Attention: Imported Water Committee

2017 Transfer and Exchange Agreement decision. (Action)

Staff recommendation
Authorize the General Manager to provide written notice by December 31, 2017, to the Metropolitan Water District of Southern California (MWD) to extend the term of the Amended and Restated Agreement between MWD and the San Diego County Water Authority for the Exchange of Water (exchange agreement) from 35 to 45 years (2037 to 2047).

Alternative
Authorize the General Manager to provide written notice by December 31, 2017, to the Imperial Irrigation District (IID) for early termination of the Agreement between IID and San Diego County Water Authority for Transfer of Conserved Water (transfer agreement) to shorten the term from 45 to 35 years (2047 to 2037).

Fiscal Impact
There is no fiscal impact as a result of this action through 2037. Impacts beyond 2037, depending on the Board decision, will vary based on future IID supply and MWD transportation costs that are currently unknown.

Background
At the December 7, 2017 Water Authority Board meeting, the Board of Directors must decide how best to align the mismatched terms of the transfer and exchange agreements. These agreements have allowed for the conservation and delivery of water to the Water Authority since 2003, as part of the historic Colorado River Quantification Settlement Agreement (QSA). While the initial term of the transfer agreement is 45 years, the exchange agreement with MWD to transport the conserved water to the Water Authority has an initial term of 35 years. There are provisions in both agreements that give the Water Authority the ability to sync the timing of both the transfer and exchange by either: (1) extending the exchange with MWD an additional 10 years to coincide with the 45-year term of the transfer agreement; or (2) terminating the IID water transfer 10 years early to match the existing 35-year exchange agreement term. Either option is a unilateral Water Authority Board decision, which may be made at its complete discretion and does not require the consent of IID, MWD or any other party. Both agreements stipulate that notice is required by December 31, 2017.

Discussion
The QSA is a complex array of agreements that was the product of eight years of negotiations. At the Federal level, it has enabled the Bureau of Reclamation the means to manage Colorado River supplies and ushered in a period of relative peace between the seven Colorado River Basin States. For the State, it represents resolution of longstanding disputes among the California parties with water rights on the Colorado River, provides substantial long-term benefits to urban and agricultural water users throughout southern California, and commits the State of California to a restoration path for the environmentally sensitive Salton Sea. The transfer agreement is often credited as the
lynchpin of this effort and a foundation from which many significant benefits have been realized across a broad array of constituencies over the past 15 years. Although the QSA agreements and terms are complex, the core benefits they have provided the San Diego region since 2003 cannot be overlooked. Acquisition of highly reliable, senior priority Colorado River water from IID was the Water Authority’s primary objective in negotiating the water transfer. The transfer has: materially improved diversification and reliability of the region’s overall supplies; dampened recent supply reductions imposed by MWD from 2009-2011; and served as a key supply component towards successfully passing the State’s “stress test” during the last drought, which resulted in the lifting of conservation mandates imposed on member agencies. Once the water transfer volume is fully ramped-up to 200,000 acre-feet (AF) annually in 2021, it will represent more than thirty percent of the Water Authority’s total annual supplies. When combined with the additional 80,000 AF of canal lining water that was concurrently approved with the transfer, the two sources will represent nearly half of the region’s water supply.

MWD’s water supply reliability is subject to ongoing climatic and regulatory uncertainty. The fate of the California WaterFix is unknown as of this writing. The impact of projected changes in climatic conditions may cause increased risk of shortages in State Water Project and Colorado River supplies. IID’s senior water rights provide improved protection against the future risk of such shortages.

Along with the reliability benefit of the QSA supplies, the price paid for QSA conserved water is currently competitive with what the Water Authority pays for each acre-foot of MWD untreated water and is projected to cost less in the next several years. In 2018 MWD’s melded supply rate is $393/AF\(^2\) (not including transportation), an amount that reflects the Tier 1 Untreated Supply Rate and payments for the Readiness-to-Serve (RTS) and the Capacity Charges. By comparison, the “all-in” cost of QSA supplies is projected to be $470/AF,\(^3\) which is: inclusive of a supply rate paid to IID; canal lining debt service and operations and maintenance (O&M) costs; environmental mitigation commitments; and all other financial requirements tied to 210,000 AF the Water Authority will receive in 2018 (not including transportation costs). While projected to be $77/AF higher, QSA supply costs as a whole are anticipated to escalate at a significantly lower rate than the combined cost of Tier 1 Untreated water and other fixed charges tied to the purchase of MWD water (such as the RTS and Capacity Charges).

Price stability of the QSA supplies is due in part to the Water Authority and IID’s execution of a Fifth Amendment to the transfer agreement that set prices through 2034 to a relatively stable index from which to base future price increases. According to the agreement, for calendar years 2016-2034 the price per acre-foot will be based on the annual increase in the Gross Domestic Product Implicit Price Deflator (GDPIPD) as published by the Bureau of Economic Analysis of the United States Department of Commerce. The Compound Annual Growth Rate of the GDPIPD over the most recent ten-year period has been 1.8 percent. By comparison, the most recent ten-year increases for MWD’s Tier 1 Untreated Supply Rate, RTS and Capacity Charges have been 11.1 percent, 5.6 percent, and 11.9 percent respectively.

\(^1\) Water transferred to the Water Authority has a higher priority (Priority 3a) than MWD’s Colorado River priorities (4 and 5). Similarly, water conserved through the All Americas and Cosoelia Canal Lining Projects is conserved Priority 3 water.

\(^2\) $393 = Untreated Tier 1 Supply Rate: $209 + (RTS Charge: $22,014 million/186,000 acre-feet of projected MWD purchases) + (Capacity Charge: $9,935 million)/351,000 acre-feet of total MWD projected deliveries.

\(^3\) $470 = Estimated cost of 2018 IID Supply: ($653/AF*130,000 AF) + socioeconomic/environmental mitigation obligations of $10.2 million + canal debt service and O&M ($3.6 million)/210,000 AF of QSA supplies.
Beginning in 2035, the transfer supply price will be based on a complex formula that considers both MWD rates and charges and the comparable cost of water transfer transactions to the IID/Water Authority transfer ("market-based pricing"). It is anticipated that the price of IID supply in 2035 will reflect the weighted average cost of water market transfers throughout the State of California and the Lower Colorado River Basin, the cost of local water supply development projects, and will include a favorable discount equal to the full MWD transportation rate applied as a reduction to the supply cost in the price formula.

Future transportation costs tied to both MWD and QSA supplies, however remain less predictable. While in September 2017, the California Supreme Court denied a petition by the Water Authority to review an Appellate Court ruling which allows MWD to include State Water Project (SWP) supply costs in the rates it charges to transport the Water Authority’s independent Colorado River supplies, the magnitude of future cost increases as a result of this decision remains unknown. MWD’s final cost share of California WaterFix and/or future costs that could be added to the transportation rate -- such as the pipeline portion of the Los Angeles County Sanitation Districts’ recycled water project⁴ -- are directly applicable in this instance. As reported to the Water Authority Board at its October 26 meeting, a significant funding gap currently exists for WaterFix; none of the Central Valley Project (CVP) contractors have agreed to participate financially,⁵ making future cost assumptions speculative. As part of the same litigation, however, the courts found based on the record before it that water supply development costs charged as part of the Water Stewardship Rate should not be applied to transportation, thus potentially lowering the cost to transport QSA water by an estimated $1 billion over the initial 45-year term of the transfer agreement. If applied to MWD’s 2018 rates, this would reflect a reduction in the transportation rate from $486/AF to $431/AF. If at any point during the 35- or 45-year term of the exchange agreement, the Water Authority chooses to seek alternative conveyance, such as a pipeline from the Imperial Valley or Mexico, it must provide MWD written notice five years prior.

Another issue that has recently found new clarity involves the Salton Sea, and the commitment on the part of the State to carry out a restoration program. Mitigation of environmental impacts and the State’s responsibility for restoration have always been a core component of successful QSA implementation. QSA-enabling legislation and extensive mitigation requirements mandated by the State Water Resources Control Board (SWRCB) under Water Rights Revised Order 2002-13 have withstood that test of time and ten years’ worth of litigation challenging all aspects of the water transfer and canal lining projects. A major component of the water transfer mitigation program has been the delivery of bucket-for-bucket mitigation water to the Salton Sea for the first fifteen years of the transfer (through 2017), followed by a transition to the approved four-step air quality mitigation plan. California legislation established the QSA Joint Powers Authority (JPA), made up of the Water Authority, IID, Coachella Valley Water District, and the California Department of Fish and Wildlife, to fund environmental mitigation related to the QSA water transfers. The amount to be paid by the three water agencies was capped at $133 million (in 2003 dollars) with most of the funds earmarked for the Salton Sea. Restoration, which was

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⁴ MWD’s 2016 feasibility study identified the project’s cost at $2.7 billion, a 2015 draft study placed its capital cost at $3.5 billion.

⁵ As of November 2017, the $16.7 billion California WaterFix Project funding commitments are short by $2.2 billion from SWP contractors and short by $7.5 billion from CVP contractors.
not addressed by the SWRCB Water Rights Order, is separate from mitigation and contemplated by QSA legislation that placed restoration as a State responsibility. While no long-term restoration program has been enacted or funded since the signing of the QSA, over the past year the State made positive progress on Salton Sea restoration issues through the development of the Salton Sea Management Program’s (SSMP) Phase I 10-Year Plan.

Building upon this momentum, the Water Authority, IID, Imperial County, the Governor’s Office, and non-governmental organizations collaborated on a Stipulated Order recently adopted by the SWRCB at its November 7, 2017 hearing that establishes a set of milestones for the initial 10 years of the SSMP. The adoption of the Stipulated Order, $80 million previously secured as part of Prop. 1, and the potential for an additional $200 million tied to Senate Bill 5 (a June 2018 water bond measure) are crucial steps in prioritizing the Salton Sea and providing certainty for the QSA. Through the Stipulated Order, the SWRCB has reinforced its support for the water transfer.

When the transfer reaches its maximum annual volume of 200,000 AF in 2021, it will comprise approximately one-third of the San Diego region’s annual supply portfolio and continue at that level for the remainder of the agreement term. Early termination of the transfer agreement with IID would result in the loss of two million acre-feet of water over the decade dropped from the term. In a normal year, the loss of QSA water transfers could be made up with additional purchases from MWD, almost doubling its share of total water supply to the Water Authority. However, in a dry year, the forfeit of QSA water transfers could result in a supply shortage between 149,000 and 224,000 acre-feet in 2035. The range is based on the dry-year demand and supply projections provided in the Water Authority’s 2015 Urban Water Management Plan (2015 UWMP) assuming 1.4 million AF in available MWD supplies and a Water Authority preferential right of 24.0 percent and 18.6 percent, respectively. One mechanism to reduce, but not eliminate, the supply gap is to develop the Additional Planned Projects identified in the 2015 UWMP. To secure all the supply needs in a 2035 dry-year analysis, the Water Authority or its member agencies would also need to explore new water supply projects beyond those already considered as Additional Planned Projects in the 2015 UWMP. Extension of the exchange agreement would provide an additional 10 years for these projects to be approved and developed.

Extending the exchange agreement to 2047 has a variety of benefits, including: supply reliability and maintaining a diversified portfolio; comparable, long-term supply costs over the extension period; realization of wheeling cost reduction from rate case results over the extension period; additional time to consider and plan for local supply projects; and additional time to consider the alternative conveyance project. Additionally, recent decisions related to the Salton Sea provide certainty on the environmental aspects of the QSA. For these reasons,staff recommends authorizing the General Manager to submit a written notice to MWD by December 31, 2017, to extend the term of the exchange agreement from 35 to 45 years (from 2037 to 2047) to align with the initial term of the transfer agreement.

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