The Metropolitan Water District of Southern California
Executive Office

September 9, 2016

Chairman Pedro Nava
Little Hoover Commission
925 "L" Street, Suite 805
Sacramento, CA 95814

Re: **Little Hoover Commission Hearing on "Special Districts"**
August 25, 2016

Dear Chairman Nava:

On behalf of The Metropolitan Water District of Southern California, I wish to submit the following comments and background information for the Commission's consideration.

Special districts in California have been created over time for local control over specific local services. The Metropolitan Water District of Southern California, in many respects, runs contrary to that tradition. Metropolitan was created for a regional purpose – to import water supplies for a growing region – that began during the Great Depression and continues to evolve to this day.

As the Little Hoover Commission revisits the organization and governance of special districts in California, it is important to keep in mind that Metropolitan is a critical institution as the largest regional water distributor and planner of its kind in the state and nation.

The impetus of the contemporary review by the Little Hoover Commission and the comments of panelists during the August 25 public hearing raised two pertinent policy issues of importance to Metropolitan, that being property taxes and "retained earnings." We welcome this opportunity to provide some background in the hope of advancing an informed discussion and debate.

Property Taxes – Colorado River

Prior to constructing a reliable supply of imported water from the Colorado River to Southern California, the property values of the inner core of Southern California were approximately $2 billion. Today, that core has expanded to cover a portion of or all of six counties and nearly 19 million people, with the property values of that core fast approaching $3 trillion.

A reliable water supply is the driver behind that economic vitality and growth and the increase in property values in Southern California over the subsequent generations. This evolution has taken place in two significant increments that both involved the use of property taxes to help make possible and to underwrite water infrastructure development.

Metropolitan was created in 1928 due to several growing Southern California cities recognizing that they needed to act collectively to advance their water future. Alone they could not solve their looming water challenge. Together they could.

The cities pursued the creation of Metropolitan through the California Legislature in order to present to southland voters an opportunity in 1931 to assess a property tax within their boundaries to construct a $220 million, 242-mile aqueduct system to the Colorado River for a new source of imported supply. Although this capital project was worth approximately 10 percent of the entire property value of the service area at the time, a level of requested investment unmatched in modern history, voters overwhelmingly approved the property tax. Initially, this was the sole revenue source for Metropolitan, given there was no water to sell during construction. The method of retiring this financial obligation evolved over time as direct purchases of water increased and the need to rely solely on property taxes decreased.

Property Taxes – State Water Project

In 1960, as Southern California continued to expand and additional water supplies loomed imperative, California voters approved the Burns Porter Act (Act) and the creation of the State Water Project. As an engineering marvel, the State Water Project entailed the construction of Oroville Dam on the Feather River, the world's largest earthen dam, and the 444-mile California Aqueduct system from the Sacramento-San Joaquin Delta to fast urbanizing Southern California. The use of property taxes as an important financing strategy was important then and remains so to this day.

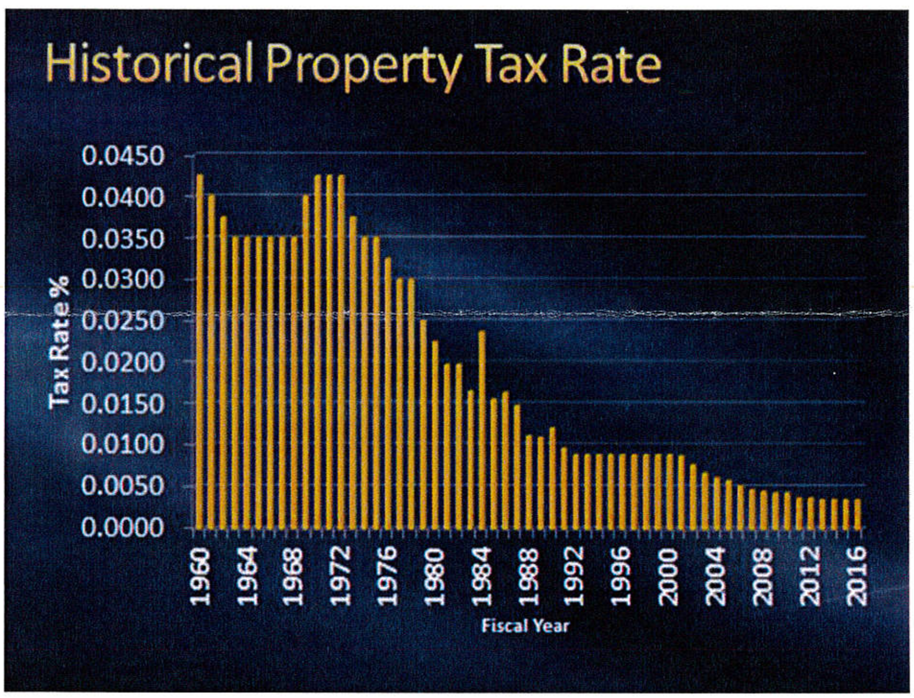
The State Water Project was constructed by the State of California, solely through financial and legal commitments of the participating public water agencies. The Act approved by California voters authorized bond financing and directed the state to enter into contracts obligating local water public agencies to pay 100 percent of the costs of the construction and ongoing operation of the water supply and delivery system in exchange for participation in the system. The Act created a property tax mechanism so the contracting local public water agencies could retire such costs through collection of property taxes. More importantly, from a state perspective, this Act ensured the local water agencies would collect the needed revenues to meet this financial obligation to the state. This is a contractual requirement to protect the state general fund that continues to this day. As the California Court of Appeal explained:

> Through this procedure, the beneficiaries of the Water Plan become the financial keystone and support rather than the General Fund and the general taxpayer. *Goodman v. County of Riverside,* 140 Cal. App. 3d 900, 906, fn. 3 (1983) (quoting press release by Alan Cranston, then State Controller).

The ability of Metropolitan and the other State Water Project contractors to recover State Water Project costs through a property tax – approved by the voters – came as a result of California's need to advance water development while protecting the state General Fund.

Property Taxes – Today and into the Future

In the 1930s, property taxes comprised 100 percent of Metropolitan's revenues. Today that percentage is closer to 6 percent. Other fixed charges and volumetric water rates comprise the bulk of Metropolitan revenues. The existing property tax assessment in Southern California that helps to retire certain Metropolitan State Water Project costs is exceedingly modest. For example, a home with an assessed valuation of $400,000 pays a property tax to Metropolitan of $14 per year. The ad valorem tax rate is .0035 percent of assessed valuations throughout Metropolitan's service area.



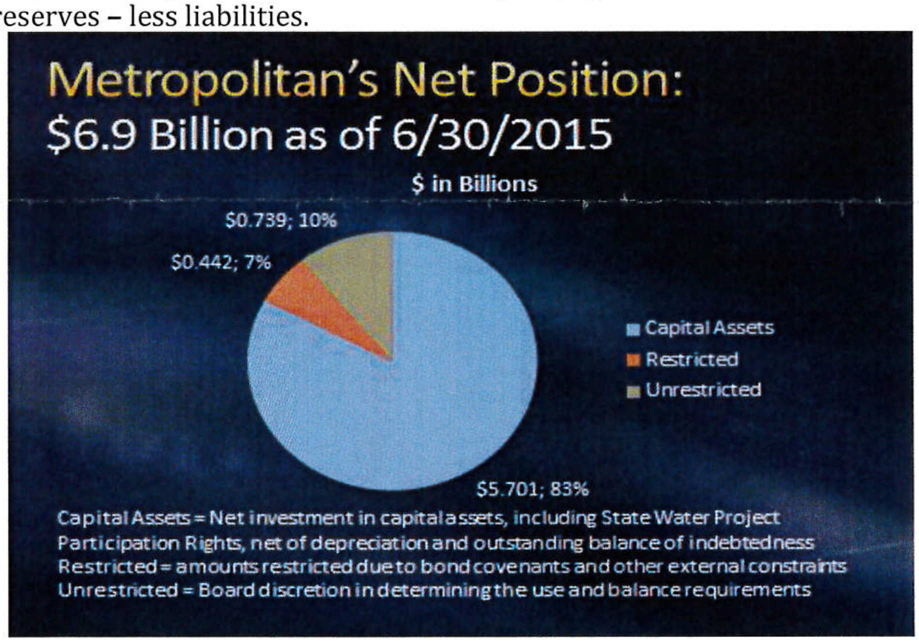
Metropolitan believes that maintaining this property tax rate is essential to the fiscal integrity of the district in the long-term. Approximately 80 percent of our costs are fixed, given the need to maintain and operate a water system in six counties that delivers water to 26 member agencies – cities, local water districts and a county water authority – serving nearly 19 million people. Yet 85 percent of Metropolitan's revenues are variable, largely due to the fluctuation in water sales. Maintaining the property tax mechanism remains important from a statewide perspective as an assurance that Metropolitan and all State Water Project contractors will meet their financial obligations to California.

Metropolitan and "Retained Earnings"

Lastly, a question has arisen as to whether Metropolitan has in excess of $6 billion in "retained earnings" based on information contained in annual reports submitted by Metropolitan to the California State Controller's Office. Metropolitan complies with the requirement to file this annual report, even though the reporting categories for this report, such as "retained earnings," can lead to a misunderstanding of Metropolitan's actual financial condition.

"Retained earnings" is a corporate term. The Governmental Accounting Standards Board provides guidance to government agencies to use "Net Position" in financial reports, which Metropolitan does. "Net Position," however, is not a category available to government agencies for reporting annual financial information to the State Controller. As such, Metropolitan reflects its Net Position in the only available category currently available from the State Controller, that being "retained earnings."

Metropolitan's Net Position – and what it reports in the "retained earnings" field in the State Controller's template – does not represent cash, on hand or otherwise. Instead, it represents all of Metropolitan's assets – including its physical infrastructure and essential financial reserves – less liabilities.



As of June 30, 2015, Metropolitan had a positive Net Position, due in large part to its investment in capital assets, which represent 83 percent, or $5.7 billion, of its Net Position. Metropolitan's infrastructure includes the Colorado River Aqueduct, hundreds of miles of pipelines, storage facilities such as Diamond Valley Lake and five of the largest water treatment facilities in the nation. Metropolitan also has participation rights in the State Water Project. Metropolitan's unrestricted Net Position (including designated funds that contractually must be held and not spent) for the same period was $739 million, or 10 percent, of total Net Position. The remaining 7 percent, or $442 million, of Net Position was restricted by bond covenants and other external constraints.

Given that Metropolitan's annual budget is approximately $1.8 billion, and revenues and expenditures can vary significantly from one year to the next, it is appropriate for Metropolitan to maintain adequate reserves. Likewise, Metropolitan maintains a six-month supply of water in reserve in the event of a natural disaster that could cut off access to imported water supplies. Moreover, given the size and reach of its regional system, Metropolitan undertakes very large capital projects. The ten-year forecast for Metropolitan's Capital Investment Plan is $2 billion. Having adequate reserves is a financial buffer that has saved ratepayers hundreds of millions of dollars over the years because of low interest rates resulting from high-credit ratings.

Looking Ahead

Significant investment decisions loom in the not-too-distant future for Southern California. The Colorado River watershed has been in drought conditions since the turn of this century, requiring new partnerships and investments to maintain supplies. Likewise, the State Water Project faces a historic investment decision in the ongoing California WaterFix process. Climate change, population growth and other challenges require expanded local efforts to lower demand and increase supplies.

During the last two fiscal years, Metropolitan invested more than $450 million to promote conservation throughout Southern California at the local level as a response to the five-year historic drought. Metropolitan is also exploring the construction of the nation's largest recycled water facility in Los Angeles County as a way to partially offset the losses in regional groundwater production that has resulted from lower local rainfall, which translates to a higher demand on Metropolitan's imported water supply system.

Maintaining a healthy financial condition and access to its traditional revenue sources remains important to the fiscal integrity of Metropolitan now and into the future.

We thank you for the opportunity to submit comments to provide information and share Metropolitan's perspective. Should the Commission or staff have any further questions or wish additional information, please do not hesitate to contact Kathleen Cole in Metropolitan's Sacramento office at (916) 650-2600.

Sincerely,

Jeffrey Kightlinger
General Manager

cc: Members of the Little Hoover Commission
Carole D'Elia, Executive Director, Little Hoover Commission
Jim Wasserman, Deputy Executive Director, Little Hoover Commission