



San Diego County Water Authority

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December 9, 2013

John (Jack) V. Foley and
Members of the Board of Directors
Metropolitan Water District of Southern California
P.O. Box 54153
Los Angeles, CA 90054-0153

MEMBER AGENCIES

- Carlsbad Municipal Water District
 - City of Del Mar
 - City of Escondido
 - City of National City
 - City of Oceanside
 - City of Poway
 - City of San Diego
 - Fallbrook Public Utility District
 - Helix Water District
 - Lakeside Water District
 - Olivenhain Municipal Water District
 - Otay Water District
 - Padre Dam Municipal Water District
 - Camp Pendleton Marine Corps Base
 - Rainbow Municipal Water District
 - Ramona Municipal Water District
 - Rincon del Diablo Municipal Water District
 - San Dieguito Water District
 - Santa Fe Irrigation District
 - South Bay Irrigation District
 - Vallecitos Water District
 - Valley Center Municipal Water District
 - Vista Irrigation District
 - Yuima Municipal Water District
- OTHER REPRESENTATIVE**
- County of San Diego

RE: Board Memo 8-1: Authorize the execution and distribution of Remarketing Statements in connection with the remarketing of the Water Revenue Refunding Bonds (Index Mode), 2011 Series A-1/A-3 and 2009 Series A-2

Dear Chair Foley and Members of the Board:

We have reviewed the December 10, 2013 Board Memo 8-1 and the redline copy of Appendix A, and have determined we must again vote against the staff recommendation to authorize execution and distribution of the Official Statement in connection with the sale of bonds. We request that staff and bond counsel respond to each of the issues and questions presented in this letter.

General Comments

At the outset, we note that a number of comments we have provided in the past have not been substantively addressed by changes in Official Statement; we do not repeat all of the points here, but have included a list of our lettersⁱ (copies of which have previously been provided to the MWD staff and board) at the end of this letter and incorporate herein points not previously addressed by MWD management.

All references are to the page numbers in the draft redline copy of the Appendix A dated November 25, 2013.

Inconsistent statements by MWD in its Official Statement and pleadings filed in Court. In describing the litigation challenging MWD’s rates, the Official Statement states that,

“to the extent that a court invalidates Metropolitan’s adopted rates and charges, Metropolitan will be obligated to adopt rates and charges that comply with any mandates imposed by the court. Metropolitan expects that such rates and charges would still recover Metropolitan’s cost of service. As such, revenues would not be affected.” (A-54)

A public agency providing a safe and reliable water supply to the San Diego region

In stark contrast to this representation, MWD has alleged in court filings that the Water Authority's lawsuit (or any member agency litigation) has a "destabilizing effect on MWD's rates and its ability to budget and plan." Further, that if the Water Authority were to prevail, it would, "threaten the current funding source for existing LRP, CCP and SDP project contracts and threaten future LRP, CCP and SDP contracts." Indeed, the impacts of the "destabilization" described in MWD's declarations and pleadings filed with the court is so great that MWD has alleged that it cannot ensure the continued administration of these programs or any of the long term investments described in its IRP if it should be required to change the cost allocation to its rates. See, for one example among many, the Upadhyay Declaration in Support of MWD's Opposition to SDCWA's Motion for Summary Adjudication at pages 7-8, (excerpt attached). Similarly, MWD's recent motion to exclude testimony by one of the Water Authority's experts states that, were the Water Authority's "proposed reallocation [of costs] to occur, member agencies would buy less water from MWD." Motion to Exclude Denham at pages 9-10 (excerpt attached).

There is no way to reconcile MWD's statements to bondholders on the one hand, and to the Court, on the other. It cannot at the same time be true that the Water Authority's rate litigation will have no impact on MWD's revenues, and at the same time, "destabilize" MWD and threaten its water supply programs and ability to budget and plan.

The real risk of destabilization. While we disagree as to the cause (it is not the result of the exercise of free speech by any member agency), we do believe that MWD is threatened by the kind of "destabilization" described in its court filings *as a result of its failure to have in place a long range finance plan and commitments by its member agencies to pay for the billions of dollars MWD is spending and plans to spend in the future.* This is not a new issue; it was well-described by an independent Blue Ribbon Task Force almost 20-years ago:

Reliability, quality and other water supply specifications cannot be made independently from the willingness of MWD customers to pay for such services. Member agencies may want, for example, the insurance provided by major investments to increase MWD standby capacity, but if forced to commit funds for such capabilities, they may actually prefer far lower levels of protection than a hypothetically "costless" water supply guarantee. (page 9; emphasis in original)

Derive IRP results starting from a willingness to pay perspective as well as from reliability and supply goals to assess whether current planning efforts adequately "loop back" and force the reappraisal of initial reliability and other operational assumptions. Member agencies, and other water users, may have a desire to improve reliability and performance capabilities beyond their willingness or ability to pay for such improvements. In the event of substantial divergences in various water users' willingness to pay for MWD capacities, Metropolitan may wish to consider more flexibly pricing wholesale

water supplies to reflect the levels of reliability and cost burdens that each user desires and is willing to bear. Effective planning can only occur after the maximum level of current and future investment member agencies will bear has been determined. (page 14; emphasis in original)

The peaking charge should recover the actual economic costs generated by peaking behavior and not be set by political considerations. (page 21; emphasis in original)

...MWD can no longer afford to build major facilities and hope that member agencies will buy enough water to pay for them over several years. The wide variation in member agency local water supply and project options means that each agency will differently value MWD water and facility investments, a fact that can frustrate needed revenue agreements...[t]he Task Force was troubled to learn...that some of the member agencies most strongly supporting big-ticket projects...also had the most aggressive plans to reduce their future MWD water purchases and develop independent supplies. In effect, such agencies appear to want MWD to develop costly backup capacity- or insurance-for their local supply strategies, while seeking to shift the costs for these benefits on to Metropolitan and other agencies and consumers. (page 23)

We have raised these issues repeatedly in the boardroom and in past letters commenting on MWD's Official Statements. Among all of the concerns we have, the single greatest concern is MWD's failure to describe in its Official Statement, the risk associated with its continued spending at the same time ***its member agencies are clearly unwilling to commit to pay for its programs.*** We also believe that the extraordinary lengths MWD and its member agencies are going to in order to impede the development of water supplies in San Diego, independent of MWD, is information that should be made available to bond counsel (it has not been) as well as present and future purchasers of MWD bonds.

Comments on Draft Appendix A dated November 25, 2013

A-1 Uniform rates for each of class of service. Appendix A states that, [m]ember agencies request water from Metropolitan...*and pay for such water at uniform rates established by the Board for each class of service*" (emphasis added). This is the only place in Appendix A where the words, "class of service" are used. Please confirm whether the water "categories" described at A-57-58 are the "classes of service" referred to in the recital at page A-1.

A-6 Standby or "dry-year peaking" demands of MWD member agencies. Due to the compartmentalization of the disclosures in Appendix A, the reader might fail to associate the withdrawals from storage described in the last paragraph on page A-6 with the Water Authority's rate litigation; specifically, the issue of MWD's failure to account for or properly

allocate the costs associated with having almost 6 million acre-feet of storage capacity and more than 3.3 million acre-feet of stored water available for withdrawal, which made possible the 300,000-500,000 acre-feet of water supply that MWD expects to draw upon to meet demands in 2013. The long-term negative impacts on MWD from its failure to identify and account for these costs are described in the Blue Ribbon Task Force Report, in the above excerpts and other portions of the Report. Appendix A should be revised to include a full discussion of this issue including potential impacts on MWD sales and rates.

A-11 Area of Origin litigation. Please provide us with a copy of the settlement agreement that is “currently being circulated among the parties for signature.”

A-18 Second supplemental agreement with Coachella. Please provide a copy of the second supplemental agreement with CVWD referred to in the second full paragraph.

A-28 Storage capacity and water in storage. What accounts for the reduction in the storage numbers since last reported in May 2013?

A-30 Preferential rights and water supply allocation plan. The second full paragraph under Water Supply Allocation Plan should be revised to include disclosure that – except in a water shortage emergency declared by the MWD board under Section 350 of the Water Code (which has never happened), or any other statutory basis MWD may believe would support limitations on the exercise of preferential rights – the MWD board has no statutory authority or ability whatsoever to diminish the statutory preferential right to water held by each of its member agencies. It is highly misleading in the context of current water rates and realities to state that, “historically, these rights have not been used in allocating Metropolitan’s water.” The historical record is clear that the cities of Los Angeles and Long Beach have every intention of calling upon their respective preferential rights to water should it be advantageous for them to do so. The Water Authority does not question these rights, which have also been confirmed by legal opinions of MWD’s General Counsel and the Court of Appeal.

A-32 Impact on MWD sales of Los Angeles updates reported in Appendix A. Two significant changes are made to Appendix A regarding the City of Los Angeles. First, that its “favored son” agreement executed by Ron Gastelum without the knowledge or consent of the board of directors, is expected to be completed six years sooner than previously disclosed. Second, that LADWP has reached a “major agreement” regarding future dust control on portions of Owens Lake. Please explain what has changed in the implementation of the AVEK agreement that accounts for the project now being completed before the end of next year (versus 2020 as previously reported in Appendix A). Please explain the impacts on MWD water sales as a result of each of these developments.

A-33 Local water supplies. The discussion of local water supplies generally is very confusing because it does not make clear to the reader what supplies are being developed by MWD (or

with subsidies from MWD) and which are not. There should also be a discussion here that ties in to later sections of the Appendix A disclosing the impact on MWD sales from the development of local water supplies by the member agencies (with and without subsidies from MWD).

A-34 Impact on MWD sales of Carlsbad seawater desalination project. We were unable to confirm whether MWD's future sales projections take into account the 48,000-56,000 acre feet of water supply expected to come on line in 2016. Please identify where that accounting is made.

A-35 MWDOC application for MWD subsidies for a seawater desalination project. Please provide us with a copy of the application. Also, please provide an analysis (facts) of the regional benefits MWD believes would support the payment of such subsidies.

A-42 Discussion of MWD's capital investment plan (CIP) illustrates the need for a long range finance plan and updated cost of service analysis. The short CIP discussion reflects the wild fluctuations as a result of poor estimations by MWD staff of capital spending and the need for pay-as-you-go funding and water rate increases. Every one of these highly inaccurate estimations results in further distortion of MWD's already improper allocation of costs to its member agencies and all MWD ratepayers. It is also unclear – except possibly for litigation purposes – why MWD is claiming that it will spend zero dollars on “supply” over the next five years. Please advise whether the words, “Cost of Service,” are used in a rate-setting context or, is intended to have some other meaning in this section of the Appendix A. Also, please advise why debt service for bonds MWD did not issue and does not expect to issue is included in the financial projections.

A-49 Risk management discussion is incomplete. As stated in multiple prior letters, we remain concerned with the inadequacy of MWD's overall risk disclosure. Many of the issues we have raised have not been addressed in the Appendix A. In particular, we remain concerned that MWD's long range finance plan is materially out of date (last updated in 2004). The draft Appendix A does not disclose that MWD is operating (by choice) without a long range finance plan because, after more than five years of working on it, MWD abandoned the effort (i.e., its member agencies could not agree on a long range finance plan to pay MWD's costs). Nor does MWD (by choice) have water rate projections that take into account and plan for all of MWD's projected costs and liabilities. These costs include, for example, some reasonable estimate of BDCP costs, other water supply programs included in the IRP, facility investments and retiree health. Almost 20-years has passed since the Blue Ribbon Task Force wisely cautioned MWD to develop and implement a plan for its fiscal sustainability; yet today, there remains **no plan** for how MWD expects to pay its costs over the long term. MWD's current ad hoc approach to financial planning is neither advisable nor sustainable and its continued spending creates a risk for all of Southern California including all of its bondholders.

A-50 MWD's actions in 2013 suspending the tax limitations in the MWD Act were not factually or legally justified. It is ironic that MWD chose to increase taxes (the net economic effect of suspending the limitation) at the same time that it was awash in cash from the over-collection of revenue from Southern California's water ratepayers. In June 2013, when MWD took the action to suspend the tax limitations, it had already collected \$314 million more than needed to pay 100% of its budgeted expenditures and caused its reserves to exceed maximum reserve level by at least \$75 million (see the Water Authority's June 5, 2013 letter RE Board Memos 8-1 and 8-2). As a matter of fact, additional tax revenue was most assuredly **not** "essential to the fiscal integrity of the district." The MWD board did not and could not make the findings necessary to support the suspension of the tax limitation, and any suggestion that the board considered in any meaningful or substantive way "factors" including the "balancing of proper mechanisms" for funding current and future State Water Project costs is unsupported by the record. If there is any document or record you believe supports this statement in the Appendix A other than the board memo, please provide copies to us in your response to this letter.

A-51 Wheeling revenues as an MWD "water sale." The Water Authority does not purchase its IID or canal lining water from MWD; it pays MWD to convey the water to San Diego. MWD's representation of these revenues as "water sales" are made for purposes of litigation only and are misleading bondholders, MWD's "disclosures" in the footnotes to its Summary of Receipts by Source notwithstanding.

A-52 Member agency purchase orders. The description of member agency purchase orders is misleading because it suggests that MWD's member agencies have made firm commitments to purchase water from MWD in the future when they have not. See discussion of this issue in prior letters commenting on the Appendix A.

A-53 Rate structure. Representations that uniform rates are collected "for every acre-foot of water conveyed by Metropolitan" are inaccurate because the rates do not take into account all of the discounted and special agreements MWD affords some but not all of its member agencies. Moreover, MWD fails to comply with cost of service legal requirements and its own act because it fails to properly acknowledge or account for different classes of service it provides to its member agencies (see comment at A-1 above, the only place in the Appendix A in which MWD mentions classes of service).

A-54 Litigation challenging rate structure. See general comments about the inconsistency between representations in the draft Appendix A and representations made to the Court.

A-60 Hydroelectric power recovery revenues. Why have the three paragraphs been deleted?

A-79 Tax increase to pay for additional payments under the State Water Contract. Please provide a copy of the opinion of MWD's General Counsel referred to in the first full


paragraph that the tax increase as described would be within the exemption permitted under Article XIII A of the State Constitution as a tax to pay pre-1978 voter approved indebtedness.

A-86 Projected revenues and expenditures. See question above, at A-34. Do these revenue projections assume that the Carlsbad seawater desalination facility comes on line in 2016? See also the questions above, at A-32. What assumptions are made about water sales to LADWP?

A-89 Long range finance plan. MWD's reserve policies are outdated, just as its 1999 Long-Range Finance Plan is. Is MWD staff relying upon and implementing all of the policies in the 1999 plan at this time?

Again, we incorporate by reference all of our prior comments which have not been corrected in this or past versions of Appendix A.

Sincerely,



Michael T. Hogan
Director



Keith Lewinger
Director



Vincent Mudd
Director



Fern Steiner
Director

Attachments

1. Declaration of Deven Upadhyay (excerpt), December 3, 2013
2. Motion to Exclude Testimony of Daniel A. Denham (excerpt), December 10, 2013

cc: Jeff Kightlinger, MWD General Manager

San Diego County Water Authority Board of Directors and Member Agencies

ⁱ Water Authority comment letters on MWD's Official Statement dated: 9/22/2010, 12/9/2010, 5/16/2011, 8/22/2011, 2/13/2012, 4/9/2012, 6/11/2012, 8/20/2012, 8/29/2012, 10/8/2012, 11/5/2012, 2/11/2013, 5/13/2013, and 6/7/2013

1 were “to improve regional water supply reliability and avoid or defer MWD capital expenditures”
2 and to meet “IRP local resource targets[.]” In that letter, SDCWA also recommended that MWD
3 pay \$250 per acre-foot of water under the project contracts to “reduce future MWD capital
4 expenditures and water supply costs.”

5 **III. MWD’s Integrated Rate Structure**

6 26. MWD funds its demand management programs through revenue generated by its
7 current, integrated rate structure which was adopted by MWD’s Board of Directors in October
8 2001 and implemented as of January 2003 (“Existing Rate Structure”). Specifically, MWD’s
9 Water Stewardship Rate is set to recover costs related to its LRP, CCP, and SDP programs.

10 27. Piecemeal legal and/or legislative challenges to MWD’s Existing Rate Structure
11 would create a destabilizing effect on MWD’s rates and its ability to budget and plan. This is the
12 case because such challenges do not account for MWD’s overall costs and policy considerations
13 in setting its rates. In contrast, challenges to MWD’s Existing Rate Structure within the Board
14 process would allow for consideration of the larger picture by all of the relevant stakeholders. As
15 a result, such challenges would not threaten to destabilize MWD’s Existing Rate Structure in the
16 way piecemeal legal and/or legislative challenges would. The RSI provision therefore protects
17 the stability of MWD’s Existing Rate Structure by encouraging resolution of rate disputes within
18 the Board process.

19 28. Piecemeal legal and/or legislative challenges to MWD’s rates that threaten to
20 destabilize MWD’s Existing Rate Structure also threaten the current funding source for existing
21 LRP, CCP, and SDP project contracts and threaten future LRP, CCP, and SDP contracts.
22 Without a stable rate structure, MWD cannot ensure the continued administration of the LRP,
23 CCP, and SDP programs.

24 29. MWD relies on a stable rate structure to adequately plan, develop and budget for
25 LRP, CCP, and SDP projects and its other capital and operating costs. MWD’s MAs rely on a
26 stable MWD budget and rate structure to plan their budgets and to set their rates. Challenging
27 MWD’s rates outside the Board process is the type of destabilizing effect the RSI provision is
28 aimed at preventing. This kind of destabilization interjects uncertainty that interferes with long-

1 term planning and budgeting that is necessary to enter into the long-term LRP, CCP, and SDP
2 project contracts. For example, if MWD were required to eliminate its Water Stewardship Rate,
3 MWD would have to make fundamental changes to its Existing Rate Structure. In particular,
4 absent changes in MWD's budgeted costs, MWD would have to increase its other rates to cover
5 the cost of existing LRP, CCP, and SDP programs. This kind of unplanned for rate increase
6 would interfere with MWD's and its MAs' ability to properly plan and budget for the future. To
7 avoid such disruptive rate increases, MWD's Board would have to consider the possibility of
8 having to decrease or discontinue its future investments in local conservation and resource
9 development projects. This kind of uncertainty also inhibits MAs from investing in long-term
10 projects that MWD needs to meet its long-term goals set forth in MWD's IRP.

11 30. SDCWA's assertion that MWD has the ability to reset its rates and adjust its rate
12 structure to meet its costs does not obviate the need for the RSI provision. Resetting of MWD's
13 rates is exactly the type of destabilization that the RSI provision was intended to prevent. Even if
14 MWD's overall revenues would not be affected by a challenge to MWD's Existing Rate
15 Structure, that does not mean that a challenge to MWD's Existing Rate Structure would not affect
16 the revenues allocated to any particular program or service, including revenues available for
17 MWD's demand management programs.

18 31. SDCWA suggests that the RSI provision is unnecessary because MWD could have
19 simply increased its fixed rate charges to "provide a measure of revenue stability." The RSI
20 provision is not aimed at protecting MWD's "revenue;" rather, it is intended to protect the
21 stability of MWD's Existing Rate Structure to ensure continued funding of the LRP, CCP, and
22 SDP programs, not some other, alternative hypothetical rate structure that MWD's Board did not
23 adopt.

1 on MWD's supposed breaches of the Exchange Agreement. West Dec., Ex. H; *see also* West
 2 Dec., Ex. I at 332:22-333:20 (Mr. Cushman testifies that he has is testifying as to topics 7 and 8
 3 in Metropolitan Water District of Southern California's Amended Notice of Deposition of Person
 4 Most Knowledgeable for San Diego County Water Authority (Exchange Agreement), concerning
 5 alleged breaches of the 2003 Exchange Agreement). He testified that there is no way to know
 6 what MWD's rate structure would look like if this Court accepts SDCWA's argument that State
 7 Water Project costs and the Water Stewardship Rate should not be allocated to MWD's
 8 transportation rates, or whether such a revised rate structure would be any more favorable to
 9 SDCWA than the current one:

10 Presuming the Water Authority prevails [in the litigation], the
 11 judge will invalidate Metropolitan's rates, and Metropolitan will
 12 have to go back and set and adopt lawful rates. How Metropolitan
 13 goes back and adopts lawful rates and charges is at this point
 14 unknown. So how it might affect the Water Authority's payments
 15 is unknown.

16 West Dec., Ex. I at 443:20-444:2

17 Mr. Denham's assumption that MWD's rate structure would otherwise remain the same if
 18 State Water Project and Water Stewardship costs were moved from transportation rates to supply
 19 rates is completely speculative, which renders his opinion inadmissible. *Biren v. Equal*
 20 *Emergency Med. Grp., Inc.*, 102 Cal. App. 4th 125, 138 (2002) ("Damage awards may not be
 21 based upon the testimony of experts who rely on speculation.").

22 Indeed, this assumption is not only speculative, Mr. Denham's admissions and basic
 23 economics refute it. Mr. Denham admits that, were these costs reallocated from transportation to
 24 supply as his report envisions, many member agencies will pay more overall for water obtained
 25 from MWD.⁴ West Dec., Ex. B. at 183:12-15 ("It's reasonable to assume, as I've previously

26 _____
 27 ⁴ Member agencies' rates would inevitably increase if State Water Project costs and the Water
 28 Stewardship Rate are moved wholesale into the supply rate. This is because, under Mr.
 Denham's assumptions, MWD would collect substantially less revenue for providing SDCWA
 with Exchange Water, while the rest of MWD's business -- including its revenue from other
 sources and its total operating costs -- remains unchanged. MWD is under a legal obligation to
 recover its costs through the rates it charges. *See* MWD Act § 134 (requiring MWD to set water
 rates at a level which will recover MWD's operating costs).

1 mentioned that the misallocated components go to supply. And with the supply rate going up,
 2 member agencies pay more . . .”). Mr. Denham admits the existence of price elasticity, which
 3 in this context indicates that as MWD’s rates increase, member agencies will buy less water from
 4 MWD. *Id.* at 171:22-25 (“Q. And you agree with the concept that all else being equal, the
 5 quantity of a demand good falls when the price of a good rises, correct? A. That’s correct.”). He
 6 also admits that MWD member agencies -- particularly one of its largest, the City of Los
 7 Angeles -- exhibit such price elasticity with regard to their water purchases from MWD. *Id.* at
 8 174:13-22.

9 Thus, logically, were Mr. Denham’s proposed reallocation to occur, member agencies
 10 would buy less water from MWD. If that occurred, MWD would likely have to adjust its rate
 11 structure to address depressed sales, since it must recover all its costs through its rates. Mr.
 12 Denham’s opinion addresses this problem by simply pretending it does not exist:

13 Q. But you didn’t take this [effect of price elasticity] into account
 14 at all on your expert report, did you? A. I did not. MR.

15 BRAUNIG: Objection; vague and ambiguous. THE WITNESS:
 16 That’s not what I was asked to do.

17 *Id.* at 172:1-6. To the contrary, he assumes that the quantity of water purchased by the other
 18 member agencies will remain static,⁵ even as the price increases:

19 Q. So you were asked to assume that prices remain -- that sales
 20 volumes would remain the same although prices went up? A. I --

21 MR. BRAUNIG: Objection to the form. BY MR. WEST: Q.
 22 Yes? A. Yes, all things would remain equal.

23 *Id.* at 172:8-15. Here again, Mr. Denham’s opinion rests on a key assumption that he admits is
 24 false. Thus, Evidence Code Section 803 requires that the opinion be excluded. *See Maatuk v.*

25 _____
 26 ⁵ For each calendar year 2011-2014, Mr. Denham divided MWD’s “revised” revenue
 27 requirements by the total number of acre-feet estimated to be sold to member agencies in that
 28 year -- *e.g.*, in 2011: “When MWD’s revenue requirement of \$453,296,142 for these cost
 elements is spread over the total number of acre-feet in the 2011 sales assumptions
 contained in the COS Report, a bundled credit of \$236/AF should be returned to the Water
 Authority, or \$33,805,324 as an overcharge for transportation in calendar year 2011.” West
 Dec., Ex. A, at Ex. B Thereto (Denham Report), 7 (emphasis added). He performed the same
 calculation for 2012, 2013, and 2014 -- again using sales assumptions contained in the Cost of
 Service Reports for those years -- and then added together the results to arrive at a total
 “overcharge” of \$188,340,476. *Id.*