



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

VIA EMAIL

June 22, 2016

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

Dear Directors:

Your letter dated June 15, 2016 regarding June Board Meeting Board Letter 8-2: Draft Appendix A.

This letter addresses your comments, received June 15, 2016, on June Board Meeting Board Letter 8-2: Draft Appendix A. Your general comments are addressed below, followed by your specific comments and Metropolitan's responses.

Appendix A provides material financial and operating information about Metropolitan to potential investors. Appendix A is prepared by Metropolitan staff and reviewed by Metropolitan's Board of Directors. Metropolitan's objective is to provide complete and accurate disclosure regarding the bonds being offered and their security and source of payment to potential investors. Appendix A is updated periodically to provide current information. Forward-looking statements or projections are based on current information such as the facts and assumptions contained within the biennial budget and ten-year financial forecast.

The comments in your letter regarding Gary Breaux's June 14, 2016 letter to the Board are, for the most part, addressed in that letter. It should also be noted that Appendix A was provided to the Board for review and approval on June 1, 2016, providing 12 days for review and comment. Also, at the March 2016 Finance and Insurance Committee meeting, staff reviewed upcoming financings including the refunding of bonds in early July 2016.

General Comments in your letter incorporate by reference all of the comments and objections contained in your delegation's past letters relating to Metropolitan's authorization, execution and distribution of Offering Statements in connection with the issuance of bonds, which were most recently addressed in Metropolitan's response letter dated November 12, 2015 to SDCWA's Comment Letter dated October 12, 2015. Metropolitan's November 2015 Response (see Attachment 1) was electronically provided to all SDCWA directors and copied to Metropolitan's Board of Directors on November 20, 2014.

This letter raises one additional point not covered in Metropolitan's response letter dated November 12, 2015. Your letter asserts that Appendix A does not disclose that there are other appellate cases that are inconsistent with MWD's arguments on appeal, including its contention that Proposition 26 does not apply to wholesale water suppliers, and cites *Newhall County Water District v. Castaic Lake Water Agency*, 197 Cal. Rptr. 3d 429 (Cal. Ct. App. 2016) in support. However, that decision expressly limits its holding and analysis to the specific fixed charge before the court and to the specific relationship between Castaic Lake Water Agency and its four customers. Metropolitan's wholesale water rates adopted by its 26 member agencies pursuant to its voluntary government structure are readily distinguishable from Castaic's facts.

Comments on Draft Appendix A dated June 15, 2016

The following specific SDCWA comments and Metropolitan's responses refer to the draft of Appendix A dated June 1, 2016, showing changes from the October, 2015 draft (Attachment 1).

A-6-7 and A-22: Colorado River. Staff has failed to include any discussion of ongoing Colorado River shortage sharing proposals it is engaged in that could result in lower Colorado River water deliveries to MWD. Staff reported at the June Board meeting on the extent of California water losses that could be sustained, but indicated that it has not yet calculated any offsetting benefits.

Metropolitan Response: Discussions regarding Colorado River sharing proposals are not discussed in Appendix A because discussions are in preliminary stages and no actions regarding this matter have been approved by the Board.

A-8-9: Integrated Resources Plan (IRP) and Breakdown of MWD Governance. MWD staff has deleted reference to the second phase of the IRP process, in which the Board of Directors would review policy issues, along with the reference to the first phase as being limited to a "technical update." Staff is reinventing history with these edits. Staff should disclose that the MWD Board did not deliberate any policy issues associated with the 2015 IRP Update prior to its adoption, including its failure to examine or consider the impacts of MWD staff's decision to assume for IRP planning purposes only 20,000 acre-feet of planned local water supply development, when the actual number is more than 10 times that -- 205,000 acre-feet -- of local projects that are currently in the full design phase with funds appropriated or at the advanced planning stage with completed certified environmental review.

We believe this breakdown in the process of MWD board governance -- which is also demonstrated, for example, by the absence of a current Long Range Finance Plan, is a material circumstance that should be disclosed to MWD investors. At a minimum, these edits in this section should not be made because they are deleting language that more accurately describes what happened with regard to the planned – and now, apparently abandoned -- two-phase process for development of the IRP.

Staff is also deleting, without explanation, reference to the "core resource strategy, uncertainty buffers and foundational actions" contained in the 2015 IRP Update. Please explain.

Metropolitan Response: The description of the IRP Update in Appendix A is consistent with the 2015 IRP Update document: “The 2015 IRP Update focuses on ascertaining how conditions have changed in the region since the last IRP update in 2010. This involves developing new reliability targets to meet the evolving outlook of the region’s reliability needs, assessing strategies for managing short and long-term uncertainty and communicating technical findings. The 2015 IRP Update also identifies areas where policy development and implementation approaches are needed. These discussions will follow the adoption of this report, and involve extensive interaction with Metropolitan’s Board of Directors and member agencies.”

The 2015 IRP Update indicates a Total Local Supply Target of 2.426 million acre-feet in 2040. This represents an increase of 227,000 acre-feet over current production levels. Approximately 207,000 acre-feet of this increase is expected to be achieved through growth in existing and under construction projects. The remaining 20,000 acre-feet is expected to be achieved through new local supply development. Along with the 20,000 acre-feet of new supply development identified in the Total Local Supply Target, the 2015 IRP Update recommends an additional 200,000 acre-feet to help address potential risk and uncertainty, bringing the total to 220,000 acre-feet. Additionally, should any of the 207,000 acre-feet of planned growth from existing and under construction projects fail to be developed, additional new local supplies would need to be brought online to compensate. The 2015 IRP Update, Appendix 5, provides a full inventory of local supply projects at differing stages of development that could help fulfill regional demands.

The terms “core resource strategy, uncertainty buffers and foundational actions” were used in the 2010 IRP Update and were not carried over in the 2015 update. Appendix A uses terms and descriptions that are consistent with those used in the 2015 IRP Update. For example, as explained in the Executive Summary for the 2015 IRP Update, the 2010 IRP Update referred to “Future Supply Actions” (a term used in the 2015 IRP Update) as “Foundational Actions.” (Executive Summary of 2015 IRP Update at p. 4.)

Finally, as noted in previous letters, the adopted biennial budget and ten-year forecast comprise Metropolitan’s long-range financial plan and are updated every two years.

A-10-15: State Water Project. MWD staff's proposed edits delete discussion of the Delta Stewardship Council and its role under the Sacramento San Joaquin Delta Reform Act to develop a comprehensive management plan for the Delta. The existing Appendix A reported pending litigation, but the proposed edits fail to include discussion of the outcome of the decision, requiring, among other things, that MWD and other state water contractors demonstrate a quantifiable reduction of the demand for Delta water. This decision and its impacts on MWD, its State Water Project supplies and plans to implement the California WaterFix must be disclosed to potential investors.

Metropolitan Response: Although the Delta Reform Act and the Delta Stewardship Council cases may eventually have an impact on supplies, Metropolitan believes any potential impacts to water supplies are too speculative to be raised in Appendix A at this time. Significantly, the decision cited in your letter, Ruling on Submitted Matter: Petitions for Writ of Mandate, Bifurcated Proceeding on Statutory Challenges (*Delta Stewardship Council Cases*, CJP No. 4758, (2016)), is not final and there are multiple motions for clarification pending. In conjunction with State Water Contractors and several other named state water contractors, Metropolitan is participating in this matter and will disclose impacts in the event of any final ruling or regulations that could have a material impact on Metropolitan's water supplies.

A-33-35: Local Water Supplies. MWD inappropriately discusses local water supply development in the context of its IRP in order to avoid discussing "the rest of the story," that this local water supply development -- which has become cost-effective as the cost of MWD water has increased -- will permanently reduce demand for MWD water. MWD staff finally acknowledged at the June board meeting its awareness that its "current business model of paying [MWD member agencies] incentives and agencies "rolling off" is not sustainable."

Metropolitan Response: The recently adopted IRP takes local water supply development into account in projecting future water demands. The quoted statement in your comment was among items listed as part of a "Recap of Board Retreat IRP Discussions" presented to the IRP Committee, rather than a staff statement. Staff has not adopted that statement or taken that position at any time. See also Response to comment on *A-8-9: Integrated Resources Plan (IRP) and Breakdown of MWD Governance* above.

A-37 and A-42-43: Water Treatment. MWD's discussion in Appendix A about water treatment does not "match" the discussion of this issue during MWD's recent rate-setting process in which it was initially claimed that MWD has a legal obligation to serve treated water and needs to recover stranded costs. Later, in response to questions contradicting this claim, MWD's legal counsel admitted MWD does not have a legal obligation to serve treated water. MWD has failed to discuss the facts and circumstances that led to its recommendation to implement a fixed water treatment charge, based on reduced demand for MWD treated water; or, the fact that the Board was unable to reach agreement how to recover these stranded costs *ex post facto*. The treated water stranded cost issue may be viewed as the "canary in the coal mine" that foretells potential

stranded assets on the supply side as well, if long term planning and financial issues are not meaningfully addressed by the Board and implemented through a revised 2015 IRP Update and Long Range Finance Plan or other planning process.

Metropolitan Response: The water rates adopted by the Board fully recover the cost of water treatment. The water treatment fixed charge still being considered by the Board is simply an alternative way to fully recover the cost of treated water. No statement was made that Metropolitan has a legal obligation to deliver treated water. Rick Giardina of Raftelis Financial Consultants stated that Metropolitan has a service obligation to do so and Director Lewinger asked if this was a legal obligation. The General Counsel responded that current Board policy, not the law, obligates Metropolitan to be prepared to provide treated water to its member agencies. This obligation has certain caveats and the Board may change its policy.

A-40: Cost of Service. The label titled "Cost of Service" is inappropriate as used to describe the elements of MWD's Capital Investment Plan. This confuses MWD's obligation to set its rates according to cost of service requirements of the common law, California statutes and the state Constitution.

Metropolitan Response: The label cost of service is consistent with Metropolitan's cost of service methodology. While Metropolitan does set its rates based on cost of service, the law applicable to Metropolitan does not require this.

A-43-44: Major Projects of CIP. MWD staff reports hundreds of millions of dollars of CIP cost increases relating to the Colorado River Aqueduct facilities and distribution system. Please provide the data supporting these reported cost increases and when it was previously reported to the Board of Directors.

Metropolitan Response: Updates on the CIP are provide to the Board quarterly and as part of the biennial budget approval process, recently completed in April 2016.

A-44: Tax Revenues. MWD is deleting the entire paragraph explaining the limitations on its taxing authority; this is misleading. The paragraph should be left in as is, or updated as appropriate.

Metropolitan Response: The description on A-44 was deleted because it was redundant. The discussion of MWD's taxing authority is described on A-46 under "Revenue Allocation Policy and Tax Revenues."

A-46: Water Sales Including Wheeling Revenues. MWD's revenues from wheeling should be reported separately from its "water sales." Combining these numbers disguises the extent to which MWD sales are reduced by member agencies that purchase water from third party sources such as the Water Authority has done.

Metropolitan Response: Revenues generated as a result of the exchange agreement between SDCWA and MWD are not wheeling revenues. Furthermore, the distinction between exchange and wheeling revenues and other revenues is not material to an investor. Appendix A describes Metropolitan's water sold and water sales in aggregate. Appendix A expressly states that the table titled SUMMARY OF WATER SOLD AND WATER SALES "sets forth the acre-feet of water sold and water sales (including sales from water wheeling and exchanges) for the five fiscal years ended June 30, 2015."

A-48-51: Litigation Challenging Rate Structure. As noted earlier, MWD's discussion of the rate litigation should account for case law that does not support MWD's contentions on appeal, including its contention that Proposition 26 does not apply to wholesale water suppliers. See discussion and footnote 1.

MWD's description of its accounting for the disputed funds deposited by the Water Authority under the Exchange Agreement should be revised to include disclosure that the newly created "Exchange Agreement Set-Aside Fund" is in a category of "funds" that is not identified in Section 5200 of MWD's Administrative Code. Instead, staff reported yesterday that this is a "Board Directed Fund," another term which is not disclosed or described anywhere in the Administrative Code or Appendix A.

It is apparent from MWD's accounting of fund balances (see pages A-54-55 discussion of MWD's financial reserve policy) that the funds paid by the Water Authority as disputed amounts under the Exchange Agreement are not being held by MWD as a security deposit, but rather, are being commingled with other unrestricted reserves the MWD board may spend in its discretion. This treatment is not only a breach of the Exchange Agreement, but contrary to statements MWD's counsel has made to the Court in the rate litigation that these funds are being held for the intended purpose of securing payment to the Water Authority if it prevails on appeal. The Water Authority's disputed funds are doing "double duty" by being available to meet MWD's minimum unrestricted reserve level at the same time they are supposed to be securing payment to the Water Authority.

But the same funds can't be used at the same time for both purposes without either dipping below minimum reserves or failing to maintain the security deposit MWD is contractually required to maintain. MWD either breached its contractual obligation to the Water Authority or its representations to bond holders when it used \$104 million from its unrestricted reserves to pay for the PVID land purchase. See Attachment 3 for a complete discussion of this issue.

We object generally to the continued practice of editing Appendix A to comport with MWD's evolving litigation strategies rather than reporting and disclosing facts that are material to potential investors.

Metropolitan Response: As disclosed on A-55 in “METROPOLITAN REVENUES—Financial Reserve Policy,” Metropolitan established the Exchange Agreement Set-Aside Fund and transferred the disputed amounts to this account. Appendix A states that Metropolitan projects that its unrestricted reserves as of June 30, 2016 will be \$408 million. This amount does not include the amounts held in the Exchange Agreement Set-Aside Fund. Appendix A has been edited to state this expressly. See the response at the beginning of this letter concerning case law.

A-51: Member Agency Purchase Orders. MWD's two-tier purchase orders are completely disconnected from the cost of service and do nothing to provide any meaningful level of financial stability for MWD. There is no reason to reference them except to create the misleading impression that they accomplish one or the other of these purposes. MWD's current two-year budget assumes zero water sales at the Tier Two level.

Metropolitan Response: The description of Member Agency Purchase Orders is accurate as stated in Appendix A.

A-52: Classes of Water Service. Unlike other outdated text, MWD continues to report "classes of water service," even though two out of the three rates have been eliminated. Cost of service law requires MWD to establish classes of customers based on their patterns of usage, not classes of water service.

Metropolitan Response: The information is accurate as presented and the eliminated rates are used in a table showing historical rates dating back to 2012. Additionally, as in past SDCWA communications, SDCWA fails to identify any legal authority that “requires MWD to establish classes of customers.” No such authority exists. As we explained at pages 3-4 of Metropolitan’s April 12, 2016 letter to SDCWA, and also at pages 3-4 of the Raftelis Financial Consultants response to SDCWA of the same date, Metropolitan’s rate structure is designed to capture the usage characteristics of Metropolitan’s 26 member agencies. Member agencies pay for the services they use.

A-54-55: Financial Reserve Policy. The fact that MWD is unwilling to "set aside" the Water Authority's disputed amounts, as it is contractually required to do, may reasonably be viewed as an indication that it is financially unable to do so. MWD has already had to borrow money through a commercial line of credit in order to replace funds it spent from the security deposit.

Metropolitan Response: See Response to comment on “A-48-51: *Litigation Challenging Rate Structure*” above.

A-57-58: California Ballot Initiatives. MWD's edits regarding Proposition 26 are inconsistent with existing law and are litigation-driven to support its argument -- rejected by the trial court -- and appellate decisions that the MWD board is the relevant "electorate" for purposes of Proposition 26.

Metropolitan Response: Metropolitan’s disclosure on California Ballot Initiatives accurately describes existing law.

A-75: Projected Costs of MWD for State Water Project Water. What accounts for the substantial increases in the minimum operations, maintenance, power and replacement costs? When was this reported to the MWD Board? Please explain.

Metropolitan Response: Projected costs to MWD for State Water Project water are reported on by the Controller as part of the quarterly Financial Review that is presented to the Finance and Insurance Committee. It was also covered in the presentations as part of the adoption of the biennial budget in April 2016 and in presentations to the Water Planning and Stewardship Committee in December 2015.

A-78-82: Historical Projected Revenues and Expenses. In recent years, MWD has not even attempted to accurately project its revenues and expenses, instead following an admitted strategy to arbitrarily collect and then decide later how to spend hundreds of millions of dollars outside of its budget and rate-setting process. Over the past five years alone, MWD collected – and has now spent – more than \$850 million outside of its budget process, shifting money from fund to fund as necessary, including funds that are not even identified in its Administrative Code, such as the Water Management Fund. MWD’s turf removal program and the unplanned purchase of the land described at page A-82, paragraph (p) as a “Pay-As-You-Go expenditure for fiscal year 2015-16” typify this erratic behavior. Since this money was spent, MWD has been forced to take out commercial lines of credit in order to maintain its required reserves. MWD’s Long Range Finance Plan is now more than ten years old, because the MWD Board is unwilling to make any commitments to pay MWD’s future costs, or grapple with the challenges of an agency spending billions of dollars with no one on the hook to pay for it.

Metropolitan Response: Metropolitan projects revenues and expenses assuming an average year hydrology. When net revenues are greater than projections, they add to the Water Rate Stabilization Fund. When the balance in the Water Rate Stabilization Fund is above the target level, the Board may appropriate these amounts for other purposes as has been the case over the past several years. For Fiscal Year 2016, it is projected that net revenues will be less than projections.


A-82-84: Management’s Discussion of Historical and Projected Revenues and Expenses. Statements by management, like its IRP, fail to disclose material factors influencing the future demand for MWD water, rate increases that will be necessary to pay MWD’s costs with a diminishing sales base, and the impacts of MWD’s recent very large unplanned expenditures (turf removal, PVID land acquisition and acquisition of Delta islands). MWD lacks an IRP resource plan that has buy-in from the member agencies that prefer the present model in which no agency is asked to commit to pay MWD any of its costs before they are invested. This problem was identified by MWD's own Blue Ribbon Task Force

more than 20-years ago but MWD has yet to address it in a meaningful way, for example, the Board's recent inability or unwillingness to adopt a fixed water treatment charge. This exercise will only become more difficult as MWD continues to spend large amounts of money under the present governance model imposing rates that have already been declared illegal.

Metropolitan Response: See Response to comment on *A-8-9: Integrated Resources Plan (IRP) and Breakdown of MWD Governance* above. The litigation filed by SDCWA challenging Metropolitan's rates is on appeal and there is not a final decision concerning the legality of the rates.

Thank you for your comments on Metropolitan's disclosure document, Appendix A. We carefully reviewed and considered them and circulated them to our bond counsel team, financial advisor, and underwriters. Appendix A was revised to address certain comments as described in this letter.

Sincerely,



Gary Breaux
Assistant General Manager/Chief Financial Officer

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

Attachment 1— Appendix A draft dated May 31, 2016, showing changes from the
October 1, 2015 draft