THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

November 19, 2012

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 November 5, 2012, regarding Board Letter 8-1

This letter responds to your proposed edits to the October 24, 2012, draft of the Official Statement for Metropolitan's Water Revenue Refunding Bonds, 2012 Series G, attached to Board Letter 8-1. Chairman Foley asked me to respond to your letter.

A-3 – Integrated Water Resources Plan
The description added of the 2010 IRP update as an "adaptive management approach" is misleading. The IRP estimated water sales numbers are substantially higher than those used in Metropolitan's Urban Water Management Plan or disclosed in its offering statements. As noted in the August 20 letter on page 1, **Reduced Sales**, Metropolitan has finally 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. However, these flawed numbers are still contained in Metropolitan's IRP, and Metropolitan's IRP is still being used as the basis of its water resources planning and spending decisions. Calls to update the IRP or adjust spending decisions to *adapt* to these reduced demands have gone unheeded. Apparently, Metropolitan believes that its water sales can only "adapt" to increase, but never to decrease. This is a materially-flawed planning assumption that is inconsistent with known facts.

Metropolitan should also include in the discussion of its IRP implications of the recent *Preserve Wild Santee* case noted in footnote 1 of this letter.

Your comment confuses the range of demands analyzed in Metropolitan's Integrated Resources Plan and the 2010 IRP Update with the water sales base used to set biennial budgets and determine water rates. The IRP resource mix addresses a range of possible supplies and demands, from 1.5 million acre-feet (MAF) to 2.5 MAF, that Metropolitan and its member agencies will manage adaptively to meet changing conditions through 2035. The water sales projections used to determine Metropolitan's biennial budget and rates, 1.7 MAF for each of fiscal years 2012-13 and 2013-14, have been conservatively set near the lower end of the range analyzed in the IRP so that there is a reasonable certainty that the sales estimate will be met or exceeded. The IRP is updated about every five years; the water sales projections are updated for every budget and rate cycle.

The draft that you reviewed explains the distinction between financial planning and resource planning projections, in response to earlier comments from SDCWA directors, on page A-77: "Metropolitan has conservatively set the water sales projections in the following table (of Historical and Projected Revenues and Expenditures) *which are below its projections for resource planning purposes.*" (Italics added.) This page also discloses that Metropolitan's water sales assumptions have been questioned by SDCWA directors.

The *Preserve Wild Santee* case has no implications material to holders of Metropolitan's bonds.

> **A-18 – Sale of Water by the Imperial Irrigation District to SDCWA**
> Add to the last sentence of the first full paragraph at page A-19, "and Metropolitan has agreed to convey and exchange to the Water Authority in 2012 an additional 16,722 acre-feet of Conserved Water, regardless of the pending dispute between the parties as to whether the water was actually made available in 2011."

Pursuant to your suggestion, updated Appendix A states: "Metropolitan has agreed to exchange with SDCWA up to an additional 16,722 acre-feet in 2012 if IID delivers that volume of conserved water after IID has met its 2012 obligation of 90,000 acre-feet."

> **A-31 – Los Angeles Aqueduct**
> Disclosure should be made of the litigation that the City of Los Angeles has recently filed challenging its Eastern Sierra environmental mitigation obligations. The implications of this litigation should also be added at page A-12 discussing the open-ended "decision tree" process for determining environmental mitigation requirements associated with the Bay Delta Conservation Plan.

Pursuant to your suggestion, Appendix A briefly describes the City of Los Angeles litigation challenging its environmental obligations.

> **A-34 – Seawater Desalination**
> The offering statement has embedded Metropolitan's disclosure of the SDCWA's Carlsbad seawater desalination project in the discussion about its own subsidy program in a manner that is misleading and creates the impression that implementation of the SDCWA's project depends upon execution of the original multi-party incentive agreement in which Metropolitan was a party. Metropolitan is not a party to the SDCWA's draft water purchase agreement with Poseidon. We suggest deleting the following sentence that was added to the middle of the last paragraph on page A-34, "In late September 2012, SDCWA released a draft water purchase agreement with Poseidon for public review." The same sentence is included in the paragraph that has been added at the top of page A-35, where it is less misleading.

The sentence you identified was moved pursuant to your suggestion. This paragraph clearly discloses that the original multi-party agreement approved by Metropolitan was not executed and that SDCWA is considering a draft water purchase agreement with Poseidon Resources LLC.

> **A-48 – Water Sales**
> While we appreciate the addition of footnote 3 to disclose that 225,000 acre-feet of Metropolitan's 1,676,855 acre-feet of water sales in 2012 were replenishment sales, the report of Metropolitan's water sales remains misleading as a result of its use of "averages" and its inclusion of its transportation and exchange of the SDCWA's Colorado River water as "water sales" by Metropolitan. Providing more detailed information about *actual sales* rather than "average" sales would help investors understand important and substantial trends in the volume of sales and price of Metropolitan water.

We did not make this edit. The presentation of water sales in Appendix A, with wheeling and exchange revenues included in water sales, is consistent with presentations in prior Official Statements. This presentation was developed by the financing team to consistently show changes in Metropolitan's rates and charges over the reporting period and Metropolitan's accounting for such revenues. Wheeling and exchange revenues are included in aggregate water sales, as in previous offering statements, and are separately disclosed under the heading "Wheeling and Exchange Charges."

Actual water sales and water revenues are disclosed in the Summary of Receipts by Source, Ten Largest Customers, Historical and Projected Revenues and Expenditures and other financial tables. Actual acre-feet sold and receipts are disclosed on the Summary of Water Sold and Water Sales Receipts table. Averages (average receipts per acre-foot and average rate per 1000 gallons) are provided to show average impacts across the range of Metropolitan's rates. The formula used to calculate these averages is described in footnote 5 to the table. This footnote cross-references the table of actual rates to avoid confusion.

A-52 – Member Agency Purchase Orders
Metropolitan fails to disclose the conclusion reached by Metropolitan's own staff and reported to the board of directors, that the use of Purchase Orders fails to meet the Board's articulated objective of providing for an annual assured revenue stream sufficient to pay Metropolitan's costs. Metropolitan's Purchase Orders are also subject to the requirements of state law and the state constitution including but not limited to Proposition 26.

The existing description accurately summarizes the current terms of the purchase orders, including board authorization of a two-year extension. The purchase orders define the Tier 1/Tier 2 price point and provide a Tier 2 price signal. Metropolitan believes that the purchase orders conform to the requirements of California law.

A-53 – Classes of Water Service (Replenishment)
The description of the "Replenishment Service Program" as a sound water resource and financial program is inconsistent with Metropolitan's own assessment of the Program as featuring "questionable and unquantifiable performance criteria for a discounted water program," loss of full service sales due to the availability of discounted water and the unequal distribution of costs and benefits among the member agencies. Given that Metropolitan has disclosed that it remains in discussion with its member agencies about how to continue discounted water sales under a new label ("incentive-based water storage program"), the last paragraph of this section, describing the fact that discounted water sales offset full service water sales, should not be deleted.

The description of historic replenishment sales was and is factually accurate. In response to your comments, we have clarified the status of discussions of a program to replace replenishment service. Such discussions may continue in the future.

A-65 and A-70 – Variable Rate and Swap Obligations
Metropolitan has added a number of disclosures in its official statement regarding a possible loss in the value of its existing swap transactions that could be as high as $169 million if interest rates remain unchanged or do not increase substantially during the remaining life of the swap agreements which range between 8-12 years. Further, it appears that the counterparty holding the swap can elect to terminate during optional dates which would result in an immediate loss to Metropolitan. This should also be disclosed in Metropolitan's offering statement. Please advise if this is a correct interpretation of the disclosures added to the offering statement and whether these investments are consistent with the board's investment policy.

Your interpretation is not correct. The market value of Metropolitan's interest rates swaps are an estimate of termination payments to its swap counterparties should all of Metropolitan's interest rate swaps be terminated at the referenced date. There is no "loss of value" to Metropolitan, rather a recognition of the market value of each swap. As stated in Appendix A, Metropolitan does not anticipate early termination of any of its interest rate swap agreements due to defaults or occurrence of a termination event. Metropolitan's swap counterparties do <u>not</u> have optional termination rights, while Metropolitan does have the right to early termination of an interest rate swap (which it exercised for all or a portion of various swap agreements in June 2012 as referenced in Appendix A). Upon Metropolitan holding any or all of an interest rate swap agreement through its final term, the swap will terminate at par (that is, the market value of the interest rate swap will be zero) and neither party will have a payment obligation to the other party. All of Metropolitan's interest rate swap agreements are in compliance with Metropolitan's Master Swap Policy.

> **A-79 – Historical and Projected Revenues and Expenditures**
> See discussion at A-48 and footnote 5 of this letter, that the word, "discounted" should be added before the words, "replenishment sales" in footnote (b) at page A-80.
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> In addition, given (1) Metropolitan's actual water rate increases as described; (2) Metropolitan's reduced water sales as described at section A-3 of this letter; (3) the time line within which Metropolitan is legally required to disclose and begin to manage payment of its combined unfunded retiree health care obligation and unfunded pension obligation currently totaling $757 million; and (4) the projected time line for BDCP implementation, there is no reasonable basis for the statement by MANAGEMENT that "rates and charges are projected to increase 3.0 percent per fiscal year" beginning in 2015 and thereafter. The *actual* rate increases over the past five years are a far better indicator of Metropolitan's future rate increases than the projection by MANAGEMENT.

Actual rate increases over the past five years are material information to help investors judge Metropolitan's financial performance. Thus Appendix A includes a table showing all rates, including replenishment rates, in effect back to January 1, 2008. Anticipated increases are based on cost projections and the conservative sales projections discussed multiple times in Appendix A and in this letter, which are derived from and consistent with budget documents, the Integrated Resources Plan, and financial reports. As discussed, Appendix A describes sales trends, details of revenues and expenditures, and the basis for future projections. Together this information provides a materially accurate representation of historical and projected revenues and expenditures.

> **A-81 – Board direction to staff to evaluate cost-of-service methodology to ensure that all rates and charges recover the full cost of service effective January 1, 2011**
> It should be disclosed that the SDCWA's MWD rate litigation alleges that Metropolitan has failed to properly allocate its costs proportionally among the member agencies that

> benefit. The staff has also failed to comply with this board direction by failing to include in its cost of service a credible plan to pay the cost of Metropolitan's unfunded retiree health care obligation and unfunded pension obligation – currently totaling $757 million. Given that investors rely upon the willingness of the Metropolitan board to raise water rates sufficiently to cover its expenses, it should be clearly disclosed in the Official Statement that these costs are not covered by the water rates and charges recommended by staff and approved by the board of directors.

Your comment fundamentally misrepresents Metropolitan's rate setting process**.** As we have previously reported and discussed, Metropolitan sets rates prospectively to recover anticipated costs of service, in the aggregate. Metropolitan's postage stamp rates recover system-wide costs; neither costs nor revenues are allocated to specific member agencies. The Board's direction in April 2009 that staff study the cost-of-service methodology with the intent to ensure that all rates and charges recover the full cost of service effective January 1, 2011, shows the Board's intent to set rates that fully recover costs and reduce reliance on reserves. This direction produced a cost-of-service review by the Long-Range Finance Plan working group in summer 2009, and Board approval of the existing methodology in November 2009. The recommended rates and revenue requirements January 2010 for rates to be effective January 1, 2011 were anticipated to meet projected costs of service. The adopted rate increases are listed following the sentence targeted in your comment.

SDCWA's allegations about Metropolitan's rates are summarized under "Litigation Challenging Rate Structure." This summary is referenced in the body of the Official Statement and various places within Appendix A, including a new reference to the litigation in the introductory list of Metropolitan's member agencies. Appendix A describes Metropolitan's pension and retiree healthcare costs, their funding status, and cost projections under "Defined Benefit Pension Plan."

> **A-81 – "Unrestricted" Reserve Balances**
> We do not understand how reserve balances that are held as collateral can be described as "unrestricted." Please explain.

We have clarified this language in response to your comment. Collateral that Metropolitan is required to post to its swap counterparties originates from the unrestricted reserve balances. While held as collateral, these amounts are contractually restricted. Should Metropolitan's swap counterparties be required to post collateral to Metropolitan in the future, then those amounts would also be held in the unrestricted reserve balances (or Metropolitan's General Fund), and will be contractually restricted as to use.

Again, board member review of the information about Metropolitan in Appendix A is a key part of the disclosure process. We have responded to your proposed edits as described above. Your November 5 letter also reiterates your opinions on points that you raised in your letter of September 4, 2012. We will not repeat the responses that we provided in the October 25 response to your October 8 letter. Your views and Metropolitan's responses have been clearly stated and another repetition would not be productive.

Sincerely,

Gary Breaux
Assistant General Manager/Chief Financial Officer

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