San Diego County Water Authority
4677 Overland Avenue • San Diego, California 92123-1233
(858) 522-6600 FAX (858) 522-6568 www.sdcwa.org

Via electronic email

August 29, 2012

Gary Breaux
Chief Financial Officer
Metropolitan Water District of Southern California
700 N. Alameda Street
Los Angeles, CA 90012

RE: Comments on Appendix A

Dear Mr. Breaux:

I write on behalf of the Water Authority's representatives on the Metropolitan board of directors. Please advise the status of Metropolitan's review of and response to our comments on the Appendix A draft, circulated in association with Board Memo 8-1 at the August board meeting (copy attached). Also, please confirm that it has been provided to Metropolitan's General Counsel, outside bond counsel, underwriter's counsel and other members of the financing team.

Thank you for your attention to this important matter.

Sincerely,

Doug Wilson

Doug Wilson

cc: Jeff Kightlinger, General Manager
Marcia Scully, General Counsel
Jack Foley, Chairman of the Board of Directors
Fern Steiner
Lynne Heidel
Keith Lewinger

Attachment: August 20, 2012 letter re: Draft Official Statement

San Diego County Water Authority
4677 Overland Avenue • San Diego, California 92123-1233
(858) 522-6600 FAX (858) 522-6568 www.sdcwa.org

August 20, 2012

Jack Foley, Chair, and
Members of the Board of Directors
Metropolitan Water District of Southern California
700 N. Alameda Street
Los Angeles, CA 90012

RE: Board Memo 8-1: Authorize the execution and distribution of the Remarketing Statement in connection with the remarketing of the Water Revenue Refunding Bonds (Index Mode), 2009 Series A-1, in the amount of $104,185,000; and authorize the execution and distribution of an Official Statement for a potential refunding of Water Revenue Bonds. (F&I) – OPPOSE

Dear Chairman Foley and Board Members:

After careful review of Board Memo 8-1 including Attachments, we must once again vote against the staff recommendation to authorize execution and distribution of the Remarketing Statement in connection with the sale of bonds. We are not comfortable that the Remarketing Statement, as drafted, provides information essential to making an informed investment decision in a manner that is not misleading. While most of the areas of our concern remain unchanged, there is one notable area of improvement and some additional issues upon which we would like to comment.

Reduced Sales

As you know, the Water Authority has been deeply concerned about Metropolitan's continued reliance on predictions of a steady growth in water sales for financial and resource planning purposes. We began raising this concern in connection with the sale of bonds in September 2010 when Metropolitan estimated sales at 2.0 million acre-feet (MAF) for fiscal years (FY) ending 2012 and 2013 and 2.1 MAF for FYs 2014 and 2015. The actual sales for FY 2012 were 1.68 MAF, including 225,000 acre feet (AF) of discounted water sales which, according to Metropolitan staff, would not have occurred had the price not been discounted. Without the discounted water sales, FY 2012 sales would have been 545,000 AF less than stated by Metropolitan in its Official Statement.

Metropolitan has reduced its water sales projections by 300,000 AF for FY 2013, 400,000 AF for FY 2014 and 350,000 AF for FY 2015 from those predicted in September 2010. While this represents a far more realistic sales forecast, there are a number of related issues associated with projected sales that have not been addressed. They include: 1) failure to adequately adjust current or future spending to reflect reduced sales; 2) failure to identify the quantity of sales that depend upon the availability of discounted water; and 3) failure to identify the financial and water rate impacts and risks associated with reduced sales. Further, these "water sales" projections also include wheeling and exchange transactions that are *not* the sale of water by Metropolitan at all (see note below), including water the Water Authority purchases from the Imperial Irrigation District (IID) and conserved water supplies from the Coachella and All-American Canal lining projects. We believe it is misleading to characterize these transactions as Metropolitan "water sales" even though

Metropolitan's choice to do so is disclosed in a footnote.

Failure to Reduce Spending

Metropolitan has failed to reduce its spending to match reduced sales projections. As a result, Metropolitan revenues have not been sufficient to cover its costs in five of the last eight years (2005-2012), even though it has reduced planned pay-as-you-go spending on capital programs and used funds collected from ratepayers for that purpose to pay operating costs. This is discussed at page A-39 of the Draft Official Statement, where it is disclosed that $265 million – more than half of the revenues collected from ratepayers during FY 2008-13 to pay for infrastructure – has instead been spent to pay operating costs. The explanation provided, that these fund transfers have been made to "reduce drawdowns of reserve balances and to mitigate financial risks that could occur in upcoming years," while technically correct, does not explain the real source of the problem: a continuing disconnect between increasing spending and MWD's decreasing water sales. (See also the footnotes on page A-58.)

Similarly, in spite of dramatically reduced sales, Metropolitan has continued to fund subsidy programs designed to further reduce its sales. These expenditures have been made on the basis of an outdated, Integrated Resources Plan (IRP) spending program. We have called for – and call again for – a moratorium on all subsidy programs until Metropolitan updates its IRP projections and develops a finance plan evidencing how Metropolitan intends to pay for these projects. It is a matter of grave concern to us that Metropolitan continues to rely not only on an outdated IRP, but on an even more outdated 2004 Long Range Finance Plan that predates it, and does not include the IRP projects that continue to be brought to our board for approval. It is equally of grave concern that Metropolitan has recently abandoned its effort – pending since 2007 – to update the Long Range Finance Plan. The absence of a coherent long range finance plan that links spending with MWD's water resource plans enables and assures that the disconnect between spending and sales will continue. This is not a fiscally sustainable path for MWD.

Reliance on Sale of Discounted Water

Although Metropolitan has reduced its sales projections, it has not indicated the volume of water sales it expects to be made at a discounted price. Although the budgets adopted by the board four months ago for FYs 2013 and 2014 do not include a replenishment rate or projections for the sale of water at a discount, staff reports to the board since that time as part of the member agency "Rate Refinement" process have indicated that development of a discounted water rate for replenishment is one of the top three priorities for the Metropolitan board to address (we disagree with that conclusion). Given the high cost of developing new water supplies, we do not understand how Metropolitan can continue to "buy high" in order to "sell low." The cost of every acre foot of water that is sold to one member agency at a discount must be paid for by some other member agency's ratepayers, thus further driving up the cost of and dampening demand for Metropolitan's firm water supplies.

Financial Impacts and Risks of Reduced Sales

The draft Official Statement does not adequately describe the financial exposure to Metropolitan of continuing to embark upon large spending projects without any assured source of revenues to pay for them. As member agencies continue to develop local water supplies – as they should – there is a real danger not only of massive stranded investments by Metropolitan, but of spiraling water rates that will be necessary to pay for them. While Metropolitan has a limited ability to shift existing State Water Project costs on to the tax rolls during fiscal emergencies, that is not the case with regard to other costs and investments.

Specific Comments on Draft Official Statement

In addition to the above broad concerns, we have the following specific comments on the draft Official Statement.

A-1 – Member Agencies

Although the draft Official Statement discloses that no member is required to purchase water from Metropolitan, and states that its member agencies "may, from time to time, develop additional sources of water," it does not describe that as Metropolitan's water rates have increased, development of local water supplies has become more cost-competitive. Nor does it disclose that many of Metropolitan's member agencies are now developing local water supply projects to reduce their purchases of Metropolitan water. As noted above, under the current rate structure, and absent any firm commitments by any of its member agencies to pay for its projects, there is a significant risk that Metropolitan will have stranded investments. One of the three issues staff has reported to the board through the "Rate Refinement" process is a claim that treated water investments by Metropolitan have already been stranded. These facts should be disclosed in the draft Official Statement.

A-3 – Integrated Water Resources Plan

As noted earlier, the IRP is outdated. It does not reflect the substantially reduced water demands Metropolitan has now recognized and reported in the draft Official Statement. The statement that, "the IRP Strategy will be continually reviewed and updated at least every five years to reflect changing demand and supply conditions," is inaccurate, as MWD has failed to adapt the plan to the sharply lower water sales that it has experienced and is projected to continue to experience over at least the next five years. Continued spending in reliance on this outdated planning tool threatens to strand Metropolitan investments and further reduce revenues at a time Metropolitan most needs them.

A-4 – State Water Project

We view the State Water Project as a core water supply for our region. The description provided of the State Water Project as "important for maximizing local groundwater potential and the use of recycled water" is too limiting and seems to imply that the planned BDCP investments are being made for the purpose of selling discounted water for groundwater replenishment and for blending with recycled water. If this is Metropolitan's plan to support BDCP investments – again, to "buy high" and "sell low" – we believe the plan has substantial negative implications for Metropolitan's future water sales and revenues.

A-11 – BDCP

The draft Official Statement describes a "commitment by Metropolitan and the Santa Clara Valley Water District to surpass the 2009 Delta Reform Act water savings targets by 700,000 af per year based on predicted future demands." The language should be modified to reflect that the board of directors has not yet received any information about this "commitment" or what it means to our region in terms of water supply reliability or cost. No detail is provided on what share of the 700,000 acre-feet of additional conservation MWD has agreed to implement.

A-17 – Quantification Settlement Agreement
While the description provided properly states that the QSA restored the opportunity for Metropolitan to receive special surplus water under the Interim Surplus Guidelines and to enter into other cooperative Colorado River water supply programs, we suggest adding a description of what the impacts on Metropolitan's water supplies and water rates would be if the QSA is interrupted. As you know, some Metropolitan board members have recently expressed concerns about the "collapse" of the QSA. We also request that you add discussion of Metropolitan's recent "Notice of Default" under the Exchange Agreement, and, how that ties in to the statement that, "the appropriate accounting for the 2011 IID-SDCWA transfer is under review by the Bureau of Reclamation and will be reflected in a future Colorado River Accounting and Water Use Report."

A-18 – Sale of Water by the Imperial Irrigation District to SDCWA
We suggest adding a disclosure that the Water Authority's litigation includes claims for breach of contract and challenges Metropolitan's calculation of the price for conveyance of water through Metropolitan's facilities. Also, that IID joined the litigation to challenge Metropolitan's wheeling rate.

A-27 – Water Conservation
There are no facts to support the general statement that, "all users of Metropolitan's system benefit from the system capacity made available by investments in demand management programs like the Conservation Credits Program," and we therefore suggest that the statement be deleted. Indeed, the facts show that Metropolitan has had system capacity available for many years – and that water conservation investments are not needed to make that capacity available. To comply with cost of service requirements, Metropolitan is required to show that the rates it is imposing on each of its member agencies to pay for its water conservation programs are proportional to the benefits each receives.

The discussion of the 2009 20 percent reductions by 2020 is confusing. We are not aware of any "accounting" prepared by Metropolitan that reflects "conservation savings that will reduce retail demands;" to the contrary, all of the IRP projects appear to be moving forward without limitation.

A-28 – Regional Water Sources
We would suggest this entire section be restructured to better reflect that all of Metropolitan's member agencies have local water supply options as well as the extent to which each is currently developing those options. While the draft Official Statement contains a great deal of detail about the plans of the City of Los Angeles (under the header, "Los Angeles Aqueduct"), similar information is not provided for the Water Authority or other Metropolitan member agencies that have ambitious plans to reduce water purchases from Metropolitan. As noted earlier, this discussion should include the fact that as Metropolitan water rates have increased – with approved increases exceeding 96% since 2006 – local water supply development has become more cost-effective.

With regard to the City of Los Angeles, discussion should be added about the impacts on MWD water rates and the stranded investment risk associated with variable water purchases by the City of Los Angeles which, as described, can swing by more than 250,000 AF annually.

It is unreasonable for purposes of long range planning to limit the local projects Metropolitan accounts for to those that are "producing water or are under construction at the time a water sales projection is made" for all agencies except LADWP, where the disclosure is based on its Urban Water Management Plan. The same standard of disclosure and measure should be applied to all agencies. We request that a section be added disclosing the Water Authority's plans to reduce future water purchases from Metropolitan as described in its Urban Water Management Plan. This would include the 205,000 AF of water conserved annually by IID (disclosed at page A-17 but out of context of sales or revenue impacts); 81,507 AF of conserved water from the combined Coachella Canal and All-American Canal lining projects (disclosed at page A-18 but similarly, not in context of sales or revenue impacts); and 56,000 AF from the Carlsbad seawater desalination project (discussed at page A-33). The discussion of the Carlsbad project should also be updated to include the August 9, 2012 announcement of a pending 60-day public review period of the Water Purchase Agreement to be released later this month.

A-39 – Capital Investment Plan Financing
See discussion above. This section should be amended to reflect why transfers from the pay-as-you-go funding has been less than budgeted.

A-43 – Risk Management
Discussion should be added regarding the factors contributing to Metropolitan's substantial risk of stranded investments and dramatically higher water rates as its member agencies continue to develop local projects in lieu of continued reliance on Metropolitan water supplies.

A-44 – Summary of Receipts by Source
It is misleading to characterize revenues from water wheeling and exchanges as "water sales." Similarly, revenues from the termination of the Las Posas water storage program should be reflected as "other collections" rather than as a "water sale."

A-45 – Water Sales Revenues
The discussion about purchase orders should be updated to reflect that, based on review and discussions over the past few years, they are not proposed to be continued when they expire on December 31, 2012.

A-46 – Average Receipts Per Acre Foot
The use of averaging is misplaced. We have suggested previously that Metropolitan account for its water sales by class of service. Given the dynamic market in which Metropolitan finds itself, it is important to identify how much water it can expect to sell at full service rates.

A-47 – Rate Structure
The discussion about Tier 1 and Tier 2 should be updated to reflect the changes now being proposed through the "Rate Refinement" process. According to reports to the board, renewal of the purchase orders is no longer under discussion, because staff is no longer recommending purchase orders or the member agencies are unwilling to sign them, or both. Given that there has been some reliance in past Official Statements on the purchase orders as an indication of member agencies' commitment to purchase Metropolitan water, we believe this is a fact that should be disclosed. The Water Stewardship Rate (WSR) discussion should also disclose that the Water Authority and its ratepayers have been disqualified from receiving any WSR program benefits and that the Rate Structure Integrity clause is being challenged in court.

A-48 – Litigation Challenging Rate Structure
The statement that, "if Metropolitan's rates are revised in the manner proposed by SDCWA in the complaint, other member agencies would pay higher rates," is argumentative. We suggest you delete the sentence, or in the alternative, revise the sentence to read as follows: "If Metropolitan's rates are revised in the manner proposed by SDCWA in the complaint, it will be because the court determines that those rates were not established in accordance with legal requirements. As a result, other member agencies would pay higher legally appropriate rates."

A-50 – Interim Agricultural Water Program (IAWP)
We suggest adding language reflecting the volume of sales that historically occurred through the IAWP (almost 120,000 AF in 2008 down to less than 30,000 AF in 2012), along with the volume of sales that have converted to pay Metropolitan's full service rates.

A-50 – Replenishment
By Metropolitan's own acknowledgement, the replenishment program has not been operated in a manner that supports the statement that water is sold at a discount because it is subsequently used "to offset demands on Metropolitan in times of shortage." Further, it has been demonstrated that replenishment sales at a discount *do* (and not "may") offset full service water sales. Metropolitan states that its water sales projections estimate the level of future production from groundwater, supported by an assumption of replenishment sales but does not identify in the draft Official Statement the extent to which its projected water sales are of discounted replenishment water. The draft Official Statement should also be amended to state that the budgets recently adopted by the board do not include any replenishment rate or estimate of reduced revenues due to the sale of discounted water (or "incentive" programs which result in the same economic impact).

A-50 – Water Rates by Category
We suggest a statement be added that the Water Authority's lawsuit questions the legality of Metropolitan's water rates and charges under California law and Constitution including Proposition 26, including that the capacity charge does not recover the cost of providing peak water supply and delivery capacity.

A-53 – Wheeling and Exchange Charges
We suggest adding a note that IID has joined the Water Authority's litigation challenging Metropolitan's wheeling rate.

A-54 – Preferential Rights
We suggest adding a note that Metropolitan's calculation of preferential rights is being challenged in the Water Authority's litigation. Also, the statement that, "historically, these rights have not been used in allocating Metropolitan's water," is misleading in that the member agencies, not Metropolitan, hold the entitlements.

A-55 – Proposition 26
We suggest a disclosure be included that the Water Authority contends in the litigation it has filed against Metropolitan that Proposition 26 applies to Metropolitan's water rates and charges, and that those rates and charges exceed the reasonable cost of services provided to the Water Authority by Metropolitan. Further, that the application of Proposition 26 to Metropolitan is used as an example

of application to wholesale providers generally in the Guidebook on Proposition 26 published by the League of California Cities. The ACWA Guide to Proposition 26 contains the same rationale, although Metropolitan is not mentioned by name.

A-71 – Historical and Projected Revenues and Expenditures
As noted at the outset, Metropolitan has been wise to finally reduce its expected sales as described. However, if it does not change course to aggressively manage its expenditures, implement a moratorium on local project subsidies and "adapt" its IRP to downsize it to match projected sales, there is no reasonable basis for the claim that water rates will be limited to 3% annually beginning in FY 2015 and "thereafter" as stated in the draft Official Statement. In addition to the costs Metropolitan is paying now, it is proposing to increase OPEB spending (see page A-71) and begin to incur costs associated with the BDCP during that time frame. It simply doesn't compute.

Thank you for the opportunity to provide comments on the draft Official Statement. We hope to work together with the rest of the board to begin to grapple with these important issues.

Sincerely,

Lynne L. Heidel

Keith Lewinger

Fern Steiner

Doug Wilson

Lynne Heidel Director	Keith Lewinger Director	Fern Steiner Director	Doug Wilson Director

cc: Jeff Kightlinger, MWD General Manager
San Diego County Water Authority Board of Directors and Member Agencies