest-bearing account, not as part of MWD's financial reserves. Moreover, the use of financial reserves for this purpose is improper to the extent that the reserves are being funded by SDCWA. Any amounts that may be due to the Water Authority from the litigation must be paid by the other member agencies, not by the Water Authority itself. MWD is in breach of the Exchange Agreement provision requiring it to deposit the disputed funds in a separate interest bearing account.

The amounts that are in dispute are being set aside in a separate account and interest is being credited on a monthly basis at the effective yield earned during the month on Metropolitan's investment portfolio, as described in the letter dated February 24, 2011 from Karen Tachiki, Metropolitan's General Counsel, to Daniel Hentschke, SDCWA General Counsel, and my October 15, 2012 letter to Tracy McCraner, SDCWA Director of Finance/Treasurer. These amounts are derived from available water revenues. Metropolitan's uniform rates to all member agencies for like classes of service mean that water revenues from all member agencies, including SDCWA, are paying toward this potential cost of service. Any amounts that may be due to SDCWA as an award in the litigation would be paid as ordered by the Court.

A-50: Member Agency Purchase Orders. The description of Member Agency Purchase Orders is misleading. We attach and incorporate by reference our letter to you dated October 8, 2012 stating objections to both the form and substance of MWD's "Amended and Restated Purchase Order." Like all other public agencies, MWD is required to align its costs with the services it provides; the creation of a "purchase order" and characterization of it as a "voluntary" agreement will not immunize MWD from the application of Proposition 26.

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As we responded on November 19, 2012, in response to the comment on purchase orders in your comment letter dated November 5, 2012, the existing description accurately summarizes the current terms of the purchase orders. Metropolitan sets rates to recover anticipated costs of service. The purchase orders determine the amount of water a member agency can buy at the lower Tier 1 rate and provide a Tier 2 price signal. The purchase orders do not affect the cost of service. Metropolitan believes that the purchase orders conform to the requirements of California law.

A-51: Replenishment. The discussion of replenishment remains misleading because it fails to disclose material concerns with this discounted water program as described in our past letters to the board (including but not limited to those dated April 25, May 6, September 12, November 4 and December 12, 2011). The last time MWD authorized the sale of water at a discount, it said that the member agencies would not purchase water at the full service price due to “budgetary and fiscal constraints.” MWD should disclose the relationship between discounted water sales (under any guise or program) and loss of full service sales, impacts on water rates and cost of service legal requirements.

The Replenishment Service Program was eliminated on December 11, 2012, as disclosed in the existing text. Since then, member agencies have been purchasing water for replenishment at full service rates. Speculation about hypothetical loss of full service sales and rate impacts due to past replenishment sales would be inappropriate and potentially misleading.

5/14/2013 Board Memo 8-1 – Set public hearing to consider suspending Section 124.5 of the Metropolitan Water District Act to maintain the current ad valorem tax rate. MWD should certainly disclose in Appendix A that it believes that the fiscal integrity of the District is currently threatened. This is a material fact that investors need to be informed of.

The Board’s action on May 14, 2013, to set a hearing and consider suspending this clause of the MWD Act has been added to Appendix A. Describing this action before a vote by the Board would have been premature. This action does not mean that Metropolitan’s fiscal integrity is currently threatened, as you allege. Rather, the Board will consider whether maintaining ad valorem taxes at current rates will maintain rate stability and a sound fiscal structure.

Your letter also alleges that Metropolitan does not have a long range finance plan and takes an ad hoc approach to financial planning. The current biennial budget includes a five-year forecast that covers anticipated costs, including funding for necessary capital refurbishments and replacements, pension liabilities and other post-employment benefits. Under the five-year plan, Metropolitan will be funding its other post-employment benefit obligations at the actuarially-required contribution annually by 2017. The five-year forecast is based on a conservative water sales estimate and projects annual rate increases of 3% in the last three years of the forecast. The five-year forecast will be updated with the next biennial budget and may be extended to a ten-year forecast. Still, it is unclear that longer forecasting would reduce risk. Instead, projections with a longer horizon become more speculative.

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Review by board members is an important part of the process to make sure that Appendix A does not contain any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading, and meets or exceeds disclosure standards. Comments from board members, finance, and legal staff and outside professionals on the financing team are discussed by the team and carefully evaluated, often resulting in clarifications or corrections to Appendix A. Other comments are not incorporated, for the reasons explained in our response letters. We appreciate your careful review of the Official Statement.

Sincerely,

A handwritten signature in black ink, appearing to read "Gary Breaux". The signature is fluid and cursive, with a prominent initial "G" and "B".

Gary Breaux

Assistant General Manager/Chief Financial Officer

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