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Dear Mike:

At a recent meeting we had in your office, following up on a prior request, you asked me again for a more detailed recitation of EDF's views on the controversy now raging in southern California over MWD's wheeling policies, especially as they bear upon the Imperial Irrigation District-San Diego County Water Authority negotiation for a voluntary long-term annual transfer of 200,000 acre feet of water or more. What follows is EDF's response on several aspects of this issue.

Part I. Facilitating Voluntary Water Transfers

EDF approaches its analysis of the IID-San Diego draft agreement from the perspective of an organization which has long supported the marketing of water in California and elsewhere in the American west. We believe that the voluntary transfer of water from willing sellers to willing buyers is a crucially important mechanism for making more efficient use of developed water supplies. We also believe transfers can bring measurable improvements to the aquatic environments of the west, both as the direct and indirect beneficiary of marketing arrangements. In addition, water purchased by a needy buyer is water not "developed" by a new dam or canal project. For all these reasons and more, including a desire to bring some measure of competition to a system long dominated by "socialist"-style institutional arrangements, we think MWD should be looking for ways to assist IID and San Diego in making their innovative proposal work, rather than for ways to obstruct its implementation.

Part II. A Level Playing Field

It is our belief, however, that this is not how MWD is approaching the IID-San Diego "deal." For evidence in support of this belief, we turn to MWD's own glossy brochure, entitled Wheeling: Gearing for the Future of Water Marketing (Feb. 1997). Noteworthy in that brochure is a section dealing with "regional water management programs," a group of water conservation, wastewater reclamation, and groundwater recovery initiatives which MWD has been heavily subsidizing for many years. In MWD's words:

> Metropolitan's water management programs include significant financial incentives for water conservation, recycling and recovery of

> local groundwater resources. These programs have significantly reduced the demand for imported water in the region, thereby reducing pressure on environmental and agricultural interests and facilitating consensus solutions to pressing statewide water problems. The incentive payments for these activities are based primarily on the fact that developing these local resources reduces future capital costs, thereby lowering the cost of access to the system for Metropolitan's member agencies and wheelers alike. Because those seeking wheeling services benefit from these programs, the equal treatment principle indicates that they should pay a proportionate share of costs.

What MWD is saying in this section of its brochure is that any entity within MWD which proposes to purchase water on its own, in addition to paying for the water it has bought and for a fair share of the costs of transporting that water through MWD's system, must also pay a share of the costs other entities in MWD's service area have incurred for their conservation, reclamation, and groundwater recovery programs. Thus, San Diego must pay IID for the water it is buying, it must pay MWD for such conveyance and storage services as it receives, and effectively it must pay Central Basin and West Basin Water Districts a share of their expensive and heavily subsidized wastewater reclamation programs. Yet, once MWD can no longer assure a full Colorado River Aqueduct (whether supplied with entitlement water, Interior Secretary-declared "surplus" water, or water developed from various other proposed alternative scenarios), San Diego's arrangement with IID would provide substantially the same statewide and nearly the same system-wide benefits as do the current conservation, reclamation and groundwater recovery programs. The transfer arrangement should therefore receive essentially the same treatment within MWD as these other programs receive (while accounting for the fact that some of these local projects may marginally reduce the need for local storage and distribution infrastructure).

All MWD member agencies subsidize the conservation, reclamation, and groundwater recovery programs, even though the direct beneficiaries of the subsidies as a result buy less water from MWD and thus, in MWD's terms, shift existing fixed cost reimbursement requirements disproportionately to other member agencies. No one, so far as I know, is arguing that West Basin or Central Basin or Orange County, who all have aggressively pursued these programs, as beneficiaries not only of MWD subsidies, but of significant federal subsidies as well, should make the rest of MWD whole as a consequence. Why then should San Diego do so when its proposal would provide equivalent benefits to the region?

Part III. <u>Stranded Costs?</u>

MWD, it has been noted, bases much of its argument for "fixed cost recovery" in the water wheeling context on an analogy it attempts to make between the current electricity restructuring situation and the water situation with San Diego and IID. In MWD's words, "[R]ecent major legislation to restructure the electric utility industry in California contains carefully designed provisions to prevent adverse financial impacts to customers as that industry undergoes a transition to a more competitive environment."

The facts are, however, that MWD's description of electricity restructuring is inaccurate and – for at least two reasons – the power and water situations are not analogous. The principal concern about stranded costs in the power industry was not over "customers," but over private utility shareholders and bondholders, who feared that they would be saddled with the losses from prior uneconomic (and, some would say, imprudent) investments by the utilities. The political compromise which emerged has protected the utilities in large part from their prior economic errors by distributing the obligation to recover stranded costs widely.

So far, on the other hand, in the water context, MWD has nowhere admitted that it has made any imprudent or uneconomic investments. Indeed, its "Wheeling" policy document is full of self-congratulation for its entire ongoing $4 billion Capital Investment Program, including Domenigoni Reservoir and massive local distribution systems primarily designed to move northern California water to the eastern and southern ends of its service area. *Even more extraordinary, however, is its claim that even the unspecified, but presumably large, future costs of a Bay/Delta solution, including an "environmentally sound transportation system for future water marketing activities" should be including in wheeling charges for use of its Colorado River Aqueduct.*

MWD, the monopolist, wants to have it both ways. On the one hand, it allegedly worries about stranded costs to some customers resulting from other customers' struggling to reduce their reliance on MWD as their sole water supplier. On the other hand, MWD continues to pursue a hugely ambitious, perhaps even reckless, capital investment program and insists not only that its member agencies repay these investments when they purchase its water, but also when they do not (as in the case of an IID-San Diego or similar water transfer arrangement).

What MWD's "Wheeling" policy endorses is the position that the cost of a Peripheral Canal, yet to be built, should be partially paid for by the parties to a water transfer arrangement seeking to keep the Colorado River Aqueduct full. I do not believe that this is either sound financial policy or sound resource policy. Please let me know if you disagree with this assessment.

Sincerely yours,

Thomas J. Graff
Senior Attorney

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cc: Maureen Stapleton, San Diego County Water Authority
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