THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

May 19, 2014

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 May 12, 2014 regarding Board Letter 8-2

This letter addresses your comments dated May 12, 2014 on Draft Appendix A to the Official Statement for Metropolitan's Special Variable Rate Water Revenue Refunding Bonds, 2014 Series D, attached to Board Letter 8-2. 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. Bond counsel does not serve as disclosure counsel and will not be responding to your letter. 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, not to promote Metropolitan's position in any litigation. Appendix A is updated for each bond offering 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 ***General Comments*** in your letter show continuing, purposeful misstatements about Metropolitan's current financial planning documents and a general lack of recognition of Metropolitan's Board-adopted policies. The biennial budget and ten-year financial forecast adopted in April 2014 comprise Metropolitan's long-range finance plan and replace the financial forecast in the previous long-range finance plan adopted by the Board in 2004. Incorporating a ten-year financial forecast within the biennial budget helps ensure that the long-range financial plan will be updated every two years.

Water rates and charges are set by the Board using projected costs of service for the budget period, and normal sales assumptions to produce stable, predictable rates. For the past two years, sales have exceeded projections, primarily due to exceptionally dry weather, a rebounding economy and other factors. In April 2014, the Board approved the use of reserves anticipated to be over the Board-adopted reserve target. As you know, in prior years when sales did not meet budget projections Metropolitan drew down reserves to meet costs as required.

Projected costs of service – how much money Metropolitan needs to provide its service – are presented and scrutinized in public board and committee meetings and workshops over a three-month budget process. This year, in the budget and rates actions the Board approved use of reserves over target to reduce future obligations, keep future rate increases reasonable and provide funding for drought response programs, in accordance with Metropolitan's policy that requires Board direction for use of these funds. Characterizing Metropolitan's detailed, open and public budget and rate setting procedures as using "massive over collections ... any way it wants" is both irresponsible and a deliberate misrepresentation of the facts.

Regarding accounting terminology referencing revenues and expenses (and receipts and expenditures), the revisions in Appendix A were made to more accurately reflect the appropriate basis of accounting (cash basis or accrual basis) for the applicable information.

Comments on Draft Appendix A dated April 30, 2014

The following specific SDCWA comments and Metropolitan's responses refer to the draft dated April 30, 2014 of Appendix A, showing changes from the November 25, 2013 draft (Attachment 2).

A-4: Drought Response Actions. MWD lacks a comprehensive board policy guiding the use and replenishment of storage reserves to meet dry-year demands. While MWD may have sufficient water in storage to meet full demands this year, the use of more than 1 million acre-feet – or, almost one half -- of MWD's reserves in one year as currently planned poses a great risk to MWD's water supply reliability next year and in future years, should the drought continue. Appendix A should disclose that risk and MWD's plan to mitigate the risk and related impacts to MWD's revenues and finances. MWD should also disclose where it expects to secure supplemental water transfers and purchases to meet regional demands under current conditions.

> **Metropolitan Response:** As most recently presented at the Water Planning and Stewardship Committee on May 12, 2014, Metropolitan's Water Surplus and Drought Management Plan ("WSDM Plan") was adopted by Metropolitan's Board in 1999. The WSDM Plan is a comprehensive board policy that guides the use of storage reserves. Its guiding principle is to "encourage storage of water during periods of surplus and work jointly with its member agencies to minimize the impact of water shortages on the region's retail customers and economy during periods of shortage." The WSDM Plan includes a matrix of stages and actions that describe operational preferences under

surplus and shortage conditions. This comprehensive plan is described in Appendix A under "Water Conservation" on page A-30.

Further, the Board reviews available storage and the need to preserve storage for future use when it considers declaring a "Regional Shortage Level" under the Water Supply Allocation Plan. This Plan is described in Appendix A under "Water Supply Allocation Plan" on page A-31. References to these discussions of the WSDM and Water Supply Allocation Plans in Appendix A will be added to the Drought Response Actions section in Appendix A. The Metropolitan Board will continue to receive regular updates and will determine where and when to obtain supplies to replenish storage and the associated cost. The possible impact on Metropolitan's revenues and finances has been addressed in large part by allocating a portion of the reserves over target to a water management fund to be used specifically for drought response.

A-4: Financial Reserve Policy. MWD's financial reserve policy for many years was to cap reserves to ensure MWD did not retain more cash than it needs from its ratepayers – as evidenced by the use of the word, "maximum level" of reserves in all previous Appendix A Official Statements. Recently, staff self-declared that the policy was not a "cap" at all, but a "target," all without a single board meeting or directive to change the policy.

The discussion of MWD's financial reserve policy at page A-4 also creates the appearance that MWD has "planned" to manage under and over collections through its "financial reserve policy." Nothing could be further from the truth. MWD's revenue and expense projections have historically been off by hundreds of millions of dollars -- over or under. This is not the result of "drought," "climate change" any other unforeseen circumstance or financial management through MWD's "reserve" policy; it is simply the result of poor planning and estimation by MWD, and the improper use of reserves for expenditures other than maintaining stable and predictable water rates and charges. As noted above, MWD has recently changed its "budget" and rate-setting process to use sales and revenue estimates that staff knows will be exceeded in seven out of ten years. MWD has chosen to set budget and rates arbitrarily, rather than best-estimated sales and expense projections that are essential to sound business management and rate-setting. This shift and the risks of such an approach should be disclosed in Appendix A.

In order to avoid the consistent, materially incorrect shortcomings in its sales estimates used in rate setting, MWD should instead take into account its member agencies actual projected demand for MWD water, which factors in their reductions or increases in reliance on local water supplies. MWD's failure to do so presents a substantial risk of stranded costs and commensurate impact driving up water rates.

Metropolitan Response: "Target" is the terminology used in Section 5202(e) of the Administrative Code. The Code states that funds exceeding the "targeted amount" (the high reserve level calculated in accordance with Board policy) shall be used for capital expenditures and for other purposes of Metropolitan, as determined by the Board. In

April 2014 the Board determined the uses of projected reserves anticipated to be over the target at the end of this fiscal year.

Metropolitan estimates that its water sales assumptions in the budget have a seventy percent statistical likelihood of being exceeded. These conservative projections are informed by experience and were lowered from prior estimates that used a fifty percent exceedance level, after a number of years in which sales fell below budget projections and reserves were drawn down to meet the costs of service. Actual water sales have always differed from projected or budgeted estimates. In fact, over the ten-year period from fiscal year 2003/04 through 2012/13, actual sales exceeded budget in five fiscal years and were less than budget in the other five years. (See “MANAGEMENT’S DISCUSSION OF HISTORICAL AND PROJECTED REVENUES AND EXPENSES—Water Sales Projections” in Appendix A.)

Water sales projections do take into account member agency demands for Metropolitan water. The information and data used for the analysis are obtained in annual surveys of member agencies through monitoring local resources projects, through coordination with water masters of groundwater basins, and from anticipated reductions due to new resources projects.

Also, please see Metropolitan’s response to “*A-59, 60 Financial reserve policy,”* particularly Metropolitan’s comments regarding Attachment 4.

A-6 Recycled Water. The description of recycled water as “not potable” is dated and should be modified. Orange County Water District already is using recycled water to recharge its groundwater basin. With today’s technology, recycled water can be treated to potable water quality.

Metropolitan Response: Thank you for this comment. The description of recycled water will be modified in Appendix A as recommended by the Finance and Insurance Committee and approved by the Board.

A-21 Sale of Water by the Imperial Irrigation District to San Diego County Water Authority. The Water Authority has objected on many past occasions to the language describing the sale of water by IID to SDCWA and transportation of that water by MWD as the payment by the Water Authority of "a lower rate" for the MWD water. This language is designed solely to support MWD's litigation arguments, and does not accurately describe the facts or terms of the Exchange Agreement. The description is misleading in that it intends to suggest to the public that MWD's water sales are higher than they really are.

Metropolitan Response: Metropolitan has consistently treated deliveries of Exchange Water as water sales since those deliveries began in 2003. In addition, the characterization of water deliveries is consistent with the terms in the Exchange Agreement. The water sales information in Appendix A discloses that water sales revenues include revenues from water wheeling and exchanges. These revenues are classified as operating revenues accordingly.

A-29 MWD water storage capacity and water in storage. The Table that describes MWD's various storage accounts should also disclose MWD's contractual obligations to deliver water out of storage. For example, on page A-26, the Appendix A described the arrangement MWD has with Southern Nevada Water Authority whereby MWD agrees to store unused Nevada's Colorado River apportionment for SNWA's later use. The Appendix A states that through 2013, MWD has stored 160,000 acre-feet of SNWA water, which it eventually will need to pay back. That information, and any other MWD obligations and limitations on available storage supplies, including take capacity, should be disclosed clearly on the table displayed on page A-29.

Metropolitan Response: The SNWA interstate banking water is part of MWD's overall storage balances, but it is not a separate storage account. Metropolitan considers contractual obligations to return water as a demand in the year the water is anticipated to be returned. As noted in Appendix A, as part of a 2012 executed amendment, it is expected that SNWA will not request return of this water before 2022.

A-43 Capital Investment Plan. Please explain why "resource development" was deleted as an objective of the Capital Investment Plan (CIP). Also, how MWD has valued "flexibility" for purposes of rate-setting and allocation of CIP costs. These edits again appear to be litigation-driven rather than based on any facts or programmatic changes to or relative benefits of the CIP.

Metropolitan Response: This section describes the types of projects in the current CIP. The categories on this table change with changes in current CIP projects. Capital projects needed for "operational flexibility," such as the projects to deliver Colorado River water to connections that typically receive State Water Project water, are included in the CIP projects planned through 2019. Projects to meet future water demands are also included. These projects and others currently in planning are described in under the new Water Delivery System Improvements in the Capital Investment Plan Appendix to the FY 2014/15 and 2015/16 Budget posted on Metropolitan's website at http://edmsidm.mwdh2o.com/idmweb/cache/MWD%20EDMS/003734789-1.pdf, starting on page 177.

A-44 Pay-as-you-go funding. The Appendix A should disclose that the over-collected revenues were not the result of "improved financial operations," as stated, but rather, were the result of poorly estimated revenues and the intentional use of sales that exceed artificial estimates as described above. The Appendix A misleads the reader into believing that MWD's over-collected revenues are the result of improved financial operations, when nothing could be further from the truth. Further, the Appendix A states that, "[a]s in prior years, pay-as-you-go funding may be reduced or increased by the Board during the fiscal year," without mentioning that the board has had an established pay-as-you-go funding policy that it has failed to meet. Moreover, there has never been any board policy discussion on the merits of changing the $95 million cap to

$160 million. MWD's lack of disclosure on financial projections and policies is arbitrary and inherently involves great risk, which should be disclosed in the Appendix A.

> **Metropolitan Response:** See the response to your General Comments above. We will clarify that pay-as-you-go (PAYG) funding is expected to increase based on improved financial *conditions* in FY 2013-14. These improved conditions were due to increased sales in a record dry year, the rebounding economy and other factors.
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> Contrary to your assertion, the increase in PAYG funding was discussed and approved by the Board during discussions for the April 2014 budget and rate actions. The policy states that it is the Board's objective to fund on a pay-as-you-go basis a portion of the capital investment plan to maintain stable rates and charges, strong financial ratios, debt capacity and appropriate reserves. The $95 million cap, increased by the Board to $160 million, was determined by the Board as part of the biennial budget process, and reflects Board approval of depositing $100 million of funds over the June 30, 2014 reserve target into the R&R Fund for future capital funding.

A-46 Distribution system - prestressed concrete cylinder pipe. Please provide a copy of the estimate to reline all 100 miles of PCCP at $2.6 billion.

> **Metropolitan Response:** The PCCP Rehabilitation and Replacement project estimate is included in the Capital Investment Plan Appendix to the FY 2014/15 and 2015/16 Budget posted on Metropolitan's website at http://edmsidm.mwdh2o.com/idmweb/cache/MWD%20EDMS/003734789-1.pdf, beginning on page 147.

A-46 Administrative Code. Please add a statement that the General Counsel has opined that the Administrative Code may be waived by the Board of Directors ex post facto, without prior notice and without even knowing that they are doing so. We are aware of no other public agency that has such an unusual procedural process, which we believe materially reduces the transparency and accountability of the MWD board of directors and limits the public's - and bond investor's - ability to be advised in advance and be heard on MWD board actions.

> **Metropolitan Response:** This comment misrepresents General Counsel Marcia Scully's statement in the General Counsel's January 10, 2014 letter (see Attachment 2). Metropolitan's Board may exercise authority granted to it by State law as long as it acts in accordance with State law. Any failure to conform to internal procedural rules that the Board adopted for its own governance would not make the Board's actions invalid. Your comment is also incorrect in suggesting that Metropolitan's Board procedures reduce "transparency and accountability" and limit "the public's—and bond investor's—ability to be advised in advance and be heard on MWD board actions." There was full compliance with the Brown Act in both the notice of the action to be taken by the Board, and the opportunity for the public to appear and be heard before the Board.

A-50 Property taxes. Please indicate that there is substantial disagreement regarding MWD's interpretation of what is "essential to the fiscal integrity of the district" and that there has been no cost-of-service study or report supporting the claim that the suspension of the tax limitation results in a "fair distribution of costs throughout MWD's service area," except for MWD's own bald assertion that is the case.

> **Metropolitan Response:** Appendix A describes the findings of the Board in its resolution adopted June 11, 2013. This resolution was adopted by the affirmative votes of directors representing more than a majority of the votes of all the member agencies and constitutes an action of Metropolitan. The votes of a minority of directors against the resolution do not invalidate the majority approval of this resolution. Future findings, if any, regarding fiscal integrity will be within the discretion of the Board.

A-52 Water wheeling and exchanges as MWD "sales." MWD continues the highly misleading practice of reporting revenues from wheeling service as MWD water sales. Wheeling service should be reported separately from the sale of MWD water supplies. It is also highly misleading to investors to use "average" dollars per gallons per acre-foot of water sold because it impedes the ability of investors in MWD bonds to understand what alternative sources of supply are competitive with MWD water supplies and therefore may be expected to reduce MWD's future water sales.

> **Metropolitan Response:** See the response to your comments from page A-21 of Appendix A. Average dollars per thousand gallons of water sold are shown in the last column on the table in response to questions in the past. This illustrates the cost of Metropolitan water for a volume of water that is more easily pictured by the average investor than an acre-foot.

A-53-55 Litigation Challenging Rate Structure. Although MWD characterized the Water Authority's rate cases as a challenge to MWD's "rate structure," the cases challenge the specific allocation of costs in the specific years at issue in each case. The description of the Court's ruling is incomplete in that it fails to mention that the Superior Court found that MWD's allocation of costs are not reasonable and violate the common law, California statutes and the California Constitution, including Proposition 26. The trial court has determined that MWD's rates violate all of these legal standards and requirements.

> **Metropolitan Response:** Metropolitan’s description of the allegations and the substance of the trial court ruling are accurate as drafted. We will consider adding the ruling’s statement regarding violation of statutes, common law and Proposition 26 to our description, pursuant to this comment and your comment referencing pages A-62-63 of Appendix A.

A-59, 60 Financial reserve policy. Please provide a copy of the probability studies of the wet periods that affect MWD's water sales. Please provide a 10-year summary of how successful the Water Rate Stabilization Fund has been in maintaining stable and predictable water rates and charges. MWD's financial reserve policies must be revised to comply with Proposition 26. MWD is essentially operating a giant slush fund without any cost-of-service basis for its rates and charges prior to or after collection of those rates and charges.

> **Metropolitan Response:** The reserve policy, establishing minimum and target reserve levels, was approved by the Board in the 1999 Update to the Long Range Finance Plan. The policy utilized probability studies of wet period that affect Metropolitan's water sales. This analysis is described in Chapter Four of the 1999 Update to the Long Range Finance Plan (see Attachment 3). This policy is adopted in section 5202 of the Administrative Code.
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> The attached ten-year summary (see Attachment 4) shows the calculated reserve minimum, target reserve and actual reserves at the end of each fiscal year and average rate increases. In fiscal years 2009/10 and 2010/11 rate increases would have been higher if not for this use of reserves. In fiscal years 2012/13 and 2013/14 Metropolitan authorized use of reserves over target to fund capital expenditures, reduce long-term obligations and fund drought management programs. Use of reserves is incorporated in the cost-of-service analysis and rate projections.

A-62 Ten largest water customers. It is misleading to characterize wheeling/exchange water as MWD "water sales" because there is no basis in law or fact for doing so.

> **Metropolitan Response:** See the response to your comments referencing page A-21 of Appendix A.

A-62-63 California ballot initiatives. The Appendix A fails to disclose that the Superior Court has already ruled that Proposition 26 applies to MWD for all rate years subsequent to the time the ballot measure was passed in November 2010, i.e., MWD is subject to Proposition 26 going forward. MWD has not established rates and charges that comply with Proposition 26 and will have the burden in court in future years to prove that it has done so. This presents a substantial risk of ongoing and continued litigation unless and until MWD changes its cost-of-service and rate-setting practices.

> **Metropolitan Response:** This section refers to "Litigation Challenging Rate Structure," which describes SDCWA's allegations under Proposition 26 and the trial court's decision. The trial court's ruling that Proposition 26 applies to Metropolitan's rates effective in 2013 and 2014 is subject to appeal and has no precedential value.

A-81 BDCP costs. Please confirm what BDCP costs have been included on the Table at page 81.

> **Metropolitan Response:** Footnote 4 will be corrected to read, "(4) Annual totals include BDCP related costs for the fiscal years ended June 30, 2014 through June 30, 2018, of $7.2 million in fiscal years 2013/14, $-0- in each of fiscal years 2014/15 and 2015/16, $15 million in 2016/17 and $24 million in 2017/18." 2013/14 costs are for DHCCP

related planning costs that Metropolitan has classified as capital related costs. Projected BDCP costs for 2016/17 and 2017/18 are reflected in the ten-year financial forecast provided in the biennial budget for fiscal years 2014/15 and 2015/16 that was approved by Metropolitan's Board on April 8, 2014.

A-84 Historical and projected revenues and expenses. MWD's projected revenues and expenses have been arbitrarily established. No member of the public or investor could know what MWD's projected revenues and expenses will be, given the arbitrary manner in which MWD has established its budget and rates as described above. Further, MWD has a poor record of projecting future rate increases; its rates have more than doubled over the past ten years, which is materially more than projected by MWD. Its future rate projections -- which include investments that may be made in the BDCP -- will supposedly result in rate increases lower not higher than in the past. This is not logical or based on any credible cost analysis or rate projections.

Metropolitan Response: See responses above.

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

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 April 30, 2014, showing changes from the November 25, 2013 draft

Attachment 2—Letter from General Counsel dated January 10, 2014

Attachment 3—Long Range Finance Plan, 1999 Update, Chapter 4 Fund Policies

Attachment 4—Ten-year summary of reserve minimum, target and actual reserves and average rate increases