



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

VIA EMAIL

January 17, 2020

Director Jerry Butkiewicz
Director Gail Goldberg
Director Michael T. Hogan
Director Tim Smith
San Diego County Water Authority
4677 Overland Avenue
San Diego, CA 92123

Dear Directors:

Re: Your letter dated January 12, 2020 regarding Draft Appendix A dated January 3, 2020.

This letter addresses your comments received January 12, 2020 (SDCWA 2020 Letter), regarding the Board Distribution of the Draft Appendix A dated January 3, 2020 (Attachment 1) and Appendix A redline draft (Attachment 2).

Appendix A provides material financial and operating information about Metropolitan to potential investors. Disclosure Counsel prepares Appendix A with assistance and oversight from the Office of the Chief Financial Officer and the Office of General Counsel. Finance, Water Resource Management, Water System Operations, Engineering Services, Office of General Counsel, and Human Resources staffs provide the information necessary to update Appendix A. Metropolitan's Controller reviews and verifies tables, statistics and financial data. Metropolitan also works with, and receives input from, its Bond Counsel and Municipal Advisor, as well as the underwriters of the bonds and their counsel, to ensure Metropolitan meets all legal requirements in the drafting of Appendix A.

Appendix A is reviewed by Metropolitan's Board of Directors. Metropolitan's objective is to provide complete and accurate disclosure regarding the bonds being offered and their security and source of payment to potential investors. Appendix A is updated periodically to provide current information. Forward-looking statements or projections are based on current information such as the facts and assumptions contained within the biennial budget (including, in the present instance,

the preliminary biennial budget to be reviewed in detail by the Metropolitan Board of Directors in February and March meetings) and ten-year financial forecast.

In the SDCWA 2020 Letter, you reference prior SDCWA letters regarding Appendix A, which have been addressed in Metropolitan's response letters electronically provided to all SDCWA directors and copied to Metropolitan's Board of Directors.

The following SDCWA comments and Metropolitan's responses refer to the redline draft of Appendix A dated January 3, 2020, showing changes from the draft dated May 1, 2019 draft (Attachment 1).

Comments Regarding Prior SDCWA Letters and Metropolitan's Responses

SDCWA Comment: "Our overarching concern is that the Appendix A as drafted and taken as a whole does not fairly disclose reduced demand for MWD water or the reliance on wheeling revenues. We have stated these concerns many times in prior letters."

Metropolitan Response: Metropolitan substantively responded to these comments regarding exchange agreement revenues in its June 22, 2018, November 15, 2018, and May 16, 2019 response letters and those responses are incorporated by reference here.

Comments in SDCWA 2020 Letter Regarding January 2020 Board Memo 8-1 (Appendix A)

SDCWA Comment: "MWD is using a methodology that fails to reasonably acknowledge member agencies' planned local projects, accounting only for projects that are already producing water or are under construction (except for 20,000 AF) ..., resulting in a predictable overstatement of the projected demand for MWD water. Unless an investor is knowledgeable with the extent of member agencies' planned projects, and likelihood of successful implementation, it would be very difficult to assess potential impacts on MWD's future revenues. Unlike hydrologic variability, there is a permanent reduction in the demand for MWD water once local projects are operational."

Metropolitan Response: Metropolitan is required to include material facts in Appendix A. Under current materiality standards established in case law and Securities and Exchange Commission enforcement actions, when information in a disclosure document pertains to a future event, "materiality will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event".¹ Including speculative assumptions regarding all planned local projects that are in varying stages of development prior to initiation of construction and are few to several years away from completion and able to produce water may be misleading to potential investors. Please also refer to Metropolitan's June 22, 2018 response to your letter dated May 7, 2018 regarding Draft Appendix A, dated April 25, 2018, explaining the basis for Metropolitan's water transaction forecasts.

¹ Basic Inc. vs. Levinson, 485 U.S. 224, 238 (1988).

SDCWA Comment: “Failure to clearly distinguish facts associated with MWD water sales and provision of wheeling service under the exchange agreement, by lumping the respective revenues together under the rubric “water transactions.”

Metropolitan Response: Metropolitan clearly discloses the terms of, and the amount of water delivered pursuant to, the exchange agreement, as well as the revenues associated with wheeling and exchange transactions in Appendix A. See Page A-26, and footnote two to table on page A-62 – Summary of Water Transactions and Revenues. The term “water transactions” is clearly defined wherever it is used and expressly states that it includes these exchanges under the exchange agreement. As we have noted in prior letters, it is not accurate to describe the delivery of Metropolitan water in exchange for the water that SDCWA makes available to Metropolitan at Lake Havasu pursuant to the exchange agreement as “wheeling.”

SDCWA Comment: “The risks associated with declining water sales and potential loss of wheeling revenues are materially different. Regarding wheeling revenues, we appreciate that MWD has noted that the Water Authority must provide a five-year notice to terminate the exchange agreement. In June Skillman’s May 16, 2019 letter responding to our comments on the then-pending Appendix A, she stated that, “Metropolitan is not aware of any other current plans for delivering water to SDCWA...” (at page 6). Given the Water Authority’s board action on July 25, 2019 authorizing a professional services contract to conduct a Regional Conveyance Study, we suggest adding to the disclosure that this Study is underway to consider alternatives to continued use of MWD’s Colorado River Aqueduct to deliver the Water Authority’s independent Colorado River water.”

Metropolitan Response: Please refer to our first response to comments in the SDCWA 2020 Letter. It is premature to include a risk of declining water exchange transactions. SDCWA’s approval of a conveyance study is far removed from any impacts to Metropolitan’s revenues. After completion of the conveyance study, SDCWA would still have to approve the new conveyance project, conduct planning, clear environmental requirements, and construct the project. Such a project, if authorized, may take decades to complete.

SDCWA Comment: “*Impacts of amendment of Coordinated Operating Agreement (COA)*. The statements are accurate that the COA Addendum will shift responsibilities for meeting obligations between the Central Valley Project and the State Water Project, resulting in a shift of approximately 120,000 acre-feet in long-term average annual exports; however, MWD should also include estimates that the shift will be about 200,000 acre-feet in a dry year.”

Metropolitan Response: As you correctly point out, Appendix A reports the impacts based on long-term average annual exports and not by water year type. The 200,000 acre feet in a dry year is the correct number based on modeling. For planning purposes, the 200,000 is taken into consideration in the average annual number.

SDCWA Comment: “Delta Reform Act. What is the basis for deleting explanation of Delta Reform Act (particularly since it is referenced in other parts of the draft Appendix).”

Metropolitan Response: The explanation of the Delta Reform Act was removed from Appendix A because it was originally included in connection with the discussion of regulatory approval activities associated with the California WaterFix. The Bay-Delta Planning Activities section, on pages A-16 to A-23, was updated to reflect DWR’s withdrawal of the California WaterFix project. The single reference to the Delta Reform Act on page A-13 in connection with the COA Addendum does not require a full explanation of the act.

SDCWA Comment: “IID sale of water to the Water Authority. The trial court and Court of Appeal have rejected MWD’s argument that the Water Authority is not buying water from IID, but is instead buying “discounted water” from MWD. These misstatements appear in many parts of the Appendix A and further confuse the presentation and analysis of the demand for MWD water as explained above.”

Metropolitan Response: Metropolitan does not contend that SDCWA does not purchase water from IID. Pursuant to the exchange agreement, SDCWA makes its purchased conserved IID water and its conserved canal lining water available to Metropolitan at its intake at Lake Havasu. In exchange, Metropolitan delivers an equal volume of water from any source through its delivery system to SDCWA. See Appendix A-26. Notably, the term “discounted water,” does not appear in Appendix A.

SDCWA Comment: “Delta Smelt and Salmon Federal ESA Biological Opinions and California ESA. The explanation states that, “State Water Project deliveries may be about the same as current conditions,” but that is premised on the assumption that the incidental take permit from CDFW under California ESA would be consistent with the federal biological opinions. There should be discussion that if the federal and state actions are not consistent, there will likely be a negative impact on the volume of water deliveries to SWP contractors including MWD. It should also be noted that until there is a new CESA permit, the SWP will be operated under the prior federal BiOps, which may also impact the volume of water supply available to MWD and other state contractors.”

Metropolitan Response: Metropolitan believes that the statement in Appendix A correctly characterizes the SWP water supply under the anticipated CESA permit. The project in the CESA permit application would reduce average annual water supply by 200,000 AF as compared to the federal Long Term Operation (and DWR’s Proposed Project in its Draft EIR). Since the federal Long Term Operation (and DWR’s Proposed Project in its Draft EIR) would increase SWP diversions by 220,000 AF, the CESA Application related reduction of 200,000 AF results in a potential over-all increase of 20,000 AF as compared to current operations. Based on currently available information, the characterization of future water supply under the state permit as being “about the same as our current conditions” is accurate. Any other characterization of SWP supply in light of the current and anticipated ESA and CESA permits would be conjecture at this point.

SDCWA Comment: “California ICS Agreement Intrastate Storage Provisions. This section should be updated to describe the dispute between MWD and IID regarding 87,594 AF of water.”

Metropolitan Response: Metropolitan received a claim from IID on December 27, 2019. Based on allegations included in such claim and facts known to Metropolitan at this time, it would be premature and speculative to include an informed discussion on IID’s claim and its potential impacts to water supply and/or expenses.

SDCWA Comment: “Conservation and Water Shortage Measures. We believe the disclosures would benefit from distinguishing broad public water conservation programs such as plumbing fixtures from agency projects given the legal requirements of Proposition 26.”

Metropolitan Response: The comment is unclear as it refers to conservation programs funded by other agencies in the context of alleged legal requirements on Metropolitan’s rates and charges. However, Metropolitan only recovers the costs of its own conservation programs through its rates and charges. Appendix A currently describes the difference between the administration of regional conservation programs and the co-funding of Metropolitan member agency programs. Appendix A also includes the total amount of expenditures on active conservation programs. Metropolitan believes such level of detail is sufficient. Lastly, as we’ve made clear in the past, Metropolitan believes that its water rates and charges are not subject to Proposition 26.

SDCWA Comment: “Regional Water Resources. See above discussion of Principal Concerns at paragraph two. While there is a statement that demand for MWD water will depend on local projects, “among other things,” the explanation goes on to say that “in recent years” demands are down for a number of reasons, not including local supply development. Taking two agencies alone as an example—the Water Authority and Central Basin MWD—we would assume that local water supply development has been a major factor if not the major factor accounting for reduced demand on MWD. See discussion of Principal Concerns, paragraph one.”

Metropolitan Response: The disclosure concerning impact of local water supply projects on demand for wholesale supplies provided by Metropolitan is accurate as stated in Appendix A. The paragraph noted includes multiple references to the impact of locally supplied water on demand for, and reliance on, Metropolitan water. There are also clear cross-references to the Local Water Supplies section when discussing future demands. See pages A-43 and A-107.

SDCWA Comment: “Recycled Water-Metropolitan Regional Program Demonstration Project. The statements in Appendix A about the purpose of the IRP and this paragraph on the regional recycled program, reinforces why this program should be included in the IRP, which it is not. Further, the estimated cost of numerous other programs is listed in the Appendix A, for example, Metropolitan’s Water Delivery System starting at page A-48, but is not included for this program. If that information is helpful for one purpose, it is helpful for all and should be included here.”

Metropolitan Response: The Regional Recycled Water Program Demonstration Project (RRWDP) could not have been included in the IRP, because the IRP has not been updated since 2015. Metropolitan, however, prepares annual progress reports between IRP updates and the last several annual reports have included information regarding the Regional Recycled Water Program, which includes the RRWDP. Metropolitan is currently preparing the 2020 IRP Update, for which it will form a committee and SDCWA will have the opportunity – like all other member agencies – to comment on the contents of the IRP Update. Anticipated costs for the full-scale Regional Recycled Water Program are not included in Appendix A because the Board has not approved the project and there are no firm financial or contractual commitments to move beyond the demonstration project at this time.

SDCWA Comment: “Capital Investment Plan Financing. The draft describes an “internal funding objective” for the funding of capital program expenditures from current revenues but does not describe what has actually transpired during the last three biennial budget cycles, namely, six years in which planned PAYGo has been shifted to pay operating expenses while hundreds of millions of dollars in unplanned debt has been required to make up the difference.”

Metropolitan Response: Appendix A is accurate – from fiscal year 2014/15 through fiscal year 2018/19, approximately 57 percent of actual capital expenditures were funded from operating revenues. Appendix A explicitly includes the expected level of bond funded capital for fiscal year 2019/20 and the level anticipated to be funded from operating revenues. Additionally, Appendix A clearly states that the internal funding objective is updated every two years in connection with Metropolitan’s capital budget. Furthermore, Appendix A states that, “as in prior years, pay-as-you-go funding may be reduced or increased by the Board during the fiscal year” and describes various factors that may affect the amount and timing of borrowings to fund capital expenditures. Appendix A describes, in great level of detail, Metropolitan’s currently outstanding bond indebtedness on pages A-80 through A-95.

SDCWA Comment: “Member Agency Purchase orders. Completely disconnected from MWD’s water resource planning and rate-setting, MWD’s purchase orders do not provide any real contractual assurances of any kind to MWD or potential investors.”

Metropolitan Response: The disclosure concerning Member Agency Purchase Orders is accurate as stated in Appendix A.

SDCWA Comment: “California Ballot Initiatives. Appendix A should be clear what MWD’s position is on the applicability of Proposition 26, because it has a major impact on its rate-setting and business plan. MWD has frequently stated that Prop 26 “does not apply,” but it says in this Appendix A that its water rates and charges “are not taxes” (which is a different position) and essentially concedes that the Court of Appeal did rule on the applicability of Prop 26 to MWD’s rates.”

Metropolitan Response: By stating in Appendix A that “water rates and charges are not taxes under Proposition 26,” Metropolitan is not conceding that the Court of Appeal ruled on the applicability of Proposition 26 to Metropolitan’s rates and charges. The Court of Appeal declined to rule on the applicability of Proposition 26 to Metropolitan’s rates. As stated previously in response letters and prior disclosure documents, Metropolitan contends that Proposition 26 does not apply to Metropolitan’s rates and charges, and its rates and charges are not taxes under Proposition 26. Metropolitan has been consistent in its position.

SDCWA Comment: “Litigation Challenging Rate Structure. The draft states that the Water Authority added a cause of action in the 2018 case to recover any Water Stewardship Rate which may be imposed, “despite suspension of this charge.” We have not received any indication from MWD that it has agreed not to seek retroactive collection of WSR payments that were included in adopted budgets but not collected due to the “suspension” of collection. If MWD agrees not to pursue collection of WSR revenue that was suspended, we will immediately reach out to the Water Authority’s general counsel to amend or dismiss claims accordingly. If MWD does not agree not to seek collection of suspended WSR revenues, then the disclosure should be changed to make that clear.”

Metropolitan Response: Metropolitan’s Board approved suspending the billing and collecting of the Water Stewardship Rate (WSR) on exchange agreement deliveries in calendar years 2018 through 2020 pending the completion of a cost allocation study of Metropolitan’s demand management costs recovered through the WSR. Metropolitan has not billed, and has confirmed it will not bill, SDCWA for the WSR for the deliveries made in these years. For example, Metropolitan’s General Counsel’s May 7, 2018 letter to SDCWA’s General Counsel stated there could not be an actionable dispute as to the WSR for 2019 and 2020 under the exchange agreement, given that the rate would not be charged. Dismissal of the claim, as offered, is appropriate. In SDCWA’s Petition for Writ of Mandate in its action filed against Metropolitan in 2018, SDCWA complains that the WSR still applies to wheeling transactions in 2018 through 2020. However, SDCWA has not wheeled any water through Metropolitan’s system in the relevant years. Please also note that the WSR, like Metropolitan’s other rates, is not imposed but rather is set by the member agency customers. Metropolitan discloses in Appendix A the financial impact of the suspension and collection of the WSR from the SDCWA exchange deliveries at A-63, which is relevant to potential investors. There, Appendix A states, “The total effect of the suspension, taking into consideration the lower revenues over the three calendar years, is estimated to be up to approximately \$46 million.” (For clarity, we deleted the word “proposed” in this sentence.)

SDCWA Comment: “Historical and Projected Revenues and Expenses. A realistic assessment of current facts would be a far superior basis for estimating projected revenues and expenses than the 2015 IRP Update. See above discussion of Principal Concerns. The 2015 IRP does not provide a reasonable foundation for estimated MWD water demands over the past five years, let alone the next five years. If water sales are distinguished from wheeling services on the graph depicting Historical Water Transactions at page A-112 (where wheeled water is being treated as the sale of

“discounted” water by MWD), a more accurate picture is presented of MWD water sales trends. We also believe this information would be of value to the MWD board as it approaches the IRP update this year. We very much look forward to working with the board on that update.”

Metropolitan Response: Appendix A clearly explains that projections of revenues and expenses for fiscal years 2020/21 through 2023/24 reflect the preliminary biennial budget for fiscal years 2020/21 and 2021/22 and the ten-year financial forecast provided therein, which is scheduled to be presented to the Metropolitan Board in February 2020. Moreover, as noted above and in prior letters, it is not accurate to describe exchange water transactions as “wheeling services.”

SDCWA Comment: “Projected Fiscal Year 2019-20 results. We note that the fiscal year 2020/21 and 2021/22 preliminary budget (not yet reviewed with the board) increases the 10-year forecast of rate increases from the 3% annually in both fiscal years 2018/19 and 2019/20 to 5% annually for calendar years 2021 through 2023, then reduces back to 3% annually thereafter. We very much look forward to review of the preliminary budget to understand what is driving these recommended rate increases (and later decreases), and working with the MWD board to explore other alternatives to increasing rates such as reducing costs.”

Metropolitan Response: Metropolitan looks forward to discussing the preliminary biennial budget for fiscal years 2020/21 and 2021/22.

Thank you for your comments on Metropolitan’s Appendix A. We have carefully reviewed and considered them and circulated them to our finance team, including Disclosure Counsel and our Municipal Advisor.

Sincerely,



Katano Kasaine
Assistant General Manager/Chief Financial
Officer/Treasurer



Marcia Scully
General Counsel

cc: J. Kightlinger
MWD Board Members
SDCWA Board of Directors and Member Agencies

Attachment 1— Board Distribution Draft Appendix A dated January 3, 2020
Attachment 2— Board Distribution Draft Appendix A dated January 3, 2020, redline draft