

- Semi/Annual Report on SWP Strategic Initiatives

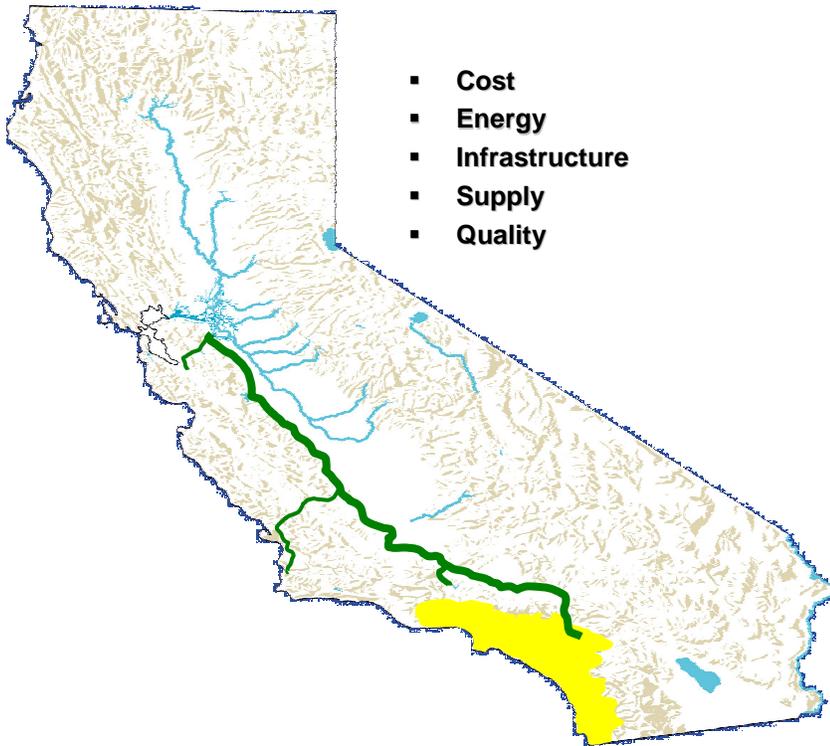
Summary

The following is a summary of State Water Project Initiatives for the period April 2006 to September 2006.

Detailed Report

Introduction

Staff continues to pursue a focused five-point strategy to maximize Metropolitan’s investments in the SWP. The SWP is exposed to many critical evolving conditions including increased demand for water, changing environmental constraints, evolving electrical energy management, rehabilitation of aging infrastructure, significant staffing and contracting constraints at DWR, and new business technology.



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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 and equity of benefits provided. 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;
- Changing ineffective administrative regulations;
- Promoting effective cost control measures within the SWP by DWR; and
- Improving use of management tools, cost reporting and relevant performance reports to the SWC.

MILESTONE:

DWR FORMALIZES MANAGEMENT TEAM

DWR recently filled two Deputy Director positions and three Division Chief positions. DWR improved its ability to make effective business decisions by formalizing its management positions, as shown in Figure 1.

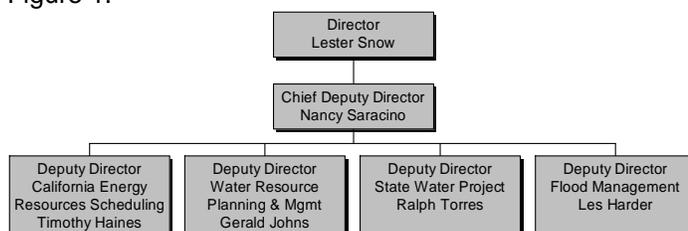


Figure 1. DWR Management.

MILESTONE:

2007 STATEMENT OF CHARGES

A preliminary analysis of the \$565 million State Water Project Charges was presented to the Board at the September meeting of the Budget Finance Investment and Insurance Committee. The 2007 SOC is \$56 million over last years' statement, primarily due to estimated energy cost increases.

MILESTONE:

ENTERPRISE BUSINESS MANAGEMENT SYSTEM UPGRADE

The upgrade of DWR's SAP enterprise business management system went "live" on July 1, 2006. The program is now in its stabilization phase during which the remaining application modules will be implemented and pending issues resolved, including any additional employee training. Thereafter, the program will move to the optimization phase to improve functionality. Metropolitan is working with DWR to utilize the new system to produce timely and consistent management reports to identify cost drivers.

MILESTONE:

DWR ENTERS INTO INITIAL CONTRACTS WITH SWPCA FOR SUPPORT ACTIVITIES

For the first time, DWR is relying on supplemental services of the State Water Project Contractors Authority (SWPCA) to carry out water studies for sanitary sewer and Municipal Water Quality Investigation (MWQI) projects. This represents a significant milestone in resolving DWR's ability to contract for such services.

EMERGING CHALLENGE

MAINTAINING VALUE FROM INVESTMENT IN HYATT-THERMALITO POWER GENERATION

A northern coalition of SWP contractors led by Kern County Water Agency continue to seek changes to DWR's 40-year practice of accounting for energy benefits from the Hyatt-Thermalito Generation Facilities. Because of Metropolitan's location near the end of the California Aqueduct, such changes could result in an increase in the transportation cost of tens of millions annually.

Litigation Timeline:

- Northern Coalition filed lawsuit (April 2005)
- Metropolitan and its Southern Coalition partners filed a Motion to Intervene (October 2005)
- Court granted mandatory intervention, giving the Southern Coalition the same rights and status as the other parties (December 2005)
- Metropolitan continues to work with DWR and the Southern Coalition to actively work on the litigation including developing our defense strategy, preparing for commencement of discovery and reviewing, analyzing and indexing key documents.

EMERGING CHALLENGE

CLAIMS FILED AGAINST 2006 SOC DENIED

The Victims Compensation and Government Claims Board declined to consider the claim Metropolitan filed related to DWR's failure to resolve errors in the annual Statement of Charges.

Metropolitan and DWR have agreed to defer the filing of any lawsuit associated with the claim. Metropolitan and DWR are meeting to discuss a technical approach and timetable for resolving errors in the claim.

Metropolitan, DWR, and other contractors have formed a working group to resolve issues with the Department of Finance associated with obtaining funding from the State for SWP capital and operating costs allocated to the State for recreation and fish and wildlife enhancement.

EMERGING CHALLENGE

DWR STAFFING

New labor agreements have provided significant salary increases to operators, mechanics and electricians, while providing little or no increases to others. As a result, employees in some classifications are seeking jobs elsewhere. For example, DWR continues to lose electric energy dispatchers, which has resulted in the average experience level dropping from 9+ years to about 2.3 years.

EMERGING CHALLENGE

DWR REVENUE BONDS

DWR is currently unable to issue Revenue Bonds for new facilities. DWR determined past Revenue Bonds proceeds have been inappropriately used to fund some portions of Project facilities allocated to the State for recreation and charged to the contractors. Until such time that the funds are returned and the contractors repaid, DWR has chosen not to issue new Revenue Bonds for on-going and planned construction. Remedying this problem is DWR's highest priority and they are working with Metropolitan and other contractors to identify and promptly implement a solution.

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. Energy is the single area of greatest cost vulnerability in Metropolitan's future SWP costs. To further illustrate this point:

- The SWP incurs about \$438 million annually, 46 percent of its budget, on energy.
- Natural gas prices are highly volatile.

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:

- Increasing 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.



MILESTONE:

LONG-TERM STRATEGIC PLANNING

DWR has entered into consultant agreements with PACE Global Risk Management, Montgomery-Watson-Harza and The Brattle Group to assist with development of long-term strategic planning for energy acquisitions. Work has begun to examine:

- Long-term power contracts;
- Opportunities to acquire financial interest in power plants; and
- Hedging strategies to stabilize power costs at competitive prices.

MILESTONE:

DWR EXTENDS TIMEFRAME FOR GAS HEDGING

The State Water Contractors collaborated with the Department of Water Resources to adjust the protocols for hedging costs of State Water Project energy through advance purchases of natural gas. Extending hedge contracts from 24 months to 36 will help DWR reduce the price volatility of the portion of the SWP's power portfolio obtained from natural gas-fired power plants. In addition, Metropolitan, the other State Water Contractors, and DWR have agreed to increase the share of the power portfolio that is hedged (see Figure 2).

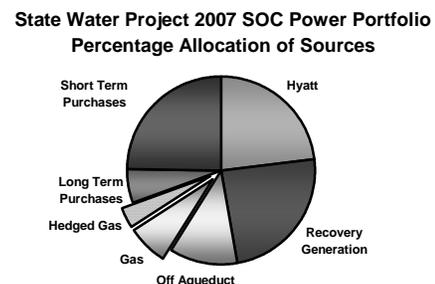


Figure 2. DWR Power Portfolio.

EMERGING CHALLENGE:

REID-GARDNER POWERPLANT

The Nevada Power Company has proposed an increase in its capital improvement program at its Reid Gardner #4 coal-fired plant. DWR's responsibility for increased cost under its contract with NPC for power from that plant could increase by about \$20 million per year over the next several years. DWR is taking the appropriate steps to assure that improvements are necessary and properly allocated under their contract that expires in 2013.

Ensure Sufficient Infrastructure Reliability

In order for DWR to deliver dependable water supplies in a cost-effective manner, DWR needs to invest in maintenance activities to sustain reliability. As Metropolitan and other Contractors increase their utilization of SWP supply and DWR moves more water through an aging infrastructure, increased focus on these efforts are needed 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 Metropolitan'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.

MILESTONE:

SHOP SERVICES AGREEMENT

A new five-year shop services became effective October 1, 2006. The new expanded agreement has greatly benefited both Metropolitan and DWR. It allows Metropolitan to maximize the use of its heavy, fixed machining tools at the La Verne shop, while allowing DWR to avoid the high cost of building its own machine shop or contracting such work out to other vendors.



Figure 3. Metropolitan Machine Shop at LaVerne.

EMERGING CHALLENGE:

STEPS NEEDED TO IMPROVE RELIABILITY OF THE SAVP

Because ensuring reliable SWP deliveries are dependent on the Santa Ana Valley Pipeline (SAVP), Metropolitan is placing a high priority on improving its reliability. Metropolitan is working very closely with DWR on developing an overall strategy

and repair approach to this pre-stressed concrete pipe. Both DWR and Metropolitan have concerns about the integrity of this pipeline and the risks associated with a potential failure. Metropolitan and DWR are meeting to jointly share technical information on testing methodology, criteria to repair a pipe section, and repair methodology.

MILESTONE:

REPAIR OF LAKE PERRIS DAM TO ENSURE WATER SUPPLY

DWR has completed its reconnaissance study, which qualitatively examines a broad range of reservoir sizes. Metropolitan and other stakeholders have requested that DWR provide cost estimates of the four top options. DWR is continuing on a parallel track with feasibility studies and associated investigations to remediate the Perris Dam facilities, anticipated for completion in November.



Figure 4. Lake Perris at its interim maximum water surface elevation of 1563 feet, 25 feet below the normal operating level. (Metropolitan Photo.)

Ensure Cost-Effective Water Supplies

In order for DWR to deliver dependable water supplies in a cost-effective manner, Metropolitan is investing in activities that ensure that Metropolitan'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 Metropolitan'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.

MILESTONE:

2006 STATE WATER PROJECT ORDER

Metropolitan continues to manage its revised 2006 State Water Project Order, which incorporates the additional water received as a result of DWR increasing the allocation to 100 percent. Figure 6 below summarizes actions taken through July. Metropolitan is projected to receive a total of 1.6 MAF through the end of calendar year 2006. In addition, plans include carrying over 200,000 AF of 2006 Table A water remaining in San Luis Reservoir for use in early 2007.

2006 SWP Revised Order--6/29/2006--(100% Allocation)

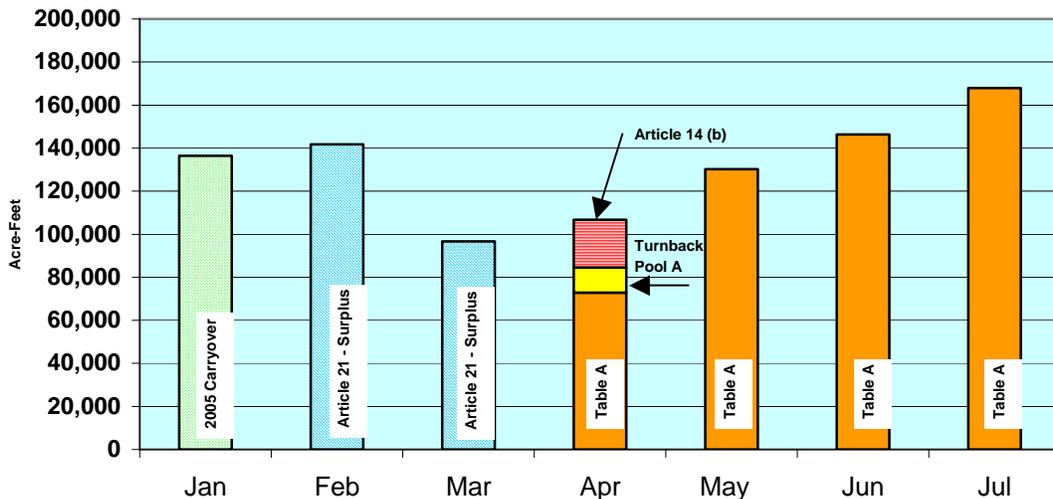


Figure 5 – Metropolitan SWP 2006 Water Order.

MILESTONE:

LAKE PERRIS WATER QUALITY IMPROVEMENTS

To ensure access to water stored in the reservoir, two water quality improvement projects are underway at Lake Perris. Following completion of the EIR and successful efforts by Metropolitan to restore grant funding, preliminary design of both projects has begun. The projects 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.

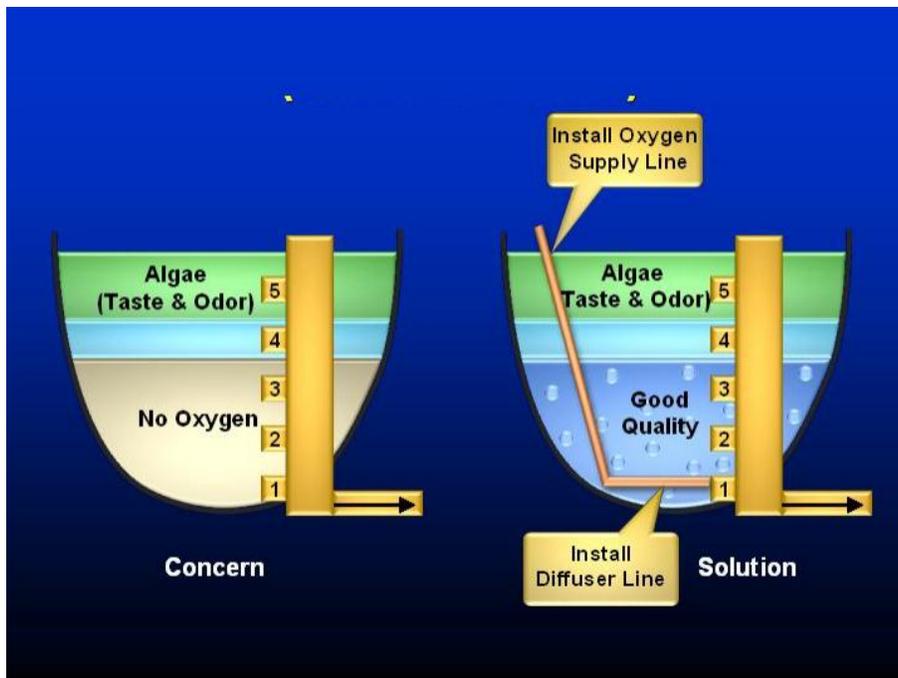


Figure 6. Lake Perris Dissolved Oxygen Project Schematic. The Dissolved Oxygen Enhancement Project would oxygenate the lower colder water in the reservoir to improve water quality.

Protect 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.

MILESTONE:

EXECUTION OF SANITARY SURVEY AGREEMENT

The JPA has executed an agreement to provide DWR with the 2006 SWP Sanitary Survey. The Survey will provide an update of drinking water regulations, source water protection regulations and enforcement. It will identify trends toward increased urbanization of the watershed and elements of the other programs and recreational use that adversely affect water quality. The Sanitary Survey will identify actions that can be taken to protect water quality.

MILESTONE:

REGIONAL BOARD RECOGNIZES DRINKING WATER QUALITY IN RENEWAL OF DELTA NPDES PERMITS

As a result of comments submitted by Metropolitan and California Urban Water Agencies, the Regional Water Quality Control Board is considering requiring those entities seeking to renew Delta NPDES permits for wastewater treatment plants to include monitoring for constituents of concern to drinking water agencies. These discharges may impact the quality of exported drinking water and exceed the salinity objectives of the South Delta. Additionally, the Regional Board is requiring permit holders to notify downstream water users in the event of an uncontrolled sewage spill.

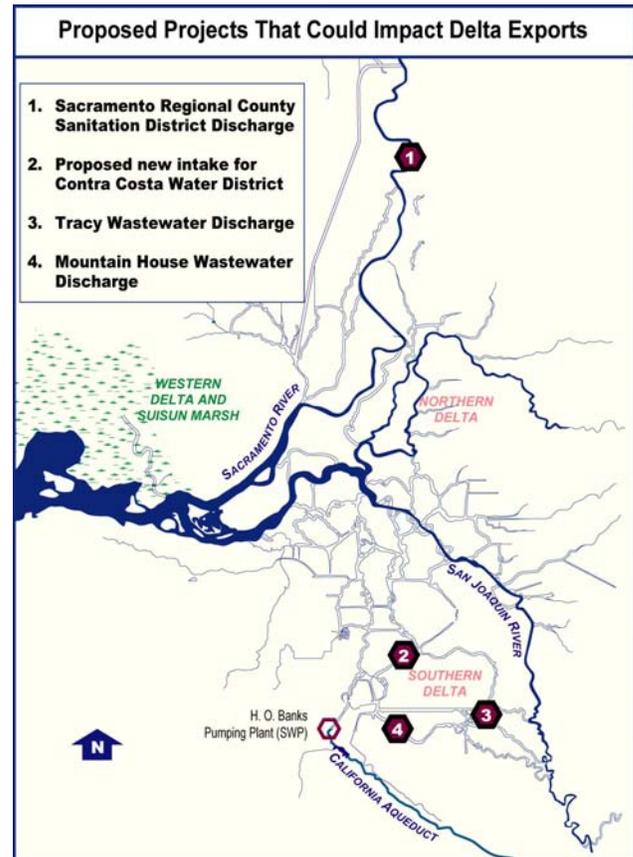


Figure 7. The Bay-Delta. (Map by Metropolitan.)

EMERGING CHALLENGE:***INCREASED URBANIZATION OF DELTA WATERSHED***

The population of the central valley is expected to double by 2040. Increases in population and trends toward increased urbanization of the Central Valley and Delta is a challenge for water resource managers. Development of these areas will result in additional urban runoff and wastewater discharges into the Delta watershed resulting in degradation of drinking water quality. Constituents of concern associated with increased wastewater discharges include organic carbon, nutrients, salinity, bromide, and pathogens.



List of Acronyms

AF – acre-feet

FEIR – Final 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

SOC – Statement of Charges

SRCSD – Sacramento Regional County Sanitation District

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

SWP – State Water Project.