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

October 13, 2014

Randy Record
and members of the Board
Metropolitan Water District of Southern California
P.O. Box 54153
Los Angeles, CA 90054-0153

RE: Finance and Insurance Committee Item 6c – Update on Purchase Orders

Dear Chairman Record and Board Members,

We have reviewed Finance and Insurance Committee (Committee) Item 6c RE Update on Purchase Orders and have a number of questions and comments we would like to ask and discuss with our fellow board members. At last month's Committee meeting, the General Manager suggested we might schedule a special Board workshop to talk about these issues, and we hope that will happen and request that such a workshop be scheduled as soon as possible.

A number of directors observed at the last Committee meeting that a short-term extension of Purchase Orders does nothing to achieve the stated purpose of bringing stability to MWD's finances. Our Chief Financial Officer has stated as much – that the terms of the existing Purchase Order have failed to achieve that objective. However, rather than abandoning that important objective – like the most recent staff proposal does, as described in the PowerPoint Presentation – we would like staff to bring back new terms that *could* achieve that objective.

At last month's Committee meeting, a number of directors also observed that this issue has to do with rates, and how MWD's capital costs and operating expenses will be paid. We agree; that's why we also believe that the Purchase Order must be based upon, and reflect MWD's costs of service. While that has not been so in the past (including but not limited to issues that were presented at the trial of the rate case), it is *certainly* not the case when member agencies are allowed to "choose" what rate to pay without regard to the costs they are causing MWD to incur. The staff presentation at the last Committee meeting showed the extent of Tier 2 rates that have been paid over the 10-year period 2003-2013; the newly proposed Purchase Order would allow these agencies (which include a significant share paid by the Water Authority, although it was not listed by name) to "choose" to pay a lower rate.

During the trial of the rate case, MWD and its counsel stated many times that Tier 2 pricing is intended to recover dry-year peaking costs. Now, with no explanation or analysis, staff is recommending that agencies be allowed to "choose" whether and when to pay these costs. At a minimum, the Board would benefit from a review of MWD's current cost of service report to explain: 1) how dry-year peaking costs are accounted for; and 2) why eliminating the annual Tier 2 rate assessment is consistent with MWD's own cost of service analysis. MWD must first determine the availability and cost of its various supply sources and capital costs, and then set tiers and rates based on cost of service requirements of the law (including Prop. 26) and industry standards.

Based on the information provided, MWD has demonstrated a need to have Tier 2 rates with a *lower* threshold, rather than a higher threshold because: 1) its State Water Project supplies are unreliable, resulting in the need for spot water transfers, water banks, surface storage, and Bay Delta Conservation Plan; 2) its Colorado River supplies need to be shored up through water transfers, agricultural conservation and fallowing, and other programs; and 3) member agencies have different annual use and dry-year peaking patterns that must be accounted for.

If MWD would institute Tier 1 and Tier 2 pricing based on the quantities of reliable supplies it has available, and its additional expenditures to secure additional supplies or enhance the reliability of its firm supply, the price differential would provide member agencies incentive (along with 20 by 2020 requirements) to develop local supplies and increase conservation – without the need for MWD to increase its own water rates to pay subsidies to "incentivize" them to do so. This would reduce overall MWD costs. There are a number of mechanisms by which allocation of Tier 1 quantities among agencies could be made, including preferential rights.

We look forward to working with you and to continued discussion of these important issues.

Sincerely,

Michael T. Hogan Keith Lewinger Fern Steiner

Michael T. Hogan	Keith Lewinger	Fern Steiner
Director	Director	Director