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TO PARTIES OF RECORD IN APPLICATION 10-04-019

This is the proposed decision of Administrative Law Judge (ALJ) Maribeth A. Bushey. It will not appear on the Commission's agenda sooner than 30 days from the date it is mailed. The Commission may act then, or it may postpone action until later.

When the Commission acts on the proposed decision, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision as provided in Article 14 of the Commission's Rules of Practice and Procedure (Rules), accessible on the Commission's website at www.cpuc.ca.gov. Pursuant to Rule 14.3, opening comments shall not exceed 15 pages.

Comments must be filed pursuant to Rule 1.13 either electronically or in hard copy. Comments should be served on parties to this proceeding in accordance with Rules 1.9 and 1.10. Electronic and hard copies of comments should be sent to ALJ Bushey at mab@cpuc.ca.gov and the assigned Commissioner. The current service list for this proceeding is available on the Commission's website at www.cpuc.ca.gov.

/s/ JANET A. ECONOME for
Karen V. Clopton, Chief
Administrative Law Judge

KVC:gd2

Attachment

Decision **PROPOSED DECISION OF ALJ BUSHEY** (Mailed 8/4/2011)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California-American Water
Company (U210W) for an Order
Authorizing Recovery of Costs for the
Lease of the Sand City Desalination Facility
and Associated Operating and
Maintenance Costs.

Application 10-04-019
(Filed April 12, 2010)

**DECISION DENYING RECOVERY OF COSTS
FOR THE LEASE OF THE SAND CITY DESALINATION FACILITY**

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**DECISION DENYING RECOVERY OF COSTS
FOR THE LEASE OF THE SAND CITY DESALINATION FACILITY**

1. Summary

This decision denies the request of California-American Water Company (Cal-Am) to include in its Monterey District revenue requirement the costs of the lease and operating and maintenance of the Sand City Desalination Plant. The decision finds that Cal-Am has failed to meet its burden of proving that terms of the lease are reasonable and prudent.

2. Background

Cal-Am filed this application seeking ratemaking approval of Cal-Am's Amended and Restated Lease Agreement with the City of Sand City for the Sand City Desalination Plant. The Commission had already found that Cal-Am failed to meet its burden of demonstrating that the terms of the original Sand City Desalination Plant lease were reasonable and prudent in Decision (D.) 09-07-021, but allowed Cal-Am to file a separate application to make the showing required to justify including the Sand City Desalination Plant costs in its revenue requirement.

**2.1. Summary of the Commission's July 2009 Decision
on Proposed Sand City Desalination Plant Lease
and Operating Agreement**

In D.09-07-021, the Commission found that Cal-Am had failed to meet its burden of demonstrating that the terms of the Sand City Desalination Plant lease are reasonable and prudent, but allowed Cal-Am to file a separate application to make the showing required to justify including the Sand City Desalination Plant costs in revenue requirement. In that decision, the Commission stated that Cal-Am then estimated the annual costs for the Sand City Desalination Plant lease to be about \$1 million.

The Commission began by noting that a public utility must demonstrate with clear evidence that the costs which it seeks to include in revenue requirement are reasonable and prudent. The term “reasonable and prudent” means that the decision is expected by the utility to accomplish the desired result at the lowest reasonable cost consistent with good utility practices, as evaluated by “cost effectiveness, reliability, safety, and expedition.”¹ Utility management must present persuasive evidence that its decision-making process and ultimate decision are reasonable and prudent.

The Commission then considered Cal-Am’s analytical process in deciding to sign the lease, and found that the record did not show a reasonable process under which Cal-Am evaluated the Sand City Desalination Plant lease. Instead, Cal-Am simply concluded that “... the cost of this water is justified since no other water is available.”² Based on this record, the Commission found that rather than showing sound decision-making, the record suggests unquestioning support for this new water source, at any price, without regard to alternatives.

The Commission then turned to the reasonableness of the actual terms and conditions of the Sand City Desalination Plant lease. Over the 15-year term of the lease, Cal-Am would pay, in net present value terms, almost 90% of the capital costs of the plant through \$850,000 annual payments even though Sand City had received a \$2.9 million grant from the State of California, which did not offset the total amount Cal-Am would pay. As to the operating expenses provided for in the lease, the Commission found that the lease obligated Cal-Am

¹ D.09-07-021 at 64.

² *Id.* at 66.

to operate the plant consistent with prudent industry practices to produce potable water at the plant and to incur all costs necessary to do so, including any required plant modifications. The Commission found that the lease contained no limitations to the costs Cal-Am must incur to fulfill its obligations to produce 300 acre-feet/year of potable water at the plant. Finally, the Commission expressed concern with the 15-year term of the lease. The Commission noted that the term is expected to run through 2024, which is well after the Coastal Water Project (11,500 acre-feet/year) and the Aquifer Storage and Recovery Plant (920 acre-feet/year) are currently estimated to begin production. These two later resources would close most of the gap between Cal-Am's available supply and its customer demand.

The Commission concluded:

Cal-Am has accepted virtually all the risks of ownership without the long-term benefits, and now seeks to transfer this risk to ratepayers... [S]o far as the record reveals and the terms of the agreement bear out, Cal-Am acquiesced in all respects to Sand City's desired terms.³

The Commission determined that Cal-Am had not met its burden of proving that the then-proposed version of the Sand City Desalination Plant lease would logically be expected, at the time it was signed, to accomplish the desired result at the lowest reasonable cost consistent with good utility practices. The Commission noted that Cal-Am's proffered justification - severe water supply limitations - provided no limit to price or risk allocation, and could be used to justify an unlimited price. Because Cal-Am had provided no evidence of tough

³ *Id.* at 70.

negotiations, a thorough analysis of alternatives for both buyer and seller, or a cost-of-service study for a cost-based lease price to show that this lease price was the lowest reasonable price consistent with good utility practices, the Commission denied the request to include the Sand City Desalination Plant lease in revenue requirement, but it allowed Cal-Am to file a subsequent application justifying the price and risk terms.⁴

2.2. Description of Current Lease Terms

On October 30, 2009, Sand City and Cal-Am executed their Amended and Restated Lease Agreement, the subject of this application.⁵ The Amended Sand City Lease Agreement did not alter the primary lease payment stream, i.e., \$850,000/year for 15 years, from the earlier version rejected by the Commission in D.09-07-021. The Amended Lease does, however, extend the term of the lease from 15 years, with a possible second 15-year “renewal” term, to a defined term of 31 years. The annual lease payment for years 16 through 30 is \$7,000 per year, and \$0.0 for year 31.⁶

Similarly, the Amended Lease did not alter Sand City’s right to designate up to 206 acre-feet/year of the Desalination Plant output be used to extend service to new or expanded connections in Sand City:

As a material obligation under this Lease, Company shall supply up to 206 acre feet per year of production from the

⁴ *Id.* at 70-71.

⁵ The Amended Lease is Attachment A to the application.

⁶ Schedule B to Amended Lease.

Desalination facility for new and expanded water users within Sand City as directed by the City.⁷

In the Amended Lease, Sand City also retained the right to impose a connection charge for any new or expanded use in Sand City, but agreed to transfer the funds so collected to Cal-Am, less an administration fee.⁸

The Amended Lease made no changes to the requirement that Cal-Am operate the plant so as to produce 300 acre-feet/year and bear all operating and maintenance costs of such production.⁹ Cal-Am is also responsible for complying with all applicable legal, insurance, and contractual obligations, and bearing all costs of such compliance.¹⁰ Cal-Am remains obligated to fund all modifications and replacements necessary to keep the desalination plant in “good working order” as well as complying with all applicable legal and environmental laws and permits.¹¹ In contrast to the earlier version of the lease, Sand City will pay a pro rata share of the cost of improvements where the useful life of the improvement extends beyond the 30-year term of Cal-Am’s lease.¹² The Amended Lease also contains a new provision that allows for future expansion of the desalination plant capacity beyond the current capacity of 300 acre-feet/year. The parties agreed that they will cooperate to obtain any needed governmental approvals to make improvements to the plant to increase

⁷ Amended Lease at 4.

⁸ *Id.* at 3.

⁹ *Id.*

¹⁰ *Id.* at 6.

¹¹ *Id.* at 9-10.

¹² *Id.* at 10.

its capacity, which are termed “Additional Project Improvements.” Although the cost allocation of any such improvements is not specified, the output of the Additional Project Improvements is committed to Sand City’s sole discretion for “new and expanded water uses in Sand City.”¹³

In its application, Cal-Am proposes that the annual lease payments be reflected in revenue requirement on a “cash” basis, rather than spread equally over the 31-year term of the lease. Specifically, Cal-Am proposes to include in Monterey District revenue requirement the \$850,000 annual lease payment for years one through 15, and then \$7,000 in years 16 through 30.¹⁴ Cal-Am states that Generally Accepted Accounting Principles (GAAP) would require that the costs of the lease be spread evenly over the term of the lease, resulting in recognized lease costs of \$414,677 per year for the 31-year term of the lease. Cal-Am explained that by instead reflecting the actual payment amount in annual revenue requirement notwithstanding GAAP requirements, Cal-Am avoids including the payment in rate base through working capital. Cal-Am stated that following GAAP requirements would “increase the average cost of the Sand City Desalination Plant’s water significantly.”¹⁵

Cal-Am proposed creating two new balancing accounts to recover all operations and maintenance expenses and replacement costs from ratepayers. Specifically, Cal-Am proposes a balancing account set initially to recover its estimated costs of operations and maintenance, and then adjust the account to

¹³ *Id.* at 6.

¹⁴ Schedule B to the Lease shows that the payment in years 15 and 31 is \$0.

¹⁵ Testimony of Jeffery M. Dana at 4.

reflect actual expenditures to ensure recovery.¹⁶ The second balancing account will be for capital replacements. Cal-Am proposes to include in revenue requirement \$122,764 each year to accumulate an account that will be debited for the costs of replacements as they occur over time. Cal-Am contends that collecting from ratepayers each year for replacements regardless of whether such replacements are necessary will eliminate rate “spikes” for replacements and allow Cal-Am a “dollar for dollar” recovery of actual costs.¹⁷

Cal-Am requests authorization to include in rates a total of \$1,446,261 in Monterey District annual revenue requirement for the Sand City Desalination Plant. Dividing this amount by 300 acre-feet results in an average cost of \$4,833/acre-foot for years 1 through 15. This is the price Monterey District ratepayers will be paying for water from the Sand City Desalination Plant in years 1 through 15. In years 16 through 30, revenue requirement will include then-current operations, maintenance, and replacements costs, with only \$7,000 in lease payments.

2.3. Moratorium Order

In D.11-03-048, this Commission directed Cal-Am to acknowledge in its tariff a water moratorium in its Monterey District ordered by the State Water Resources Control Board. The moratorium prohibits new connections and certain increased uses of water by existing customers that would be served by diversions of the Carmel River. The Commission required that Cal-Am’s tariff recognize Condition 2 of the 2009 Cease and Desist Order. Condition 2 prohibits diversions from the Carmel River for new connections or increased uses at

¹⁶ *Id.* at 9.

certain types of existing service addresses. The Commission concluded that Cal-Am has no obligation to serve any new connections in its Monterey District and increased uses are so prohibited.

The Commission found that the Cease and Desist Order did not include Sand City within the terms of the moratorium because any new service connections in Sand City will be served exclusively by the desalination plant, and not by Carmel River water.¹⁸

2.4. Assigned Commissioner Ruling

On September 30, 2010, the assigned Commissioner John Bohn issued a Ruling Setting Schedule for Completing Record, which required additional information in the record on the following topics: 1) Cal-Am's Monterey District needs; 2) ratepayer interests; 3) requirements of the California Public Utilities Code; and 4) requirements of the State Water Resources Control Board. These topics were to be addressed in a written response detailing how the Amended Lease is reasonable and prudent with respect to the particular subjects identified by Commissioner Bohn. The Division of Ratepayer Advocates (DRA) was also allowed to file and serve a written response to the supplemental information provided by Cal-Am. The ruling determined that no evidentiary hearing was required and that with the completion of the filings authorized by the ruling, the record would be complete and the proceeding submitted for resolution by the Commission.

¹⁷ *Id.* at 7-8.

¹⁸ D.11-03-048 at 27. See also Amended A.10-05-020, at 9; February 10, 2011 Comments by the City of Sand City and Requested Revision to Proposed Decision at 2-3.

The ruling noted that throughout its application and supporting documents, Cal-Am stated it has an urgent and immediate need for an alternative water supply to reduce its draw from the Carmel River as required by the State Water Resources Control Board. The proposed Sand City Desalination Plant lease, however, provides that only 31.3% of the plant output may be reliably used to offset Carmel River draws. The majority of the plant output, 68.7%, could be used to support and justify additional customer connections and expansions in Sand City, but Cal-Am proposes to allocate 100% of the capital and operating costs of the desalination plant to Monterey District ratepayers. The ruling required Cal-Am to explain how Sand City customer growth, the primary purpose of desalination plant, meets the needs of the Monterey District system, as well as the reasonableness of deploying Monterey District staff and capital resources, with a service connection moratorium then-pending, on a project where only 31.3% of the output certain to provide new supply.

The ruling also required Cal-Am to reconcile its rate proposal with Commission precedent on granting moratorium exceptions where the exception-seeker was required to contribute to the water utility the resource from which the new connections would be served and provide surplus water supply for existing customers.¹⁹

¹⁹ See *Hillview Water Company, Inc.*, (D.06-01-005), (authorizing moratorium exception where real estate developer agrees to contribute water supply that will serve new connections, with no less than 25% surplus to benefit existing customers); *Re Citizens Utilities Company of California*, 34 CPUC 2d 84, 88 – 91 (D.89-12-020) (analyzing Pub. Util. Code §§ 453 and 2708, and authorizing an exception to the moratorium where the real estate developer will “bear the entire financial risk and burden of the development of the water production sources and treatment facilities” to be transferred to the utility

Footnote continued on next page

The ruling found that in the 2009 decision, the Commission focused on the price and risk allocation terms in the Sand City Desalination Plant lease and found that Cal-Am had not adequately justified those terms. The Amended Plant lease, however, appeared to substantially *increase* the costs proposed to be allocated to ratepayers for the first 15-year term and to shift substantially all of the risk for high operating or replacement costs to ratepayers, with such risk significantly increased due to the now 31-year term of the plant lease. The ruling also found that total costs had increased. Cal-Am's 2009 estimated total annual cost for the 15-year term of the Sand City Desalination Plant lease was about \$1 million, but in the current application, the estimated annual costs for the first 15 years of the same plant have increased 44% to \$1,446,261. The ruling also noted the increased risk of extending, from 15 years to 31 years, Cal-Am's blanket obligation to Sand City to produce 300 acre-feet/year at the plant, regardless of cost. The Commission had already questioned in D.09-07-021 whether such a blanket obligation is in the interests of Cal-Am's Monterey District ratepayers. The ruling also questioned the reasonableness of new or expanded Sand City customers obtaining service from Cal-Am at the Monterey District average tariffed rate, which is about 62% lower than the cost of the Sand City Desalination Plant.

Finally, the ruling noted that Cal-Am proposed two balancing accounts (for operations and maintenance expenses and for capital replacement costs). This use of balancing accounts for plant operated by Cal-Am is at odds with the Commission's standard practice in general rate cases of using a forecasted test

and where the facilities were expected to produce water sufficient for the new connections plus "a surplus of water for the benefit of all customers.")

year, a practice intended to create an incentive for Cal-Am to carefully manage its costs.

3. Cal-Am's Response

Cal-Am filed its response on October 18, 2010. Cal-Am maintains that the Amended Lease provides the least costly alternative source of water to meet the water supply shortage in Cal-Am's Monterey District, while allowing Cal-Am to reduce its diversions from the Carmel River.

3.1. Factual Misconceptions

Cal-Am alleges that the ruling contains factual inaccuracies which distort the issues and also fails to present Cal-Am's decision to enter in the Amended Lease in an accurate light. First, Cal-Am claims that the amount the ruling quoted for cost per acre-foot misrepresents the actual cost and ignores the customer benefits of extending the lease from 15 to 31 years. Cal-Am points out that the average price of water over the life of the project is \$2,956 per acre-foot, whereas the ruling quoted \$4,833 per acre-foot. Cal-Am emphasized that during the renegotiation of the Amended Lease, Cal-Am used the \$2,956 per acre-foot amount as the basis for its decision to execute the Amended Lease.

Additionally, Cal-Am asserts that 100% of the Sand City desalination plant production is currently available to Monterey District customers. Cal-Am expects that based on current market conditions for real estate development, Sand City will not make use of its full 68.7% allotment (206 acre-feet/year) for potentially up to 20 years, and Cal-Am estimates that 95% of the production will be available to Monterey District customers for the first 10 years.

Lastly, Cal-Am believes the ruling misrepresented Cal-Am's pursuit of the Sand City Desalination Plant in light of the State Water Resources Control Board moratorium on delivering water to new connections or increased use at existing

service addresses. Cal-Am argues, first, that the moratorium was not then currently in effect, and, second, that the Sand City Desalination Plant predates the moratorium and will likely outlast the moratorium, which is only in effect until the Regional Desalination Plant (or similar project) is completed.

3.2. Monterey District System Needs

Cal-Am says its decision to enter into the Amended Lease is reasonable and prudent for several reasons. First, there are currently no applications pending to use the production of the Sand City Desalination Plant, which allows Cal-Am to use all of the production to meet its customers' needs. Second, the water is available when Cal-Am expects a shortfall.

Regarding the reasonableness of deploying Monterey District staff and capital resources on the project, Cal-Am argues again that the ruling incorrectly characterizes the project output at 31.3%. Cal-Am estimates that over the term of the Amended Lease, more than half of the Sand City production will be used to reduce Cal-Am's diversion from the Carmel River. In light of the yield of amount and availability of production, Cal Am maintains that its use of the Monterey District resources is justified.

Regarding Commission precedent on granting moratorium exceptions, Cal-Am argues that the several key differences limit the applicability of the cited precedent of *Hillview Water Company, Inc.*, and *Re: Citizens Utilities Company of California*, note 19 above, to the Amended Lease. First, Cal-Am contends that *Hillview* and *Citizens* demonstrate that adding Sand City customers while the moratorium is in effect does not violate Sections 453 or 2708.²⁰ Cal-Am

²⁰ Response, at 20.

distinguishes its actions from *Hillview* and *Citizens* because the utilities in those cases asked the Commission to create new exceptions to the existing moratoria. Cal-Am maintains that the moratorium does not apply to new or expanded uses within Sand City served by the desalination plant. Moreover, as discussed previously, the Sand City Desalination Plant pre-dates the moratorium. Cal-Am asks the Commission to evaluate its amended lease based on facts and circumstances existing at the time of the lease formation, when the moratorium was not an issue. Therefore, Cal-Am argues, the moratorium was not an obstacle to renegotiation of the original lease.

3.3. Customer Interests

Cal-Am proposes to consolidate rates for customers in its Monterey District. There will not be a different rate structure for customers not affected by the moratorium. Cal-Am explains that costs are spread over the entire customer base, so the concept of “below-cost components” is not applicable.

The ruling also asked Cal-Am to explain how its proposed balancing accounts would create an incentive to carefully manage the costs of the Sand City Desalination Plant. Cal-Am maintains that the balancing account tracking of operations and maintenance costs and major replacement costs does not remove them from Commission oversight. The Commission and DRA may review the accounts during a general rate case and determine if the estimated recorded costs are reasonable. Additionally, Cal-Am argues, it will have to file an advice letter in order to true up the balancing accounts on an annual basis.

Cal-Am’s also argues that extending the lease from 15 to 31 years benefits its Monterey District customers by reducing the average annual lease payment from \$850,000 to \$414,677, by giving Cal-Am access to the desalination plant for a greater portion of its expected useful life. Lastly, Cal-Am maintains that it

conducted a detailed cost analysis for the Amended Lease and that the extension provides the least costly alternative source of water supply to meet the shortage in its Monterey District. Cal-Am believes these cost benefits will continue throughout the lease term.

Regarding the benefit to customers of the provision in the Amended Lease which credits Cal-Am's 2009 payment to Sand City as payment for year 15, Cal-Am argues that the Amended Lease was the product of a negotiation and Cal-Am could not dictate each provision in the lease. It maintains that the overall agreement represents a reasonable and prudent alternative for dealing with the water shortage at the lowest possible cost, and that the Commission should not focus on specific provisions which may not benefit Cal-Am's Monterey District customers. Cal-Am also reminds the Commission that it renegotiated certain terms of the lease to address concerns raised in D.09-07-021, and that the overall benefits of the lease outweigh any detriment from the accreditation of year 2009 lease payment.

3.4. Public Utilities Code Requirements

Cal-Am argues that Section 453 of the Public Utilities Code does not apply to the Amended Lease because Cal-Am itself is not imposing a connection charge. The connection fee contained in the Amended Lease is imposed by Sand City, which has the authority to impose fees on those seeking to build or expand within the city. This fee is an addition to the fee charged by Monterey Peninsula Water Management District (MPWMD) for a permit.

In explaining how recovering the costs of the Sand City Desalination Plant from all Monterey District customers complies with Section 453, Cal Am maintains that the production from the Sand City Desalination Plant will benefit all Monterey District customers by reducing its diversions from the Carmel

River. Therefore, it is appropriate for Cal-Am to recover costs from all of its Monterey District customers.

3.5. State Water Resources Control Board Requirements

Regarding compliance with the State Water Resources Control Board's directions to reduce diversions from the Carmel River, Cal-Am asserts the board was chastising Cal-Am for focusing on large projects such as the Coastal Water Project and the Monterey Dam and Reservoir Project while neglecting smaller projects similar to Sand City. Therefore, the amended lease furthers the State Water Resources Control Board's goals.

4. DRA's Response

DRA filed its response on October 25, 2010. DRA argues that Cal-Am has not demonstrated that the Sand City Desalination Plant costs under the Amended Lease are reasonable and prudent. DRA maintains that Cal-Am's decision to renegotiate the Amended Lease did not account for ratepayer interest. Cal-Am is faced with a short-term supply gap, for which it has not demonstrated that it considered the potential for demand-side measures to close this gap. Additionally, DRA claims that Cal-Am did not show whether it considered supply sources other than recycled water. DRA thinks Cal-Am's existing ratepayers in effect will be required to fund the Sand City Desalination Plant even though the Amended Lease obligates 68.7% of the plant's total 300 acre-feet/year of water to new and expanded uses in Sand City.

DRA believes Cal-Am's proposed ratemaking treatment attempts to inappropriately shift costs from future to current ratepayers and favors the company at ratepayer expense. While not opposed to a balancing account to recover power costs, DRA adamantly opposes the entirely new authorization of balancing accounts for typically forecasted expenses. DRA proposes that major

repair and replacement costs should be addressed in Cal-Am's General Rate Case filings, not through a balancing account. Rather than permitting a new balancing account to accrue customer funds at the rate of \$122,764 per year, DRA recommends the Commission allow Cal-Am to recover in rates only those capital expenses which Cal-Am has actually forecast for the years 2010-2014, with subsequent recovery requests occurring within the framework of the General Rate Case.

DRA opposes Cal-Am's proposed use of working capital, but DRA concurs with Cal-Am's proposed ratemaking treatment of the initial \$850,000 lease payment. DRA also supports Cal-Am's request to recognize continuing lease payments on a cash basis.

5. Discussion

Pursuant to Pub. Util. Code § 451, all rates collected by Cal-Am must be just and reasonable, and increases can only be approved by the Commission after a showing by Cal-Am that the increase is justified as provided in Pub. Util. Code § 453.

The shortage of water supply in Cal-Am's Monterey District is well-known and longstanding, as discussed in D.09-07-021. As also discussed in that decision, this shortage does not justify acquiring a water source at any price, regardless of financial risk. To justify including the costs of the Sand City Desalination Plant in revenue requirement, Cal-Am must demonstrate with clear evidence that the costs which it seeks to include in revenue requirement are reasonable and prudent. As the Commission noted in D.09-07-021, the term "reasonable and prudent" means that the decision is expected by the utility to accomplish the desired result at the lowest reasonable cost consistent with good utility practices, as evaluated by "cost effectiveness, reliability, safety, and

expedition.” As set forth below, Cal-Am has not demonstrated that the Sand City Desalination Plant will provide additional water supply to the Monterey District at the lowest reasonable costs. Therefore, we deny this application.

We agree that Cal-Am has made a sufficient showing that the water available from the Sand City Desalination Plant would assist in reducing Cal-Am’s draw from the Carmel River, Cal-Am’s stated objective. Up to 68.7% of that assistance, however, may be withheld from reducing Cal-Am’s Carmel River draw and instead redirected to serve new demand from Sand City customers.²¹ Consequently, only 31.3% of the plant production is reliably available to achieve the objective of reducing Cal-Am’s draw on the Carmel River.

Although less than 100 acre-feet/year are committed to Cal-Am use, the provisions of the Amended Lease continue to require Cal-Am to bear any and all costs of producing the full 300 acre-feet/year. In short, Cal-Am proposes to obligate ratepayers to fund 100% of the costs of the Sand City Desalination Plant with only 31.3% of the water production reliably available to serve Cal-Am’s customers.

Cal-Am expects that most of the plant production will be available for its existing customers during the majority of the lease term. Sand City new and expanded customer demand over the 31-year term of the lease is unpredictable. The Commission’s experience and expertise in forecasting water supply and demand has shown that long term transactions, which would include the 15-year

²¹ “As a material obligation under this Lease, Company shall supply up to 206 acre feet per year of production from the Desalination facility for new and expanded water users within Sand City as directed by the City.” Amended Lease at 4.

original Lease term and to an even greater degree the current 31-year term, are subject to substantial unpredictability. For example, the Commission reviews all Class A water utilities' revenue requirement in a general rate cases on a three-year schedule. Consequently, we give little weight to Cal-Am's expectations of water availability over the term of the amended lease.

The Amended Lease, however, is unequivocal in providing that 206 acre-feet per year of water production may be withdrawn at any time for new or expanded water users in Sand City as directed by the City of Sand City. Equally unequivocal is Cal-Am's commitment to provide 300 acre-feet per year of water, and bear all costs. The lack of symmetry between the supply availability and cost allocation provisions of the Amended Lease, as the Commission found with similar provisions in the original Lease, is not reasonable and prudent.

Notwithstanding the redirection of 68.7% of water production, all costs of the plant remain squarely the responsibility of Cal-Am. This would impose a burden without a compensating benefit because Cal-Am will be paying for water production which it has no authority to use to achieve its objective - reducing its draw from the Carmel River.

In fact, Cal-Am is obligated to incur costs that may effectively triple the costs of the water supply it will actually obtain in furtherance of its desired result - reduction in withdrawals from the Carmel River. Such cost allocation is not reasonable; it also means that Cal-Am's ratepayers will have to pay not only the costs under the Amended Lease but also the cost to replace in the Monterey systems the water re-directed to new or expanded uses in Sand City. Consequently, we are not able to conclude that the terms of the Sand City Desalination Plant lease are reasonable and prudent.

Cal-Am persists in its willingness to accept, and then seek to transfer to ratepayers, all risks of operating the Desalination Plant over the 31-year term of the Amended Lease. As set forth in the Commission's analysis of the initial lease in D.09-07-021, this one-sided risk allocation obligates Cal-Am to produce 300 acre-feet per year of water regardless of cost. The long-term financial and environmental risks of the Sand City Desalination Plant are significant, and the risk allocation terms have the effect of making Cal-Am, or its ratepayers, a guarantor of plant production. Placing these risks exclusively on Cal-Am or its ratepayers, especially where Cal-Am is only reliably entitled to 31.3% of the plant output, is not reasonable.

Finally, Cal-Am points to its urgent need to increase water supply as justification for including the costs of the Sand City Desalination Plant in revenue requirement, but Cal-Am has deployed its management and capital resources to procure a project with 68.7% of the output committed to Sand City customer growth rather than increasing Monterey District supply. Management labor expense and capital costs are significant components of revenue requirement. These expensive resources, funded by ratepayers, should be deployed to projects that reliably and cost-effectively serve ratepayer interests. Here, the Sand City Desalination Plant does little to advance ratepayer interests in decreasing withdrawals from the Carmel River, but greatly increases financial and operational risk. We conclude that deploying management and capital resources to procure the Amended Lease also fails to meet applicable standards for reasonable and prudent utility actions. Consequently, Cal-Am must remove all management and capital costs associated with the Sand City Desalination Plant from any ratemaking recovery requests, including but not limited to its existing memorandum account and its current general rate case.

6. Further Directives to Reduce Carmel River Withdrawals

As indicated above, the Sand City Desalination Plant lease is not a reasonable and prudent way to address the water supply needs of the Monterey District, including the reduction of withdrawals from the Carmel River. In order to address the water supply issue, we return to the overall objectives we adopted for Cal-Am in its last Monterey District general rate case, D.09-07-021, where this Commission expressed support for Cal-Am's water supply objectives and particularly encouraged innovative projects based on the unique features of the Monterey District:

We agree with many of American Water's objectives and directives. The Monterey system has extreme supply challenges and local residents and businesses, which already experience elevated rates with expensive capital projects on the horizon, cannot be expected to withstand limitless rate increases. We agree that dialogue between customers and Cal-Am is essential to understanding customers' priority needs and their view of cost versus service level trade-offs. American Water's support for innovative solutions could include temporary supply restrictions targeted at outdoor landscape irrigation during periods of peak demand. We also share American Water's focus on reducing non-revenue or unaccounted for water as a means to delay or offset capital supply projects, and we will adopt the requirement that such opportunities be "closely scrutinized." Most importantly, we support American Water's objective of innovative solutions, particularly for the Monterey system. We would like to see Cal-Am propose more projects designed to utilize unique features of the Monterey system to meet customer needs cost-effectively.

We reiterate our support for these objectives and continue to encourage Cal-Am to develop and implement cost-effective measures to meet the needs of its Monterey District customers without exposing these customers to the financial and operational risk associated with the Sand City Desalination Plant lease.

In the 2009 decision, the Commission singled out the use of potable water for landscape irrigation as unreasonable in the Monterey District due to the severe supply restrictions, and directed Cal-Am to transition such users to non-potable alternatives:

As Cal-Am has repeatedly stated and demonstrated throughout this proceeding, the Monterey district is confronting severe supply limitations. The continued use of potable water for landscape irrigation is unreasonable and fundamentally at odds with resource limitations confronting Cal-Am in the Monterey district.

Transitioning users of potable water for landscape irrigation to non-potable alternatives is an urgent obligation of Cal-Am. While rate design can and must provide financial incentives for customers to make this change, Cal-Am has an important role in providing alternative supply options. As pointed out by the Independent Reclaimed Water Users Group, such alternative projects could have lasting benefits to the district's customers.

Demonstration projects, feasibility studies, and other means to develop, evaluate, and implement the innovative solutions called for by the American Water directives require leadership from Cal-Am. We find that these types of projects are a necessary companion effort to adopting a rate design that provides financial incentives to transition from potable to non-potable water use for irrigation. Cal-Am did not anticipate this outcome and has not sought such funding in

this proceeding. We will, therefore, authorize Cal-Am to file an application for alternative supply projects for landscape irrigation.

As discussed above, American Water's corporate directives, with which we agree, state that "innovative solutions" particularly for large irrigation users are appropriate where, as here, existing water supply capacity is limited. The record shows that the City of Pacific Grove is analyzing, apparently without Cal-Am's support, a stormwater recovery project to serve the Pacific Grove golf courses. The record suggests that other options may be available as well. Cal-Am should assign a high priority to developing and implementing alternative options for large-scale potable water irrigation users.²²

We emphasize that Cal-Am should be pursuing all available means to meet the urgent need to reduce the use of potable water for landscape irrigation. As also noted in the 2009 decision, the Monterey District system experiences water supply shortages during the summer season, and the system has surplus supply during most winter months. Landscape irrigation usually occurs during the summer months so that reducing this unreasonable use of potable water is an obvious measure to achieve Cal-Am's goal of reducing draws from the Carmel River.

Although authorized in the 2009 decision, Cal-Am has not filed an application for approval of a program specifically directed at reducing this unreasonable use of potable water. To ensure that Cal-Am provides the leadership urgently required to reduce the use of potable water for landscape irrigation in the Monterey District, Cal-Am is directed to file and serve within

²² D.09-07-019, *mimeo* at 131 - 132.

90 days of the effective date of today's decision an application setting forth a program to reduce such use.

California American Water Company's program should contain the following elements:

- a. Gradually implemented but mandatory restrictions on the use of potable water for landscape irrigation based on time of year or Carmel River levels;
- b. Each year, projects sufficient to produce no less than 300 acre-feet per year of additional alternative sources of irrigation water or reduced demand of potable water for landscape irrigation; and
- c. Customer education plan to inform customers that the use of potable water for landscape irrigation is highly disfavored, will be subject to increasing restrictions and higher prices, and ultimately will likely be prohibited.
- d. Other innovative programs, projects, pilots, experiments, or other measures that may be reasonably designed to reduce the use of potable water for landscape irrigation.

In addition to Cal-Am's lack of progress on reducing the use of potable water for landscape irrigation, we are dismayed at Cal-Am's similar lack of progress on reducing the Monterey District's non-revenue or unaccounted for water.²³ As also noted above, in the 2009 decision we required that Cal-Am

²³ In D.09-07-019, we used the term "unaccounted for" water to describe the difference between total system water production and total system water sales. The better term, as indicated by Cal-Am in its current general rate case, A.10-07-007 at CAW Exhibit 3, is "non-revenue water." The components of non-revenue water are: (1) apparent losses (due to inaccurate metering), (2) real losses (caused by leaks), (3) unbilled metered

Footnote continued on next page

“closely scrutinize” opportunities to reduce non-revenue water. Cal-Am’s current general rate case, however, shows that its Monterey District non-revenue water has actually increased from 11.59% to 12.8% despite the financial incentive mechanism created in the 2009 decision. The amount of non-revenue water reported in the current general rate case is nearly 1,500 acre-feet per year, or about five times the total output of Sand City plant, to which Cal-Am has devoted exceptional amounts of capital and management resources. Although the Commission is addressing the non-revenue water issue in the pending general rate case, Cal-Am should continue to aggressively pursue reasonable opportunities to reduce non-revenue water and thereby reduce draws from the Carmel River.

7. Comments on Proposed Decision

The proposed decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code, and comments were allowed under Rule 14.3 of the Commission’s Rules of Practice and Procedure. Comments were filed on _____ and reply comments were filed on _____ by _____.

8. Assignment of Proceeding

Michel Peter Florio is the assigned Commissioner (after expiration of the term of the formerly assigned Commissioner, John Bohn) and Maribeth A. Bushey is the assigned ALJ in this proceeding.

(could include utility’s own use), and (4) unbilled, unmetered (such as firefighting or mains flushing). See A.10-07-007, Exhibit D, Minimum Data Requirements, Section II.E.1.

Findings of Fact

1. Cal-Am's Monterey District is and has been experiencing a water supply shortage.
2. The Amended Sand City Desalination Plant Lease allows the City of Sand City to redirect up to 206 acre feet per year from serving Cal-Am's existing customers to serving new or expanded uses in Sand City.
3. The supply of water from the Sand City Desalination Plant available pursuant to the Amended Lease to reduce Cal-Am's draw from the Carmel River is not reliable.
4. The Amended Lease requires Cal-Am at its expense to produce 300 acre-feet/year of water regardless of cost.
5. The Amended Lease imposes all operating, maintenance, and capital replacement costs on Cal-Am.
6. The supply of water from the Sand City Desalination Plant available pursuant to the Amended Lease is not shown to be cost effective because, among other things, Cal-Am must incur the costs to produce 300 acre-feet/year of water but only has reliable access to 94 acre-feet/year.
7. Cal-Am's decision to deploy management and capital resources in pursuing the Sand City Desalination Plant lease was not reasonable and prudent.
8. All management and capital costs associated with the Sand City Desalination Plant should be removed from any Cal-Am ratemaking recovery requests, including but not limited to its existing memorandum account and its current general rate case.
9. No evidentiary hearing was necessary for this proceeding.
10. The use of potable water for landscape irrigation is unreasonable in the Monterey District due to the severe supply restrictions.

11. Cal-Am has not exhausted the unique features of the Monterey District to reduce Carmel River withdrawals. Among these features is the potential for further limiting the use of potable water in landscape irrigation and aggressively pursuing opportunities to reduce unaccounted for water.

Conclusions of Law

1. The Amended Lease is not reasonable and prudent.
2. The costs of the Amended Lease should not be included in Monterey District revenue requirement.
3. Cal-Am's request to include in Monterey District revenue requirement the annual lease payments to the City of Sand City pursuant to the Amended Lease should be denied.
4. Cal-Am's request to include in Monterey District revenue requirement the operating, maintenance, and capital replacement costs of Amended Lease should be denied.
5. Cal-Am should remove all management and capital costs associated with the Sand City Desalination Plant from any ratemaking recovery requests, including but not limited to its existing memorandum account and its current general rate case.
6. Cal-Am should be required to file an application with a program to move toward significantly reducing the use of potable water for landscape irrigation.
7. This decision should be effective today.
8. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. California American Water Company's request for authorization to increase its Monterey District revenue requirement to reflect the annual payments to the City of Sand City for the Sand City Desalination Plant is denied.
2. California American Water Company's request for authorization to increase its Monterey District revenue requirement to reflect the operations, maintenance, and capital replacement costs of the Sand City Desalination Plant is denied.
3. If, and to the extent, California American Water Company decides to have a role in operating the Sand City Desalination Plant, California American Water Company must file and serve quarterly verified statements showing that personnel and assets used in operating the Plant are not included in any regulated utility revenue requirement.
4. No later than 45 days after the effective date of this order, California American Water Company must file and serve in this proceeding a compliance statement and accounting showing that it has removed all expense and capital costs associated with the Sand City Desalination Plant from any ratemaking recovery requests, including but not limited to any existing memorandum account and its current general rate case.
5. California American Water Company is directed to file and serve within 90 days of the effective date of today's decision an application setting forth a program to reduce the use of potable water for landscape irrigation in the Monterey District.

- a. Gradually implemented but mandatory restrictions on the use of potable water for landscape irrigation based on time of year or Carmel River levels;
 - b. Each year, projects sufficient to produce no less than 300 acre-feet per year of additional alternative sources of irrigation water or reduced potable water demand;
 - c. Customer education plan to inform customers that the use of potable water for landscape irrigation is highly disfavored, will be subject to increasing restrictions and higher prices, and ultimately will likely be prohibited; and
 - d. Other innovative programs, projects, pilots, experiments, or other measures that may be reasonably designed to reduce the use of potable water for landscape irrigation.
6. Application 10-04-019 is closed.

This order is effective today.

Dated _____, at San Francisco, California.