

**To:** San Diego County Water Authority

**Date:** April 9, 2012

**From:** FCS Group

**CC:** Board of Directors, Metropolitan Water District of Southern California

**RE:** Review of MWD's "Response to SDCWA Report on Cost of Service Review"

This memo responds to the Metropolitan Water District (MWD) General Manager and General Counsel April 5, 2012 letter titled "Response to SDCWA Report on Cost of Service Review." MWD's letter attempts to address the issues and concerns we raised in our March 12<sup>th</sup> report regarding the allocation and recovery of system costs through the existing and proposed rates and charges. MWD raises certain points on which we agree and have not disputed. However, the underlying issue of a misallocation of supply related costs is not resolved by information provided in MWD's April 5<sup>th</sup> response. MWD fails to demonstrate the proportionality of its cost allocation and cost recovery.

In summary, we believe that there are five main issues as follows:

1. MWD fails to demonstrate that transporting third-party provided water through its own internal transmission and distribution facilities has a cost relationship to MWD's purchased water supplies delivered through the State Water Project (SWP). MWD does not own the SWP, and is not entitled to recover, through MWD's transportation rates, costs incurred by *the State of California* associated with its delivery of a supply of water to MWD.
2. We do not dispute the fact that MWD operates complex internal distribution and transportation facilities, which require operational flexibility. This need, however, does not provide requisite justification to recover external supply related costs on non-MWD water transported through MWD facilities. MWD's contract with the California Department of Water Resources is a supply contract and as such should be categorized in its cost allocation plan as a water supply cost. MWD must account for its costs in a way that fairly accounts for the cost of supply and the cost of transport and cannot require a few transport customers to subsidize supply-only customers. Under MWD's rate structure, the Water Authority is required to pay for MWD's internal transportation facilities as well as a disproportionate share of MWD's supply costs, while at the same time MWD's water supply customers benefit from artificially reduced water supply rates.
3. We do not dispute that MWD may charge unbundled rates, nor did we contend that MWD must charge a point-to-point rate. However, under the existing and proposed rates and charges, MWD commingles costs for MWD owned distribution and transmission facilities with costs incurred from California's state-owned SWP. The mere fact that the California Department of Water Resources provides MWD with a detailed invoice does not provide any justification for recovering external supply related costs on transported third-party water.
4. We believe that the MWD cost allocation does not adequately recover the cost to provide standby supplies and capacity for annual demand fluctuations. The current and proposed rates impose an undue burden on agencies with relatively steady annual demands to subsidize those agencies that use the MWD supplies for on-call, periodic, supplemental supplies.
5. The April 5<sup>th</sup> response contends that "Metropolitan's functionalization of costs and allocation of costs to services leads to fair and reasonable rates. Member agencies bear the costs of the services they use and agencies that use the same service pay the same rate." Contrary to this

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assertion, the existing and proposed rates do not meet industry standards or equity requirements for proportional allocation and recovery of costs. Our report did not suggest—and we do not intend to suggest—that MWD should charge different rates for the same service. Rather, MWD should charge the same and equitable rates for each type of service. MWD’s rates fail to recognize that the transporting of the Water Authority’s third-party supplied water represents a unique class of service that differs from MWD-supplied water.

The remainder of this memorandum addresses some specific items raised by MWD in their April 5<sup>th</sup> response, but is not intended to be exhaustive or a point-counterpoint response on our part. Rather, we believe that our issues are well documented in our original March 12<sup>th</sup> report.

## ADDITIONAL CONSIDERATIONS

The following section addresses some of the items raised in the MWD response.

- MWD does indeed impose the System Power Rate (SPR) on the Water Authority’s transfer water from the Imperial Irrigation District, which is counter to MWD’s own wheeling policy. The MWD rate analysis illustrates recovering power-related costs over the full 1.65 million acre-feet (MAF) estimated to be sold and/or transported through its facilities in both 2013 and 2014. At issue is the fact that MWD uses the SPR to recover not only the cost of its own internal transportation and distribution power costs, but also power costs in the SWP. Those are not MWD’s power costs—they are the State of California’s—and they should not be treated as part of MWD’s power rate. There is no rational nexus for recovering SWP supply related power costs on third-party supplies transported through MWD’s system.
- While MWD Board “policy” is fundamental to the effective management and operation of the MWD facilities, Board policy alone does not supersede MWD’s obligation to provide a legal, equitable, and proportional recovery of costs.
- It is important to clarify a misstatement made in the April 5<sup>th</sup> MWD response concerning our contentions about the System Access Rate (SAR). We do not assert that the SAR should not be charged against wheeled water. Rather, at issue is the inclusion of supply related costs in the SAR that is imposed on the transportation of third-party water. We have contended that including supply related costs in the SAR and charging the full SAR on third-party transported water creates a direct subsidy of MWD-supplied water by those agencies transporting non-MWD water through MWD facilities. This negatively impacts the ability to create an efficient water transfer market, which MWD purports to support, by artificially inflating the cost to transport third-party water and artificially reducing the cost of MWD-supplied water.
- MWD states that we have confused concepts relating to peaking and standby charges. We did not do so, and we fully understand the distinction between seasonal peak capacity within MWD’s internal facilities and standby supplies required to meet sporadic annual demands. The MWD facilities are sized to meet peak summer demands, which MWD attempts to address by recovering costs through the capacity charge, albeit at an inconsequential amount at around \$30 million per year. The Readiness-to-Serve (RTS) charge, although still a volumetric charge based on a long-term rolling average, is intended to account for the cost to provide standby and emergency service. There is a significant cost to maintaining this reserve capacity and supplies, including MWD’s annual payment for the take-or-pay SWP contract. However, only a nominal amount of the fixed portion of these supply costs is recovered through the RTS, shifting the remainder of the cost recovery to the annual volumetric rates. For example, in 2013, MWD’s budget totals \$1.4 billion, with a majority of its costs being fixed. The RTS will only recover \$140 million of the annual budget, of which only \$30 million is for non-emergency, peak demands. Because several member agencies use MWD-supplied water as an on-call supply

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source to supplement their own supplies, MWD has secured and plans to secure significant standby supplies (i.e., IRP “buffer” supplies, CRA programs, Central Valley storage/transfer programs, etc.). The cost to maintain this on-call annual supply capacity should be equitably captured in the MWD cost allocation and rates. As it is today, member agencies with relatively steady water demands are required to pay for a disproportionate share of the cost for this standby capacity for others through their annual volumetric rates, while those agencies creating the need for this standby capacity avoid most of the carrying costs to provide these on-call supplies. The proposed rates perpetuate a significant subsidy being paid by MWD member agencies that do not have sporadic, annual demands on MWD.

- No one questions that MWD member agencies have a right to acquire water from sources other than MWD. As noted earlier, we concur that fluctuation in annual demands poses a substantial revenue risk for MWD. However, recovering supply related costs through charges on non-MWD water transported in its facilities places a disproportionate and arbitrary burden on transportation-only customers and is not an appropriate means to mitigate revenue risk. Additionally, MWD could mitigate this revenue uncertainty by adjusting its rate structure to more effectively recover the cost of providing reserve capacity for annual demand fluctuations. In addition to mitigating its revenue risk, this would place the cost burden of maintaining reserve supplies and capacity on agencies that significantly benefit from having standby supplies. This approach would also then address the existing subsidy of agencies with large variability in their annual demands by agencies with relatively steady demands.
- The Water Stewardship Rate (WSR) is imposed on all water transported using MWD facilities. MWD provides no clear nexus to demonstrate that the WSR investments create distribution and transmission capacity, nor does MWD provide any other evidence of a transportation avoided cost, in order to substantiate charging this fee on transportation. Without such supporting evidence illustrating that continuing with these local supply investments will provide a transportation benefit, there is no rational basis for imposing the WSR on transported water. MWD contends that the WSR benefits all users because it provides regional supply reliability, yet the charge is levied only against water transported using MWD facilities and not on each member agency’s potential demand on MWD-supplied water. Yet even if MWD’s contention about improved regional supply reliability were true (and there is no evidence in the record supporting this), there is no basis upon which to charge this on the Water Authority’s third-party water from IID. The Water Authority invested in IID transfer water to create its own supply reliability; it should not have to pay an additional “reliability” charge on its third-party supply source. Notably, MWD does not impose these costs on any other agency’s local supplies. If MWD is indeed charging the Water Stewardship Rate to ensure regional supply reliability, the cost allocation should assign supply reliability costs to each member agency based on its need for that reliability, including the need for on-call standby capacity and supplies, as addressed above. Finally, as noted in our March 12<sup>th</sup> report, imposing a fee on water supplied and/or transported to the Water Authority, while singularly barring the Water Authority from participating in future WSR projects, places an undue and arbitrary burden on that single member agency, regardless of the purported regional benefit.
- MWD notes that in 2009 a total of 20,000 acre-feet of transfer water from the Placer County Water Agency was wheeled through the SWP on behalf of the Water Authority, thereby attempting to justify allocating millions of dollars in SWP supply related costs every year to non-MWD supplied water. We disagree that there is any cost linkage. Transporting of third-party supplies through MWD’s internal transmission and distribution system is wholly different than a separate wheeling arrangement through the state-owned SWP. To address unique, single-use circumstances, MWD could create a fair and reasonable rate for others to convey non-MWD supplied water under MWD’s SWP supply contract. Alternatively, as the Water Authority must transport water using the SWP, it has the option to pay the California Department of Water

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Resources wheeling rate. The Water Authority could also pay another state contractor to use their own SWP contract to wheel the Water Authority's third-party supplied water similar to how the City of Los Angeles plans to wheel water under its agreement with the Antelope Valley East Kern Water Agency, and for which MWD gave its consent.

## CONCLUSION

MWD staff's characterization of our findings as based on a mere misunderstanding of the MWD facilities or a case of differences in opinion is incorrect. The background information provided in the rate proposals and MWD staff's response do not provide sufficient justification for recovering SWP supply related costs through transportation charges applied to non-MWD transported water. Finally, neither MWD's cost-of-service analysis nor staff's response sufficiently addresses the substance of the other issues raised in our March 12, 2012 report.