



# San Diego County Water Authority

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(858) 522-6600 FAX (858) 522-6568 www.sdcwa.org

March 9, 2014

Randy Record 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: Approve and Authorize execution and distribution of Remarketing Statements in connection with the remarketing of the Water Revenue Refunding Bonds (Index Mode), 2011 Series A-2 and A-4 and 2012 Series B-1 and B-2

**Chair Record and Board Members:**

The Water Authority's MWD Delegates have reviewed the March 10, 2015 board memo 8-1, including the redline copy of Appendix A dated February 26, 2015, and determined we must vote against staff's recommendation to authorize the execution and distribution of the Official Statement and Remarketing Statements in connection with the refunding of bonds. While we support staff's general financial management objective, we do not believe that the bond disclosures fairly present current and projected water supply conditions, MWD's financial position or risk. We request that staff and bond counsel respond to each of the issues and questions presented in this letter.

**General Comments**

We attach and incorporate by reference our last letter to you dated November 17, 2014 ("November Letter"), to which no response has been received from MWD or its bond counsel. None of the major issues addressed in the General Comments section has been addressed, including but not limited to:

- Financial risk associated with the absence of a long range finance plan or any commitments by MWD's member agencies to pay for MWD's long-term water supply investments;
- Uncertainty created by the current MWD budget process, which is no longer based on actual projections or expenses, but instead, is based on arbitrary numbers which result in the systematic over-collection of revenues from MWD ratepayers (in the

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hundreds of millions of dollars); and

- Continued violation of Proposition 26 and cost of service legal requirements due to the failure of MWD's accounting system to track revenues it receives from different sources.

A more complete discussion of these issues is included in our November Letter and in the Comments on Appendix A, below.

We do note and appreciate the edit that was made in the new draft Official Statement at page A-51, noting that MWD's statutory authority and voter authorization to levy *ad valorem* taxes to pay its outstanding general obligation bonds and to satisfy its State Water Project (SWP) obligations is *limited to the debt outstanding as of 1990-91*. We felt this omission from past versions of Appendix A was both material and misleading (see our November Letter at p. 3, RE paragraph A-49) and appreciate you adding this language in the current draft.

### **Comments on Draft Appendix A**

*A-3: Metropolitan's Water Supply and A-4: Drought Response Actions.* The discussion in these and other sections of the draft Appendix A fails to accurately report the severity of MWD's current water supply conditions in the context of this fourth-consecutive drought year or for 2016 and beyond. See our March 6, 2015 letter to the MWD board RE: Water Planning and Stewardship Committee Agenda/Water Supply Management Strategies Including Use of Storage, incorporated herein by reference. Taken together with other sections of the draft Appendix A, in which water sales are projected for the next five years (see page A-83) but where the source or cost of the water to be sold is not identified, the draft Appendix A fails to present an accurate picture of MWD's water supply situation or financial risk.

*A-7: State Water Project.* We presume the final document will be corrected to reflect the recent action taken by the Department of Water Resources (DWR) to increase the SWP allocation to 20%. With regard to SWP supplies, we believe MWD should also disclose that it used all of its available DWR flex storage in 2014 (219,000 AF) and that those supplies not only will not be available in 2015, but must be paid back to DWR within five years. More broadly, MWD should make full disclosure in the draft Appendix A of *all* water supplies it has "borrowed" and which therefore include pay-back requirements that could affect the availability of supplies in future years. MWD should also disclose the unique service requirements associated with serving the "SWP-Exclusive Area;" this issue has not previously been addressed in MWD's Integrated Resources Plan (IRP).

*A-16: Colorado River.* The draft Appendix A should be revised to include a discussion about current Basin States' efforts to increase storage in Lake Mead and the US Bureau of Reclamation's analysis regarding the probability of shortages on the Colorado River

beginning in 2016. These shortages, coupled with continued drought and severe limitations on SWP supplies present material water supply and financial challenges to MWD. MWD has borrowed 162,000 AF of water from the Southern Nevada Water Authority; as noted above, this and other water supply "debt" should be fully disclosed in the Appendix A. At page A-5, MWD added language that the CRA is anticipated to operate at capacity in 2015, "*assuming additional supplies are acquired.*" MWD should identify how much water it needs to keep the CRA operating at capacity and the potential sources of water supplies to do so.

*A-30: MWD's Water Storage Capacity and Water in Storage.* The amount of water in storage shown does not match data presented in MWD's January 2015 WSDM report; please reconcile the differences. We also believe MWD should amend this presentation to clearly reflect how much water is available for dry-year use and how much is required for emergency storage (626,000 AF).

*A-31: Water Conservation.* This section of the draft Appendix A is misleading because MWD has not measured and its conservation programs do not require any measurement of actual water conservation savings from MWD programs. There is no evidence to support the statement that the 2009-2012 water sales numbers reflect the "success" of MWD's water conservation programs.

*A-32: Water Surplus and Drought Management Plan and Water Supply Allocation Plan.* See concerns expressed at A-3, above. Regarding Preferential Rights, contrary to the statement in the draft Appendix A, these rights have been "used" in many ways over the years in allocating MWD's water. MWD itself has been clear that the MWD board does not have the authority to change rights MWD member agencies have under the MWD Act, including Preferential Rights. If MWD persists in making this misleading statement, it should at a minimum disclose as a recent example, that in October 2014, the Central Basin Municipal Water District asserted a claim to water based on Preferential Rights. The claim was only "rescinded" after MWD agreed to provide additional water supplies it had previously refused to deliver.

*A-51: Metropolitan Revenues.* See November Letter at p. 3, RE A-49: Metropolitan Revenues: General. Given the reality that many MWD member agencies are planning to reduce their purchases of MWD water, MWD should describe the role it anticipates tax revenues may play *or it believes must play* in the future in order to sustain MWD's fiscal integrity.

*A-55: Litigation Challenging Rate Structure.* MWD should disclose that the amount of damages awarded to the Water Authority may be determined by the Court in an amount that exceeds the amount that is held in the escrow account. Further, that the Court's April 24, 2014 Statement of Decision found that Proposition 26 applies to MWD to all rates set after the date of enactment of the measure. Finally, the draft should disclose that the May 2014 case has been stayed by stipulation of the parties.

*A-57: Member Agency Purchase Orders.* MWD should disclose that there is no cost of service basis for the terms described in MWD purchase orders. See also November Letter at p. 4, RE A-56: Member Agency Purchase Orders.

*A-58: Classes of Water Service.* See November Letter at p. 4, RE A-56: Classes of Water Service.

*A-59: Additional Revenue Components.* MWD is proposing an edit that is inconsistent with all past cost of service analyses by MWD, namely, to change the statement that the RTS charge is designed to recover "a" portion of capital expenditures for infrastructure projects needed to provide standby service and peak conveyance needs, to the statement that the charge is designed to recover "the" portion of capital expenditures made for those purposes. This is nothing more than *ex post facto* "sleight of hand" designed to shore up MWD's litigation posture. There is no cost of service analysis to support this change and the change is inconsistent with how MWD's cost of service was performed and with how its rates have been established. If MWD wants to make this change, it must do so as a matter of substance, with an accurate calculation of costs MWD incurs to provide standby service and peak conveyance needs. That is not what is captured by the current RTS charge and that is what the current cost of service report states, which is different than the "edit" MWD is proposing to make in the draft Appendix A.

*A-60: Financial Reserve Policy.* Proposition 26 applies to MWD; as a result, the MWD board does not have complete discretion *ex post facto* to determine how to spend over-collected revenues that are not based on any cost of service analysis. The planned over-collection of revenues and refusal to account for and track revenues by rate category subjects MWD to the further risk of litigation based on its unlawful practices.

*A-62: Ten Largest Customers.* See November Letter at p. 5, RE A-62.

*A-63: California Ballot Initiatives.* See November Letter at p. 5, RE A-63.

*A-76: State Water Contract Obligations.* As noted above and in numerous prior letters we have authored on a variety of subjects, the Water Authority believes it is highly misleading for MWD to substitute old estimates or arbitrary numbers for planning purposes when actual numbers (or at least more reasonable estimates based on currently known data) are available. No more clear illustration exists how this skews financial and water resource planning (and, in this context, how it misrepresents information to investors) than MWD's use of "budgeted" State Water Project costs. MWD chose to "budget" based on a 50% water supply allocation at the same time the actual allocation was 5%. In the draft Appendix A, MWD is still using its budget numbers to describe its projected costs for SWP water, even though the SWP allocation is actually 20% with very little if any expectation of change this year. This means that MWD is (mis)representing that it will incur costs to acquire SWP water

that it knows it will not incur and sell SWP water that it knows it will not have to sell.

*A-82: Historical and Projected Revenues and Expenses.* Based on the available information, it is unreasonable to predict that MWD water sales will be as described at page A-83 unless the drought ends, MWD finds sources of water supply that it has thus far been able to identify or secure or MWD imposes deeper supply cuts. The description of forecasted MWD water sales should include a more robust analysis of water supplies remaining in storage and where MWD expects to secure the water it needs to meet these sales projections.

*A-84: Operations Funded from Prior Year Revenues.* Please identify 1) why operations are being funded by prior year revenues (and whether the same operations were also included in the current year's budget); 2) the source of revenues used to pay these operating costs; and 3) why operating costs would be paid from revenues deposited to the Water Management Fund.

*A-87: Water Sales Projections.* See discussion above, at A-82. Where will MWD secure the water supplies that water sales projections are based on?

We incorporate by reference all of our comments in prior letters to MWD that have not been corrected in this or past versions of the Official Statement, including but not limited to the comments in our November Letter.

Sincerely,



Michael T. Hogan  
Director



Keith Lewinger  
Director



Fern Steiner  
Director



Yen C. Tu  
Director

Attachments:

1. Water Authority Letter on MWD's Official Statement dated November 17, 2014

cc: Jeff Kightlinger, General Manager  
Dawn Chin, Office of the Board of Directors



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November 17, 2014

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### MEMBER AGENCIES

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Camp Pendleton  
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Rainbow  
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Ramona  
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Rincon del Diablo  
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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 8-2: Authorize the execution and distribution of (1) the official Statement in connection with the issuance of the Waterworks General Obligation Refunding Bonds, 2014 Series A; and (2) Remarketing Statements in connection with remarketing of the Water Revenue Refunding bonds (Index Mode), 2011 Series A-1 and A-3, and 2009 Series A-2 –  
**OPPOSE**

Dear Chair Record and Members of the Board:

The Water Authority's MWD Delegates have reviewed the November 18, 2014 board memo 8-2, including the redline copy of Appendix A, and have determined we must vote against staff's recommendation to authorize the execution and distribution of the Official Statement and Remarketing Statements in connection with the refunding of bonds. While we support staff's objective to refund debt in order to reduce MWD's financial obligations, we do not believe that the bond disclosures fairly present MWD's financial position or risk. 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 the Official Statement; we do not repeat, but incorporate herein by reference all of the issues that have been raised in prior letters that have not been substantively addressed by MWD management.

We noted in our last comment letter that MWD had abandoned its effort to conduct a comprehensive update of its 2004 Long Range Finance Plan, now more than 10 years old. Rather than continue to work with the member agencies to determine their willingness to pay MWD's long-term capital and operating costs -- an effort that was unsuccessful after five years of on again/off again "rate refinement" meetings -- MWD chose to simply "declare" that the 10-year rate forecast in its biennial budget *is* its long-range financial plan. But the biennial budget contains no reference to how MWD will ensure a sustainable revenue source from its member agencies to support MWD's projects and programs in the long term. The draft Appendix A fails to disclose that MWD has not been successful in its efforts to develop long-term revenue commitments to pay for long-term water supply investments.

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The Draft Appendix A also fails to disclose the unusual manner in which MWD is now establishing its budget and its rates, based not on actual projected water demand nor projected expenses, but on the basis of an arbitrary number that MWD itself expects to exceed in seven out of 10 years. This approach fails to even attempt to meet cost-of-service requirements in setting MWD's rates and charges, and instead, results in intentional, systematic revenue over-collection from MWD ratepayers, with ex-post facto decision-making by the MWD board of directors on how to spend the intentionally over-collected rate dollars without any cost-of-service standard of transparency, accountability or legality.

MWD also fails and refuses to track or account for revenues it receives from the different rates it charges for the services it provides. For this reason, it cannot and does not ensure that rate revenues are spent on the intended purposes. For example, funds over-collected from the System Access Rate and System Power Rate are being used to pay for water conservation programs that benefit supply service customers, rather than being used to set lower transportation rates in the following year. The cross-subsidy between services can be demonstrated by the fact that even though data stated in A-91 indicates MWD "water sales" (in which MWD improperly includes revenues from the transportation service it provides to the Water Authority) exceeded budget in five fiscal years between 2004/05 and 2013/14. In reality, MWD's actual water sales (i.e., not including revenues from the Water Authority's transportation service payments) exceeded budget in only three of those years. Unlike water demand, which is inherently more difficult to predict, MWD revenues from the transportation service it provides to the Water Authority are entirely predictable and do not vary because of hydrology. MWD's practice of comingling revenues from the different rates it charges causes illegal cross subsidies and results in rates that do not bear a reasonable relationship to the costs of providing a particular service. Each and every one of these practices results in illegal rates being charged by MWD.

#### **Comments on Draft Appendix A**

All references are to the page numbers in the draft redline copy of the Appendix A dated 11/06/14.

*A-4: Drought Response Actions.* The discussion in this section of the Official Statement is insufficient to advise a reader of the risks associated with MWD's dwindling imported and stored water supplies given the possibility of a continuing drought. The fact that MWD is projected to use between 1 million acre-feet (MAF) to 1.3 MAF of its available storage reserves in calendar year (CY) 2014 alone is material. While MWD notes that it declared a Water Supply Alert last February and doubled its conservation subsidy budget, it does not mention that these efforts have thus far failed to reverse the demand trend that will result in the consumptive use of more than one-half of its available storage reserves in 2014.

Appendix A should discuss and disclose how MWD plans to meet 2015 demands under these circumstances in the event that the drought continues. MWD should provide supporting facts, operational projections and the assumptions used to support its statement that the Colorado River Aqueduct is expected to operate at capacity, given that it projects that it will exhaust the bulk of its Lake Mead water storage in 2014. The analysis should include consideration of any delivery limitations MWD may experience in areas served exclusively by the State Water Project as well as MWD's plan to ensure that emergency storage reserves are preserved for their intended purposes

(i.e. providing water service following a catastrophe that cuts off imported water supplies).

*A-5: Integrated Water Resources Plan.* Appendix A should disclose that it would be imprudent to make any long term water supply planning decisions based on the badly outdated 2010 Integrated Resources Plan (IRP). Although the Draft Appendix A mentions that the IRP is scheduled to be updated in 2015, it does not disclose the risks of continuing to make decisions based on outdated data that is known to MWD today – a material deficiency. Moreover, MWD has not even begun to conduct the necessary coordination with member agencies to update the plan. In the past, it has taken MWD about two years to complete the update. Without having a current long-term supply plan and accurate data taking into account changed circumstances, MWD is at risk of committing to pay for long-term water supply projects in excess of what its member agencies are willing to buy. The IRP also assumes that MWD will have revenues available from water rates that have been declared illegal. MWD has claimed in court filings that this has a "destabilizing effect on MWD's rates and its ability to budget and plan" (our December 9, 2013 letter is attached for your ease of reference; see pages 1-3 (Dec. 9 Letter)). If MWD actually believes its own representations to the Court, then this should be disclosed.

*A-7: State Water Project.* Appendix A should disclose that the Agreement in Principle reached to extend the State Water Project contract does not address cost allocation related to the Bay Delta Conservation Plan (BDCP). Depending on how BDCP costs are proposed to be allocated, MWD's share of the BDCP could vary widely and have a substantial impact on MWD's water rates and charges, and as a result, have a substantial impact on reducing MWD's future water sales. Since it is expected that the financing of BDCP will continue to be under a take-or-pay contract, MWD is at risk of being liable for payments far in excess of revenues that may reasonably be anticipated from water sales. In such a case, MWD would have no alternative but to find that increased taxes are necessary in order to ensure its fiscal integrity. These fiscal realities are capable of being addressed, and should be addressed in the Draft Appendix A.

*A-15: Water Bond.* Appendix A should disclose that the Water Bond will provide funding for local water supply projects that are anticipated to reduce demand for MWD water supplies.

*A-32: Water Supply Allocation Plan.* We have previously requested that disclosures be made regarding Preferential Rights that have not been made (Dec. 9 Letter, page 4). We renew our request that a more complete discussion of preferential rights be included in Appendix A. Disclosure should also be made of recent actions and communications from MWD member agencies with regard to enforcement of their preferential rights and the impact such actions would have on MWD's water supply planning, supply allocation and drought response.

*A-49: Metropolitan Revenues: General.* The MWD Act clearly limits property tax collections to the amount necessary to pay annual debt service on MWD's general obligation bonds, plus the portion of its State Water Contract payment obligation attributable to the debt service on State general obligation bonds for facilities benefitting MWD *that were outstanding as of 1990-91*. It is misleading to delete the qualifying language, "that were outstanding as of 1990-91." MWD should disclose that its own Chief Financial Officer, Gary Breaux, informed the MWD board prior to its vote in August of this year suspending the tax rate limitation that the action was *not* essential to the fiscal integrity of MWD. The action by the MWD board in suspending the tax rate limitation does not comply with Section 134 of the MWD Act. Further, it should be disclosed that the MWD board did not engage in



any substantive discussion or deliberation of alternatives in order to achieve a "fair distribution of costs," and was provided with no data to support the conclusory statement by staff that suspension of the tax rate limitation would "enhance MWD's fiscal stability" or result in "a fair distribution of costs across MWD's service area."

*A-53: Delta Supply Surcharge.* The Delta Supply Surcharge was, as stated, designed to recover additional supply costs associated with pumping restrictions. Appendix A should disclose the financial risks associated with the board's suspension of the Delta Supply Surcharge, even though the pumping restrictions remain in place, especially in the context of the staff recommendation to change the terms of MWD purchase orders (action this month) to eliminate Tier 2 revenues, the original purpose of which was also to recover the high cost associated with obtaining additional water supplies. Both actions result in setting the Tier 1 water rate higher than the cost of providing that service. There is no rational basis for MWD reducing the rates associated with the costs of obtaining additional water supplies.

*A-56: Member Agency Purchase Orders.* Appendix A should disclose the purchase order modifications recommended by staff to be considered this month, including the financial impacts and risks associated with the elimination of MWD's Tier 2 revenues. MWD should also disclose that, during the trial of the Water Authority rate cases, MWD represented that Tier 2 revenues were a mechanism to ensure that all MWD member agencies pay their fair share of dry-year peaking costs. Since there has been no change in MWD's rates or cost of service, there is no explanation of how these costs will now be recovered except in the form of another illegal cross-subsidy.

*A-56: Classes of water service.* This section of the Draft Appendix A is inaccurate and materially misleading in several respects. First, MWD has multiple rates, including a Water Stewardship Rate, System Access Rate, and System Power Rate and Wheeling Rate. MWD also sells treated and untreated water. The costs that MWD incurs to provide these and other services, such as dry-year peaking, are not the same for all MWD member agencies. These differences are required to be identified and the associated costs properly allocated through a cost-of-service process to ensure that beneficiaries pay for the services they receive. MWD's simplistic statement that it has a single class of water service is not only inaccurate; it results in rates that are illegal under California law and exposes MWD to the continued risk of litigation.

*A-58: Readiness-to-service Charge.* Having disclosed that the RTS recovers only a portion of capital expenditures for infrastructure projects needed to provide standby service, Appendix A should also disclose how the remaining portion of these capital costs are recovered. In addition, the statement that the RTS recovers capital expenditures related to "peak conveyance" needs is inconsistent with MWD's rate memo; please explain this discrepancy and correct for it in one or both documents.

*A-59: Financial Reserve Policy.* MWD should disclose that the MWD board does not have unlimited discretion to determine how revenues are spent, through the creation of reserves, or otherwise; rather, all of MWD's rates and revenues are subject to California cost-of-service requirements under the common law, California statutes and Constitution. The planned over-collection of revenue and refusal to utilize balancing accounts or any other mechanism to account for and track revenues by rate category subjects MWD to the further risk of litigation.

*A-62: Ten Largest Water Customers -Water Sales Revenues.* It is highly misleading to characterize wheeling revenues as MWD "water sales." We have requested many times that you correct this summary so that investors are not required to figure out by reference to a small footnote that MWD's water sales are not as high as described.

*A-63: California Ballot Initiatives- Proposition 26.* Appendix A should include disclosure of the fact that Judge Curtis E.A. Karnow has already ruled that MWD is subject to Proposition 26 (2010). MWD should also disclose how or why, if it is not now subject to Prop. 26, it could "affect future water rates and charges."

We incorporate by reference all of our prior comments in prior letters to MWD that have not been corrected in this or past versions of the Official Statement.

Sincerely,



Michael T. Hogan  
Director



Keith Lewinger  
Director



Fern Steiner  
Director



Yen C. Tu  
Director

Attachment: Water Authority Comment Letter on MWD Draft Official Statement, dated 12/9/13



## San Diego County Water Authority

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December 9, 2013

John (Jack) V. Foley and  
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#### MEMBER AGENCIES

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#### 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 letters<sup>i</sup> (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)

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Chairman Foley and Members of the Board of Directors

December 9, 2013

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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

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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

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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.

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*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



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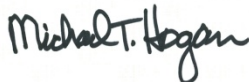
paragraph that the tax increase as described would be within the exemption permitted under Article XIII A of the State Constitution as a tax to pay pre-1978 voter approved indebtedness.

*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

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<sup>i</sup> 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.

24  
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26  
27  
28

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.<sup>4</sup> West Dec., Ex. B. at 183:12-15 ("It's reasonable to assume, as I've previously

26 \_\_\_\_\_  
 27 <sup>4</sup> 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,<sup>5</sup> 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 <sup>5</sup> 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.*