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Ratesetting

TO PARTIES OF RECORD IN APPLICATION 10-04-019

This is the revised 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 revised 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 revised 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 **REVISED PROPOSED DECISION OF ALJ BUSHEY**
(Mailed 12/2/2011)

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)

**REVISED DECISION DENYING APPROVAL OF
SAND CITY DESALINATION PLANT LEASE AND AUTHORIZING FILING OF
SAND CITY DESALINATION PLANT PURCHASED WATER BALANCING
ACCOUNT AND SURCHARGE ADVICE LETTERS**

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**REVISED DECISION DENYING APPROVAL OF
SAND CITY DESALINATION PLANT LEASE AND AUTHORIZING FILING OF
SAND CITY DESALINATION PLANT PURCHASED WATER BALANCING
ACCOUNT AND SURCHARGE ADVICE LETTER**

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 operation 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. This decision authorizes Cal-Am to receive payment for water from the Sand City Desalination Plant at the price Cal-Am offered in its alternative ratemaking proposal.

2. Background

California-American Water Company (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, dealing with overall rates for Cal-Am's Monterey District, 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. The Commission rejected the Sand City Desalination Plant Lease signed on November 5, 2007, between the City of Sand City and Cal-Am, for the Sand City Water Supply Project, a reverse osmosis desalinization facility with a projected annual capacity of 300 acre-foot per year. The Commission noted that the terms of the Lease reserved to Sand City the unilateral right to allocate up to the entire projected capacity of 300 acre-feet per year to “new and expanded uses within Sand City,” but that regulatory approvals had subsequently reduced the amount that could be redirected to 206 acre-feet. The Commission 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 also stated that Cal-Am then-estimated the annual costs for the Sand City Desalination Plant lease to be about \$1 million.

DRA opposed including the Sand City Desalination Plant Lease in revenue requirement and argued that the small amount of water potentially and temporarily available would not justify the costs, and that alternative projects could result in greater and permanent water savings. DRA contended that that Cal-Am had not evaluated the cost-effectiveness of the Sand City Desalinization Plant against reduced water consumption from additional conservation programs or enhanced measures to reduce unaccounted for water.

In its analysis, 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 suggested 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 was not used to 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 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

¹ D.09-07-021 at 64.

² *Id.* at 66.

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) were then 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 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

³ *Id.* at 70.

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

⁴ *Id.* at 70-71.

⁵ The Amended Lease is Attachment A to the application.

⁶ Schedule B to Amended Lease.

⁷ Amended Lease at 4.

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 31-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 its capacity, which are termed “Additional Project Improvements.” Although the cost allocation of any such improvements is not specified, the output of the

⁸ *Id.* at 3.

⁹ *Id.*

¹⁰ *Id.* at 6.

¹¹ *Id.* at 9-10.

¹² *Id.* at 10.

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 difference between the actual payment and the amount collected in revenue requirement as working capital, which is part of rate base. 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. Cal-Am explained that its 2009 payment is credited to year 15.

¹⁵ Testimony of Jeffery M. Dana at 4.

reflect actual expenditures to ensure recovery.¹⁶ The second balancing account would 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 would be paying for water from the Sand City Desalination Plant in years 1 through 15, if the treatment of lease payments proposed by Cal-Am as described above were adopted by the Commission. 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

¹⁶ *Id.* at 9.

¹⁷ *Id.* at 7-8.

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 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 the increased uses covered by Condition 2 are 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 then-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

¹⁸ D.11-03-048 at 27. See also Amended Application (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.

record would be complete and the proceeding submitted for resolution by the Commission.

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 as a whole.¹⁹ 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 is certain to provide additional 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

¹⁹ The customers located in Sand City comprise only a small portion of Cal-Am's Monterey district ratepayers.

which the new connections would be served and provide surplus water supply for existing customers.²⁰

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. The proposed balancing accounts similarly shifted substantially all of the risk for high operating or replacement costs to ratepayers, with such risk now significantly increased due to the now 31-year term of the amended 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

²⁰ 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 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.")

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 collects about \$1,820.30 per acre-foot in contrast to the annual Sand City plant costs of \$4,833 per acre-foot for the first 15 years.

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 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. Alleged 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.

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 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 20 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 Public Utilities Code Sections 453 or 2708.²¹ Cal-Am 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.

3.3. Customer Interests

Cal-Am proposes to consolidate rates for customers in its Monterey District. In other words, the higher costs of the Sand City Desalination plant will be averaged in with all other Monterey District supply costs. There will not be a different rate structure for moratorium-exception customers in Sand City; these customers will not pay the actual and higher costs of the Sand City Desalination Plant. 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

²¹ Response at 20. Pub. Util. Code § 2708 provides that when the Commission finds that a water company has reached the limit of its capacity to supply water, the Commission may order a moratorium on new or additional customers pending further order of the Commission.

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 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, which prohibits public utilities from discriminating among their customers, 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.²²

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

²² The Commission's exclusive authority to fix rates, including connection fees, for public utility water service in Cal-Am's Monterey district is discussed below.

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 alternative supply sources other than recycled water. DRA thinks Cal-Am's existing ratepayers in effect will be required to fund the entire Sand City Desalination Plant even though the Amended Lease allows 68.7% of the plant's total 300 acre-feet/year of water to be reallocated 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 if approved by the Commission, 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 succeeding General Rate Cases.

DRA opposes Commission approval of the Amended Lease, but should the Commission approve it, DRA opposed Cal-Am's proposed use of working capital, but did agree with Cal-Am's proposed ratemaking treatment of the initial \$850,000 lease payment and Cal-Am's request to recognize continuing lease payments on a cash basis.

5. Cal-Am Alternative Ratemaking Proposal

In its comments on the August 4, 2011, proposed decision, Cal-Am presented an alternative ratemaking proposal to address concerns about the rate impact of the Sand City Desalination Plant Lease.²³ The purpose of the alternative ratemaking proposal was to significantly reduce the initially requested annual revenue requirement.²⁴ Cal-Am's proposal began by using the average annual lease payment, \$414,677, over the 31-year duration of the Lease, rather than \$850,000 per year for years 1 through 15, and \$7,000 per year for years 16 through 31 as Cal-Am initially proposed. Cal-Am explained that \$414,677 could be considered an alternate lease cost. Cal-Am stated that it "would also be willing to accept shareholder responsibility for the working cash requirement associated with the carry[ing] cost of the lease prepayments."²⁵ Cal-Am proposed memorandum accounts for purchased power and operations and maintenance costs, to allow Cal-Am and the Commission to gain more information "through operating experience before costs are passed through to ratepayers."²⁶ Repair costs could also be recorded in a memorandum account, or set in a general rate case.

As discussed below, we accept portions of Cal-Am's proffered ratemaking alternatives in fashioning a cost recovery approach for water produced at the

²³ Cal-Am comments at iii.

²⁴ *Id.* at 18.

²⁵ *Id.*

²⁶ *Id.*

Sand City Desalination Plant and delivered to the Monterey District as if this were purchased water.

6. 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 § 454.

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." Below we evaluate each issue set forth in the scoping memo and determine that Cal-Am has not demonstrated that the Sand City Desalination Plant Lease will provide additional water supply to the Monterey District at the lowest reasonable costs. Therefore, we deny approval of the Amended Sand City Desalination Plant Lease in this application.

Denying approval of the Amended Sand City Desalination Plant Lease, however, does not resolve all outstanding issues on this matter. As Cal-Am correctly points out, the Sand City Desalination Plant is now producing water that is being used to serve customers in Cal-Am's Monterey District, and no costs

are currently reflected in Monterey District revenue requirement for this water supply. As discussed in more detail below, we build on the alternative ratemaking proposal put forward by Cal-Am and develop an ersatz purchased water ratemaking methodology to provide Cal-Am reasonable compensation for water delivered to the Monterey system, i.e. a ratemaking methodology that treats the water produced by the desalination plant as purchased water.

We begin, however, by addressing the issues the assigned Commissioner identified in the scoping memo.

6.1. Cal-Am's Monterey District System Needs.

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.²⁷ 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 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

²⁷ "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.

include the 15-year 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 31-year term of the amended lease.

Cal-Am argues that Sand City's interest in redevelopment and eliminating urban blight has indirectly served the Monterey District's needs by making water available now, when it is most needed.²⁸ Cal-Am does not, however, address the unreliability of this water source, nor does Cal-Am explain how the short-term usefulness of this water supply justifies the 31-year commitment to produce water regardless of cost in support of customer growth in Sand City.

We, therefore, find that the primary purpose of the Amended Lease is to provide for customer growth in Sand City, and only 31% of the supply will be reliably used to accomplish the District's need to reduce withdrawals from the Carmel River. Any availability of water beyond the 31% is temporary and unpredictable. We, therefore, conclude that meeting the need of the Monterey District to reduce withdrawals from the Carmel River is not the primary purpose of the Amended Lease.

The scoping memo next directed Cal-Am to justify expending District staff and capital resources on a project where only 31% of the output going towards new supply. Cal-Am explained that based on recent market conditions for real estate development, it "estimates" that over the life of the project more than half

²⁸ Cal-Am Response to Assigned Commissioner Ruling at 17.

of the Sand City Desalination Plant output will go toward reducing withdrawals from the Carmel River, and not to new development in Sand City.²⁹

In D.09-07-021, we made the following observations about Cal-Am's decision-making process:

We begin with Cal-Am's analytical process in deciding to sign the lease. Cal-Am's witness explained that due to the required extreme reductions in draw from the Carmel River required by Order 95-10 and Seaside Basin, Cal-Am must obtain new water sources to serve its customers in the Monterey district, and the Sand City Desalination Plant is the only new source available to deliver water in 2009. Cal-Am's witness concluded that the need for this facility was so "obvious" that the costs did not require written justification in the rate increase application. In response to a data request from DRA seeking an explanation as to "why Cal-Am believes purchasing water from the Sand City Desalination plant is a prudent and cost-effective action," Cal-Am provided no analytical cost data whatsoever and simply concluded that: "the cost of this water is justified since no other water is available." The record does not contain any written analysis, dated prior to Cal-Am's execution of the lease, such as budget justification documents. Similarly, no evidence was presented of Cal-Am's evaluation or negotiation of the proposed terms of the lease, before entering into the lease.³⁰

Cal-Am's presentation in this proceeding has not countered the conclusions we reached in 2009 regarding the original lease, the essential terms of which live on in the Amended Sand City Desalination Plant Lease. Since 1995, Cal-Am has been subject to an obligation to reduce its withdrawals from the Carmel River. Cal-Am must consistently deploy its Monterey District resources in ways that seek to meet this obligation. The primary purpose of the

²⁹ Cal-Am Response to Assigned Commissioner Ruling at 13 - 14.

³⁰ D.09-07-021 *mimeo* at 65 - 66.

Sand City Desalination Plant, residential and commercial development in Sand City, does not assist Cal-Am in meeting its obligation to reduce withdrawals from the Carmel River. Cal-Am has not justified using expensive management and capital resources for this project.³¹

The scoping memo next directed Cal-Am to address Commission precedent requiring entities seeking exemption from a moratorium to contribute the resource to serve the exemption customers at no cost to the utility.

In response, Cal-Am argued that the moratorium from the State Water Resources Control Board does not apply to new or expanded water customers in Sand City, such that no exemption is required. This is circular reasoning, however. The customers are not subject to the moratorium because the plant exists and is dedicated to serving the new customers. At issue here is whether existing customers, who are subject to the moratorium, should be allocated the costs of the plant that enables Sand City to be outside of the moratorium.

The Commission decisions relied on in the Scoping memo and cited above, however, stand for the proposition that customers subject to a service connection moratorium should not be required to incur costs to serve moratorium-exempt customers.³² Cal-Am provides no justification for its proposed deviation from Commission precedent, or a persuasive analysis supporting a change in Commission policy.

³¹ The scoping memo also observed the State Water Resources Control Board's frustration with Cal-Am's inability or unwillingness to focus on reducing its withdrawals from the Carmel River rather than on large projects which will also support customer growth. *See* Scoping Memo at 15.

³² *See* Hillview, D.06-01-055 and Citizens Utilities, D.89-12-020, cited *infra* note 20.

The most urgent need of Monterey District system is to reduce Carmel River withdrawals, and that is not the primary and permanent purpose of the Sand City Desalination Plant Lease. Moreover, allocating all plant costs to the entire District but designating 67% of the plant to serve customer growth only in Sand City is at odds with our cost allocation precedent. Consequently, we conclude that the Lease does not meet the water supply needs of the Monterey District.

6.2. Customer Interests

The scoping memo next noted that the price and risk allocation terms in the Amended Lease appeared to be less favorable for customers than the initial lease which the Commission rejected in 2009. The scoping memo stated that the costs allocated to customers had increased from about \$1 million a year to \$1.4 million, and that the proposed balancing accounts had the effect of shifting substantially all operating risk to ratepayers. The scoping memo observed that new Sand City customers, if served pursuant to Cal-Am's existing Monterey District tariff would be paying about \$1,800 per acre-foot but that the water supply which justified their connection would cost about \$4,833 per acre-foot for the first 15 years of the 31-year term of the Amended Lease.

Cal-Am responded that customers are served with consolidated rates, not supply-specific rates.

While consolidated rates is a general ratemaking principle, the supply circumstances in the Monterey District and particularly in Sand City are far from ordinary. Here, application of the general consolidated rates principle has the effect of requiring Monterey District customers outside of Sand City to subsidize moratorium-exemption customer growth in Sand City. Cal-Am has offered no instance where this Commission has previously authorized such cost allocation.

Similarly, Cal-Am offered no persuasive rationale for this Commission to adopt this novel cost allocation methodology. DRA expressed its “deep concern” with Cal-Am’s proposal to have existing Monterey District customers subsidize new customer growth in Sand City.

Using scarce Monterey District resources to subsidize customer growth in Sand City remains the primary purpose of the Amended Sand City Desalination Plant Lease. Extending the term of the Lease with much lower annual payments in years 15 through 31 has the effect of lowering the average annual Lease cost, but the additional 15-year commitment to produce 300 acre-feet of water annually regardless of cost, also greatly increases financial risk. Cal-Am argued that the Amended Lease should be evaluated by its average cost over the 31-year term, and not its ratemaking proposal which would have the actual \$850,000 a year lease payments for years 1 through 15 recovered immediately from customers, and then only \$7,000 per year for years 16 through 31. Although the price terms are not dispositive of our evaluation of the Amended Lease, due to the long term and much higher price proposed to be allocated to ratepayers immediately, we will consider the price terms of the Amended Lease based on the actual proposed ratemaking rather than a theoretical average.

Cal-Am next contends that its proposed balancing accounts are subject to Commission review and that its “good business practices” will provide sufficient incentive for careful cost control. Cal-Am argues that extending the term of the lease from 15 to 31 years, with annual lease payments reduced from \$850,000 in the first 15 years to only \$7,000 in the second 15 years, will create additional savings for customers.

The scoping memo, however, focused on Cal-Am’s expanded 31-year obligation to the City to produce 300 acre-feet/year of water regardless of cost,

which had been rejected by the Commission in the 2009 decision as creating excessive risk even when the obligation was limited to 15 years. Cal-Am offered no risk analysis in support of the term extension. DRA provided an analysis that showed Cal-Am facing a short-term supply deficit pending the Coastal Water Project being placed in service, and that Cal-Am had not fully evaluated all options to meet a short-term need.

6.3. Conclusion

The unreliable supply available pursuant to the Amended Lease contrasts to Cal-Am's unequivocal 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.

In fact, Cal-Am is obligated to incur costs that may effectively triple the costs of the water supply it will actually obtain to further its desired result-reduction in withdrawals from the Carmel River. Such cost allocation is not reasonable; it also means that Cal-Am's ratepayers would 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 to reduce Carmel River withdrawals, 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, we deny Cal-Am's request for approval of the Sand City Desalination Plant Lease. Other than as allowed below, 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 any existing memorandum or balancing accounts.

6.4. Paying for Water Delivered

As described above, the terms and conditions of the Sand City Desalination Plant Lease are not reasonable and prudent, and we deny Cal-Am's request to include the annual lease payments in revenue requirement and to

establish balancing accounts for the repairs, operations and maintenance, and purchased power costs.

Nevertheless, as strenuously and correctly argued by Cal-Am in comments on the proposed decision, the Plant is now and has been producing potable water for Cal-Am's Monterey District without compensation to Cal-Am. In those same comments, Cal-Am offered an alternative ratemaking proposal, with a substantially lower annual cost to Monterey District ratepayers. Based on that offer, we have developed a ratemaking approach to the Sand City Desalination Plant that treats the water produced by the plant as purchased water and compensates Cal-Am for water delivered at the price Cal-Am offered in its alternative ratemaking proposal. This ratemaking approach also allows Cal-Am to offer service to new customers in Sand City.

To the extent Cal-Am produces water at the Sand City Desalination Plant and delivers such water to the Monterey District system for use by District customers, we will allow Cal-Am to include the costs of the water so delivered in Monterey District revenue requirement for recovery from District ratepayers. Specifically, we authorize Cal-Am to file and serve a Tier 2 Advice Letter to establish the Sand City Desalination Plant Surcharge and the Sand City Desalination Plant Purchased Water Balancing Account. This surcharge shall be separately stated on Monterey District customers' bills. The balancing account shall be set to recover the annual cost of water delivered from the Sand City Desalination Plant and used to reduce the District's withdrawals from the Carmel River. Cal-Am may include in the balancing account only actual amounts of water delivered, measured in acre-feet, priced as described below.

The price for each acre-foot of water delivered shall be based on Cal-Am's alternative ratemaking proposal discussed above, shall assume plant production of 300 acre-feet per year, and shall be calculated as follows:

<u>Fixed cost</u>	\$414,672
<u>Escalated costs</u>	
Repair Costs	\$122,764
Other O&M	\$ 86,012
<u>Actual Purchased Power</u>	<u>\$156,374</u>
TOTAL	\$779,822

To calculate the price per acre-foot, plant production is assumed permanently to be 300 acre-feet per year for every year the plant produces water for delivery to the Cal-Am Monterey system.³³ The total of fixed, escalated, and actual costs will then be divided by 300 acre-feet to get a price in dollars per acre-foot. Here, for the initial year of the Sand City Desalination Plant Balancing Account, is \$779,822 divided by 300 acre-feet, resulting in a price per acre-foot of water delivered of \$2,599.

The fixed cost of \$414,672 is the annual amount Cal-Am offered in its alternative ratemaking proposal. It is based on the average cost of the Sand City Desalination Plant Lease over the 31-year duration of the Lease. As described above, however, we are unable to find the Lease reasonable and prudent so we do not rely on the Lease terms as the basis for that amount. Rather, we find that it is a reasonable proxy for fixed costs over the expected life of this plant. This

³³ Unless the plant production increases, then the amount must be increased.

amount is fixed for the expected 31-year duration of purchased water deliveries from the Sand City Desalination Plant to the Monterey District, and is not subject to review or revision in subsequent rate cases or other Commission proceedings.

One-sided risk allocation was another basis for today's decision denying approval of the Sand City Desalination Plant Lease. In its application, Cal-Am proposed balancing accounts to protect its shareholders from any cost increases guaranteed by the Lease. To equitably allocate this risk we will allow only the current estimates for repairs and other operations and maintenance costs, (\$122,764 and \$86,012), to be escalated annually and included in the price for the water delivered from the Plant for the 31-year term of the Lease. In this way, ratepayers will pay only escalated current costs and be shielded from the risk of unexpected cost increases brought about by the water production guarantee in the Amended Lease. Specifically, the price for water delivered from the Sand City Desalination Plant shall include the cost of repairs and other operations and maintenance expense as set forth in Cal-Am's alternative ratemaking proposal, (\$122,764 and \$86,012), escalated annually using the attrition year formula in Section VII of the Rate Case Plan in D.07-05-062 or its successor.

The price of water recorded in the Sand City Desalination Plant Purchased Water Balancing Account for water delivered to the Cal-Am Monterey District system from the Sand City Desalination Plant shall also include the actual cost of purchased power. The expected cost shall be forecasted in each general rate case and trued up annually to actual costs incurred via the Balancing Account.

As stated above, Cal-Am has incurred costs prior to today's decision and delivered water to the Monterey District. To compensate Cal-Am for these deliveries, Cal-Am is authorized to include in the Sand City Desalination Plant Purchased Water Balancing Account costs as specified below for water delivered

to the Monterey District system from the Sand City Desalination Plant prior to approval of the Surcharge, but only to the extent such costs were properly recordable in a memorandum or balancing account at the time they were incurred. Cal-Am shall include in its Advice Letter creating the Sand City Desalination Plant Purchased Water Balancing Account the actual monthly production from the Plant previously delivered to the Monterey District. Such production, measured in acre-feet, shall be priced at \$2,599 per acre-foot delivered. The resulting total cost for water delivered may be included in the Sand City Desalination Plant Purchased Water Balancing Account and amortized over a period of not less than twelve months, but only to the extent that the costs of providing that water were properly recordable in a memorandum or balancing account at the time they were incurred. Interest will accrue as specified for the memorandum or balancing account into which the costs were properly recordable for periods prior to the date of this decision.

Cal-Am must file and serve a special tariff for new or expanded water connections in Sand City for so long as the service connection moratorium established in D.11-03-048 remains in effect for the Monterey District. Cal-Am must file a Tier 2 Advice Letter and obtain Commission authorization for a Sand City Moratorium Exemption Service tariff no less than 180 days prior to the proposed date for commencing such service. The Sand City Moratorium Exemption tariff shall provide that service to new water connections in Sand City shall be subject to Cal-Am's Monterey District tariffs, with the exception that the water supply costs for such service shall be based on the actual costs of the Sand City Desalination Plant instead of Cal-Am's Monterey District average system supply costs. All other cost components of Cal-Am's Monterey District revenue requirement shall also be included in the cost tabulation for the Sand City

Moratorium Exemption tariff including water delivery system costs, overheads, cost allocation, and rate design as authorized by the Commission in the latest general rate case. To the extent water from the Sand City Desalination Plant is used to serve customers pursuant to the Sand City Moratorium Exemption Service tariff, that water production shall be excluded from the Sand City Desalination Plant Surcharge. In this way, the fraction of the Sand City Desalination Plant costs that corresponds to the share of water used to serve moratorium exception customers will be excluded from the costs allocated to the other customers in the Monterey District.

The Sand City Desalination Plant Surcharge and the Sand City Desalination Plant Purchased Water Balancing Account, in combination with the Sand City Moratorium Exception tariff, will enable Cal-Am to be reasonably compensated for its water deliveries to the Monterey District and to moratorium exception customers. These ratemaking treatments will result in rates that are just and reasonable as required by § 451, and supported by the record in this proceeding.

7. Connection Fees

The Amended Sand City Desalination Plant Lease shows that two governmental entities may contemplate imposing “connection charges” on new or expanded uses of water in Sand City by customers of Cal-Am. First, in Section 3(c) of the Sand City Desalination Plant Lease, the parties agree that the City of Sand City “may, in its sole discretion, charge connection fees, hookup charges, or similar fees or charges to new or expanded water uses.” The amount of any such charges is not specified, but all amounts collected will be turned over to Cal-Am, less an unquantified administrative fee.

Second, the Lease recites that: “the Monterey Peninsula Water Management District currently charges connection fees to new or expanded water connections within the Company’s service area.”³⁴ Cal-Am further asserts that these fees will total “close to \$6 million” and that payment of the fee “allows for the application for a water connection permit to the District.”³⁵ Cal-Am states that the connection fee is “paid to the District.” Cal-Am claims that prospective Cal-Am customers must apply to the District for a “water connection permit” and pay a “connection fee” based on “calculated annual consumption.” The record contains only the recital in the Amended Lease and Cal-Am’s description of the District’s “connection fee” and lacks any definitive evidence about the nature of the fee, or the legal basis for imposing it. Consequently, we will address Amended Lease Recital 15 only to the extent that Cal-Am and Sand City, the parties to the Amended Lease, might intend the recital to approve or validate the District’s “connection fees.”

In its response to the Assigned Commissioner’s Ruling, Cal-Am argues that the right ascribed to Sand City in Section 3(c) of the Lease to “in its sole discretion, charge connection fees, hookup charges or similar fees or charges to new or expanded water uses within City’s city limits,” and to remit any such collections to Cal-Am, is within the City’s “authority to impose fees as a precondition for the privilege of developing land.”³⁶ Cal-Am’s argument is at

³⁴ Amended Sand City Desalination Plant Lease, unnumbered 15th recital on page 2.

³⁵ *Id.* If Cal-Am’s representations regarding the District’s “connection fee” are accurate, this fee would increase the total cost of the Desalination plant to Monterey District customers by nearly 70%.

³⁶ Response to Assigned Commissioner’s Ruling at 27.

odds with the plain words of the Lease agreement, which link the fee to water service and not a building permit or development entitlement, and provide that the fee, minus an amount for administration, will be paid to Cal-Am.

Accordingly, we give Cal-Am's argument no weight, and focus on the actual terms of the Lease to evaluate the City's proposed connection fee.

The rates Cal-Am charges for public utility water service in its Monterey district are subject to the exclusive jurisdiction of this Commission pursuant to the California Constitution and Public Utilities Code. The California Courts have recognized that this Commission is "not an ordinary administrative agency, but constitutional body with far-reaching powers, duties and functions." Utility Consumers Action Network v. PUC, 120 Cal. App. 4th 644, 654 (2004). As set forth in the California Constitution, this Commission "may fix rates, establish rules, examine records, issue subpoenas, administer oaths, take testimony, punish for contempt, and prescribe a uniform system of accounts for all public utilities subject to its jurisdiction," Art. 12, § 6. The California Supreme Court has held that this Commission has the authority to fix just, reasonable, and sufficient rates to be charged by public utilities, and that the power to fix rates shall be liberally construed. Southern Cal. Edison v. Peevey, (2003) 31 Cal. 4th 781, 792. Local regulations that conflict with the Commission's regulations pursuant to statutory authority are void. Cal. Water & Telephone v. County of Los Angeles, (1967) 253 Cal. App. 2d 16, 27 (finding that county requirements for service, design, and construction of water facilities built by CPUC-regulated utilities conflict with the statutory jurisdiction of the Commission to establish standards for the design and construction of those facilities and are thus void).

Private corporations or persons that “own, operate, control, or manage a line, plant or system for the...furnishing of...water directly or indirectly to the public” are public utilities. Art. 12 § 3. Cal-Am is a public utility subject to the jurisdiction of this Commission.

Here, the California Constitution and Statutes (see, e.g., Pub. Util. Code § 454) have given the Commission authority to set public utility rates. The Commission has exercised that authority to set rates for public utility water service by Cal-Am in the Monterey District. Those rates do not include a connection fee, although connection fees can be and often are a component of a water utility’s authorized tariffs.³⁷

Cal-Am must provide public utility service in its Monterey District at its Commission-approved rates consistent with the precedent set forth in Cal. Water and Telephone v. County of Los Angeles, any inconsistent regulation of rates is void. Here, the connection fee purportedly authorized by Section 3(c) of the Lease would be collected from a Cal-Am Monterey District customer and then remitted to Cal-Am (minus an administrative charge); thus resulting in Cal-Am receiving a rate for public utility water service different from the Commission-authorized rate in Cal-Am’s Monterey District tariffs. That is not permissible. As discussed above, this Commission has the exclusive jurisdiction to fix rates for the provision of public utility water service in Cal-Am’s Monterey service area.

In light of the limited record concerning the Monterey Peninsula Water Management District’s “connection fee,” we are unable to address it in any

³⁷ To the extent Cal-Am believes that a connection fee would be useful in its Monterey District, Cal-Am should apply to the Commission for authorization to charge such a fee.

detail. However, we note that Amended Lease recital 15 regarding the Monterey Peninsula Water Management District's "connection fee," does not and cannot grant any authority to the District it does not otherwise have.

Today's decision does not address the authority the City of Sand City and any other governmental entities to charge fees to Monterey residents for building permits, development authorizations, or any other lawful purpose.

8. 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. To provide Cal-Am guidance on addressing Monterey District water supply, 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 strongly encourage Cal-Am to develop and implement cost-effective measures to meet the needs of its Monterey District customers. These measures are even more urgent now due to the Sand City Desalination Plant purchased water ratemaking adopted in today's decision. That ratemaking methodology results in a \$2,599 per acre-foot marginal cost of water supply. This cost, which greatly exceeds the cost of Cal-Am's existing supply, heightens the need for Cal-Am to use every available opportunity to ensure that these expensive water resources are used wisely.

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.³⁸

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.

³⁸ D.09-07-019, *mimeo* at 131 - 132.

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

Cal-Am'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;
- 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 may 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.

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.³⁹ As also noted above, in the 2009 decision we required that Cal-Am “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. The Commission will address the non-revenue water issue in the pending general rate case and issue any further directives to Cal-Am regarding opportunities to reduce non-revenue water and thereby reduce draws from the Carmel River in that proceeding.

9. Comments on the Proposed Decision and the Revised Proposed Decision

The original 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 September 7, 2011, and reply comments were filed on September 14, 2011.

³⁹ 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 (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.

The originally proposed decision did not provide Cal-Am with any recovery for its costs of operating the Sand City Desalination Plant. In opposition to the originally proposed decision, Cal-Am argued that water production from the Sand City Desalination Plant was a vital component of its Monterey District supply and that the water from the plant was the most cost-effective option available at the time Cal-Am entered into the Amended Lease. Cal-Am pointed out that the cost of the Sand City Desalination Plant is significantly lower than the average cost of the Regional Desalination Plant recently approved by the Commission. Cal-Am pointed to the requirements of the State Water Resources Control Board to reduce diversions from the Carmel River, and Commission's Water Action Plan as promoting investment in water supply and infrastructure. Cal-Am stated that it has in good faith operated the Desalination Plant for over year, producing water for the Monterey District at a cost of over \$1 million for which the proposed decision would deny all cost recovery.

DRA supported the originally proposed decision.

On December 10, 2011, the revised proposed decision 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 _____.

10. 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.

Findings of Fact

1. Cal-Am's Monterey District is and has been experiencing a water supply shortage.

2. In D.09-07-021, the Commission rejected the Sand City Desalination Plant Lease signed on November 5, 2007, between the City of Sand City and Cal-Am, for the Sand City Water Supply Project, a reverse osmosis desalinization facility with a projected annual capacity of 300 acre-foot per year that had been constructed by the City.

3. Thereafter, Cal-Am entered into the Amended Sand City Desalination Plant Lease which requires Cal-Am at its expense to produce 300 acre-feet per year of water regardless of cost.

4. Cal-Am is operating the Sand City Desalination Plant and has delivered water to the Monterey District for the use of District customers. Cal-Am's Monterey District revenue requirement does not include any of the costs of the Sand City Desalination Plant.

5. 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.

6. The reliable supply of water from the Sand City Desalination Plant available pursuant to the Amended Sand City Desalination Plant Lease to reduce Cal-Am's draw from the Carmel River is 94 acre-feet per year.

7. The Amended Sand City Desalination Plant Lease imposes all operating, maintenance, and capital replacement costs on Cal-Am.

8. The Amended Sand City Desalination Plant Lease exposes Cal-Am to significant operational and financial risk because Cal-Am must produce 300 acre-feet of potable water each year of the 31-year term regardless of cost.

9. The terms of the Amended Sand City Desalination Plant Lease do not meet the Monterey District system needs or serve existing District customer interests because, among other things, Cal-Am is obligated to produce 300 acre-feet per year of water but only has reliable access to 94 acre-feet per year.

10. Cal-Am's decision to deploy management and capital resources in pursuing the Sand City Desalination Plant lease was not reasonable and prudent.

11. 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 any memorandum account and its current general rate case, except as authorized in the Sand City Desalination Plant Purchased Water Balancing Account and Surcharge.

12. No evidentiary hearing was necessary for this proceeding.

13. Cal-Am proposed an alternative ratemaking treatment for costs of the Sand City Desalination Plant with \$414,677 included in revenue requirement each year of the 31-year term of the lease for the lease payments, and memorandum accounts or general rate case treatment for costs of operations and maintenance, repairs, and purchased power.

14. Cal-Am's proposed \$414,677 per year for the term of the Sand City Desalination Plant lease is a reasonable proxy for fixed costs over the expected life of the Plant.

15. The escalation rates for expense items in attrition years in Section VII of the Rate Case Plan adopted in D.07-05-062, or its successor, are reasonable escalation rates for current estimates of the operations and maintenance and repair expenses to be included in the Sand City Desalination Plant Purchased Water Balancing Account and Surcharge.

16. Amended Sand City Desalination Plant Lease Section 3(c) does not relate to the authority of the City of Sand City to issue building permits or development entitlements.

17. Amended Sand City Desalination Plant Lease Section 3(c) purports to authorize the City of Sand City to set and collect a connection or hook up fee for public utility water service in Cal-Am's Monterey District and then give the money collected, minus an administrative fee, to Cal-Am.

18. Amended Sand City Desalination Plant Lease recital 15 states that "the Monterey Peninsula Water Management District currently charges connection fees to new or expanded water connections with Company's service area."

19. The use of potable water for landscape irrigation is unreasonable in the Monterey District due to the severe supply restrictions.

20. 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 Sand City Desalination Plant Lease is not reasonable and prudent because it exposes Cal-Am to the significant operational and financial risk of producing 300 acre-feet of potable water each year of the 31-year term regardless of cost, and the Lease retains the authority to designate the bulk of the water production for new and expanded residential and commercial development in Sand City, rather than reduction of Cal-Am's withdrawals from the Carmel River.

2. 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 Sand City Desalination Plant Lease should be denied.

3. Cal-Am's request to establish balancing accounts to recover in the Monterey District revenue requirement the operating, maintenance, and repair costs of the Sand City Desalination Plant Amended Lease should be denied because the balancing accounts have the effect of transferring to customers all the operational risk of the Plant.

4. Cal-Am should remove all management and capital costs associated with the Sand City Desalination Plant from any existing ratemaking recovery requests, including but not limited to its existing memorandum account and its current general rate case and instead should recover costs of the Sand City Desalination Plant only through the specific ratemaking mechanisms authorized by today's decision.

5. Cal-Am should be authorized to collect a surcharge for the reasonable costs of water produced at the Sand City Desalination Plant and delivered to the Monterey District for the use of District customers.

6. The annual amount for lease payments offered by Cal-Am in the alternative ratemaking proposal is a reasonable proxy for the fixed costs of the Sand City Desalination Plant over the life of the plant.

7. Escalating current forecasts of repair and operations and maintenance costs is a sound ratemaking methodology to compensate Cal-Am for reasonable costs while at the same time protecting ratepayers from the financial risk inherent in Cal-Am's Amended Sand City Desalination Plant Lease.

8. The actual costs of electric power purchased from a Commission-regulated public utility are reasonable costs to be included in the price of purchased water from the Sand City Desalination Plant.

9. Cal-Am should be authorized to file a Tier 2 Advice Letter creating the Sand City Desalination Plant Purchased Water Surcharge and Sand City Desalination Plant Purchased Water Balancing Account.

10. No later than 180 days before providing service, Cal-Am should file a Tier 2 Advice Letter to create a Sand City Moratorium Exemption Service Tariff for any new water service connection provided in Sand City while Cal-Am's Monterey District service connection moratorium remains in effect. Water service provided under the Sand City Moratorium Exception Service Tariff shall include all amounts included in the Monterey District revenue requirement, with the exception that water supply costs shall be the actual costs incurred by Cal-Am for water production at the Sand City Desalination Plant in the 12 months immediately preceding the filing of the Advice Letter.

11. This Commission has exclusive authority pursuant to the California Constitution and the Public Utilities Code to fix the rates for public utility water service provided by Cal-Am in its Monterey District.

12. Amended Sand City Desalination Plant Lease Section 3(c) attempts to fix rates different than the rates approved by this Commission for public utility water service in Cal-Am's Monterey District, this intruding on this Commission's authority to fix rates, and is therefore void.

13. Amended Sand City Desalination Plant Lease recital 15 regarding the Monterey Peninsula Water Management District's "connection fee" does not and cannot grant any authority to the District that it does not otherwise have.

14. 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.

15. This decision should be effective today.

16. 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 (Cal-Am) decides to have a role in operating the Sand City Desalination Plant, Cal-Am 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, other than as authorized pursuant to the Sand City Desalination Plant Surcharge and the Sand City Moratorium Exemption tariff.

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 , other than as authorized

pursuant to the Sand City Desalination Plant Surcharge and the Sand City Moratorium Exemption tariff.

5. California-American Water Company must file and serve within 120 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 may 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. California-American Water Company is authorized to file and serve a Tier 2 Advice Letter establishing the Sand City Desalination Plant Purchased Water Surcharge. Such surcharge must provide for recovery of amounts properly recorded in the Sand City Desalination Plant Purchased Water Balancing Account, and shall apply to all volume tiers of service in systems subject to the service connection moratorium in D.11-03-048.

7. California-American Water Company is authorized to file and serve a Tier 2 Advice Letter establishing the Sand City Desalination Plant Purchased Water Balancing Account. Such balancing account must include the annual cost of water provided from the Sand City Desalination Plant and used to reduce the

Monterey District's withdrawals from the Carmel River subject to the limitations set forth below:

- a. Only costs for actual water delivered, measured in acre-feet, may be included.
- b. The price for each acre-foot of water delivered shall be determined annually. Below is the calculation for the first year of the Sand City Desalination Plant Purchased Water Balancing Account. The fixed cost and annual plant production amounts are permanently established; other amounts shown are subject to change, as specified below, in the ensuing years that the Plant produces water for delivery to the Monterey District system:

Fixed cost	\$414,672
Escalated costs	
Repair Costs	\$122,764
Other O&M	\$ 86,012
<u>Actual Purchased Power</u>	<u>\$156,374</u>
COST TOTAL	\$779,822

Annual Plant Production	300 acre-feet
Price per acre foot	\$ 2,599

Fixed Cost: this amount shall not change for each year of the 31-year contact, shall not be subject to further review, escalation, or modification, and may in no way be increased to reflect any other cost related to the Sand City Desalination Plant.

Escalated Costs: shall use the amounts specified above as the base amount for 2012 and may be annually escalated using the ratemaking formula for expense items in attrition years as set forth in Section VII of the Rate Case Plan in D.07-05-062 or its successor.

Actual Purchased Power: shall be forecasted in each general rate case and trued up annually to actual costs incurred.

Annual Plant Production: this amount shall not change for each year of the 31-year contract, shall not be subject to further review, modification, and may in no way be decreased to reflect any operational changes at the Sand City Desalination Plant, but this amount must be increased to reflect increased production at the Plant.

- c. Interest on all amounts properly recorded in the balancing account, less debits, shall accrue at the 90-day commercial paper rate as specified in Utility Standard Practice U-27-W (May 2008) or its successor.
- d. California-American Water may include in the balancing account all water delivered from and after the date of this decision.

8. California-American Water is authorized to include in the Sand City Desalination Plant Purchased Water Balancing Account \$2,599 per acre-foot for water delivered to the Monterey District system from the Sand City Desalination Plant prior to the effective of today's decision, to the extent such costs were properly recordable in a memorandum or balancing account at the time the costs were incurred. California-American Water Company must include in its Advice Letter creating the Sand City Desalination Plant Purchased Water Balancing Account an auditable accounting of the actual monthly water production from the Plant delivered to the Monterey District. Such production, measured in acre-feet, must be priced at \$2,599 per acre-foot delivered. The resulting total price for water delivered may be included in the Sand City Desalination Plant Purchased Water Balancing Account Surcharge and amortized over a period of not less than twelve months. For the period prior to the effective date of this decision, interest shall accrue as specified for the memorandum or balancing account in which the costs were properly recordable at the time they were

incurred, based on allowable costs of \$2,599 per acre-foot. From and after the effective date of this decision, the interest rate on such amounts shall be as specified for other amounts recorded in the Sand City Desalination Plant Purchased Water Balancing Account.

9. So long as the service connection moratorium established in Decision 11-03-048 remains in effect for the Monterey District, California American Water Company must file a Tier 3 Advice Letter and obtain Commission authorization for a Sand City Moratorium Exemption Service tariff no less than 180 days prior to the proposed date for commencing such service. The Sand City Moratorium Exemption tariff must provide that new service connections in Sand City shall be subject to California American Water's Monterey District tariffs, with the exception that the water supply price for such service shall be based solely on the actual costs of the Sand City Desalination Plant. To determine such actual costs, California American Water Company must include in its Advice Letter creating the Sand City Moratorium Exemption tariff an auditable accounting of the actual costs of water production at the plant for the 12 months immediately preceding the Advice Letter filing. Water delivery, other district system costs, overheads, cost allocation, and rate design, and all other requirements for Monterey District customers shall be as authorized by the Commission in the Monterey District's most recent general rate case. The Advice Letter filing shall include work papers and other supporting documents necessary to demonstrate the calculations of the Exemption tariff rate. To the extent water from the Sand City Desalination Plant is used to serve customers pursuant to the Sand City Moratorium Exemption Service tariff, that water production shall be excluded from the Sand City Desalination Plant Purchased Water Balancing Account and Surcharge.

10. Amended Sand City Desalination Plant Lease Section 3(c) is void and shall be of no force and effect.

11. Application 10-04-019 is closed.

This order is effective today.

Dated _____, at San Francisco, California.