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August 30, 2018

Informational Hearing

Department of Water Resources:
Proposed Water Supply Contract Extension & Amendments

- I. *Rachel Ehlers*, Principal Fiscal & Policy Analyst, Legislative Analyst's Office
- II. *Cindy Messer*, Chief Deputy Director, Department of Water Resources
Joel Ledesma, Deputy Director, State Water Project, Department of Water Resources
- III. *Deven Upadhyay*, Assistant General Manager/Chief Operating Officer for The Metropolitan Water District of Southern California
Valerie Pryor, General Manager of Alameda County Flood Control and Water Conservation District, Zone 7
- IV. *Roger B. Moore*, Attorney, Law Office of Roger B. Moore
- V. Public Comment

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Informational Hearing - Background Paper

Department of Water Resources: Proposed Water Supply Contract Extension & Amendments

Reason for This Hearing: State law (Section 147.5 of the Water Code¹) requires the Department of Water Resources (department) to present information regarding the terms and conditions of its renewal or extension of a long-term water supply contract in an informational hearing before the Joint Legislative Budget Committee (JLBC), and relevant policy and fiscal committees identified by Legislative leadership, at least 60 days before the department finalizes approval of the changes. On May 10, 2018, the department submitted a package of materials related to the outcomes of its negotiations for the extension of, and other amendments to, long-term water supply contracts to the JLBC. According to the department, the Administration began negotiating the terms and conditions for these renewals and amendments in 2013. This hearing serves as the required informational hearing regarding the contract extensions under Water Code Section 147.5.

Prior to this hearing, on July 3, 2018, the Senate Committee on Natural Resources and Water held an informational hearing on this subject, entitled “Overview of the Proposed Contract Amendments between the Department of Water Resources and the State Water Project Contractors.” The background paper for that hearing, which includes additional details regarding the history of the State Water Project and specific provisions of the existing and as-proposed-to-be-amended contracts, is available online at: <https://sntr.senate.ca.gov/content/2018-informationaloversight-hearings>.

¹ Section 147.5 reads: “At least 60 days prior to the final approval of the renewal or extension of a long-term water supply contract between the department and a state water project contractor, the department shall present at an informational hearing before the Legislature the details of the terms and conditions of the contract and how they serve as a template for the remaining long-term water supply contracts. This presentation shall be made to the Joint Legislative Budget Committee and relevant policy and fiscal committees of both houses, as determined by the Speaker of the Assembly Rules Committee and the Senate Committee on Rules. The department shall submit a copy of one long-term contract to the Joint Legislative Budget Committee no less than 30 days prior to the scheduled hearing.”

Background on the Contracts: The department and public water agencies located throughout the state originally entered into the 29 water supply contracts now proposed to be extended and amended in the 1960's. The initial lengths of those contracts were 75 years, with expiration dates that range from 2035 to 2042. The contracts govern how water is provided to local agencies through the State Water Project (SWP), which serves approximately 26 million people and 750,000 acres of farmland. The SWP includes 700 miles of tunnels, pipelines, dams, aqueducts, and siphons that allow for transport of water within the state from north to south. Construction, operation and maintenance costs are principally funded by contractors that purchase the water, while the state authorizes staff positions and provides up to \$10 million General Fund related to recreational uses.

Various contract provisions determine how much water the department delivers to each contractor in a given year, along with the allocation of costs associated with delivery of that water, and other issues that may be unique to one or more contractors. The allocation of SWP costs among the contractors is based on a complex set of criteria, including the contractors' annual entitlements to water and relative benefits to the water users. As a result, some contractors pay more for an equivalent unit of water than others. Many of the project's costs are debt-financed, and debt service is treated as an operating expense (mostly paid for by the contractors under terms of the contracts).

Proposed Contract Amendments: The department indicates that it began negotiations over the proposed contract extensions and financing-related provisions in 2013. From May 2013 through June 2014, the department and 29 contractors held 23 public negotiation sessions before arriving at an Agreement in Principle for the contract extension. The agreement would extend the expiration date of all of the contracts until December 31, 2085. According to the department, a number of its public plans and analyses all project that SWP water supplies will remain necessary well into the future, even once the potential for local investment in other options, such as desalination and recycling, is taken into account.

The amendments resulting from the agreement also include the following financial provisions:

- An amendment to accelerate certain future financing costs, rather than amortizing those costs over the entire life of the contracts. The department refers to this as changing from amortizing capital costs over a relatively long repayment period to using a "pay-as-you-go" billing system.
- An amendment to increase the cap on an existing General Operating Account that functions as a reserve in case of cash flow deficiencies or emergencies, from \$32 million to \$150 million, with a provision for future adjustments.
- Creation of a new State Water Resources Development System (SWRDS) Reinvestment Account (SRA) to provide funds to finance capital costs for which bonds are not issued and a new SWRDS Support Account (SSA) to provide funds to pay for expenditures that are not chargeable to the contractors.

- An amendment to allow the department to issue bonds and to charge contractors for financing costs of repairs and capital projects, regardless of whether the facilities were in existence prior to January 1, 1987 (which is a current contract requirement), and to finance other capital projects that are not already listed in the contract if the department and at least 80 percent of the affected contractors, as defined, mutually agree.
- An amendment to change, until the end of 2035, rate provisions so that projected annual rate reductions would increase if revenues permit, but contractors would forgo any additional rate management reductions; and,
- Establishment of a new SWRDS Finance Committee comprised of department and contractor representatives. The committee would make recommendations to the department director regarding financial policies of the SWP and other specified matters.

The department submitted a model consolidated contract amendment, along with related materials, to the JLBC on May 10, 2018. The department has also prepared a Draft Environmental Impact Review (EIR) under the California Environmental Quality Act (CEQA) to assess possible environmental impacts associated with the proposed contract amendments. The Draft EIR was released on August 17, 2016 and concluded that the amendments would not have physical environmental impacts because they are primarily financial in nature. The final EIR will not be completed until after this hearing has taken place.

According to the department, one of the main benefits of the contract extension is to avoid escalating costs related to bond financing. Because there are only 17 years remaining until the anticipated expiration of the first contracts in 2035, the department indicates that it is limited to selling bonds with 17-year maturity dates, rather than the typical 30-year term. The department indicates that bonds with longer terms, and therefore lower repayment costs, may be used for capital upgrades and repairs, including reinforcing Perris Dam and Sisk Dam against seismic failure, reconstructing the Thermalito Powerplant in the aftermath of a damaging fire, reconstructing the spillways at Oroville Dam and completing other repairs. As a result, the department believes the proposed extension and amendments will make water provided through the SWP more reliable and affordable as one component of local agencies' water supplies.

Relationship to the WaterFix Project: The WaterFix project is currently proposed to include construction of two 30-mile-long subterranean tunnels to re-route water under the Sacramento-San Joaquin Delta in order to deliver it to farms in the western San Joaquin Valley and cities in Southern California. The department asserts that the proposed contract renewal and financing-related amendments are not directly caused by, or related to, the Waterfix project. At the same time, however, the department does acknowledge that extending the length of the contracts and changing their financing provisions as described above may have a significant impact on the cost of bond funding that would pay for the WaterFix project if it moves forward.

The WaterFix project is highly controversial and there are strong feelings among stakeholders on all sides. The department believes that Article 1 (ap) of the existing contracts, which defines "Water System Facilities" for which revenue bonds may be sold, already authorizes the sale of bonds to finance construction of WaterFix facilities. This is because the department considers the

project's proposed facilities to meet the definition of "Delta facilities" which are already included in the list. The department has filed a validation action in Sacramento Superior Court in an effort to confirm this interpretation, which has also been controversial.

The department has been negotiating with water contractors over additional amendments to the contracts that are intended to directly address cost allocations for the WaterFix project. They have held 15 negotiating sessions this year and arrived at a draft Agreement in Principle. The proposed changes would provide for participation and allocation of costs among 24 contractors and exclusion of 5 contractors located north of the Delta. The department intends for the Agreement in Principle to next guide the drafting of actual amendments and then an analysis of the potential environmental effects of the proposed changes under CEQA.

Because Section 147.5 of the Water Code only references amendments that renew or extend the contracts, existing law does not appear to currently require the department to submit these Waterfix cost-related amendments to the Legislature for review. As discussed below, however, AB 2649 (Bloom) was recently amended to propose changes to existing law regarding future significant contract amendments.

Recent Policy Committee Hearing: The Senate Committee on Natural Resources and Water's background paper for its informational hearing provided analysis of current and persistent issues that may be relevant to the proposed amendments, including:

- *WaterFix.* The background paper referenced many environmental organizations' contentions that unless and until various issues related to WaterFix are resolved, any contract amendments, including the ones that are the subject of this hearing, are premature at best.
- *Lingering concerns with the Monterey agreement.* The Monterey agreement is an agreement between the department and contractors, which resulted in related contract amendments and which stemmed from disputes related to Article 18 of the contracts. Article 18 governs reductions to the allocation of water related to shortages. Several environmental groups have raised questions about why the maximum amount of water each contractor may request each year from the SWP (which is established in Table A of the contracts) is not being reduced under the contract amendments to reflect the lower amounts of water that have historically been provided.
- *Davis-Dolwig Act Decisions and the SWP being "off-budget".* The Legislative Analyst's Office has repeatedly expressed concern regarding the department's discretion over how to allocate costs under the Davis-Dolwig Act, which governs fish and wildlife enhancements and recreation in the SWP. In addition, the larger allocation of funds to support operations and capital outlay expenditures of the SWP are not currently subject to appropriation in the annual budget bill. Apart from obtaining authorization from the Legislature for Davis-Dolwig expenditures and the creation of new staff positions, DWR has authority to expend SWP funds without legislative approval.

- *Reducing Dependence on the Delta & Investment in Source Watersheds.* The Delta Reform Act of 2009 (Statutes of 2009, 7th Ex. Sess., Ch. 5) requires regions that rely on the Delta watershed to improve their self-reliance for water through specified efforts. Water Code Section 108.5 also recognizes and defines source watersheds as integral components of California’s water infrastructure. The background brief for the Natural Resources & Water Committee’s hearing indicates that the proposed amendments do not appear to address these state policies.
- *Legislature’s Role in Future Contract Amendments.* As referenced above, Water Code Section 147.5 requires the department to present details related to the renewal or extension of a long-term water supply contract to the JLBC. However, it does not appear to presently impose a similar requirement related to other future amendments which may have significant impacts (including, but not limited to, those currently being negotiated related to WaterFix).

During the Committee’s hearing, members of the Legislature raised several questions, including: 1) whether there is additional information regarding the financial effects of the proposed amendments, and any future amendments, that can and should be made available to the Legislature and the public, 2) whether the Legislature should have a role in the Finance Committee the proposed amendments seek to establish, 3) how the SWP fits into the state’s long-term water planning, 4) how the Legislature will be engaged with respect to future amendments to the contracts, and 5) what the relationship is between the proposed amendments and the amendments being developed with respect to the WaterFix project.

Stakeholder Comments: A number of stakeholders, including several environmental and food-safety groups and the San Diego County Water Authority, submitted letters to the JLBC requesting that this hearing be delayed in order for the WaterFix-related amendments currently being negotiated to be available to the Legislature and public at the same time the Legislature is considering the amendments that are the subject of this hearing. By contrast, the State Water Contractors submitted a letter requesting for this hearing to happen as soon as possible to avoid the financial compression that delay could cause and to update financing-related provisions.

Proposed Statutory Changes Regarding Contract Amendments: As described above, existing law requires the department to submit proposed amendments that renew or extend long-term water contracts to the Legislature. Those renewal or extension amendments cannot be finalized until 60 days after a Legislative hearing. Once this hearing has occurred, a similar requirement does not appear to exist related to any future amendments to the contracts that do not address their further renewal or extension.

AB 2649 (Bloom) proposes statutory changes requiring greater transparency regarding, and an opportunity for Legislative review of, future amendments of long-term water contracts. More specifically, AB 2649 would require the department to submit to the Legislature specified information about proposed amendments, and associated costs, for changes that would: a) have projectwide significance with substantially similar terms offered to all contractors, or b) permanently transfer a contractual water amount between contractors. If AB 2649 is enacted, final approval of contract amendments that are subject to its requirements could not take place

until at least 60 days after the department submits the required information. AB 2649 would also require the department to notify the Legislature at least 10 days before holding public sessions to negotiate significant contract amendments.

Questions: Below are some questions Members may wish to ask witnesses during the hearing:

1. What do you view as the most critical impacts of the changes made by the proposed renewal and financing-related amendments?
2. What are the costs or savings for contracting agencies and water customers associated with these proposed contract amendments?
3. What do you support about the proposed renewal and financing-related amendments? What concerns do you have about these proposed amendments?
4. How does the department provide notice to the public and to critical stakeholders regarding negotiations related to contract amendments? Are there improvements to this process that can be made?
5. How would the changes proposed in AB 2649 improve transparency regarding future amendments to long-term contracts?