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TO: San Diego County Water Authority

FROM: Thomas Gaffney / Reed Schmidt

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SUBJECT: Metropolitan Water District of Southern California Water Rates

Introduction

Bartle Wells Associates (“BWA”) provided San Diego County Water Authority (“SDCWA”) a memo dated March 5, 2010, which explained our investigation into the water rates charged by the Metropolitan Water District of Southern California (“MET”) to its member agencies.

As you requested, we have prepared this supplement to our March 5th opinion regarding rates proposed for adoption by MET’s Board of Directors. In particular, we write to comment on MET’s contention in its March 30th letter to the San Diego County Water Authority (SDCWA) that “the 2010 cost of service study and rate methodology is also consistent with water industry best practices, and complies with cost of service and rate guidelines in the American Water Works Association’s Manual M-1, Principles of Water Rates, Fees, and Charges.” We have also reviewed MET’s April 5th response to comments the SDCWA provided to MET last month that reflected our March 5th opinion and an April 6, 2010 report from MET’s rate consultant. We conclude for the reasons stated below that the rates proposed by MET are *not* consistent with industry practice or the AWWA Manual and, therefore, do not comply with California’s legal requirement¹ that MET’s rates be apportioned among its customers in a manner that reflects the proportionate cost to serve each.

NARUC System of Accounts

MET Board Action Item 8-2 for its April 13, 2010 meeting (“Board Letter 8-2”), states in Attachment 2, on Page 8, “the functional categories developed for Metropolitan’s cost of service process are consistent with the American Water Works Association rate setting guidelines, a standard chart of accounts for utilities developed by the National Association of Regulatory Commissioners (NARUC), and the National Council of Governmental Accounting.” This statement, however, contradicts MET’s Independent Auditors Report of KPMG LLP. That report states in note 1(b) **Principles of Presentation** to the Basic Financial Statements for June 30, 2009 and 2008: “Metropolitan is accounted for as an enterprise fund

¹ We do not opine on legal issues, but take the legal standards mentioned here from the letter of the SDCWA’s Special Counsel, Colantuono & Levin, P.C., to MET dated April 12, 2010.

and applies all applicable Governmental Accounting Standards Board (GASB) pronouncements in its accounting and reporting. In addition, Metropolitan follows Financial Accounting Standards Board pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.” There is no reference to the NARUC System of Accounts.

The Uniform System of Accounts for Class A Water Utilities (1996) published by NARUC, Section 610 requires separate cost accounting for water purchase costs, as follows:

“610. Purchased Water

A. This account shall include the cost at the point of delivery of water purchased for resale.

B. The records supporting this account shall be so kept as to show for each supplier from which water is purchased, point of delivery, quantity purchased, basis of charges, and the cost of water purchased.”

As described in our March 5th opinion, all the costs MET pays the State Department of Water Resources (DWR) under MET’s agreement with DWR are water supply costs and should be assigned to a “purchased water,” or Supply, account. MET does not account for those costs in that manner and ascribes these costs to the rates it imposes for transporting water across its own system in Southern California. MET’s cost-of-service rate structure clearly does not follow the NARUC standard. MET’s rate consultant opines that it is “appropriate” for MET to divide its DWR Supply cost into “functional categories, such as Supply, Conveyance and Aqueduct, and Hydroelectric” because DWR provides sufficient detail that MET may do so and MET’s contract with DWR does not provide for aggregate per-acre-foot pricing. This amounts to a statement that MET may deviate from industry standards requiring all Supply costs to be characterized as such because it has received an itemized billing statement of costs incurred by its water supplier or perhaps just because it is possible to do so. MET’s approach is incorrect. Industry standards require the MET’s financial obligations to the DWR to be accounted as Supply costs as demonstrated by the very authorities upon which MET’s rate consultant claims to rely.

AWWA Manual M1

Contrary to MET’s assertion, its cost-of-service rate design is not consistent with the American Water Works Association’s *PRINCIPLES OF WATER RATES, FEES, AND CHARGES*, AWWA Manual M1 (5th Ed., 2000). It is inconsistent with regards to its accounting of operation and maintenance expenses, its allocation of costs of service to cost components, distribution of costs to customer classes, and design of wholesale water rates.

Operations and Maintenance Expenses. MET does not classify its operations and maintenance expenditures according to the AWWA manual and the NARUC system of accounts. Rather, MET misclassifies its costs of service (i.e., revenue requirement) by service function and does not follow the five functional operation areas listed in the AWWA manual,

namely, source of supply, treatment, transmission and distribution, customer accounts and administrative and general expenses. See Table 4, Revenue Requirement (by service function) in Board Letter 8-2, Attachment 2, page 15 of 36.

Cost-of-Service Allocation. MET's cost-of-service allocation also deviates from the AWWA Manual. Costs of service should be allocated to different customers in proportion to their service requirements. The AWWA Manual states in Chapter 7 "Allocating Costs of Service to Cost Components," on page 49:

"The basic premise in establishing adequate rate schedules that are equitable to different customers is that rates should reflect the cost of providing water service. A sound analysis of the adequacy of charges requires that costs be allocated among the customers commensurate with their service requirements. This approach recognizes differences in the costs of providing service to different types of customers."

If MET were to follow this principle as it claims, it would not ascribe sums paid to the DWR for an imported water supply to the cost of water transportation via facilities in Southern California. We discussed this in more detail in our March 5, 2010 memo.

Distribution of Costs to Customer Classes. In Board Letter 8-2, MET does not calculate unit costs as described in Chapter 8 of the AWWA manual. While Schedule 8, in Attachment 2, on page 24-36 of Board Letter 8-2, allocates total costs by service function to rate design elements, it does not calculate unit costs, which could then be used to design the rates and charges. Each service unit (function), such as supply, would be assigned a cost, such as dollars per acre-foot. There needs to be an intermediate schedule between Schedule 8 and Schedule 9, which summarizes the rates and charges. None is provided and therefore it is not possible to determine that the rates and charges were calculated in a manner that is consistent with industry standards. For this reason, as well, we conclude that MET's cost allocation is not consistent with the AWWA Manual.

Wholesale Rates. BWA also finds MET's rates and charges are not consistent with AWWA Manual's standards for cost allocation and rate design for wholesale customers. The AWWA Manual states in Chapter 31 "Wholesale Rates," on page 233:

"A cost analysis is required to determine revenue requirements of wholesale water service and to allocate this revenue requirement to individual wholesale customers or to the wholesale group as a class. The analysis should include specific conditions of service to wholesale customers, specific type and level of service provided, and consideration of the way in which the utility actually provides service to its customers. Properly designed rates should recover the cost, as nearly as is

practicable, of providing service to a customer, or a class of customers, with minimal cross-subsidizing among customer classes.”

Regarding determining cost of service applicable to wholesale customers, the AWWA manual clearly states that the specific conditions of serving each wholesale customer must be considered. MET’s cost analysis fails to adhere to the AWWA Manual’s principles because it does not identify or consider the specific conditions of service to wholesale customers and does not describe each member agency’s specific level of service. Rather it uses a rate system that treats the cost of an imported water supply as a MET-system-wide transportation cost. This misallocation artificially increases the charge for transportation services, disproportionately impacts customers who purchase transportation rather than supply services, and fails to reflect within the rate structure the true cost of supplies purchased by MET. This misallocation of costs also results in other negative impacts to water supply development objectives specified by the California Legislature and MET board of directors, as more fully described in our March 5, 2010 memo.

More fundamentally, MET’s rate methodology does not consider how the MET water system actually works. MET purchases water under a contract with DWR and the point of delivery of that water is at MET’s facilities in Southern California. MET also obtains water from the Colorado River that it imports using MET’s Colorado River Aqueduct. MET delivers water purchased from DWR and Colorado River water through facilities MET owns within its service territory. SDCWA purchases water from MET. SDCWA also receives transportation of water not owned or purchased by MET across the MET’s system within the Southern California region but is required to pay a price for that service that is calculated on the basis of the cost of capital facilities, operations, maintenance, power and other expenses paid to the DWR under a water supply contract for the imported water supply used by others. Thus, an **intra**regional transportation charge is established on the basis of the cost of an **inter**-regional water supply – a cost that has no logical relationship to the cost of the Southern California transportation services provided to SDCWA.

Thus, MET’s rate design also fails the AWWA principles by allowing for cross-subsidization among customer classes by not setting the supply rate properly to recover the SWP supply costs and for the other reasons detailed in our March 5th memo. In particular, by improperly allocating certain SWP, local water supply development projects, conservation, and other supply costs to its conveyance service function, MET undercharges most of its member agencies for supply services and overcharges other agencies for transportation services.

As to the Water Stewardship Rate in particular, MET charges water supply and transportation customers alike for the cost to develop conservation and local water supply projects, both of which serve supply objectives and generate water supplies for MET’s member agencies, yet these costs are recovered from both supply and transportation rates. MET’s staff and consultant suggest that local supply development and water conservation subsidies are properly charged to water transportation customers because these programs conserve capacity

in distribution lines that can be used for transportation. This reasoning, however, neglects two key facts: (1) MET is not obligated to provide transportation services it cannot provide due to a lack of capacity, and (2) MET has had substantial available capacity in its facilities to deliver water and fully expects to have that capacity available in the future years it has forecasted. As discussed in our March 5, 2010 memorandum, conservation and local supply development are supply functions and the notion that conservation must be encouraged by artificially inflating the cost of transportation of water through Met facilities is inconsistent with modern day realities and California water law and policy. In his book, "Comprehensive Guide to Water and Waste Water Financing and Pricing" (2d Ed., 1993) on page 168, MET's consultant describes supply costs as follows: "*Source of supply*: operating and capital costs associated with the source of water supply (reservoir construction and maintenance costs, water right purchases, **supply development costs, conservation costs, etc.**)" (Emphasis added.)

MET's April 5, 2010 Response to Public Comments to Proposed Rates and Charges

MET's General Manager and General Counsel sent a memo dated April 5, 2010 in response to public comments made at the March 8, 2010 public hearing before the Business and Finance Committee. That April 5th memo responds to a March 8th letter from SDCWA Assistant General Manager, Dennis A. Cushman, on MET's proposed rates and charges.

MET asserts that it allocates its costs to different categories based on their service functions. The memo summarizes the cost allocation approach stated in Attachment 2 to the April 13, 2010 Board letter. The April 5, 2010 memo states on page 3 "Metropolitan uses the SWP as a conveyance facility." The memo goes on to state "Since first accounting for payments in 1963-64, Metropolitan has consistently recorded SWP capital costs in its financial statements as payment for use of the SWP facilities, i.e., entitlements." Thus, MET asserts that it is providing a conveyance service across the State Water Project. However, MET does not own or control the State Water Project, but is rather a customer of the DWR, under a water supply contract, with respect to the Water Supply provided by the SWP. MET does not maintain and operate the SWP – the DWR does. Instead, under its contract with the DWR, the MET pays a take-or-pay charge to the DWR as a customer does to a supplier. Stated differently, the costs for which MET wishes to account under its SWP contract are not its costs to account for – they are the DWR's costs. Proper cost accounting requires an agency to distinguish between the contract price it pays another for a supply and its own direct costs to transport that supply across its own facilities. The SWP is a wholesale supply service to MET. MET, in turn, combines its SWP and Colorado River supplies and provides wholesale MET water to its member agencies

The MET staff memo does not meaningfully address SDCWA's contention that the Water Stewardship Rate should be assigned to supply costs. The memo asserts that the demand management and local water supply development programs reduce MET's capital costs and that, therefore, "it is appropriate for all users of the system to bear a proportional cost for these incentives." This begs the question. It is not enough to show that costs have a benefit to

MET's customers. It must also be shown what portion of that benefit accrues to each class of MET customers and that the MET's rates fairly apportion costs to those who benefit from them. To simply say, "all customers benefit and must therefore pay" essentially admits MET has not done the cost-accounting and rate-design tasks required by industry practice and by the law as expressed in the Colantuono & Levin letter referenced in footnote one above. While there may be more than one way to properly allocate these costs, industry practice requires recovery of the costs of these incentives in proportion to the supply of MET water that is sold by MET to its member agencies. As discussed above, local supply development and conservation are not transportation costs.

Despite the plain distinction between the MET's contractual relationship with the DWR and SWP and the operation and maintenance of its own Colorado River Aqueduct, MET staff concedes its rates treat DWR payments and MET costs to operate the CRA alike. Thus, MET concedes it treats a Supply cost and a Transmission and Distribution cost alike when industry standards require them to be distinguished and properly assigned.

The fact that MET wheels a small amount of water across the SWP does not change the fundamental nature of its relationship to the SWP. Indeed, the terms and conditions of MET's right to wheel water through the SWP is also determined by its contract with DWR.

The memo briefly describes MET's unbundled rate structure in response to SDCWA's assertion that MET's rate structure requires a customer or class of customers to bear costs that ought to be borne by others. But reference to the unbundled nature of MET's rate structure does not respond to the issues SDCWA has presented. The allocation of costs to unbundled rates and charges recovered from customers should be proportional to use and costs of service of each customer or customer class. Thus, the issue is not the unbundled rate structure but the allocation of costs of service to the correct service functions.

In the memo, MET staff states "this full cost of water would be the same regardless of whether the costs were recovered in the supply component or the system access rate." BWA disagrees. Because different member agencies take different water services and are not charged the same combination of unbundled rates and charges, the total cost of water differs by member agency. This, of course, is the very point of rate design – to fairly apportion an agency's costs to those who benefit from the services provided by the incurring of those costs. MET staff, moreover, does not address the real issue that by increasing supply rates to reflect actual supply costs, MET would give its customers and the Southern California region it serves greater incentives to conserve water, develop local supplies, and develop a water market as both the MET Board and the State Legislature wish Southern Californians to do. If the true cost of water supplied to member agencies from the Bay Delta and other sources were reflected in MET rates, MET member agencies would logically respond by looking at alternate sources. All of which is to say, if MET priced its services consistently with cost-of-service principles and industry practice, it would allow its rates to send accurate price signals to its customers and not distort their economic incentives by requiring one set of customers to subsidize another.

Raftelis Financial Consultants, Inc., Independent Review of FY 2010/11 Cost of Service and Rate Setting Process

RFC Raftelis Financial Consultants, Inc., MET's rate consultants, prepared a final report, dated April 6, 2010, entitled *INDEPENDENT REVIEW OF FY 2010/11 COST OF SERVICE AND RATE SETTING PROCESS* ("RFC REPORT). RFC's review process, as described on page 10 of the RFC Report, consisted of four major tasks: (1) reviewing whether the 2010 COS and rate methodology is reasonable and consistent with California law and the Metropolitan Water District Act; (2) reviewing whether the 2010 COS and rate methodology is consistent with water industry best practices, and complies with COS and rate guidelines in the AWWA Manual M-1, *PRINCIPLES OF WATER RATES, FEES, AND CHARGES*; (3) reviewing whether 2010 proposed rates have been developed consistently with MET Board policies, and more specifically, with the 2001 Rate Structure Framework; and (4) reviewing whether the 2010 COS is accurate and consistent with the 2001 COS model.

RFC finds the 2010 COS and rate methodology consistent with the MWD Act, consistent with the 2001 rate structure framework, and that it is accurate and consistent with the 2001 model. BWA's opinion on the 2010 COS and rate design were addressed in our March 5th memo. We question the cost allocation and rate structure and conclude they are both inequitable and fail to meet the policy goals of the MET board.

The RFC Report also fails to state that MET's service functions differ from those shown in the AWWA manual. MET's functional categories are supply, conveyance and aqueduct, storage, treatment, distribution, demand management (i.e., conservation), administrative and general, and hydroelectric. By contrast, the AWWA manual shows the following major functions: source of supply, pumping, water treatment, transmission and distribution, customer accounting, and administrative and general.² As BWA stated in its March 5th memo, we believe that MWD improperly allocates its revenue requirement and that more of it should be assigned to the supply service function. Because MET has different classes of customers that take different levels of service, industry standards and rate design principles require those differences to be reflected in MET's rate design. However, the fundamental issue is not the service categories themselves, but the fact that MET charges costs related to supply to service categories that are related to transportation. Although public water utilities have some flexibility to establish service categories that reflect their operations, they do not have flexibility to assign costs to improper categories as MET has done.

The RFC Report states, on page 7,

“...a major portion of the revenue requirement and the Supply category is the SWP, for which the Department of Water Resources (“DWR”) provides an annual Statement of Charges to the State Water Contractors (“SWC”). This

² See Table 7-3 Allocation of O&M Expense—Base-extra capacity method, page 56, AWWA Manual M1, fifth edition, 2000.

invoice is categorized as Delta Water Charge, Transportation Charge, variable power, and Off-Aqueduct Power Facilities. Based on this invoice, MWD has indicated that they have assigned these components to the respective functional categories, such as Supply and Conveyance and Aqueduct.”

RFC finds this process of “functionalizing” SWP costs to be appropriate. BWA does not agree with MET’s service functions. We conclude that the DWR charges should be classified as Supply costs because MET neither owns nor operates the SWP, but rather, has a contractual relationship with DWR with respect to the imported water supply delivered via that facility to MET’s facilities in Southern California. The AWWA manual indicates service functions. Each water utility has to determine which costs are assigned to the service functions. BWA and RFC differ on how costs are assigned to service functions.

Further, we do not agree with RFC’s conclusion that MET’s proposed 2011 rates are consistent with its 2001 Cost of Service study (“2001 COS”). As RFC notes on page 9 of the RFC Report, the 2001 COS described the Tier 2 Water Supply Rate as intended to “reflect MWD’s cost of developing long-term supplies of water,” yet, RFC concedes that MET now actually uses that rate solely to recover the cost of short-term water transfers used to address current drought conditions. (See pages 3, 9, and 15 of the RFC Report.) However, the cost of developing long-term supplies of water such as recycled water and seawater desalination is assigned to other rates. Plainly, the 2011 rates deviate materially from the 2001 COS as RFC’s own report demonstrates.

Conclusion

For the reasons stated here and in our March 5th opinion, we conclude that the rates MET proposes to impose as of January 1, 2011 are not consistent with industry standards, fail to fairly apportion costs among customer classes in proportion to the cost of serving each, and require transportation customers to subsidize water supply customers. For these reasons, MET’s rates are inconsistent with industry practice and cost-of-service rate design principles and California law as described in the Colantuono & Levin letter referenced in footnote 1 above.

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