



December 19, 2019

VIA EMAIL AND U.S. MAIL

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

Gloria Gray, Chairwoman; MWD Board of Directors
 Metropolitan Water District of Southern California
 700 N. Alameda Street
 Los Angeles, CA 90012

Re: Settlement Offers

Dear Gloria and MWD Board of Directors:

This letter serves to inform you of two important decisions by our Board of Directors today which I am authorized to transmit to MWD by this letter. First, for the reasons stated below, the Water Authority voted not to act upon MWD's 998 offers (together, the MWD offers in all cases are the "998 Offer"), which MWD General Manager Jeff Kightlinger came and discussed with us today. Second, also as stated below, the Water Authority hereby makes a formal public offer in response to MWD's 998 Offer to settle all of the pending rate litigation. We present our formal public settlement offer first, and then explain why MWD's 998 Offer was not acted upon by our Board and thus will expire by its own terms.

The Water Authority Offer

The Water Authority Board has authorized me to present in this letter a formal offer to the MWD Board to settle all of the pending rate litigation. Each of the following terms is material to the offer:

WATER AUTHORITY OFFER TO MWD

1. MWD, within 60 days of signing the written settlement agreement referenced below, shall pay the Water Authority \$140 million. This payment covers all claims in all the rate cases filed between 2010 and 2018, and thus through MWD rate years 2011-2020.
2. A validation judgment will be entered in the 2011-14 rate year cases with the following material provisions: (a) MWD breached the Exchange Agreement, and the Water Authority suffered damages in the amount of \$28,678,190.90, plus interest, as confirmed by Judge Wiss (fully included in #1 above); (b) MWD 2011-14 wheeling and Exchange Agreement rates are unlawful to the extent they include demand management costs; (c) State Water Project ("SWP") transportation costs imposed in 2011-2014 are recoverable for wheeling and Exchange Agreement pricing as stated in the appellate decision; (d) Rate Structure Integrity ("RSI") unlawful and unenforceable; (e) Proposition 26 applies to MWD rate-setting; and (f) MWD's preferential rights calculation must include the Water Authority's Exchange Agreement payments. All parties give up any right to appeal.

3. The Water Authority to dismiss cases for rate years 2015 through 2020 without prejudice. Water Authority covenants not to sue MWD for all 2015-2020 MWD rates so that MWD is insured those rates are immunized from challenge. The Water Authority also agrees that -- so long as MWD's rate structure is unchanged for 2021 and 2022 rate years, and there are no material changes to the methodology for the allocation of MWD's costs – it will not sue on rates for those years. Years beyond 2022 are not subject to agreement by either side. MWD and the Water Authority also covenant not to sue the other or the other's agents for anything related to the previously filed litigation.
4. MWD agrees it will not seek to collect demand management costs for Exchange Agreement deliveries for 2018-2019 rate years under the Water Stewardship Rate or any other collection mechanism.
5. The Exchange Agreement shall be amended to change the price term at Section 5.2 as stated in this paragraph and paragraph 6. The price shall be \$450 per acre-foot commencing with January 1, 2020 (the "Fixed Price"). On January 1, 2020, the \$450 per acre-foot price shall be increased by an amount equal to the escalation of the Construction Cost Index (20 Cities) as published in Engineering News Record for the preceding year. On January 1 of every subsequent year, the Fixed Price shall be increased by an amount equal to the escalation of the Construction Cost Index (20 Cities) as published in Engineering News Record for the preceding year. No Water Stewardship Rate, demand management costs, or conveyance costs incurred by Metropolitan for improvement or repair of the Colorado River Aqueduct, local distribution system, or State Water Project will be added to the Fixed Price.
6. As of 2019, the price under the Exchange Agreement is \$453 AF, which consists of a \$326 System Access Rate and a \$127 AF System Power Rate (the "2019 Price Components"). The Water Authority shall be protected against any changes in the recovery of costs that are currently included in either of the 2019 Price Components as follows: Should at any point in time during the term of the Exchange Agreement MWD in any manner move any of the costs in either of the 2019 Price Components to any other cost recovery mechanism (such as a fixed charges, or property taxes), the Water Authority's Fixed Price shall be reduced commensurately. For example, the System Access Rate is currently about 72% of the overall 2019 Price Components. Should MWD move 50% of cost recovery of the System Access Rate to another form of cost recovery, the Fixed Price would receive a credit of about 36% (half of the 72% portion of the overall 2019 Price Components). Also, if there is a material reduction or elimination of costs that are currently in the 2019 Price Components, the Water Authority will similarly receive a commensurate reduction in the Fixed Price.
7. Metropolitan will work with SDCWA staff to schedule delivery of exchange water on a more flexible basis than current deliveries within a calendar year at no cost to SDCWA. The Exchange Agreement shall be amended to address the delivery flexibility within the calendar year.

8. Both MWD and the Water Authority bear their own fees and costs of all the rate litigation.
9. MWD agrees that all MWD Board members and the agencies they represent have a right to see applicable MWD rate models at least 60 business days before any public hearing on the rates and 90 days prior to any MWD Board vote on MWD rates or rate structure.
10. The parties will draft and execute a formal written settlement agreement with the above material terms, and other standard mutually acceptable terms, within 60 days of acceptance of this offer. The above dismissals and judgment will be entered promptly after execution of the final settlement agreement.
11. This offer must be accepted by the MWD Board of Directors with no additional conditions, and such acceptance transmitted in writing to the Water Authority no later than close of business on January 31, 2020.

The Water Authority believes that the offer it has presented above is fair for a number of reasons.

First, the \$140 million in consideration for settlement is just a small percentage of the overall amounts at risk for MWD in the litigation for these years. Attached is a Fact Sheet that explains the amounts in dispute in the rate cases, and the basis of the Water Authority's claims for recovery. The Water Authority is willing to agree to settle the pending claims now, in the hope that resolving them will lead to working together with the MWD Board of Directors as described below. However, if the Water Authority is forced to continue to litigate the rate cases it will seek the full amount in dispute in the litigation.

Second, the Water Authority's offer would achieve finality of the pending litigation. Every rate case between the parties would be concluded, and MWD would have assurance that its 2021-22 rates under the current rate structure are insulated from any challenge by the Water Authority. Further, by having a set Exchange Agreement price going forward, the parties would have certainty on this key element. The protections we added above are an important addition to what MWD offered. With those protections, we would accept the escalator index MWD proposed.

Third, the Water Authority's offer would assure transparency in MWD's rate-setting process by making MWD's rate model available to member agencies. The rate model is not something that MWD should hide from its member agencies, whose representatives all have to vote on MWD's rates and who represent the public interest. We are willing to work with MWD and the other MWD member agencies in the documentation of the settlement to have a protocol that MWD's member agencies can support.

Fourth, the Water Authority's offer would establish a framework for ensuring that MWD's future rates comply with applicable California law, including Proposition 26. The Court of Appeal has applied Proposition 26 to MWD's rate-setting, and dragging out the litigation to keep fighting about this issue – which has already been decided – is not productive or in anyone's interest. The Water Authority does not dispute that the MWD Board has discretion to set rates and charges, provided that is done in compliance with applicable legal standards.

Finally, the mutual covenants described above will provide both parties the necessary finality, while negating the need for releases, which are problematic as noted in the 998 section below. The Water Authority's proposed settlement would let the parties move forward and work cooperatively as the MWD Board undertakes an important update of its Integrated Resources Plan, budget and rates looking ahead to 2022. Our Board of Directors believes that this offer is reasonable, and we hope that MWD accepts it.

The offer is being presented publicly because the Water Authority is no longer comfortable negotiating with MWD in confidential meetings. The confidentiality agreement, which covered those meetings, is terminated, as we will not be having further meetings under it. Of course, the Water Authority will continue to honor the terms of that agreement as to past meetings.

MWD's 998 Offer¹

The Water Authority Board of Directors has decided not to act on MWD's 998 Offer, which thus will expire on its own terms. The main reasons for this decision are as follows:

1. The 998 Offer Provides No Certain Benefits, And Creates Many Risks

The main supposed benefit in the 998 Offer is that MWD will provide the Water Authority a rate certain starting at \$450 AF, and going up annually with an escalator from the Engineering News Record. MWD claims that this has billions of dollars in value to the Water Authority. Such claims, however, are highly speculative and exceedingly risky because: (a) Once our Exchange Agreement price is de-linked from the transportation charges MWD imposes on its volumetric rates to all its members, the 998 Offer provides no protection against MWD moving cost recovery for transportation expenses onto fixed charges or taxes. Indeed, MWD has been seeking to move cost recovery to fixed charges for some time. To date a majority of the MWD Board has generally opposed such changes. However, de-linking our Exchange Agreement would allow such fixed charges to benefit other member agencies at our expense (as we would be paying both the set Exchange Agreement price and also fixed charge, with no reduction in price on the Exchange Agreement, though other MWD members would have their transportation rates reduced while also paying fixed charges). Such a risk is unacceptable to the Water Authority, and MWD put nothing in the 998 Offer to address this known concern. (We have added such protections to the offer above.) Also, (a) no cap or control of any kind was listed on WaterFix costs that MWD retained the right to charge; and (b) the price offered was not linked to cost of service in any way, and if WaterFix does not occur SWP costs may drop significantly in coming decades as current SWP obligations are paid off, yet there is no reduction to account for the fact that MWD would no longer be incurring these costs, even though other member agencies would see their transportation rates reduced. (We also added protections for this kind of circumstance.)

¹ Legal information in this letter provided by counsel.

2. *The 998 Offer Demands Full General Releases, Civil Code Section 1542 Waivers, and Dismissals With Prejudice*

The 998 Offer demands that the Water Authority give MWD a full and complete release, with waiver of Civil Code section 1542's protection against giving up unknown claims, as well as with prejudice dismissals. These are terms we cannot accept for a number of reasons. First, our agency has many dealings with MWD, including hosts of contracts, billings, commitments, etc. MWD did not limit this release to matters at issue in the lawsuits, but instead demanded in the 998 Offer full and complete releases of everything between the agencies. That cannot be done. Further, MWD demanded that "SDCWA shall also execute a Civil Code Section 1542 waiver . . ." This would mean we would give up even all our unknown claims against MWD. It would be irresponsible for the Water Authority, or any other public agency, to sign such broad releases and waivers with an entity with whom they have regular dealings. Finally, the Water Authority has no way of knowing what rates and charges MWD may impose in the future. If there were "with prejudice" dismissals, presumably MWD would argue that there were issues in the dismissed litigation about issues such as proportionality or Proposition 26 or the rate model, and then claim that these issues could not be raised in the future. That also is not acceptable.

3. *The 998 Offer Is Not Legally Valid*

The 998 Offer is not a legally valid Code of Civil Procedure section 998 offer because of the general release and 1542 waivers demanded, and because of the demand for a speculative Exchange Agreement amendment. Under section 998, a court must be able to determine whether the prevailing party obtained a more favorable recovery at trial. *Valentino v. Elliot Sav-On Gas, Inc.*, 201 Cal. App. 3d 692, 697-98 (1988). An offer with nonmonetary terms must still "be sufficiently specific to allow the recipient to evaluate the worth of the offer and make a reasoned decision whether to accept." *Fassberg Constr. Co. v. Hous. Auth. of City of L.A.*, 152 Cal. App. 4th 720, 764 (2007), as modified on denial of reh'g (June 21, 2007). *An offer containing a full general release with full 1542 waivers, as MWD demanded here, cannot meet this standard.* *Ignacio v. Caracciolo*, 2 Cal. App. 5th 81, 89 (2016). See also *Chen v. Interinsurance Exch. of the Auto. Club*, 164 Cal. App. 4th 117, 122 n.5 (2008). Similarly, an offer of possible future benefits based on contract amendments whose supposed benefits are predicated on decades of unknown events is purely speculative and uncertain.

4. *The 998 Offer Demands That the Water Authority Can Never See MWD's Rate Model*

The 998 Offer makes demand that the Water Authority never seek to see MWD's rate model showing how MWD allocates its costs and sets rates. We believe this is an issue of basic public transparency, and that all MWD Board members and the agencies they represent have a right to see the rate model so they can understand MWD's water rates and charges.

Therefore, the Water Authority Board of Directors voted not to act upon MWD's 998 Offer.

In conclusion, we are very pleased that both agencies have made public offers to resolve the parties' ongoing litigation. This allows all stakeholders and the general public to see what is

Chairwoman Gray and MWD Board of Directors

December 19, 2019

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being offered and discussed by both sides. We hope that MWD accepts our offer, and we are available to answer any questions MWD may have in the interim. Thank you.

Sincerely,



Jim Madaffer
Chair of the Board

cc: (via email):

Water Authority Board of Directors
Sandy Kerl, Water Authority General Manager
Mark Hattam, Water Authority General Counsel
Jeff Kightlinger, MWD General Manager
Marcia Scully, MWD General Counsel

FACT SHEET – ISSUES IN SDCWA/MWD LITIGATION¹

What's been decided so far?

- a. MWD breached Exchange Agreement by charging its WSR² on transportation (2011-14)

Damages + interest	=	\$48 million (appx.³)
Suspension of collection of WSR (2018-2020)		\$45 million

- b. MWD could include current SWP costs in its transportation rate (no damages awarded)⁴

- c. MWD miscalculated preferential rights, about 100,000AF rights per year awarded to Water Authority⁵

- d. MWD's RSI⁶ clause illegal

Damages (restitution)		TBD (still pending; see below)
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What's still pending?

- a. MWD breached Exchange Agreement by charging its WSR on transportation (2015-17)⁷

Damages + interest	=	\$32 million
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- b. Restitution for RSI years (2011-2017)⁸

Damages + interest	=	\$64 million
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- c. Offsetting benefits of wheeled water supplies⁹ (2011-2020; \$250/AF low estimate)

Damages + interest	=	\$660 million
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- e. WSR on supply purchases (2018-2020)¹⁰

Damages + interest	=	\$24 million
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- e. Attorney's fees/costs = **\$15 million**

¹ MWD's 998 offer proposes that the Water Authority agree to an amendment of the Exchange Agreement; however, no amendment is at issue in the litigation, and thus is not shown here.

² Water Stewardship Rate.

³ All dollar numbers are approximate.

⁴ The Water Authority had already paid the disputed rates.

⁵ This is not a damages issue; MWD has corrected its calculation of preferential rights. As a comparable for valuation of the 100,000 AFY of water, the Carlsbad Desalination Project cost about \$1 billion to produce up to 56,000 AFY.

⁶ Rate Structure Integrity.

⁷ This issue was decided against MWD in the 2011-2014 cases but MWD claims it now has a new administrative record and therefore wants to try the issue again.

⁸ Represents the difference between the Water Authority share of payments to fund WSR projects and benefits received with WSR payments to Exchange Agreement netted out for the period indicated; does not include Water Authority's claim for subsidies for Carlsbad, though such LRP funding could be an alternative value for the same period. Overall, prior to adjustment for damages and recent LRP contracts, the Water Authority to date has paid **\$170 million more to fund WSR programs than it has received in benefits.**

⁹ The wheeling statute requires MWD to calculate offsetting benefits but MWD refuses to do so even though the Court of Appeal applied the wheeling statute to the Exchange Agreement.

¹⁰ The claim for WSR on supply charges for 2015-2017 is duplicative of the (b) restitution claim and so is not listed separately.