

- Semi/Annual Report on SWP Strategic Initiatives

Summary

The following is a summary of State Water Project Initiatives for the period October 2005 to March 2006.

Detailed Report

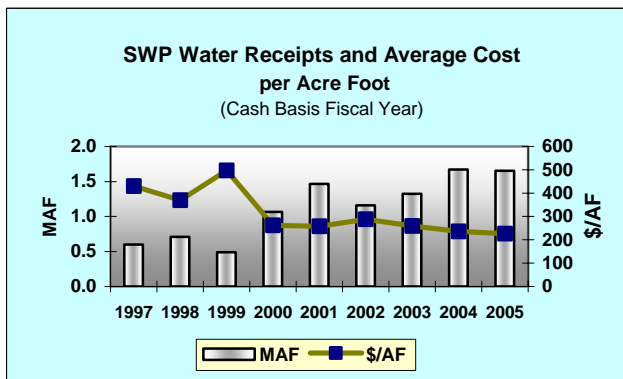
Introduction

Staff has developed a focused five-point strategy to maximize Metropolitan's investments in the SWP. The SWP is exposed to many critical evolving conditions including expectations for increased water deliveries, changing environmental and cost pictures for electrical energy, rehabilitation of aging infrastructure, and new business technology. The table below summarizes progress in the five strategic areas:

Initiatives to Control Cost and Increase Value

Investment	Costs/Business Practices	Energy Resources	Infrastructure Reliability	Water Supply	Water Quality
Perris Reservoir			✓	✓	✓
Santa Ana Valley Pipeline			✓		✓
Tehachapi East Afterbay	✓	✓	✓		
Relicensing Oroville Power Generation Facilities	✓	✓		✓	
East Branch Enlargement	✓		✓	✓	
Shop Services Agreement	✓		✓		
Renewed MWQI Agreement	✓				✓
Environmental Water Account				✓	

As Metropolitan continues to more fully utilize its SWP assets, unit costs have declined.



Because a large percentage of the costs of operating the SWP are fixed, the overall unit cost for Metropolitan's SWP supplies has declined, even as energy and maintenance costs of aging facilities have increased.

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Emerging Issues:

Hyatt-Thermalito energy cost litigation (see page 3)

Protest of Statement of Charges (see page 3)

Legislation to improve DWR business practices (see page 5)

Litigation initiated to protect water quality in Sacramento River watershed (see page 9)

Ensure Costs are Accurate and Reasonable and Promote Efficient Business Processes

Metropolitan is the largest SWP contractor, with 46 percent of the Project's annual yield. It repays the State for the costs of developing and transporting water supply. Because of the significant cost exposure and the need for reliable supplies, Metropolitan strives to influence the efficiency of operations. This is a challenging endeavor because the project is physically and administratively complex. Cumbersome State administrative requirements impair the project's ability to respond to changing conditions, legal challenges and new technology. Metropolitan and the State Water Contractors (SWC) are working to help the Department of Water Resources (DWR) progress under this challenging environment.

Metropolitan is taking actions to ensure that costs are accurate, reasonable and appropriate for the benefits received. Staff actions are focusing on the following goals:

- DWR obtaining a cost-effective Federal power license for Lake Oroville power generation complex that protects water supplies;
- Ensuring that DWR billings are accurate and reasonable;
- Obtaining compensation for services provided to the State related to managing the SWP;
- Maintaining the value of the investment in Hyatt-Thermalito power generation facilities;
- Removing ineffective administrative regulations, if necessary, through legislation;
- Promoting effective cost control measures within the SWP by DWR establishing budgetary and operational performance standards; and
- Improving use of management tools, cost reporting and relevant performance reports to the SWC).

Accomplishment:

OROVILLE FERC RELICENSING AGREEMENT SIGNED ON SCHEDULE

The Settlement Agreement for the Lake Oroville Hyatt Thermalito power generation facilities was signed March 21, 2006. Metropolitan is influencing DWR to obtain a new license that minimizes cost increases and protects supplies. A team of water contractors including Metropolitan concluded negotiations with local interests and the resources agencies that protects water supplies at a reasonable cost. The agreement is now awaiting California Department of Finance approval before submission to FERC.



Oroville Reservoir. (Photo courtesy of DWR.)

Accomplishment:

ENSURED THAT CHARGES ARE ACCURATE AND REASONABLE

Richardson and Company, Metropolitan's outside auditor on the SWP charges, completed its 2006 audit of the \$517 million charges to ensure that Metropolitan's costs are reasonable and accurate. The results of the audit were presented to the Department of Water Resources. The review will result in DWR reducing future costs by \$22.8 million.

Accomplishment:

IMPROVED MANAGEMENT PROCESS BY PUBLISHING REGULAR MANAGEMENT REPORTS

The SWC are influencing DWR to enhance detailed reports necessary for daily operation of the SWP by DWR contracting agencies as part of the enterprise business systems upgrade. Metropolitan continues to provide comments to enhance DWR quarterly management reports.

Accomplishment:***IMPROVED OPERATIONAL FOCUS THROUGH DEVELOPMENT OF STATE WATER CONTRACTORS PRIORITIES***

Priorities of the SWC's for Contract Year 2005/06 were completed and conveyed to the Director of the DWR. These priorities aligned closely with Metropolitan's priorities for the SWP. Key priorities DWR agreed to include:

- Operate the SWP as a business;
- Complete the South Delta Improvement Program EIR/EIS;
- Develop long-term energy portfolio;
- Complete EIR for Monterey Settlement; and
- Complete Oroville Relicensing.

Accomplishment:***ENTERPRISE BUSINESS SYSTEMS UPGRADE***

DWR is upgrading their enterprise business systems. The upgrade will benefit Metropolitan by providing timely and effective management reports that will increase SWP operational efficiency and help control costs. The design phase for the migration to the new system was completed and it is scheduled to commence operations on July 1, 2006. Installed software enables project staff to test and develop reports. Remaining work is focusing on data conversions required to support DWR business processes, development of new custom business support systems, systems documentation and implementation training.

Accomplishment:***DWR INCREASING STAFF***

DWR is on track to fill 80 new positions to improve capability in critical areas where it has increasingly relied on outside services. The areas are financial, energy and facility maintenance. All three areas are expected to benefit with reduced costs and improved performance.

Emerging Challenge***MAINTAINING VALUE FROM INVESTMENT IN HYATT-THERMALITO POWER GENERATION***

A coalition of agricultural and Northern Contractors filed suit against DWR claiming that the contract was improperly administered. They are seeking increased revenue from sale of energy generated at Hyatt Thermalito facility to defray their cost of water.

Metropolitan is actively supporting DWR's 40 year-old administrative practice of allocating energy benefits to reduce energy costs and to ensure that financial benefits flow to those that paying for the generating facilities.

The litigation seeks to shift costs among the water contractors. The court recognized that Metropolitan and other southern contractors would be adversely effected if the plaintiffs were successful and granted Metropolitan intervention in the litigation. If the plaintiffs are successful Metropolitan's energy costs could increase by tens of millions annually.

Emerging Challenge***PROTEST LETTER SENT TO DWR AND CLAIM FILED WITH VICTIMS COMPENSATION AND GOVERNMENT CLAIMS BOARD***

Sudden, unexpected changes in the Department of Water Resources administrative process for correcting errors in the Statement of Charges caused Metropolitan and other contractors to file Protest Letters with the Department. In the past DWR had a practice of providing an extension of time to resolve protests. Now, to protect Metropolitan's legal position in the event that DWR does not resolve the protest bills Metropolitan filed, a claim was also filed with the Victims Compensation and Government Claims Board. Quantified claims total \$18 million and other claims yet to be calculated are estimated to be worth tens of millions.

Ensure Cost Effective Reliable Energy Sources

With the expiration of long-standing contracts, and with radical changes in energy market regulations, the SWP is experiencing increased exposure to energy and fuel price fluctuations, credit risk, and unit reliability risk in accomplishing its water delivery operations. Energy is the single area of greatest cost vulnerability in Metropolitan's future SWP costs. To further illustrate this point:

- *The SWP incurs about \$350 million annually, 40 percent of its budget, on energy.*
- *Nationwide energy prices are rising.*

Metropolitan is leading the effort to ensure that the SWP has a reliable supply of energy at an affordable and predictable cost. Staff actions are focused on the following goals:

- Improving attention to energy decisions and conditions by DWR and SWC management;
- Developing a strategic plan and approach to SWP energy management;
- Influencing DWR's power portfolio development to reduce risk;
- Implementing construction of key facilities to favor off-peak pumping; and
- Ensuring reliable infrastructure because the ability to use cost-effective off-peak energy for pumping is intrinsically linked to the availability of pumping units.

Accomplishment:

DWR AGREED TO IMPLEMENT A NEW ENERGY MANAGEMENT STRUCTURE

DWR is filling a new management position to oversee a newly formed organizational unit that will create a strategic energy management plan. At the SWC's urging, this unit would develop a risk-based, competitive energy strategy for the future and protect the SWP's position in the regulatory arena.

Accomplishment:

MANAGEMENT ENERGY DECISION MAKING

Metropolitan is providing a representative to DWR's management decision committee, responsible for large energy purchase decisions. At the SWC's urging, DWR also started issuing regular management snapshot reports with bottom-line information to inform its management on key issues and exposures regarding the \$350 million annual energy cost.

Accomplishment:

DWR INITIATED A NEW GAS HEDGING PROCEDURE

DWR initiated a gas hedging procedure to dampen spikes in electrical energy cost associated with natural gas prices. In order to obtain the services of a gas-trading firm, DWR had to overcome State-contracting rules that previously did not recognize this type of contract.

Accomplishment:**COMMENCED CONSTRUCTION OF KEY FACILITIES**

Tehachapi East Afterbay—Metropolitan is benefiting from DWR's recent construction of a 1,250 acre-feet afterbay just downstream of the Edmonston Pumping Plant lift. The afterbay is providing increased opportunities for the "string" of five San Joaquin valley pumping plants to pump off-peak. This \$70 million project will save between \$10 to \$20 million annually in power costs. Although the project will not be completed until February 2007, an interim connection is making the majority of benefits available in April 2006.



The Tehachapi East Afterbay Phase 1 construction has been completed and the interim connection will begin providing benefits in April. This photo shows the facility during its initial filling in March. (Photo courtesy of DWR.)

Emerging Challenge:**LEGISLATION TO IMPROVE CONTRACTING ABILITY FOR ENERGY RESOURCES**

Metropolitan's and the SWC's Boards expressed support for SB 1506 introduced by Senator Margett (R-Arcadia) that would exempt the Department of Water Resources from the cumbersome state procurement processes for purchases, sales and exchanges of electrical power or natural gas. This proposed exemption would allow DWR to react more quickly to changing needs and opportunities. This could help make them more competitive in the dynamic energy markets.

Ensure Sufficient Infrastructure Reliability

In order for DWR to deliver dependable water supplies in a cost-effective manner, DWR is increasingly investing in maintenance activities to sustain reliability. As MWD and other Contractors increase their utilization of SWP supply and DWR moves more water through an aging infrastructure, this program seeks to ensure that equipment and pipelines are ready when needed at a reasonable cost.

To ensure that DWR is operating and maintaining SWP conveyance facilities with MWD's interests in mind, staff is pursuing the following goals:

- Monitoring and influencing key projects; and
- Providing operations and maintenance-related support to DWR under a shop-services agreement.

Accomplishment:

ADVANCED EFFORTS TO COMPLETE EAST BRANCH ENLARGEMENT

East Branch Enlargement (EBE) — DWR, in response to a request from the EBE contractors, has agreed to increase the capacity of the East Branch by carrying out the following activities:

- Complete the remaining 140 cubic feet per second (cfs) Enlargement under Phase I,
- Develop timing and staging for the Phase II Enlargement in coordination with stakeholder contractors, and
- Evaluate innovative design, construction, and O&M Practices for Phase II.

Metropolitan and DWR are scheduling an East Branch flow test in Spring 2006 to further define existing capacity and hydrologic characteristics.

Accomplishment:

STEPS TAKEN TO MINIMIZE SAVP OUTAGE IMPACTS

Santa Ana Valley Pipeline (SAVP)—Metropolitan negotiated a shorter outage of this water supply pipeline necessary to accomplish critical repairs to avoid outage impacts. DWR held the outage to less than thirty-days for the repairs and encasement work. In addition, during the outage MWD closely communicated and coordinated operational adjustments with member agencies to minimize outage impacts. Finally, MWD and DWR together

revised the refill procedures resulting in shortening the refill time from 48 to 36 hours.



Santa Ana Valley Pipeline with exposed broken wires. If not repaired this condition could have resulted in a catastrophic failure of the pipeline. (Photo courtesy of DWR.)

Accomplishment:

CONDITION ASSESSMENT PROGRAM

Condition Assessment Program — In order to plan and manage rehabilitation costs of aging facilities, DWR has instituted a Condition Assessment Program. This Program identifies specialized projects from each plant to allow for proactive maintenance planning and implementation. It supports DWR's one-year and five-year maintenance planning process, prioritization of identified specialized projects, and DWR's annual budget cycle.

Accomplishment:***ADVANCED EFFORTS TO REPAIR LAKE PERRIS DAM TO ENSURE WATER SUPPLY***

Lake Perris—DWR initiated a remediation study of options to bring the dam into compliance with current seismic standards. DWR also started a reconnaissance study that will assess the benefits and impacts of a full range of options. Metropolitan, in a partnership with the Desert Water Authority and the Coachella Valley Water District, emphasized the need for this study to assure the most supportable investment in the reservoir.



Lake Perris at its interim maximum water surface elevation of 1563 feet, 25 feet below the normal operating level. (MWD Photo.)

Ensure Cost-Effective Water Supplies

In order for DWR to deliver dependable water supplies in a cost-effective manner, MWD is investing in activities that ensure that MWD's State Water Contract rights are not adversely impacted, that support the Environmental Water Account, and that manage its water supplies through several water management action accounts.

Metropolitan continues to work with other SWP Contractors and State Agencies to ensure cost-effective water supplies. Staff actions are focused on the following goals:

- Revising MWD's 2006 State Water Project Order to maximize supplies;
- Implementing the Environmental Water Account Agreement;
- Completing the Monterey Amendment EIR; and
- Ensuring access to Lake Perris storage.

Accomplishment:

SUBMITTED 2006 STATE WATER PROJECT ORDER

MWD has structured its 2006 SWP water order to take advantage of prior-year carryover and other non-Table A supplies, in order to maximize total deliveries to Metropolitan. Through March, MWD has taken delivery of approximately 370,000 AF of wet year unregulated supplies in addition to the current 80 percent allocation. Staff is planning to take additional supplies such as surplus water (Article 21).

Accomplishment:

EXECUTED ENVIRONMENTAL WATER ACCOUNT (EWA) AGREEMENT

Metropolitan executed an exchange program for the EWA, a program that protects the SWP from pumping restrictions imposed by regulatory agency actions to protect fish. In late 2005, MWD implemented a water exchange agreement to assist the EWA. Under the exchange, MWD receives a dry-year supply of water in return for reducing deliveries in wet years.

In 2005, the EWA protected the SWP from over 340,000 AF of regulatory cuts.

MWD entered into an exchange agreement that resulted in an exchange of 50,000 AF to the EWA. MWD will receive an equivalent amount from EWA in a future dry year.

Accomplishment:

ISSUED DRAFT ENVIRONMENTAL IMPACT REPORT (DEIR) FOR LAKE PERRIS WATER QUALITY IMPROVEMENTS

Since 2000, Metropolitan has been working with other State agencies to ensure access to water stored in the reservoir. In March Metropolitan issued the DEIR for the Lake Perris Pollution Prevention and Source Protection Program. The Program will improve Lake Perris water quality by providing solutions that reduce pathogen risks resulting from body-contact recreation and by remediating low levels of dissolved oxygen in the lower portions of the reservoir, both of which have historically constrained access to stored water during summer months. The work is being partially funded by grants issued by the State Water Resources Control Board.

Project and Improve Water Quality

The quality of SWP water is highly variable and is dependant upon hydrologic changes in SWP watersheds. Changing water quality conditions creates challenges in meeting drinking water standards, managing integration of various water supplies, recharging groundwater basins and recycling water.

Metropolitan is pursuing the following SWP water quality goals:

- Promoting projects to protect and improve water quality in the Bay-Delta watershed and SWP system;
- Implementing the DWR/SWC Municipal Water Quality Investigations (MWQI) program; and
- Ensuring effective implementation of a policy governing introduction of non-project water in the California Aqueduct.

Accomplishment:

RENEWAL OF MWQI AGREEMENT

Last November, the MWD Board authorized renewal of the MWQI Program. The revised agreement extended the program for three years, increased the Program budget, and provided increase flexibility to complete needed studies. Supplemental Program services will be performed through the SWP Contractors Authority (JPA). Entering into a contract with the JPA is an important milestone in business processes for DWR and will enable timely progress to be made on critical water quality studies. One of the first steps will be the completion of a Sanitary Survey, which is required of water agencies that treat SWP water.

The MWQI Program ensures comprehensive water quality monitoring and analyses and allows the urban contractors to coordinate their quality and SWP operational needs.

Accomplishment:

INSTALLATION OF VERNALIS MONITORING STATION

A new monitoring site was installed at Vernalis on the San Joaquin River to sample for constituents of concern to agencies delivering drinking water. This new monitoring site at Vernalis will continuously capture bromide, total organic carbon, and other important data for determining the water quality of the San Joaquin River and its overall influence on the Delta. The data will help develop a more

accurate water quality model and ultimately provide information useful in Delta operations.



Vernalis Monitoring Station (Photo courtesy of DWR.)

Emerging Challenge:

LITIGATION REGARDING SACRAMENTO REGIONAL WASTEWATER TREATMENT PLANT

In 2004, the Sacramento Regional County Sanitation District (SRCSD) approved a plan to expand its wastewater treatment plant. In response to potential water quality degradation from the expansion, urban SWC signed a funding agreement between the SWC and participating contractors to pursue litigation or settlement activities. Metropolitan, the SWC and several SWC member agencies filed a CEQA lawsuit against SRCSD alleging that they violated CEQA in approving the wastewater treatment plant expansion project. The litigation is currently in the record preparation process. The SWC and many of its member agencies continue to work with SRCSD to identify watershed-based solutions that could offset the water quality impacts of SRCSD's planned expansion.



List of Acronyms

AF – acre-feet

DEIR – Draft Environmental Impact report

DWR – California Department of Water Resources

EBE – East Branch Enlargement

JPA – SWP Contractors Authority

MWQI – Municipal Water Quality Investigations

SAVP – Santa Ana Valley Pipeline

SRCSD – Sacramento Regional County Sanitation District

SWC – State Water Contractors, Inc. (Includes Metropolitan)

SWP – State Water Project.