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Client-Matter: 25783-063

**BY HAND DELIVERY**

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**Re: San Diego County Water Authority vs. Metropolitan Water District of Southern California**

Dear Counsel:

Enclosed are statutory Offers to Compromise under Code of Civil Procedure Section 998 in all pending *SDCWA v. Metropolitan, et al.* cases, 2010-2018 (collectively, "Offer to Compromise").

This cover letter and the attached "Monetized Benefits of Metropolitan's Offer to Compromise" provide an explanation as to why Metropolitan believes this is a very favorable offer for SDCWA. A proposed settlement agreement and release containing the same terms as the Offer to Compromise will be provided shortly.

We look forward to careful consideration of these materials by the SDCWA Board of Directors.

**Value to SDCWA of Metropolitan's Offer to Compromise**

**1. Payment of \$72.097 Million for Water Stewardship Rate Payments on Exchange Agreement Deliveries (2011-2017)**

In all of SDCWA's rate challenges from 2010 to 2018, SDCWA has challenged Metropolitan's allocation of its Water Stewardship Rate (WSR) to transportation within Metropolitan's rate structure. The price term in the parties' Exchange Agreement is based on Metropolitan's transportation rates, including the WSR.

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The WSR recovers the costs of Metropolitan's demand management programs, under which Metropolitan provides conservation and local resources development incentive funding to its member agencies, their sub-agencies, and in the case of conservation directly to residents and businesses throughout Metropolitan's Southern California service area. The WSR is part of Metropolitan's full service rate, which is comprised of both supply and transportation rates for the sale and delivery of water.

In the 2010-2012 rate cases, SDCWA prevailed in its argument that there was not sufficient evidence in the administrative record for the years 2011-2014 to support Metropolitan's allocation of the WSR to transportation, and therefore that the WSR should not have been included in the parties' Exchange Agreement price for those years.

Metropolitan already tendered to SDCWA \$44,373,872.29, the full amount of these 2011-2014 WSR payments under the trial court's damages award, plus interest based on Metropolitan's calculation, with a reservation of Metropolitan's right to seek on appeal an appropriate set-off from the award. The set-off is based on the fact (under SDCWA's own argument) that if SDCWA had not paid the WSR as part of its exchange deliveries, it would have paid a higher WSR on its full service deliveries. Although SDCWA returned the tendered payment, Metropolitan's tender stopped the accrual of interest as of February 2019.

Other Metropolitan rate cycles are based on different administrative records and SDCWA's challenges to the price term for those years are currently on hold pending final completion of the 2010-2012 cases on remand and any appeal. Metropolitan included further evidence and analysis in the administrative records for the 2014, 2016, and 2018 rate setting cycles to support the allocation of the WSR to transportation. Metropolitan believes the administrative records for each of those cycles, concerning rates for 2015-2020, sufficiently support the allocation of WSR to transportation. Nonetheless, Metropolitan suspended charging SDCWA the WSR on exchange deliveries from 2018-2020, pending a cost of service study of the most appropriate allocation of demand management costs in Metropolitan's rate structure.

Metropolitan's Offer to Compromise proposes to settle the litigation in part by paying SDCWA \$72,096,671.32, consisting of (a) SDCWA's WSR payments on Exchange Agreement deliveries for 2011-2014, plus interest, through mid-December 2019, based on SDCWA's interest calculation; and (b) SDCWA's WSR payments on Exchange Agreement deliveries for 2015-2017, without interest, since those payments have never been litigated and consequently there has been no finding concerning the sufficiency of the record in those years.

The offered payment is beneficial to SDCWA for the following reasons:

- a. Metropolitan would pay the full WSR payment amount on exchange deliveries for 2011-2014 that SDCWA seeks. Metropolitan would forgo its right to appeal the trial court's damages award for 2011-2014 as lacking the appropriate set-off for the increase in the full service price.
- b. Metropolitan would pay interest on the 2011-2014 amount based on SDCWA's interest calculation, which Metropolitan believes is incorrect.
- c. Metropolitan would pay interest on that amount for ten additional months through December 2019, rather than stopping interest as it is entitled to do as of February 2019, due to Metropolitan's payment tender to SDCWA at that time.
- d. Metropolitan would pay the full WSR payment amount on exchange deliveries for 2015-2017 that SDCWA seeks. This matter has never been litigated so SDCWA has no entitlement to this payment. Metropolitan would forgo its right to defend its allocation of the WSR to transportation from 2015 forward based on a different administrative record. Metropolitan believes if litigated, Metropolitan would prevail. Because the 2015-2017 WSR payments have not been litigated and Metropolitan believes it would prevail, Metropolitan would not pay interest on the return of those payments.

## **2. Exchange Agreement Fixed Price Term (2019-2112)**

As noted, the parties' Exchange Agreement price term is based on Metropolitan's transportation rates: the WSR, the System Access Rate, and the System Power Rate. The Exchange Agreement has a 110 year term (to 2112) and due to the large volume of water exchanged under it, SDCWA's contractual payments to Metropolitan are sizable. SDCWA proposed the current price term in 2003 and Metropolitan accepted it as proposed. Before that, the price term was simply a fixed dollar figure with an escalator, and was not tied to Metropolitan's rates.

Basing the price term on Metropolitan's rates has created an unfortunate dynamic where SDCWA has an incentive to challenge Metropolitan's rates in every rate cycle, in an effort to invalidate rates that are part of the price term, claim breach of contract, and thereby reduce SDCWA's contractual payments. SDCWA has challenged Metropolitan's rates, with an accompanying claim of breach of the Exchange Agreement price term, in every rate setting cycle since 2010: 2010, 2012, 2014, 2016, and 2018. In these cases, SDCWA seeks court orders not only invalidating rates in the years applicable to each rate cycle, but also court orders directing

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Metropolitan to change its rates extending into the future. In this way – except where the court finds the administrative record in a rate cycle to be insufficient – the pending litigation concerns not just rates and the Exchange Agreement price in current years, but also future rates and the price term going forward throughout the contractual term. All of these cases are still pending.

The same rates that SDCWA challenges apply to all 26 Metropolitan member agencies. Metropolitan's Board of Directors sets the rates the member agencies pay, and the Board is entirely comprised of representatives of those member agency customers. No other member agency has challenged Metropolitan's rates or supported SDCWA's efforts, and nine member agencies have joined the litigation in support of Metropolitan to actively defend the rates.

The inherent incentive in the Exchange Agreement price term for SDCWA to continually challenge rates in every cycle is expensive and disruptive for all parties. SDCWA and Metropolitan have each spent tens of millions of dollars on attorneys' fees in this nearly-ten year litigation, and untold hours of staff time has been expended relating to the litigation. Metropolitan and SDCWA should be spending their time and energy on positive efforts to benefit their customers and service areas, and to address the water challenges of today and tomorrow.

Metropolitan therefore proposes as part of its Offer to Compromise to amend the Exchange Agreement to change the price term, to once again make it a fixed number with an escalator, unrelated to Metropolitan's rates. Metropolitan has proposed a discounted price, which would be exceptionally valuable to SDCWA. When applied over the length of the Exchange Agreement, the changed price term is estimated to provide SDCWA with savings of between \$5.5 billion and \$8.4 billion (in 2019 dollars).

Metropolitan's proposed price starts with the current contract price, which is already discounted based on the Metropolitan Board's decision to not charge the WSR through 2020, and applies a further discount of \$3 per acre-foot. This results in a price of \$450 per acre-foot, which could be implemented as early as December 2019. Metropolitan then proposes use of the ENR Construction Cost Index (20 Cities), which is less than Metropolitan's average rate increases. Should any new state Delta conveyance project go forward, and after a cost of service study, Metropolitan would add the identified portion of the transportation cost of the project to the Exchange Agreement price.

The significant savings to SDCWA is based on the following:

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If the current contract price is retained, SDCWA is estimated to pay Metropolitan between \$11.978 billion and \$17.984 billion (in 2019 dollars) through 2112.<sup>1</sup>

If SDCWA accepts the changed contract price, SDCWA is estimated to instead pay Metropolitan between \$6.455 billion and \$9.520 billion (in 2019 dollars) going forward.

The difference (in 2019 dollars) is between \$5.523 billion and \$8.464 billion (in 2019 dollars), not including SDCWA's avoidance of significant future State Water Project (SWP), Colorado River Aqueduct, and distribution system costs that would no longer be due as part of the Exchange Agreement price.

This offered Exchange Agreement price term is particularly beneficial to SDCWA because:

- a. SDCWA would have a price going forward that alleviates its significant litigation loss as to SWP costs. Metropolitan *won* the major issue in the litigation, when the Court of Appeal ruled that Metropolitan's System Access Rate and System Power Rate are lawful, properly include SWP transportation costs, and are properly charged as part of the Exchange Agreement price. The California Supreme Court declined SDCWA's request to review this decision and it is final. Yet, by changing the price term as Metropolitan has offered, SDCWA would not be charged increased SWP costs over time that Metropolitan may lawfully include and SDCWA is unable to challenge. This includes what are expected to be substantial costs to address anticipated subsidence repairs on the SWP.
- b. A fixed price term also allows SDCWA to avoid additional significant maintenance and repair costs on the Colorado River Aqueduct, which SDCWA has never contended in court that it is not required to pay. It also allows SDCWA to avoid similar costs on Metropolitan's local distribution system, which SDCWA has also never challenged in court.
- c. SDCWA would have a price going forward that contains no demand management costs, when there has been no such court ruling.

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<sup>1</sup> This is based on the current price term, assuming inclusion of a WSR starting in 2021 that is allocated 75 percent to transportation rather than 100 percent, based on the current cost of service study. Most of the water that SDCWA exchanges is conserved water purchased from the Imperial Irrigation District under a transfer agreement that can extend through either 2047 or 2077. The remainder of the water that SDCWA exchanges is water conserved by lining the All-American and Coachella canals, and that exchange extends through 2112. The two different amounts throughout these estimates are based on whether the IID transfer terminates in 2047 or 2077.

- d. The \$3 per acre-foot discount off the current price alone is a savings to SDCWA of \$43.2 million to \$63.6 million.
- e. SDCWA would have a lower annual escalation through 2112. Metropolitan's annual transportation rate increases, which reflect increasing costs to Metropolitan, have averaged 4.6 percent. The Construction Cost Index's annual increases have averaged 3.3 percent.
- f. On January 1, 2020, Metropolitan's rates will increase based on Metropolitan's adopted rates and biennial budget for fiscal years 2018/19 and 2019/20. The contract price for 2020, even with WSR excluded, will rise to \$482 per acre-foot. Metropolitan's analysis is that the present value of the additional cost to SDCWA resulting from an Exchange Agreement price term based on the rates in 2020 will exceed any amount that SDCWA could win in the litigation. It is also likely that continued litigation will not be completed in 2020 and future rate increases would further erode the value of any settlement to SDCWA.

### **3. Exchange Agreement Delivery Flexibility**

The Exchange Agreement provides for SDCWA to make the water that it purchases from the Imperial Irrigation District (IID), and obtains from the lining of canals, available to Metropolitan at Lake Havasu. It calls for Metropolitan to deliver a like amount of water from any source to SDCWA in equal 1/12th deliveries every month, regardless of when SDCWA makes the IID and canal lining water available to Metropolitan.

The Exchange Agreement does not provide SDCWA with the ability to change Metropolitan's exchange deliveries, such as with less water in certain months and more water in other months. Because SDCWA is an annual net purchaser of water from Metropolitan, this was not seen as a problem at the time the Exchange Agreement was executed. However, after the recent drought, Governor Brown's emergency executive order on conservation, and other factors that have changed water demand patterns, SDCWA now has challenges managing these base loaded deliveries to meet shifting demand patterns in certain times of the year. This past year, SDCWA requested delivery flexibility based on its needs and Metropolitan accommodated the request.

As part of the Offer to Compromise, Metropolitan is offering to provide future flexibility in its delivery of exchange water to SDCWA within a calendar year. The parties would renegotiate this provision in the Exchange Agreement to shape deliveries over the course of the calendar year to more efficiently meet SDCWA's current demand patterns. This would effectively provide SDCWA access to Metropolitan's storage, treatment and delivery capabilities

to regulate its IID and canal lining supplies at no cost. Metropolitan would not be providing delivery flexibility beyond the calendar year. Metropolitan believes the new flexibility offered within a calendar year is of great benefit to SDCWA.

#### **4. Attorneys' Fees and Costs**

Metropolitan's Offer to Compromise includes each party bearing its own attorneys' fees and costs. The Court of Appeal vacated the trial court's attorneys' fees and costs award, and ordered that court on remand to determine which party, if any, is the prevailing party. Metropolitan had by far the victory with the highest monetary value, when the Court of Appeal upheld the System Access Rate and System Power Rate and their inclusion in the Exchange Agreement price. Metropolitan believes the trial court on remand will find that it is the prevailing party and that SDCWA owes it in excess of \$10 million in attorneys' fees and costs.

#### **SDCWA's Claims**

Metropolitan does not believe that SDCWA can prevail on its claims in the pending cases; and even if it could, it could not expect to exceed the value of Metropolitan's Offer to Compromise.

SDCWA seeks approximately \$30 million in restitution in the Rate Structure Integrity remand trial. Based on its recent court filing, SDCWA no longer seeks other previously-requested equitable relief with respect to certain projects.<sup>2</sup>

SDCWA challenges various aspects of Metropolitan's rates and charges – such as contending that Metropolitan's Water Stewardship Rate as part of the full service rate is invalid, and that other rates and charges do not follow cost of service – but the claims are without legal and factual basis, and in any event the amounts at issue are less than the value of Metropolitan's offer. SDCWA has also asserted procedural challenges to Metropolitan's practices that are both without merit and without monetary value.

SDCWA has asserted a claim for "offsetting benefits" pursuant to Water Code Section 1810, et. seq., under a theory that these statutes should be applied to the Exchange Agreement. The trial court found SDCWA's offsetting benefits claim was waived in the 2010 and 2012 cases, and there are significant procedural, legal, and factual flaws in SDCWA's assertion of the claim in the 2018 case. SDCWA has asserted the claim in an effort to reduce the Exchange Agreement price term by billions through 2112, but even if the claim had any merit – which it

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<sup>2</sup> Nonetheless, Metropolitan's Offer to Compromise requires an express waiver of any claim for funding for projects allegedly affected by Metropolitan's Rate Structure Integrity provision, including the Carlsbad desalination project.

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does not – Metropolitan’s offer to change the price term provides a greater monetary benefit than the offsetting benefits SDCWA has sought.

**Effect of Offer to Compromise**

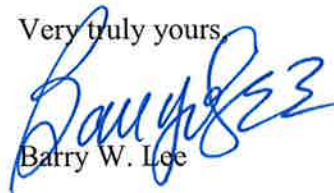
If SDCWA does not accept the Offer to Compromise, and does not obtain a better result in the litigation, certain cost shifting applies:

- a. Even if SDCWA were the prevailing party, it could not recover post-offer statutory costs, and
- b. It would be required to pay Metropolitan’s post-offer statutory costs.

These statutory costs include post-offer attorneys’ fees under the Exchange Agreement, which with trials and appeals could be expected to be in the millions.

We request that this letter and the enclosed set of Offers to Compromise and Monetized Benefits sheet be provided to your client – the full SDCWA Board of Directors – in accordance with California Rules of Professional Conduct, Rule 1.4.1. We look forward to SDCWA’s response.

Very truly yours,



Barry W. Lee

Enclosures