



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

February 19, 2013

Director Vincent Mudd
Director Keith Lewinger
Director Fern Steiner
Director Doug Wilson
San Diego County Water Authority
4766 Overland Avenue
San Diego, CA 92123

Dear Directors:

Your letter dated February 11, 2013, regarding Board Letter 8-1

This letter responds to your questions and comments to the January 30, 2013 draft of Appendix A to the Official Statements for Metropolitan's Water Revenue Refunding Bonds, 2013 Series A and B and 2013 Series C, attached to Board Letter 8-1. Chairman Foley asked me to respond to your letter.

Answers to your questions about Metropolitan's interest rate swaps and the proposed swap terminations, to the extent not fully addressed in the Finance and Insurance Committee discussion of this item on February 11, are in Metropolitan's quarterly swap reports. The January 2013 report, for the quarter ended December 31, 2012, is posted at <http://edmsidm.mwdh2o.com/idmweb/cache/MWD%20EDMS/003725136-1.pdf>. We plan to provide a report at the April Finance and Insurance Committee meeting, when the next quarterly report will be available.

You also requested a report on Metropolitan's investment policies. The Statement of Investment Policy must be updated and presented for Board approval annually, by law and pursuant to the Administrative Code. See Board Letter 8-1 approved on June 12, 2012. As explained in the Statement of Investment Policy, the California Government Code restricts the types and credit quality of investments that Metropolitan and other California local agencies may enter into. Metropolitan's investment criteria are in fact more restrictive than Government Code requirements. The current Statement of Investment Policy is posted at <http://edmsidm.mwdh2o.com/idmweb/cache/MWD%20EDMS/003722374-1.pdf>.

We appreciate your acknowledgment of our changes to draft Appendix A in response to prior comments. Review by Board members is an important part of the process to update Appendix A. Comments from Board members, many from the Water Authority delegation, are discussed and

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carefully evaluated, often resulting in clarifications or corrections to Appendix A. Your most recent comments and our responses are set forth below.

A-10: State Water Project operational constraints. Why is the last sentence of the first paragraph being deleted (the information is not outdated and remains relevant to July 2012 storage levels through July 2012)? Also, please reconcile the numbers reported in this paragraph with those contained in this month's Water Planning and Stewardship Committee, Item 6a, PowerPoint Presentation slide 21 of 27, Attachment 3.

This paragraph now discusses cumulative estimated losses to the State Water Project due to pumping restrictions for the 2008-2012 period, as well as disclosure of losses affecting calendar year 2013 deliveries as of the end of January. Information about State Water Project storage as of July 1, 2012 was outdated. State Water Project storage as of January 1, 2013 is found under the heading, "Storage Capacity and Water in Storage."

A-18: Sale of water by Imperial Irrigation District to SDCWA and MWD Exchange Agreement. The last sentence should be updated and corrected to reflect that IID did in fact meet its 2012 conservation obligation of 90,000 acre-feet, and, also delivered the additional 16,722 acre-feet of conserved water which MWD agreed to exchange and did exchange in 2012.

An update of this sentence is premature. We will revise it to be consistent with the Bureau of Reclamation's 2012 accounting of Colorado River deliveries after that accounting is released.

A-26: Discrepancies between the draft Official Statement and MWD's January 2013 WSDM staff report to Board of Directors RE MWD's storage capacity and actual water in storage. The draft Official Statement reports MWD's storage capacity to be 113,000 acre-feet lower and water in storage 4,000 acre-feet higher than MWD January 2013 Water Surplus and Drought Management report to the board of directors, Attachment 4. Please clarify the discrepancies.

The WSDM storage table and the Appendix A storage table are not intended to be apples-to-apples comparisons. The Appendix A storage table takes a longer-term view whereas the WSDM report is a short-term, month-to-month snapshot. The shorter-term WSDM report includes one-time or short-term capacity (Drop 2 reservoir storage credit that can only be used once and Article 56 carryover that is unpredictable over the longer term) that is not appropriate for the longer-term perspective of Appendix A. Appendix A includes capacity in the San Bernardino Valley Municipal Water District Coordinated Operating Agreement that was not included in the WSDM report because we do not plan to purchase water for storage under this agreement this year.

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Also there are differences in timing. The Appendix A storage balances include regular accounting reconciliations for Lake Mead ICS and the DCWV Advance Delivery Account that were not available for the WSDM report table, resulting in a discrepancy of 4 TAF. There was a 3 TAF difference between the capacity listed for member agency storage programs in the two tables, some of which is attributable to rounding. We conformed Appendix A with the number in the WSDM report.

A-33: Replenishment and the sale of discounted water. It would be misleading to delete the discussion about a new storage program to replace the Replenishment Service Program unless these plans have in fact been abandoned by MWD and the member agencies. Just a few months ago, before the “rate refinement” process was terminated, MWD and the other member agencies had identified the sale of discounted water as a “top priority.” See Attachment 2, page 3 at A33 and A-52 and Attachment 1, page 6 at A-53.

We have restored a description of ongoing discussions.

A-44: Growth in number of unbudgeted MWD employees. Based on the edited numbers, MWD has added 93 employees since last October. Based on the presentation to the Board Budget Workshop on February 12, 2012, this number exceeds the budgeted employees by 45 employees (see slide, Attachment 5). What is the source of funding being used to pay the costs of the unbudgeted positions?

We have updated the employee count to February 13, 2013. Metropolitan has 33 fewer regular full-time employees as of that date than in October 2012. The numbers in the January draft were not correct.

A-48: Revised (“extended”) purchase orders as evidence of MWD’s projected water sales revenues. We believe it is misleading to discuss the revised Purchase Orders in the context of disclosures about MWD’s projected water sales revenues, for the reasons described in the letter from the Water Authority’s General Counsel to MWD’s General Counsel dated December 27, 2012, Attachment 6. Given that at least 19 of the 22 member agencies executing the revised Purchase Orders had already met the minimum revised purchase order commitment even before the extension, the revised Purchase Orders provide no meaningful assurances to investors about MWD’s future sales revenues.

The Purchase Orders set the Tier 1 limits of member agencies, as disclosed in this section. Purchase Orders were extended to keep the Tier 1/Tier 2 pricing signal in place. We have reorganized the paragraph and added a cross-reference to the description of the Tier 1/Tier 2 water supply rates to clarify this. We also made some clarifying edits in response to comments from co-bond counsel.

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A-50: Source of funding to pay SDCWA to the extent it prevails in the litigation. MWD has not changed the following statement: “If Metropolitan’s rates are revised in the manner proposed by SDCWA in the complaint, other member agencies may pay higher rates unless other actions are taken by the board.” The Water Authority inquired about the basis of this statement when it was changed by MWD, because it is inconsistent with the claims being published by many MWD member agencies and at times by MWD itself. See Attachment 2, page 3 at A-50. Neither MWD nor its member agencies has explained why this change was made to the last draft Official Statement, which previously stated that, “If Metropolitan’s rates are revised in the manner proposed by SDCWA in the complaint, other member agencies would pay higher rates.” The language in the current draft Official Statement is inconsistent with the expectations described in the Fitch ratings that have just been assigned to MWD bonds [Friday, February 8, 2013 3:37 pm EST.]:

CASH RESERVES FOR RISK

The unrestricted cash amount above excludes additional restricted cash of \$67.5 million that is set-aside for disputed amounts paid by the San Diego County Water Authority (SDCWA), which are the subject of ongoing litigation. ***To the extent the litigation is decided in favor of SDCWA and Metropolitan Water District must make a payment to SDCWA, Fitch anticipates that any settlement would be collected from other member agencies in a timely manner.*** The litigation relates to the rate methodology used to allocate costs between members. (Emphasis added.)

The expected source of money that would be used to pay SDCWA is a material fact; at a minimum, it is something we believe an investor would be interested in knowing when considering whether to invest in MWD bonds.

The statement that “other member agencies may pay higher rates unless other actions are taken by the board” recognizes the board’s discretion over rates and charges. As I explained in my letter to you on October 25, 2012, “The Board may authorize a variety of actions to replace lost revenues and close a budget shortfall, including raising rates, reducing costs, restructuring of rates and charges, and other options depending on the circumstances.” The Fitch report does not prescribe the source of any settlement paid to SDCWA, but assumes that the settlement amount would be recovered from other member agencies.

A-51: More on MWD purchase orders. See comments above at A-48. In addition, MWD should disclose during the discussion at A-51 that its largest customer (see footnote 1 at page A-2) – the Water Authority – signed the revised Purchase Order under protest, and why. Further, MWD should note that it rejected SDCWA’s execution of the revised

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Purchase Order. See Attachment 7, letter from MWD General Counsel to SDCWA General Counsel dated January 4, 2013.

The existing disclosure that there are 22 Purchase Orders now in effect is accurate. SDCWA provided its Purchase Order extension under terms that showed its lack of consent to, and unwillingness to be bound by, the terms of the agreement, as described by Metropolitan's General Counsel in Attachment 7 to your letter. Mutual consent is necessary to reach an effective agreement. However, the circumstances under which SDCWA's existing purchase order expired are not material to investors.

A-52: Inaccurate, ex post facto characterization of how Replenishment Service Program was operated. The edits to the first sentence of the Replenishment section change the prior statement describing program *objectives* to an inaccurate statement of fact about purported benefits of the sale of discounted water as replenishment. See discussion at Attachment 1, page 6 at A-53 and Attachment 2, page 3 at A-33 and A-52.

We have revised this paragraph to take your comments into account.

A-55: MWD's financial reserve policy, the use of "unrestricted reserves" as "collateral" and failure to establish a separate interest bearing account for SDCWA litigation deposits. It is not possible to confirm from the information and commingled descriptions provided at A-55 whether MWD is in compliance with its financial reserve policies. One thing that is clear is that MWD has failed to establish a separate interest bearing account for SDCWA litigation deposits as required by the Exchange Agreement. The very purpose of the requirement of a "separate interest-bearing account" was to *restrict* MWD's use of those monies for other purposes. MWD has also failed to explain how reserve balances that are held as collateral can be described as "unrestricted." See Attachment 1, page 8 at A-81. No response to this question has been provided by MWD.

I responded to your comment about collateral deposits in my November 19, 2012 letter. SDCWA litigation deposits also are accounted for in Metropolitan's reserves. It is accurate to include them in the section discussing reserve deposits.

A-72: Inclusion of Bay Delta Conservation Plan construction costs in projected costs of MWD for State Water Project water. Please identify what construction costs have been included in the 2016 and 2017 projected costs for anticipated construction of additional State Water Project facilities.

See footnote 4 to the table, "Projected Costs of Metropolitan for State Water Project Water."

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A-74: Failure to raise rates to fund pension and Other Post Employment Benefits (OPEB) liabilities. As of January 1, 2011, MWD's combined unfunded retiree health care obligation and unfunded pension liability is at least \$757 million. When this number is next updated, the number will likely approach the \$1 billion mark. Although there are many disclosures of fact in the draft Official Statement, the burden of this liability on future water ratepayers and the cost of water are not described. MWD's plan to "begin OPEB funding above annual pay-as-you-go amounts with \$5 million in the fiscal year 2012-13 budget" and statement that it "intends" to increase this amount by \$5 million per fiscal year to an annual funding amount of \$25 million beginning in fiscal year 2016-17 defies the reality of other statements that it will, at the same time, begin construction of the BDCP and hold rate increases to 3%. This estimate pales in comparison to MWD's average annual rate increases of 5.6% over the past 30 years (1984-2014), and its average annual rate increases of 7.9% over the past 10 years (2004-2013). It is difficult to imagine that MWD will impose far lower annual rate increases, while at the same time invest billions of dollars more on its Bay Delta water supplies and begin modest payments to its unfunded OPEB liability. Further, given that the MWD board has not been willing to raise water rates now to pay for these liabilities, one is left to wonder why it will be willing to do so in the future at a time when MWD's BDCP costs are substantial.

Metropolitan's funding of its pension and OPEB costs, projected funding requirements from PERS, budget projections and actuarially-determined unfunded liability are fully disclosed. This disclosure is factual based on Metropolitan's financial results and budget and PERS projections. The five-year budget projections already include a build-up of pension costs and a plan to fund the actuarially required contribution (ARC) for OPEB. Your statement in the above paragraph is speculative and unsupported by Metropolitan's current projections. See our response to your next comment.

A-80: Management's projections and assumptions concerning future events and circumstances that may impact MWD's revenues and expenditures are unreasonable. Based on all of the detailed comments we have provided in regard to past draft Official Statements, and other resource planning and financial issues at MWD, we do not believe that management's projections and assumptions as described in the draft Official Statement are reasonable. MWD's continued reference to long-outdated planning documents in its Official Statement is a matter of concern to us and should be a matter of concern to investors, not the least of which is the 1999 Long Range Finance Plan which even MWD has abandoned as a planning document for board planning purposes. Aside from all of the data, simple common sense suggests that there is no way that MWD can do everything that it says it will do beginning in 2016 (IRP projects, construction of BDCP and increase payments to OPEB) and at the same time, hold rate increases to 3 percent – all at the same time its sales are down 25% and its member agencies are constructing and planning more local water supply

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projects throughout Southern California to reduce their demand for increasingly expensive imported water supplies.

Metropolitan's projections and assumptions described in Appendix A are founded on current Board-approved policies, approved budgets and current, conservatively-based projections. The Long Range Finance Plan, originally adopted in 1999, is cited as the source of the Metropolitan's minimum/maximum financial reserve policy. This policy, as subsequently amended by the Board, is included in Administrative Code section 5202. The Integrated Resources Plan, most recently updated in October 2010, provides a framework for regional water resources development over a long-term planning horizon. It seeks to provide regional reliability through 2035, with regional collaboration, by stabilizing Metropolitan's traditional imported water supplies, continuing to develop local resources, and providing adaptive long-term planning for contingency resources.

The biennial budget for fiscal years 2012-13 and 2013-14 and the five-year projections contained in the adopted budget provide funding for core IRP projects (such as construction costs for Bay-Delta conveyance anticipated to be paid by State Water Project contractors), local resources projects, and pension and OPEB. The budget and five-year forecast conservatively assume water sales at levels fifteen percent below Metropolitan's long-term sales average. The twenty-five percent drop in sales cited in your letter compares a single-year low to a single-year peak, a less stable assumption than the long-term sales average. Moreover, the conditions that generated this drop (described in Appendix A) are returning to normal. Current year financial performance is exceeding expectations, illustrating the reasonably conservative level of Metropolitan's water sales assumptions.

The projections cited in Appendix A indeed should cover costs of providing reliable supplemental water supplies for Metropolitan's service area with annual average rate increases of 3-5 percent over the next five years, based on budget assumptions. Actual results are likely to differ from projections. The goal of each Official Statement is to disclose material current facts and reasonable projections, the bases for those projections and the factors that could affect future performance—all founded on reasonable assumptions.

We appreciate your careful review of the Official Statements.

Sincerely,



Gary Breau
Assistant General Manager/Chief Financial Officer

The Metropolitan Water District of Southern California

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cc: J. Kightlinger
M. Scully
MWD Board of Directors
SDCWA Member Agencies