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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](http://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](mailto: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](http://www.cpuc.ca.gov).

/s/ KAREN V. CLOPTON  
Karen V. Clopton, Chief  
Administrative Law Judge

KVC:rs6

Decision **PROPOSED DECISION OF ALJ BUSHEY**  
(Mailed 2/27/2013)

**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 AUTHORIZING FILING OF SAND CITY DESALINATION PLANT  
PURCHASED WATER BALANCING ACCOUNT AND SURCHARGE ADVICE  
LETTERS, AND APPROVING PARTIAL SETTLEMENT AGREEMENT**

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**DECISION AUTHORIZING FILING OF SAND CITY DESALINATION PLANT PURCHASED WATER BALANCING ACCOUNT AND SURCHARGE ADVICE LETTER, AND APPROVING PARTIAL SETTLEMENT AGREEMENT****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. However, 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) seeks 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, 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. *See* Decision (D.) 09-07-021 (summarized below).

**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 desalination facility with a projected annual capacity of 300 acre-feet per year. The Commission noted that the terms of the Amended 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. The Commission also stated that Cal-Am then estimated the annual costs for the Sand City Desalination Plant lease to be about \$1 million.

The Division of Ratepayer Advocates (DRA) opposed including the Sand City Desalination Plant Amended 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 Cal-Am had not evaluated the cost-effectiveness of the Sand City Desalination 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.”<sup>1</sup> 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.”<sup>2</sup> 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 did not limit costs Cal-Am must incur to fulfill its obligations to produce

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<sup>1</sup> D.09-07-021 at 64.

<sup>2</sup> *Id.* at 66.

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.<sup>3</sup>

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

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<sup>3</sup> *Id.* at 70.

Commission denied Cal-Am's application, but allowed Cal-Am to file a subsequent application justifying the amended price and risk terms.<sup>4</sup>

## **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.<sup>5</sup> 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 Amended 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.<sup>6</sup>

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.<sup>7</sup>

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.<sup>8</sup>

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<sup>4</sup> *Id.* at 70-71.

<sup>5</sup> The Amended Lease is Attachment A to the application.

<sup>6</sup> Schedule B to Amended Lease.

<sup>7</sup> Amended Lease at 4.

<sup>8</sup> *Id.* at 3.

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.<sup>9</sup> Cal-Am is also responsible for complying with all applicable legal, insurance, and contractual obligations, and bearing all costs of such compliance.<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup> 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 Additional Project Improvements is committed to Sand City’s sole discretion for “new and expanded water uses in Sand City.”<sup>13</sup>

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<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 6.

<sup>11</sup> *Id.* at 9-10.

<sup>12</sup> *Id.* at 10.

<sup>13</sup> *Id.* at 6.

In its new 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 Amended 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.<sup>14</sup> Cal-Am states that Generally Accepted Accounting Principles (GAAP) would require that the costs of the Amended Lease be spread evenly over the term of the Amended Lease, resulting in recognized lease costs of \$414,677 per year for the 31-year term of the Amended 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.”<sup>15</sup>

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 reflect actual expenditures to ensure recovery.<sup>16</sup> The second balancing account would be for capital replacements. Cal-Am proposes to include in revenue

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<sup>14</sup> 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.

<sup>15</sup> Testimony of Jeffery M. Dana at 4.

<sup>16</sup> *Id.* at 9.

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.<sup>17</sup>

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 Amended 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 imposed in a 2009 Cease and Desist Order 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 certain types of existing service

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<sup>17</sup> *Id.* at 7-8.

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.<sup>18</sup>

#### **2.4. Assigned Commissioner Ruling**

On September 30, 2010, the then-assigned Commissioner John Bohn issued a Ruling Setting Schedule for Completing Record in Cal-Am's new application. The ruling 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 by Cal-Am detailing how the Amended Lease is reasonable and prudent with respect to the particular subjects identified by Commissioner Bohn. 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 filings authorized by the ruling, the record would be complete and the proceeding submitted for resolution by the Commission.

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<sup>18</sup> D.11-03-048 at 27.

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.<sup>19</sup> 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. Under Commission precedent, the exception-seeker was required to contribute to the water utility the resource from which the new connections would be served and to provide surplus water supply for existing customers.<sup>20</sup>

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<sup>19</sup> The customers located in Sand City comprise only a small portion of Cal-Am's Monterey District ratepayers.

<sup>20</sup> See, e.g., 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)

*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. 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 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.

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(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").

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. Costs and Benefits**

Cal-Am alleges that the ruling contains factual inaccuracies regarding the issues and Cal-Am's decision to enter in the Amended Lease. First, 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 available to Cal-Am 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.<sup>21</sup> Cal-Am distinguishes its actions from Hillview and Citizens because the utilities in those cases asked the Commission to create new exceptions to existing moratoria. Cal-Am maintains that the moratorium does

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<sup>21</sup> 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.

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 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, and by giving Cal-Am access to the desalination plant for a greater portion of its expected useful life. Lastly, Cal-Am maintains that on the basis of its detailed cost analysis for the Amended Lease, 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 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; therefore, the Commission should not focus on specific provisions which may not benefit Cal-Am's Monterey District customers. Cal-Am asserts that the overall benefits of the Amended Lease outweigh any detriment from the accreditation of the 2009 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 charge contained in the Amended Lease is imposed by Sand City, which has the authority to impose such fees on those seeking to build or expand within the city.<sup>22</sup>

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<sup>22</sup> 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.

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 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. However, DRA agreed with Cal-Am's proposed ratemaking treatment of the initial \$850,000 lease payment and with Cal-Am's request to recognize continuing lease payments on a cash basis.

#### **5. Cal-Am Alternative Ratemaking Proposal**

A proposed decision (PD) on the Amended Lease was published on the August 4, 2011. In comments on the PD, Cal-Am presented an alternative ratemaking proposal to address concerns about the rate impact of the Amended Lease. The purpose of the alternative ratemaking proposal was to significantly reduce the initially requested annual revenue requirement. Cal-Am's proposal would use the average annual lease payment, \$414,677, over

the 31-year duration of the Amended 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.” 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.” Repair costs could also be recorded in a memorandum account, or set in a general rate case.

On December 2, 2011, a revised PD was mailed which accepted portions of Cal-Am’s ratemaking alternative in fashioning a cost recovery approach for water produced at the Sand City Desalination Plant and delivered to the Monterey District as if this were purchased water.

## **6. Reopened Record on Price for Purchased Water**

On February 3, 2012, the assigned Commissioner issued an amended scoping memo setting aside submission and allowing the parties to submit additional information on the issue of the appropriate price for purchased water from the Sand City Desalination Plant.

On March 2, 2012, DRA served testimony of witness Rauchmeier. The testimony explained that after DRA filed its comments on the original PD, Cal-Am had announced that it would not proceed with the proposed Regional Desalination plant. This change in facts caused DRA to conclude that the water to be available from the Sand City Desalination Plant would benefit the Monterey system and that the revised PD’s value of \$2,599 per acre-foot was reasonable. Witness Rauchmeier arrived at this conclusion by comparing this

price to new water supply options or conservation programs and concluding that the revised PD's suggested price fell within the range of prices for Cal-Am's alternatives.<sup>23</sup>

On March 16, 2012, DRA served reply testimony of witness Aslam which further supported DRA's recommendation that the Commission reject the Amended Lease for the plant. Witness Aslam explained that Cal-Am has not performed sufficient analysis or due diligence in assessing the Amended Lease to justify a Commission finding that the Lease was necessary or cost effective.

On March 2, 2012, Cal-Am served supplemental testimony of its witnesses, Sabolsice, Dana, and Stephenson. The testimony included a request to increase the annual costs of the plant to reflect a new item, possessory interest property taxes, of \$61,749, and to show an increase in power costs. Cal-Am opposed a new tariff for new service connections in Sand City and argued that the new customers would result in lower costs for all customers in the Monterey District.

On March 30, 2012, the City of Sand City filed comments summarizing the evidentiary presentation by DRA and Cal-Am and concluding that the record showed Cal-Am made a prudent decision in entering into the Amended Lease.

On August 15, 2012, Cal-Am and DRA filed and served their settlement agreement on the price for purchased water and Cal-Am's programs to reduce the use of potable water for landscape irrigation in the Monterey District. The settlement agreement is Attachment A to today's decision. The settlement agreement requests that the Commission authorize Cal-Am to include in the Monterey District revenue requirement water delivered from the Sand City

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<sup>23</sup> No hearings were held. The Cal-Am and DRA testimony are included in the record, having been filed and served pursuant to the February 3, 2012, Scoping Memo.

Desalination Plant priced at \$2,599 acre-foot through Cal-Am's next general rate case. The settlement agreement further provides that the Commission will review Cal-Am's variable operating costs for the plant in the next general rate case and may revise the price for water delivered. In the settlement agreement, Cal-Am agrees to include in its next general rate case application a report on programs it has instituted and other efforts to reduce the use of potable water for landscape irrigation in the Monterey District.

## **7. 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 long-standing, 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."<sup>24</sup> Below we evaluate each issue set forth in the scoping memo and

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<sup>24</sup> D.09-07-021 at 64.

determine that Cal-Am has not demonstrated that the Sand City Desalination Plant Amended lease will provide additional water supply to the Monterey District at the lowest reasonable costs. Therefore, we deny approval of the Amended 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 below, we build on the alternative ratemaking proposal put forward by Cal-Am and using the provisions of the parties' settlement agreement, develop a purchased water ratemaking methodology to provide Cal-Am reasonable compensation for water delivered to the Monterey system.

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

### **7.1. 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.<sup>25</sup>

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<sup>25</sup> "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.

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's new and expanded customer demand over the 31-year term of the Amended 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 original term and to an even greater degree the current 31-year term, are subject to substantial unpredictability. 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.<sup>26</sup> 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 31.3% 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 31.3% is temporary and unpredictable.

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<sup>26</sup> Cal-Am Response to Assigned Commissioner Ruling at 17.

The scoping memo directed Cal-Am to justify expending District staff and capital resources on a project where only 31.3% of the output goes 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 of the Sand City Desalination Plant output will go toward reducing withdrawals from the Carmel River, and not to new development in Sand City.<sup>27</sup>

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 Desalinization 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 Desalinization 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.<sup>28</sup>

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<sup>27</sup> Cal-Am Response to Assigned Commissioner Ruling at 13 – 14.

<sup>28</sup> D.09-07-021 *mimeo* at 65 – 66.

Cal-Am's presentation in this proceeding does not answer the concerns we raised in 2009 regarding the original lease, the essential terms of which live on in the Amended Lease. Since 1995, Cal-Am has been subject to an obligation to reduce its withdrawals from the Carmel River. Cal-Am must deploy its Monterey District resources efficiently and effectively to meet this obligation. The primary purpose of the 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.

The scoping memo next directed Cal-Am to address Commission precedent requiring entities seeking an exception from a moratorium to contribute the resource to serve the exception 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 exception 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 stand for the proposition that customers subject to a service connection moratorium should not be required to incur costs to serve moratorium-exception customers.<sup>29</sup> Cal-Am provides no justification for its proposed deviation from

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<sup>29</sup> See Hillview, D.06-01-055 and Citizens Utilities, D.89-12-020, cited note 20.

Commission precedent, or a persuasive analysis supporting a change in Commission policy.

The most urgent need for Cal-Am is to reduce its Carmel River withdrawals, and that is not the primary and permanent purpose of the Sand City Desalination Plant. Moreover, allocating all plant costs to the entire Monterey District but designating 68.7% of the plant to serve customer growth only in Sand City is at odds with our cost allocation precedent. Consequently, we conclude that the Amended Lease does not effectively or efficiently meet the water supply needs of the Monterey District.

## **7.2. Customer Interests**

The scoping memo noted that the price and risk allocation terms in the Amended Lease appeared to be less favorable for customers than those of 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 we often use consolidated rates, the supply circumstances in the Monterey District, and particularly in Sand City, are far from ordinary. Here, use of consolidated rates would require, in effect, that Monterey District customers outside of Sand City subsidize moratorium-exception customer

growth in Sand City. Similarly, Cal-Am had not cited precedent or offered a persuasive rationale for this Commission to adopt this perverse cost allocation methodology. For existing Monterey District customers to subsidize new customer growth in Sand City despite the water supply constraints affecting the district is unacceptable.

Using Cal-Am's scarce Monterey District resources to subsidize customer growth in Sand City is equally unacceptable. It is true that extending the term of the Amended 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 next contends that its proposed balancing accounts are subject to reasonableness review and will, therefore, provide sufficient incentive for careful cost control. Cal-Am also argues that extending the term of the Amended 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. Thus, Cal-Am believes the risks and benefits to customers are improved under the Amended Lease.

However, we find that neither the balancing accounts nor the lower payments over the last 15 years effectively mitigates the risk arising from the Amended Lease's 31-year obligation to Sand City to produce 300 acre-feet/year of water regardless of cost of production. The Commission in D.09-07-021 found such operating risk excessive risk even when the obligation was limited to 15 years. Cal-Am offered no risk analysis in support of the term extension.

**7.3. Conclusion**

The unreliable supply available pursuant to the Amended Lease contrasts with Cal-Am's unrestricted commitment to provide 300 acre-feet per year of water, and to bear all related 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 or 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, namely, 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 system the water re-directed to new or expanded uses in Sand City.

In addition, 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 Amended 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.

#### **7.4. Paying for Water Delivered**

For reasons described above, we deny Cal-Am's request to include the annual lease payments in revenue requirement and to establish balancing accounts for repair, operation and maintenance, and purchased power costs.

Nevertheless, the Desalination Plant is now and has been producing potable water for Cal-Am's Monterey District without compensation to Cal-Am. Besides the Amended Lease, 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,<sup>30</sup> we will allow Cal-Am to include the costs of the water so delivered in Monterey District revenue requirement. Specifically, we authorize Cal-Am to file and serve Tier 2 Advice Letters to establish the Sand City Desalination Plant Surcharge and to incorporate into its tariffs the Sand City Desalination Plant Purchased Water Balancing Account as authorized by today's decision. This

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<sup>30</sup> Other than customers served pursuant to the Sand City exception tariff discussed below.

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 and priced as described below.

The price for each acre-foot of water delivered shall be based on Cal-Am’s alternative ratemaking proposal, 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 ÷ 300 af = \$2,599/af

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.<sup>31</sup> The total of fixed, escalated, and actual purchased power costs will then be divided by 300 acre-feet to get a price in dollars per acre-foot. As provided in the settlement agreement for water deliveries in 2012 or prior, Cal-Am may record in the Sand City Desalination Plant Balancing Account the amount of such water deliveries priced at \$2,599 per

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<sup>31</sup> Unless the plant production increases, then the amount must be increased.

acre-foot of water delivered so long as such costs were properly recorded in a memorandum account.

The fixed cost of \$414,672 is the annual amount Cal-Am offered in its alternative ratemaking proposal, and is carried through in the settlement agreement. It is based on the average cost of the Amended Lease over the 31-year duration. As described above, however, we are unable to find the Amended Lease reasonable and prudent so we do not rely on the Amended lease terms as the basis for that amount. Rather, we find that this price is consistent with DRA's testimony on the cost of alternatives for Cal-Am and it is a reasonable proxy for fixed costs over the expected life of this plant. This 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 Amended Lease. In its application, Cal-Am proposed balancing accounts to protect its shareholders from any cost increases guaranteed by the Amended Lease. The settlement agreement provides that variable costs will be subject to future Commission review to ensure that only just and reasonable costs, as required by § 451, are included in the price for water delivered from the Sand City Desalination Plant. Although we approve this component of the settlement agreement, our approval is also limited by our determination that the cost allocation terms of the Amended Lease are not reasonable or prudent. This additional limitation applies to the overall price for the purchased water from the Sand City Desalination plant and is necessary to shield ratepayers from the risk of unexpected cost increases brought about by the water production guarantee in the Amended Lease.

Specifically, as set forth above, the cost allocation terms of the Amended Lease require Cal-Am to produce water at the plant regardless of cost. One of the purposes of our use of the purchased water proxy is to leave the operational cost risk with shareholders, and to protect ratepayers from assuming Cal-Am's guarantee of production regardless of cost. In D.09-07-021, the Commission rejected Cal-Am's proposal to allocate to ratepayers the operational risk of its commitment to produce 300 acre-feet of water per year regardless of cost. Here, the settlement agreement provides for the Commission to review the operating costs to ensure that only just and reasonable costs are included in the variable cost component of the purchased water price. We emphasize that such review could result in disallowance of specific costs or even a determination that the price of purchased water from the Sand City Desalination Plant has become uneconomic due to cost increases, and that no further such purchases should be funded by Monterey District ratepayers. Retaining the option to disallow costs or cease purchases from the Sand City Desalination Plant is necessary to ensure that shareholders, and not ratepayers, remain responsible for the water production operational risk accepted by Cal-Am in the Amended Lease.

Accordingly, recognizing that today's decision grants no guarantee to Cal-Am that Monterey District ratepayers will purchase water produced at the Sand City Desalination Plant regardless of cost of production, we find that the settlement agreement provisions for fixed and variable costs are reasonable in light of the whole record, consistent with the law, and in the public interest as required by Rule 12.1(d).

The settlement agreement provides that 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 will include the actual cost of purchased power. The expected cost will be forecasted in each general rate case and trued up annually to actual costs incurred via the balancing account. We find that the settlement agreement provision for actual purchased power costs is reasonable in light of the whole record, consistent with the law, and in the public interest as required by Rule 21.1(d).

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, the settlement agreement provides that Cal-Am should be authorized to include in the Sand City Desalination Plant Purchased Water Balancing Account costs as specified in today's decision 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 incurred after April 2010 and were tracked in Cal-Am's Cease and Desist order memorandum account. Cal-Am shall include in its Advice Letter incorporating into its tariff the Sand City Desalination Plant Purchased Water Balancing Account the actual monthly production, measured in acre-feet, and be priced at \$2,599 per acre-foot delivered. Any costs in excess of \$2,599 per acre-foot are disallowed for rate recovery and must be removed from the memorandum account. 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. 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. This final pricing provision of the settlement agreement is also reasonable in light of the whole record, consistent with the law, and in the public interest as required by Rule 12.1(d).

Turning now to tariff issues not addressed in the settlement agreement, we conclude that Cal-Am must file and serve a special tariff for new or expanded water connections in Sand City. The special tariff must remain in effect 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 for a Sand City Moratorium Exception Service tariff no less than 180 days prior to the proposed date for commencing such service. The Sand City Moratorium Exception tariff will provide that service to new water connections in Sand City will be subject to Cal-Am's Monterey District tariffs, with the exception that the water supply costs for such service will be based on the actual per acre-foot costs of the Sand City Desalination Plant instead of Cal-Am's Monterey District average system supply costs.<sup>32</sup> All other cost components of Cal-Am's Monterey District revenue requirement will also be included in the cost tabulation for the Sand City Moratorium Exception tariff including water delivery system costs, overheads, cost allocation, and rate design as authorized by the Commission in the latest Monterey District general rate case.

To the extent water from the Sand City Desalination Plant is used to serve customers pursuant to the Sand City Moratorium Exception Service tariff, that water production will be excluded from the Sand City Desalination Plant Purchased Water Balancing Account and 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

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<sup>32</sup> The actual plant costs may differ from the purchased water price Cal-Am is authorized to book to the Sand City Desalination Plant Purchased Water Balancing Account.

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. The settlement agreement pricing provisions for fixed and variable, purchased power, and memorandum account costs including interest, are reasonable in light of the whole record, consistent with the law, and in the public interest as required by Rule 12.1(d).

#### **8. 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 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 Amended 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."<sup>33</sup> Cal-Am asserts that these fees will total "close to \$6 million," that payment of the fee "allows for the application for a water connection permit to the [Water Management] District," and that the connection fee is "paid to the [Water Management] District."<sup>34</sup> Cal-Am claims that prospective Cal-Am customers must apply to the Water Management 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 (*see* section 2.4 of today's decision), 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

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<sup>33</sup> Amended Sand City Desalination Plant lease, unnumbered 15th recital at 2.

<sup>34</sup> *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%.

land.”<sup>35</sup> We will focus our analysis on Cal-Am tariffs for water service in its Monterey District to evaluate the proposed connection fee.

As a public utility subject to the Commission’s jurisdiction, the rates Cal-Am charges for public utility water service in its Monterey District are also 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).

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<sup>35</sup> Response to Assigned Commissioner’s Ruling at 27.

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.<sup>36</sup>

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, and any inconsistent regulation of rates is void. Here, the connection fee purportedly authorized by Section 3(c) of the Amended 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.

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

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<sup>36</sup> 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.

## 9. Further Directives to Reduce Carmel River Withdrawals

As indicated above, the Sand City Desalination Plant Amended 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<sup>37</sup> in its last Monterey District general rate case, D.09-07-021 at pages 11-12, 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

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<sup>37</sup> American Water, referred to in the quoted passage from D.09-07-021, is the parent company of Cal-Am.

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 D.09-078-021, we singled out the use of potable water for landscape irrigation as unreasonable in the Monterey District due to the severe supply restrictions, and we 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.<sup>38</sup>

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

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<sup>38</sup> D.09-07-021, *mimeo* at 131 - 132.

unreasonable use of potable water. In this settlement agreement, Cal-Am agrees to submit a detailed report in its next general rate case on the programs it has instituted and other efforts to reduce the use of potable water for landscape irrigation in the Monterey District.

We strongly support this provision of the settlement agreement and encourage Cal-Am to provide the leadership urgently required to reduce the use of potable water for landscape irrigation in the Monterey District.

In its work to achieve this goal, Cal-Am should consider 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. Developing target levels of additional alternative sources of irrigation water or reduced demand of potable water for landscape irrigation;
- c. Establishing a comprehensive customer education plan to inform customers that the use of potable water for landscape irrigation is disfavored, will be subject to increasing restrictions and higher prices, and ultimately may be prohibited;
- d. Enlisting assistance from community gardening groups or the University of California Cooperative Extension Service; and
- e. Creating innovative programs, projects, pilots, experiments, or other measures that may be reasonably designed to reduce the use of potable water for landscape irrigation.

Today's decision provides us an opportunity to further our goal of discouraging the use of potable water for landscape irrigation by applying the Sand City Desalination Plant Surcharge only to water service being used for

landscape irrigation. The resulting higher cost will create a financial disincentive to use potable water for landscape irrigation. We, therefore, direct that the Sand City Desalination Plant Surcharge apply only to volumetric service provided in the top two rate tiers or pursuant to landscaping irrigation tariff. Our purpose in applying the surcharge to these limited types of service is to lead to ratepayers to use less potable water, especially expensive desalinated water, for landscape irrigation.

#### **10. Comments on Proposed Decisions**

The original proposed decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties on August 4, 2011, and the revised proposed decision was mailed for comment on December 2, 2011. Parties filed comments and reply comments on both proposed decisions. The second proposed decision was mailed to 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 \_\_\_\_\_, 2013, and reply comments were filed on \_\_\_\_\_, 2013 by \_\_\_\_\_.

#### **11. 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 of production.

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 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 production 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 expense 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 \$414,672 included in revenue requirement each year of the 31-year term of the Amended 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 \$414,672 per year for the term of the Sand City Desalination Plant Amended Lease is a reasonable proxy for fixed costs over the expected life of the Plant.

15. Cal-Am and DRA entered into a settlement agreement that resolved the price for purchased water from the Sand City Desalination Plant, and the settlement agreement is reproduced at Attachment A to today's decision.

16. The settlement agreement provided for (1) a fixed cost component of \$414,672 per year for each year of the term of the Amended Lease, and (2) an initial surcharge shall be based on a price per acre-foot of \$2,599 for water delivered.

17. The settlement agreement provided that the Commission will review variable costs for the Sand City Desalination Plant in future general rate cases to ensure that only just and reasonable costs are included.

18. The settlement agreement provided that actual purchased power costs will be recorded in the balancing account.

19. The settlement agreement provided that Cal-Am may include in the Sand City Desalination Plant Purchased Water Balancing Account \$2,599 per acre-foot for water delivered to the Monterey District after April 2010 and prior to the effective date of today's decision so long as such costs were recorded in the Cease and Desist memorandum account.

20. The settlement agreement provided that Cal-Am will submit a report on its efforts to reduce the use of potable water for landscape irrigation in its next general rate case.

21. 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.

22. 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.

23. 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."

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

25. 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 Amended 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 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 expense and capital costs associated with the Sand City Desalination Plant from any existing ratemaking recovery requests, 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. Allowing the Commission to review future variable costs of operating the Sand City Desalination Plant for inclusion in the price for purchased water delivered from the Plant, and not guaranteeing any such purchases unless the resulting price is just and reasonable, 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. The settlement agreement is reasonable in light of the whole record, consistent with the law, and in the public interest as required by Rule 12.1(d) of the Commission's Rules of Practice and Procedure.

10. The settlement agreement should be approved.

11. The Sand City Desalination Plant Purchased Water Balancing Account should be authorized. Cal-Am should file Tier 2 Advice Letters creating the Sand City Desalination Plant Purchased Water Surcharge and incorporating into its tariffs the Sand City Desalination Plant Purchased Water Balancing Account.

12. The Sand City Desalination Plant Surcharge should apply only to volumes delivered under the top two service tiers or pursuant to a landscape irrigation tariff.

13. No later than 180 days before providing service, Cal-Am should file a Tier 2 Advice Letter to create a Sand City Moratorium Exception Service Tariff for any new water service connection provided in Sand City while Cal-Am's Monterey District service connection moratorium is in effect. 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 per acre-foot 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.

14. 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.

15. 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.

16. 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 Water Management District that it does not otherwise have.

17. 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.

18. This decision should be effective today.
19. Application 10-04-019 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 include a verified statement in its next general rate case application 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 Exception tariff.
4. No later than 45 days after the effective date of this order, California-American Water Company must file and serve a Tier 1 compliance advice letter containing a 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 or application, other than as authorized pursuant to the

Sand City Desalination Plant Surcharge and the Sand City Moratorium Exception tariff.

5. The settlement agreement between California-American Water Company and the Division of Ratepayer Advocates, included as Attachment A to today's decision, is approved and the parties must comply with its terms. The pricing terms of the settlement agreement are set forth below.

6. As specified in the settlement agreement, California-American Water Company must in its next general rate case application submit a report on the programs it has instituted and other efforts to reduce the use of potable water for landscape irrigation in the Monterey District.

7. 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 the top two tiers of service or landscape irrigation tariff service in systems subject to the service connection moratorium in Decision 11-03-048.

8. California-American Water Company (Cal-Am) is authorized to establish the Sand City Desalination Plant Purchased Water Balancing Account and to file and serve a Tier 2 Advice Letter to incorporate the Account into its tariffs. The Balancing Account shall reflect a forecasted amount of water to be delivered from the Sand City Desalination Plant, subject to annual adjustment to reflect actual water delivered. The price for water delivered and used to reduce the Monterey District's withdrawals from the Carmel River shall be determined as set forth below:

- a. The price for actual water delivered, measured in acre-feet, may be included, so long as the price remains just and reasonable.
- b. The initial price for each acre-foot of water delivered is \$2,599 per acre-foot. The fixed cost and annual plant production amounts are permanently established; variable costs are subject to change in the next general rate case, with actual purchased power costs included:

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

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

Fixed Cost: this amount shall not change for each year over the period of time water is purchased and delivered to the Monterey District for use by District customers, 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.

Variable Costs: shall use the amounts specified above as the base amount for 2012 and these amounts may be revised by the Commission in subsequent general rate cases.

Actual Purchased Power: shall be forecasted in each general rate case and trued up annually to actual costs incurred as part of the balancing account adjustment to reflect actual water deliveries.

Annual Plant Production: this amount shall not change for each year over the period of time water is purchased and delivered to the Monterey District for use by

District customers, 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. Cal-Am may include in the balancing account all water delivered from and after the date of this decision where the Commission has determined that the price for such water deliveries is just and reasonable. Should actual production costs at the Sand City Desalination Plant become unreasonable, the Commission may order any unreasonable costs excluded from the price tabulation, cease water purchases from the Plant, or take other such actions as may be necessary to ensure that ratepayers do not bear the unreasonable costs.

9. California-American Water Company (Cal-Am) 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 recorded in the Cease and Desist memorandum account at the time the costs were incurred. Cal-Am must include in its Advice Letter incorporating the Sand City Desalination Plant Purchased Water Balancing Account into its tariffs 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 cost 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. Any costs in excess of \$2,599 per acre-foot are disallowed for ratemaking recovery and must be removed from the memorandum account. 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.

10. California-American Water Company (Cal-Am) must file a Tier 2 Advice Letter for a Sand City Moratorium Exception Service tariff. Such tariff shall apply to new service connections in Sand City so long as the service connection moratorium established in Decision 11-03-048 remains in effect for the Monterey District, and must be filed no less than 180 days prior to the proposed date for commencing such new service. The Sand City Moratorium Exception tariff must provide that new service connections in Sand City shall be subject to Cal-Am's Monterey District tariffs, with the exception that the water supply price for such service shall reflect the actual costs of the Sand City Desalination Plant. Cal-Am shall use its best efforts to determine such actual costs and may use reasonable simplifying assumptions in creating the Sand City Moratorium Exception tariff. Such tariff may use a surcharge rate methodology and must include work papers and other supporting documents necessary to demonstrate the reasonableness of the calculations of the Exception tariff rate. To the extent water from the Sand City Desalination Plant is used to serve customers pursuant to the Sand City Moratorium Exception Service tariff, that water production volume

shall be excluded from the Sand City Desalination Plant Purchased Water Balancing Account and Surcharge.

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

12. Application 10-04-019 is closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.

# **ATTACHMENT A**

CITY OF SAND CITY

and

CALIFORNIA-AMERICAN WATER COMPANY, INC.

**AMENDED AND RESTATED LEASE AGREEMENT**

Dated as of 10/30, 2009

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SCHEDULE X  
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Definitions  
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 Basic Rent  
 Acceptance Testing Protocols

THIS AMENDED AND RESTATED LEASE AGREEMENT, dated as of 10/30, 2009 (the "Amended Lease"), is between the CITY OF SAND CITY, a municipal corporation (the "City"), having an address at City Hall, 1 Sylvan Park, Sand City, CA 93955, as City, and CALIFORNIA-AMERICAN WATER COMPANY a California corporation (the "Company"), having an address at 1033 B Avenue, Suite 200, Coronado, CA 92118. City and Company are hereinafter sometimes referred to collectively as the "Parties".

RECITALS :

WHEREAS, pursuant to Section 9 of Article XI of the California Constitution and the general municipal laws of the State of California and City's other general authority and power, City has undertaken to construct a reverse osmosis desalination facility (the "Project") with a projected annual production capacity of three hundred (300) acre-feet per year to better serve the needs of its inhabitants for potable water; and

WHEREAS, City desires to enter into an operating lease (within the meaning of GAAP) with Company to maintain and operate the Project; and

WHEREAS, Company is the certificated water purveyor for the Monterey Peninsula, including, but not limited to, the City of Sand City.

WHEREAS, the parties wish to set forth their relationship which will enable the operation of the Project, in furtherance of the corporate purposes of the City.

WHEREAS, Company and City entered into the original Lease for the operation the Project on November 9, 2007;

WHEREAS, the California Coastal Commission acted in April of 2005 to approve the issuance of a Coastal Development Permit for the Project;

WHEREAS, the Monterey Peninsula Water Management District acted in October of 2007 to approve issuance of Water Distribution System permits necessary for the operation of the Project in the manner contemplated by this Lease;

WHEREAS, the California Coastal Commission acted in February of 2008 to approve amendments to the Coastal Development Permit necessary for the Project to be operated by Company in the manner contemplated by this Lease;

WHEREAS, the Coastal Development Permit ("CDP") issued by the California Coastal Commission for the development of the Project, limits the Project to the production of no more than 300 acre feet per year of potable water.

WHEREAS, the time to challenge the approval of the Coastal Development Permit and Water Distribution Permits approved for the Project has expired;

WHEREAS, the Coastal Development Permits and Water Distribution Permits approved for the Project have been issued;

WHEREAS, Company has identified a need for water supplies that exceed the existing term of the Lease;

WHEREAS, City desires the Project to be operated over a longer term than originally agreed in the Lease;

WHEREAS, Company has paid the first two rent payments of \$850,000 due under the Lease;

WHEREAS, the Monterey Peninsula Water Management District currently charges connection fees to new or expanded water connections within Company's service area;

WHEREAS, City and Company desire to continue to have an operating lease within the meaning of GAAP to maintain and operate the Project;

NOW, THEREFORE, City and Company hereby agree, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged and agreed, one to the other, as follows:

1. Demise; Assignment of Water Rights.

(a) In consideration of the agreements and provisions of this Lease, City hereby grants, demises and lets to Company, and Company hereby leases from City, subject to the terms and conditions hereinafter set forth and for the Term as described in Article 2 hereof, all of City's right, title and interest in the Land Parcel and the Project Improvements as of the Basic Term Commencement Date, which includes all tangible equipment and personal property described in or contemplated by the Approved Plans, or now or hereafter constructed or placed on, affixed or appurtenant to, or used in connection with, the Project and the Land Parcel, together with any and all accessions, additions, improvements, substitutions and replacements thereto or therefor, (all of the foregoing, collectively, the "Leased Property"). As further reflected in the Approved Plans, the Project Improvements include, but are not limited to (i) offsite extraction wells, pumps and feed-water pipelines, (ii) the reverse osmosis desalination facility, (iii) a concentrate discharge pipeline and related blending station, (iv) a horizontal injection well adjacent to the beach, (v) a backup electrical power generator, and (vi) a pipeline connection between the desalination facility and the Company's transmission main located at the intersection of Catalina and Olympia Streets. During the Term, Company shall have: (i) an exclusive right to occupy and possess the Land Parcel and all Project Improvements installed thereon for the purposes described in this Lease; (ii) an exclusive right to use all Project Improvements not located on the Land Parcel; and (iii) a non-exclusive right to use and possess any rights-of-way where the Project Improvements are installed outside of the Land Parcel for the purposes described in this Lease.

(b) In addition to the demise of the Leased Property, City hereby assigns to Company, for as long as the Lease remains in effect, that portion of City's rights under the Final Decision entered in California American Water vs. City of Seaside, et al (Superior Court Case No. M66343, Monterey County) to produce brackish water from the Aromas Sands formation of the Seaside Groundwater Basin which is necessary to produce no more than 300 acre feet of potable water each year.

2. Term.

(a) Subject to the provisions hereof, Company shall have and hold the Leased Property for a term (the "Basic Term") which shall begin on the Basic Term Commencement Date and continue for thirty-one (31) years, unless sooner terminated or extended as hereinafter provided. Prior to the Basic Term, it is contemplated this agreement shall be deemed to be a binding agreement by City and Company to commence the Lease on the Basic Term Commencement Date, subject to the terms hereof.

(b) Twelve (12) months prior to the expiration of the Basic Term, the Parties shall meet and confer to discuss the operation of the Project Improvements at the conclusion of the Basic Term.

(c) Notwithstanding any other provision of this Lease, at Company's sole option, this Lease may be terminated if the Basic Term Commencement Date does not occur prior to December 31, 2009 (the "Outside Date").

(d) Notwithstanding any other provision of this Lease, either City or Company may terminate this Lease prior to the Basic Term Commencement Date if, after both Parties have used their best efforts to secure such entitlements, either City or Company have not obtained all government approvals necessary to construct or operate the Project Improvements.

3. Rent.

(a) Company shall pay the rent provided for in Schedule B (as the same may be amended, modified, supplemented or replaced from time to time pursuant to the terms of this Lease) annexed hereto ("Basic Rent"), on the dates and in the amounts therein set forth, to City, by check to City's address or by bank wire transfer or electronic funds transfer of immediately available funds to any place within the continental United States to which bank wire or electronic funds transfers can be made as City may from time to time designate to Company in writing at least ten (10) days prior to the applicable payment date.

(b) Company shall not be obligated to pay any rent other than Basic Rent, it being agreed that this is not a "net lease." Company will, however, be directly responsible for paying its costs of operating and maintaining the Leased Property, including costs relating to materials, supplies, cleaning, maintenance, routine repairs, liability insurance and utilities.

(c) The Parties agree that City may, 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. If City chooses to impose such fees or charges, then such fees or charges, less a reasonable administration fee, shall be paid to Company within 15 days of the end of the calendar month such charge or fee was collected to Company. Company shall apply such fee in the manner directed by the CPUC.

4. Use. Company may only use the Leased Property as a desalination facility. Company shall operate the Leased Property, consistent with Prudent Industry Practices, to produce 300 acre feet of potable water per year throughout the Term, and deliver the water produced by the Leased Property to Company's water distribution system for Monterey County.

Potable water produced from the desalination facility may be used only to: (i) offset production from Company's existing sources of supply for its Monterey County water distribution system; or (ii) to serve connections for new and expanded water uses within Sand City authorized by the Monterey Peninsula Water Management District. 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 uses within Sand City as directed by the City. Company shall report the volume of potable water actually it produces from the Leased Property to City on a bi-weekly basis throughout the Term.

5. Delivery of Leased Property Upon Completion of Project Improvements. The Project Improvements are to be built in accordance with the Approved Plans and are to be delivered to the Company for testing in accordance with the protocols set forth in Schedule C. (the "Acceptance Testing Protocols"), at the time the California Department of Public Health determines that water produced by the Project can be delivered into the Company's water distribution system. The Project Improvements shall be substantially complete (with the exception of the relocation of intake well no. 3 as provided in Paragraph 11(b)(ii) which will be completed and delivered to Company on or before June 30, 2010) and free of any mechanics liens. Company shall make a complete inspection to ensure it is satisfied with the condition of the Leased Property before to accepting delivery for testing.

Company shall conduct all of its testing in accordance with the Acceptance Testing Protocols. City shall cause the Acceptance Test Report to be prepared as specified Acceptance Test Protocols. Upon completion of Acceptance Test Report stating results reasonably satisfactory to Company, the parties shall sign a certificate evidencing Company's acceptance of the Project and the Engineer's Operations and Maintenance Manual, and the Basic Term shall commence. The certificate will be accompanied by a schedule of all equipment that comprises the Leased Property, as agreed to by City and Company upon completion of startup testing. If the Project does not perform in accordance with its design specifications prior to the Outside Date, then the Parties may agree to extend the Outside Date or either of the Parties terminate this Lease.

6. Taxes and Other Charges; Company's Right to Contest.

(a) Company acknowledges that the possessory interest created under this Lease may be subject to property taxation and Company may be subject to the payment of such property taxes. Except as set forth below, Company shall pay and discharge, on or before the last day upon which the same may be paid without interest or penalty, all taxes, assessments, levies, fees, water and sewer rents and other governmental and similar charges, general and special, ordinary or extraordinary, and whether or not the same shall have been within the express contemplation of the parties hereto, and any interest and penalties thereon, which are levied or assessed or are otherwise due during the Term and which relate to or arise out of (i) the use, occupancy, operation or possession of the Leased Property, or any part thereof, or the transactions contemplated by this Lease, (ii) the Leased Property or the interest of Company therein, (iii) Basic Rent payable by Company hereunder or, (iv) gross receipts from the Leased Property. If any tax or assessment levied or assessed against any Leased Property may legally be paid in installments, Company shall have the option to pay such tax or assessment in installments; provided, however, that, upon the termination or expiration of the Term, Company

shall pay any such tax or assessment which it has been theretofore paying in installments in full on or prior to such termination or expiration date. Such taxes, assessments, fees, water and sewer rents and other governmental charges shall be apportioned between City and Company as of the date on which this Lease terminates or expires with respect to the Leased Property so long as such taxes, assessments, fees, rents or charges would otherwise be payable by City.

(b) Notwithstanding the foregoing, nothing in this Lease shall require payment by Company of (i) any franchise, estate, inheritance, succession, transfer (other than transfer taxes, recording fees, or similar charges payable in connection with a conveyance hereunder to Company pursuant to any provision hereof), gross or net income or profits or gross receipts taxes of City or any other Indemnified Party, (ii) any taxes (including any minimum taxes and withholding taxes) imposed by any federal, state or local government on, or measured by, the gross or net income of City or any other Indemnified Party, or any tax preferences or dividends paid, or (iii) any taxes in the nature of capital gains, excess profits, accumulated earnings or personal holding Company taxes, unless any such tax is in lieu of, or a substitute for, any other tax or assessment upon, or with respect to, the Leased Property, which, if such other tax or assessment were in effect, would be payable by Company hereunder. Company shall furnish to City promptly (and in any event within thirty (30) days after the later of (i) the date the same becomes due and payable and (ii) the date of written demand by City, as the case may be) proof of the payment of any such tax, assessment, fee, rent or charge which is payable by Company. Such taxes, assessments, fees, water and sewer rents and other governmental charges shall be apportioned between City and Company as of the date on which this Lease terminates or expires with respect to the Leased Property.

(c) City shall not impose a tax, fee, or other charge upon the Company's interest in the Leased Property, or the Company's operation of the Leased Property, nor shall the value of the Leased Property, the Company's interest therein or the value of the operation of the Leased Property be added to the value of the Company's other property or operations within the City in determining the amount the City is due from the Company for any other lawful tax, fee, or charge.

(d) Notwithstanding the provisions of paragraphs (a) and (b) of this Article 6 and the provisions of Article 8 hereof, Company shall have the right to contest, by appropriate legal proceedings, any tax, charge, levy, assessment or Lien, and/or any Legal Requirement affecting the Leased Property, and to postpone payment of, or compliance with, the same during the pendency of any such contest, provided that (i) the commencement and continuation of such proceedings shall suspend the collection thereof from, and suspend the enforcement thereof against City, the other Indemnified Parties, and the Leased Property; (ii) no part of the Leased Property nor any Basic Rent or other sums payable by Company hereunder shall be in imminent danger of being sold, forfeited, attached or lost; (iii) there shall not exist (A) any material interference with the use and occupancy of the Leased Property or any part thereof, or (B) any interference with the payment of Basic Rent; (iv) Company shall diligently prosecute such contest to a final settlement or conclusion, or, if Company deems it advisable to abandon such contest, Company shall promptly pay or perform the obligation which was the subject of such contest; and, (v) during the permitted contest there shall not be a risk of the imposition of criminal liability on City or any other Indemnified Party for failure to comply with the obligation which was the subject of such contest.

7. Legal Requirements; New or Expanded Water Uses

(a) City shall use reasonable efforts to obtain all necessary approvals from all Governmental Authorities requisite to the construction and operation of the Project. City shall obtain all approvals necessary to increase connections for new and expanded water uses in Sand City as provided in Article 4, and Company shall provide any assistance requested by City to secure all other necessary approvals for the construction and operation of the Project for the purposes described in Article 4.

(b) During the Term, City shall provide Company, at the Company's expense, any assistance it requests to help Company maintain or renew existing permits, licenses and authorizations or to obtain new approvals which may be required, provided that new approvals of a specified duration and that have a useful life that extends beyond the Basic Term shall be prorated in the manner provided in Paragraph 11(b)(ii). The Parties shall cooperate to secure any Governmental Action required to make improvements to the Project to allow the production capacity of the Project to be increased to more than 300 acre feet annually ("Additional Project Improvements"). Any additional production resulting from the Additional Project Improvements shall be delivered to the Company's water distribution system and used to further offset production from Company's existing sources of supply for its Monterey County water distribution system until such time as the City directs that such additional production be used to serve connections for new and expanded water uses in Sand City or as the City may otherwise direct. The costs of entitling, constructing and maintaining the Additional Project Improvements shall be specified in a subsequent amendment to this Amended and Restated Lease.

(c) Company shall, at all times during the Term, at Company's own cost and expense, (i) perform and comply, and cause the Leased Property to comply, in all material respects with all Legal Requirements, provided that City shall not impose any new zoning or other requirements applicable to the Project during the Lease (ii) comply in all material respects with all provisions of insurance policies required pursuant to Article 13 hereof and (iii) comply in all material respects with the provisions of all material contracts, agreements, instruments and restrictions existing and approved by Company at the commencement of this Lease, or thereafter suffered or permitted by Company, affecting the Leased Property or any part thereof, or the ownership, occupancy, use, operation or possession thereof.

(d) Nothing in this Lease shall be construed as requiring Company to obtain permits, licenses, or any other entitlement on behalf of a developer seeking to develop a new or expanded water use.

(e) Nothing in this Lease shall be construed as obligating Company to construct at its expense any infrastructure or other improvements necessary to serve new or expanded water uses. All infrastructure expenses for new and expanded water uses will be allocated pursuant to California Public Utilities Commission rules and regulations for investor-owned water utilities, or other applicable law.

8. Liens. Company acknowledges that good title to the Leased Property will be vested in City prior to the Basic Term Commencement Date. The Project Improvements shall be delivered to Company at the commencement of the Basic Term without any Liens or other claims. During the Basic Term, subject to the provisions of paragraph (d) of Article 6 hereof, Company will promptly, but no later than sixty (60) days after its Actual Knowledge of the filing thereof, at its own expense remove and discharge of record, by bond or otherwise, any Lien (other than Permitted Encumbrances) upon the Leased Property which arises solely out of Company's possession, use, operation and occupancy of the Leased Property.

9. Indemnification; Fees and Expenses.

(a) Prior to the Basic Term Commencement Date, City shall fully indemnify Company and all applicable Indemnified Parties against any and all liabilities, obligations, losses, damages, costs, expenses, actions, suits and causes of action or claims of any kind or nature relating to this Lease or the Leased Property or the transactions contemplated hereby, except to the extent that such liabilities, obligations, losses, damages, costs, expenses, actions, suits, and causes of action or claims are a result of, or claimed to be a result of, the failure of Company to perform any Legal Requirement or contractual obligation on its part to be performed, or the negligence, recklessness or intentional acts of Company.

(b) During the Basic Term, and subject to the limits in (c) below, Company shall indemnify the City and other applicable Indemnified Parties against all liabilities, obligations, losses, damages, costs, expenses, actions, suits and causes of action or claims, of any kind or nature, (the foregoing, collectively, "Losses", and, individually, a "Loss") arising from the use, operation, maintenance, or management of the Leased Property during the Basic Term in connection with any of the following events: (A) any injury to or death of any person, and/or any damage to, or loss of, Property on the Leased Property directly connected with the, use, nonuse, occupancy, operation, possession, condition, construction, maintenance, repair or rebuilding of the Leased Property; (B) any claims by third parties relating to any violation or alleged violation of (1) any provision of this Lease, or (2) any Legal Requirement affecting the Leased Property or the operation of the Leased Property as described in Article 4.

(c) Notwithstanding the foregoing or the provisions of Article 10 hereof, Company shall not be required pursuant to this Article 9, Article 10 hereof or otherwise hereunder to indemnify: (i) City or any other Indemnified Party for any property or other damage that is covered or should have been covered by the insurance to be maintained by City, (ii) City or any particular Indemnified Party for any Losses resulting from, arising out of, or which would not have occurred but for City's or such other Indemnified Party's own negligence, fraud or willful misconduct; (iii) City or any particular Indemnified Party for any Losses resulting from, arising out of, or which would not have occurred but for a breach by City or such Indemnified Party of any representation, warranty or covenant made by City or such Indemnified Party in this Lease or any other related document; (iv) any Indemnified Party for any taxes, except as set forth in Article 6 hereof; (v) any Indemnified Party for any losses resulting from the authorization or giving or withholding of any future amendments, supplements, waivers or consents with respect to the Lease or the Leased Property by such Indemnified Party other than such as have been consented to in writing by the Company; (vi) any Indemnified Party for any Losses resulting from, arising out of or which would not have occurred but for acts or events

solely with respect to any portion of the Leased Property that occur after return of possession thereof to the City or its designee pursuant to and in accordance with the terms of this Lease; or (vii) for Loss or Losses arising from a defect in the design or construction of the Leased Property. City shall also indemnify Company against all liabilities solely to the extent that such liabilities are a result of a defect in the design or construction of the Leased Property.

(d) Nothing in this Article 9 or in Article 10 hereof shall be construed to give rise to any third party beneficiary rights with respect to any Person who is not an Indemnified Party.

10. Environmental Matters.

(a) Without limiting the generality of any of the provisions of this Lease, Company covenants that, at all times during the Term, the Leased Property, the Company, all sublessees and any assignee of Company shall comply in all material respects with all applicable Environmental Laws and Environmental Permits.

(b) Without limiting the generality of the provisions of Article 9 hereof, Company agrees to indemnify, defend and hold harmless each of the City and the Indemnified Parties and each of their respective employees, assigns, officers, directors, shareholders, partners, trustees and beneficiaries (each an "Environmental Indemnity Party"), from and against any and all Losses which may be suffered or incurred by, or asserted against, such Environmental Indemnity Party to the extent arising directly or indirectly out of any environmental contamination of the Land Parcel or Leased Property or resulting from Company's operation of the Leased Property, including, without limitation, (i) the presence, use, storage, transportation, disposal, release, threatened release, discharge, emission or generation of any Hazardous Substances or of any material, waste or substance which is directly or indirectly a product of, or contains, petroleum, including crude oil or any fraction thereof, natural gas, or synthetic gas usable for fuel or any mixture thereof, from, on, over, under or in the Leased Property in violation of any Environmental Law or Environmental Permit, whenever discovered, and including any such liability with respect to other Property caused by such Hazardous Substances and/or environmental contamination located on or emanating from the Land Parcel and/or Leased Property, or (ii) the violation or alleged violation by Company, or any Person claiming by, through or under Company, of any Environmental Law or Environmental Permit, provided, however, that (A) Company shall in no event be required to indemnify any Environmental Indemnity Party for any liability caused by such Hazardous Substances and/or such environmental contamination occurring after Company has returned the Leased Property to City in accordance with the terms of this Lease, unless such liability relates to the period prior to such return of the Leased Property; (B) Company shall not be liable for any violation relating to Hazardous Substances in the Project Improvements built by City, it being agreed that City shall indemnify Company and its applicable Environmental Indemnity Parties against any such related liabilities; and (C) Company shall not be liable for any violation arising from a defect in the design or construction of the Leased Property.

(c) Notwithstanding paragraph (a) and (b) of this Article 10, City shall be responsible for compliance with the Coastal Development Permit issued for, relating to, or connected with its work reconstructing wells pursuant to paragraph 11(b)(i) and shall cooperate with Company in complying with all other Environmental Laws and Environmental Permits

issued for, or relating to, or connected with Company's work reconstructing wells pursuant to paragraph 11(b)(i).

11. Maintenance and Repair; Modifications; Assignment of Warranties.

(a) On and as of the Basic Term Commencement Date, Company shall deliver to City an Officer's Certificate certifying that it has received the Project Improvements in new condition, repair and appearance, subject only to minor "punchlist items", if any, which are approved by Company and set forth in writing on such date with respect to the Project Improvements. All "punchlist items" shall be corrected by City within 30 days after the Basic Term Commencement Date. Any punchlist items not corrected within that 30 day period may, at the sole option of Company: (i) be corrected by Company and City shall reimburse Company for all costs incurred to correct said punchlist items; (ii) be corrected pursuant to other agreement between City and Company; or (iii) remain uncorrected with a pro rata reduction in Basic Rent to correspond to the Project's shortfall in meeting its specifications.

(b) Except as provided in Paragraphs 11(b)(i) and 11(b)(ii), Company will, at its own cost and expense, keep and maintain the Leased Property, including any altered, rebuilt, additional or substituted equipment, structures and other improvements or Modification thereto (as defined herein), in the same condition as delivered to Company on the Basic Term Commencement Date, ordinary wear and tear and the consequences of casualty (described in paragraph (c) of Article 12 hereof), condemnation or taking excepted, and (except as otherwise provided in paragraph (c) of Article 12 hereof with respect to repairs following a casualty to be made by City, as owner) will make all ordinary repairs and replacements, foreseen or unforeseen, which may be required, as reasonably determined by Company, to be made upon, or in connection with, the Leased Property in order to keep the same in such condition, ordinary wear and tear and the consequences of casualty (described in paragraph (c) of Article 12 hereof), condemnation or taking excepted, including taking, or causing to be taken, all actions necessary to maintain the Leased Property in compliance, in all material respects, with any applicable Legal Requirements, including all applicable Environmental Laws and Environmental Permits. Without limiting the generality of any of the foregoing, Company shall keep the Project Improvements in good working order and operating condition, in accordance with: (i) applicable manufacturer's standard operating and maintenance procedures; and (ii) operating, maintenance, repair and replacement procedures recommended by the DB Contractor and agreed to by Company, as necessary to enforce warranty claims against any vendor or manufacturer of any portion of the Equipment.

(i) Notwithstanding the foregoing, in the event it becomes necessary to relocate any of the intake wells or the discharge well during the Basic Term, the parties shall meet and confer regarding such necessary relocation and City shall approve the location of such new wells. City's approval shall not be unreasonably withheld.

(ii) Provided that Company operates the Project Improvements as provided in the Engineer's Operations and Maintenance Manual, Company's obligation for any repairs, maintenance, alterations, upkeep, replacement, rebuilding, substitutions, or modifications – including such work necessary to

keep the premises in compliance with Legal Requirements, including all applicable Environmental Laws and Environmental Permits – that must be made by Company under Paragraph 11.(b), but that will also have a useful life that exceeds the Basic Term, including but not limited to the relocation of intake or discharge wells, shall be prorated. Company shall pay for that portion of the work equal to percentage of the work's useful life that remains under the Basic Term. The City shall pay for the balance. For example, if work is required under Paragraph 11(b) three years prior to the expiration of the Basic Term and that work has a useful life of 10 years, Company shall pay 30 percent of the cost of the work and City shall pay 70 percent of the cost of the work. The useful life of the work shall be determined with reference to National Association of Regulatory Utility Commissioners, American Water Works Association, or similar regulated water utility association standard.

(c) City hereby assigns to Company whatever claims and rights City may have against the DB Contractor, any other contractor, vendor, engineer, architect or manufacturer under the provisions of the respective construction, design, sales or manufacturer's warranty agreements or other agreements, and City agrees to execute and deliver, at Company's expense, such documents as may be necessary to enable Company to obtain customary warranty service and servicing obligations furnished by all such contractors, vendors, sellers or manufacturers.

(d) During the Term, so long as no Event of Default hereunder has occurred and is continuing, Company may make any modifications, alterations, additions and/or improvements to the Leased Property, whether or not structurally integrated with the Project Improvements (each a "Modification"); provided that no such Modification: (i) materially or adversely affects the value, utility, operation and/or useful life of the Leased Property, or (ii) violates in any material respect any agreement or restriction (including, without limitation, any Legal Requirement, Environmental Law or Environmental Permit) to which the Leased Property is subject; and provided further that such Modification is of comparable style, quality, workmanship and materials to the Project Improvements as originally constructed, as certified in writing by Company. City and Company shall meet and confer regarding any material Modifications to the Leased Property. Title to any Modification (i) required to be made to the Leased Property to ensure that the Leased Property was and/or would continue to be in compliance with any Legal Requirements applicable thereto; or, (ii) that cannot be removed without (A) causing material damage to the Leased Property or (B) materially and adversely affecting the value, utility, operation or useful life of the Leased Property (as determined by reference to the value, utility, operation and useful life of the Leased Property without regard to such Modification), as certified in writing by Company (collectively, "Non-severable Modifications"), shall vest with City and be subject to this Lease without any increase in Basic Rent as a result of such Non-severable Modifications. Subject to the immediately succeeding sentence, title to all other Modifications (collectively, "Severable Modifications") shall vest with Company. In the event that Company returns the Leased Property to City, Company shall be entitled to remove any Severable Modifications prior to such return of the Leased Property, provided, however, that if any such Severable Modifications are not so removed prior to the return of the Leased Property to City by Company, title thereto shall thereupon vest with City subject to City's acceptance thereof. If City does not accept such Severable Modification upon return of the Leased Property, Company shall remove such Severable Modification from the

Leased Property upon demand of City. Any Modification shall be made at the sole cost and expense of Company, unless otherwise agreed with City that it should be made by and at the cost of City.

12. Condemnation and Casualty

(a) City agrees that it will not initiate any condemnation, eminent domain or other similar proceedings against the Leased Property.

(b) If the Leased Property, or any part thereof shall be damaged or destroyed by fire or other casualty, and Company may not, or does not, elect to terminate this Lease pursuant to paragraph (c) of this Article 12, then Company shall give prompt written notice of such casualty to City. City shall, at City's own cost and expense, proceed with diligence and promptness to carry out any necessary demolition and to restore, repair, replace, and/or rebuild the Leased Property in order to restore the Leased Property to a condition and fair market value, utility and remaining useful life not less than the condition and fair market value, utility and remaining useful life thereof immediately prior to such casualty. City and Company shall meet and confer regarding casualty repairs, including but not limited to, the nature of the repairs, the replacement equipment, contractor qualifications, potential disruptions to operations, and schedule. No repair work done by City pursuant to this paragraph shall violate the terms of any restriction, easement, condition or covenant or other matter affecting title to the Leased Property, and all repair work done by City pursuant to this paragraph (b) of Article 12 shall be undertaken and completed in a good and workmanlike manner and in compliance in all material respects with all Legal Requirements then in effect with respect to the Leased Property. During the period that the Leased Property is inoperable, Basic Rent shall fully abate hereunder by reason of any damage to or destruction of, the Leased Property. If the proceeds of any casualty insurance policy maintained by City are less than the estimated cost of restoring, replacing or rebuilding the Leased Property to the condition and fair market value required above in this paragraph (b), then City shall make-up any such deficiency with its own funds. Loss of any intake or discharge wells shall not be considered a 'casualty' loss for the purposes of this Lease. Replacement or rebuilding of intake or discharge wells due to such natural causes shall be performed by Company and the cost of any such replacement or rebuilding shall be shared by Company and City in accordance with Paragraph 11(b)(ii).

(c) If, at any time during the Basic Term, (i) all or a substantial portion of the Leased Property shall be condemned or taken in the exercise of the power of eminent domain by any sovereign, municipality or other public or private authority; or (ii) shall be damaged or destroyed by fire or other casualty, and the Leased Property cannot readily be fully restored within six (6) months with funds available from City or under its casualty insurance, then Company may, in any such case, give written notice to City of Company's intention to terminate this Lease with respect to the Leased Property not later than one hundred twenty (120) days after the occurrence of such casualty, condemnation or taking.

(d) Company's notice to City shall (i) contain a description of the relevant condemnation, taking or casualty, and (ii) specify the date on which this Lease shall terminate with respect to the Leased Property. Upon any complete termination of this Lease, City shall reimburse to Company of any advance rent applicable to the period after the termination. Upon

termination, Company shall have no further obligations hereunder except pursuant to any provisions of this Lease which, by their terms, expressly survive such termination.

13. Insurance.

(a) Prior to the commencement of the Basic Term, City shall, at its own cost and expense, maintain or cause to be maintained (by the DB Contractor building the Project Improvements) with respect to the Leased Property valid and enforceable insurance of the following character:

- (i) Commercial General Liability Insurance or Comprehensive General Liability Insurance with Broad Form CGL endorsement with limits of not less than \$1,000,000 each occurrence and \$2,000,000 general aggregate. Completed Operations coverage shall extend two years beyond completion of performance under the DB Contract. The DB Contractor and any related architects and/or engineers shall also obtain adequate Professional Liability or Errors and Omissions insurance.
- (ii) Worker's Compensation Insurance as required by laws and regulations applicable to and covering employees performing under this Lease. Employer's Liability Insurance protecting employer against common law liability, in the absence of statutory liability, for employee bodily injury arising out of the master-servant relationship with a limit of not less than \$1,000,000 each accident, \$1,000,000 disease-policy limit, \$1,000,000 disease-each employee.
- (iii) All-Risk Property Insurance with a limit equal to the replacement cost of the Leased Property during the Basic Term.

(b) During the Basic Term, Company shall be responsible for maintaining the type of insurance described in clause (a)(i) and (a)(ii) and City shall maintain the insurance in clause (a)(iii). City may elect to self-insure the risks related to the losses under the clause (a)(iii) insurance.

(c) In addition to the foregoing, every insurance policy maintained in accordance with this Article 13 shall: (i) name the other party as additional loss payee as its interest may appear w'th respect to (a)(iii);; (ii) provide that the issuer waives all rights of subrogation against City or Company or any other person insured under such policy, (iii) provide that thirty (30) days advance written notice of cancellation, modification, termination or lapse of coverage shall be given to City and Company; and (iv) be primary relative to the respective use, occupancy and operations of premises by City or Company and without right or provision of contribution as to any other insurance carried by City or Company or any other interested party.

(d) Company and City shall deliver to the other prior to the Basic Term certificates of insurance, reasonably satisfactory to City and Company, evidencing all of the insurance required under paragraph (a) of this Article 13; provided, however, that City shall not

be obligated to deliver such certificates of insurance with respect to required insurance coverages as to which City has retained the risk of loss (self-insured). After the expiration of any required insurance policy, the primary insured shall deliver to the other party certificates of insurance evidencing the renewal of any such policy. City shall provide Company with written notice of any determination to self-insure with respect to any risk theretofore covered by externally procured insurance.

(e) Company and City shall comply with all of the terms and conditions of each insurance policy maintained pursuant to the terms of this Lease to the extent necessary to avoid invalidating such insurance policy or impairing the coverage available thereunder.

14. Quiet Enjoyment.

(a) So long as no Event of Default under this Lease shall have occurred and be continuing, City covenants that Company shall and may at all times peaceably and quietly have, hold and enjoy the Leased Property during the Term without hindrance by City or any Person claiming through or under City.

15. Subletting; Assignment.

(a) Neither this Lease nor the Leased Property shall be mortgaged, by Company. Any such mortgage or pledge shall be null and void.

(b) Company may only assign its interest in this Lease in connection with the consolidation or merger of Company into any other Person or the sale, lease or other transfer or disposal of all or substantially all of Company's assets in the Monterey Peninsula area (whether in one transaction or in a series of related transactions), if and only if (i) the assignee of Company's interest, or the corporation or other Person which results from any such consolidation, merger, acquisition, sale, lease, transfer and/or disposition of assets, if not Company, assumes all of Company's obligations, duties and liabilities under this Lease; and (ii) any such assignment, consolidation, merger, acquisition, sale, lease, transfer and/or disposition of assets would not result in a violation of any regulatory requirement applicable to City, including but not limited to any and all licensing requirements applicable to the operator of the Leased Property.

16. Events of Default and Remedies.

(a) Any of the following occurrences or acts shall constitute an event of default under this Lease (each an "Event of Default"):

- (i) if Company shall default in making payment of any installment of Basic Rent, which default shall continue for ninety (90) days after the same first becomes due and payable; or
- (ii) if Company or City shall default in the performance of any covenant, agreement or obligation on the part of Company or City, as applicable, to be performed under this Lease, and such default shall continue for a period of thirty (30) days after written notice

thereof is received by the defaulting party, unless such default is curable and the defaulting party shall be diligently proceeding to correct such default (but in no event for a total period of longer than one hundred eighty (180) days after the receipt of such notice as provided above); or

- (iii) if Company or City shall file a petition in bankruptcy or for reorganization or for an arrangement pursuant to the Bankruptcy Code, or shall be adjudicated bankrupt or become insolvent or shall make an assignment for the benefit of its creditors, or shall admit in writing its inability to pay its debts generally as such debts become due, or shall be dissolved, or shall suspend payment of its obligations, or shall take any corporate action in furtherance of any of the foregoing; or
- (iv) if a petition or answer shall be filed proposing the adjudication of Company or City as bankrupt, or proposing its reorganization pursuant to the Bankruptcy Code, and (A) Company or City, as applicable, shall consent to the filing thereof, or (B) such petition or answer shall not be discharged or denied within sixty (60) days after the filing thereof; or
- (v) if a receiver, trustee or liquidator (or other similar official) shall be appointed for, or take possession or charge of, Company or City, or of all or substantially all of the business or assets of Company or City or its estate or interest in the Leased Property, and such official shall not be discharged within sixty (60) days thereafter, or if Company or City shall consent to or acquiesce in such appointment; or
- (vi) if, as of the time when the same shall have been made, any representation or warranty of Company or City set forth herein, or in any consent, notice, certificate, demand, request or other instrument delivered by or on behalf of Company or City, as applicable, in connection with or pursuant to this Lease shall prove to have been incorrect or untrue in any material respect as of the time when made, and the condition or circumstance giving rise to such incorrect or untrue representation or warranty shall continue for a period of thirty (30) days after Company or City has Actual Knowledge thereof, unless such condition or circumstance is curable and Company or City shall be diligently proceeding to correct such condition or circumstance (but in no event for a total period of longer than one hundred eighty (180) days after Company or City has Actual Knowledge thereof); or

(b) This Lease and the term and estate hereby granted are subject to the limitation that, whenever an Event of Default shall have occurred and be continuing, the non-

defaulting party may, at its option, elect to exercise any one or more of the rights and remedies set forth in the following paragraphs.

- (i) Terminate this Lease upon giving an additional 30 days written notice and in the case of default by Company, the City may re-enter the Leased Property upon termination. Such notice shall specify the date of such termination, and the Term with respect to the Leased Property shall expire by limitation at midnight on the date specified in such notice as fully and completely as if said date were the date herein originally fixed for the expiration of the Term hereby granted, and Company shall thereupon quit and peacefully surrender the Leased Property to City, and, upon the date following the date specified in such notice, or at any time thereafter, City may re-enter the Land Parcel.
- (ii) Sue to collect damages caused by the breach by the other party, including, if applicable, following a default by Company, make a claim for accrued unpaid Basic Rent through the time of any re-entry by City. City shall only be entitled to sue for the present value of the balance of Basic Rent due under the Lease to the extent the Basic Rent exceeds the greater of (A) fair market rental of the Leased Property or (B) the actual rental obtained by City upon a reletting. City shall have a duty to mitigate Company's damages by diligently trying to relet the Leased Property at the best available rent.
- (c) The non-defaulting party may exercise any other right or remedy which may be available to it under applicable law or at equity, including, without limitation, bringing a suit for specific performance, and the non-defaulting party may proceed by appropriate court action to enforce the terms hereof or to recover damages for the breach hereof or to rescind this Lease.
- (d) If an action shall be brought for the enforcement of any provision of this Lease in which it is found that an Event of Default has occurred, the non-defaulting prevailing party shall be entitled to seek reimbursement of its attorneys' fees and expenses.
- (e) No right or remedy herein is intended to be exclusive of any other right or remedy, and every right and remedy shall be cumulative and in addition to any other legal or equitable right or remedy given hereunder, or at any time existing hereunder or at law. The failure of City or Company to insist upon the strict performance of any provision or to exercise any option, right, power or remedy contained in this Lease shall not be construed as a waiver or a relinquishment thereof for the future.

17. Notices. All notifications, notices, demands, requests and other communications herein provided for or made pursuant hereto shall be in writing and shall be sent by (i) registered or certified mail, return receipt requested, and the giving of such communication shall be deemed complete on the third (3rd) Business Day after the same is deposited in a United States Post

Office with postage charges prepaid, (ii) reputable overnight delivery service, and the giving of such communication shall be deemed complete on the immediately succeeding Business Day after the same is deposited with such delivery service or (iii) legible fax with original to follow in due course (failure to send such original shall not affect the validity of such fax notice), and the giving of such communication shall be complete when such fax is received:

- (a) if to City, addressed to such party at its address set forth in the first paragraph of this Lease, or at such other address in the continental United States as City may furnish to Company in writing, or
- (b) if to Company, addressed to such party at its address set forth in the first paragraph of this Lease, or at such other address in the continental United States as Company may furnish to City in writing.

18. Estoppel Certificates. Each party hereto agrees that, at any time and from time to time during the Term, it will promptly, but in no event later than thirty (30) days after written request by the other party hereto or more than once per year, execute, acknowledge and deliver to such other party or to any prospective purchaser, assignee or mortgagee or other Person designated by such other party, a certificate stating, to such party's Actual Knowledge, (a) that this Lease is unmodified and in full force and effect (or if there have been modifications, that this Lease is in full force and effect as modified, and setting forth any modifications); (b) the date to which Basic Rent and other sums payable hereunder have been paid; (c) whether or not a default by Company in the payment of Basic Rent or any other sum of money due or required to be paid hereunder has occurred and is continuing, and whether or not any other default by Company hereunder has occurred and is continuing with respect to which a notice of default has been served or of which the signer of the estoppel certificate has Actual Knowledge, and, if there is any such default, specifying the nature and extent thereof; (d) whether or not there are any setoffs, defenses or counterclaims against enforcement of the obligations to be performed hereunder existing in favor of the party executing such certificate; and (e) stating that Company is in possession of the Leased Property or, alternatively, setting forth the parties in possession and identifying the instruments pursuant to which they took possession.

19. Surrender.

(a) Upon the expiration or earlier termination of the Term, Company shall peaceably surrender the Leased Property to City in the condition required by Article 11 of this Lease.

(b) Without limiting the generality of the foregoing, upon the surrender and return of the Leased Property to City pursuant to this Article 19, the Leased Property shall be (i) in accordance and compliance with all Legal Requirements and (ii) free and clear of any Lien.

(c) Company acknowledges and agrees that a breach of any of the provisions of this Article 19 may result in damages to City that are difficult or impossible to ascertain and that may not be compensable at law. Accordingly, upon application to any court of equity having jurisdiction over the Leased Property, City shall be entitled to a decree against

Company requiring specific performance of the covenants of Company set forth in this Article 19.

20. Separability. If any provision of this Lease or the application thereof to any Person or circumstance shall to any extent be invalid and unenforceable, the remainder of this Lease, or the application of such provision to persons or circumstances other than those as to which it is invalid or unenforceable, shall not be affected thereby, and each provision of this Lease shall be valid and shall be enforceable to the fullest extent permitted by law.

21. Recording. Simultaneously with the execution of this Lease, City and Company have executed a mutually acceptable form of memorandum of lease which shall be promptly recorded in the real property records of Monterey County, California.

22. Limitation on Recourse. All obligations of the Company under this Lease shall be on a non-recourse basis to its shareholders, officers, and directors and their respective parent companies, subsidiaries and affiliates (other than the Company). The sole recourse of the City or any other Person for any obligation of the Company under this Lease shall be to the Company and its assets; provided that the limitation on recourse set forth in this Article 22 shall not limit any rights of the City or any other Person under applicable law relating to fraudulent transfers or voidable preferences.

23. Force Majeure.

(a) If by reason of "force majeure," as defined in this Article 23, a party is rendered unable, wholly or in part, to carry out its obligations under this Lease, and if such party gives notice and reasonably full particulars of such force majeure in writing to the other party promptly after the occurrence of the cause relied on, the affected party, and only so far as and to the extent that it is affected by such force majeure, shall be excused from performance hereunder without liability; provided, however, such cause shall be remedied with all reasonable dispatch.

(b) For purposes of this Agreement, "force majeure" shall mean an event that creates an inability to perform that could not be prevented or overcome by the due diligence of the affected party, including but not limited to, any act, omission or circumstance occasioned by or in consequence of any acts of God, strikes, lockouts, acts of the public enemy, wars, sabotage, blockades, insurrections, riots, epidemics, landslides, lightning, earthquakes, fires, storms, hurricanes, tornadoes, floods, washouts, civil disturbances, explosions, power outages the failure or inability to obtain any necessary governmental authorization which has been sought or requested, as the case may be, in good faith by all reasonable legal means, and any other cause, whether of the kinds herein enumerated or otherwise, not reasonably within the control of the affected party.

(c) For "force majeure" events occurring prior to City filing a Notice of Assignment with the Monterey Peninsula Water Management District pursuant to that District's Sand City Water Supply Project Ordinance, where such "force majeure" event cannot be cured within six (6) months, then either party shall have the right to terminate this Lease. For "force majeure" events occurring after to City's filing a Notice of Assignment with the Monterey Peninsula Water Management District pursuant to that District's Sand City Water Supply Project

Ordinance, where such "force majeure" event cannot be cured within six (6) months, then Company shall have the right to terminate this Lease.

24. Miscellaneous.

(a) This Lease embodies the entire agreement between City and Company relating to the subject matter hereof and supersedes all prior agreements and understandings, written or oral, relating to such subject matter.

(b) This Lease shall be binding upon, and shall inure to the benefit of and be enforceable by, the parties hereto and their respective successors and assigns permitted hereunder.

(c) No term or provision hereof or Appendix, Exhibit or Schedule hereto may be amended, changed, waived, discharged, terminated or replaced orally except by a written instrument, in accordance with applicable terms and provisions hereof, executed by each of the parties hereto.

(d) No failure, delay, forbearance or indulgence on the part of any party in exercising any right, power or privilege hereunder shall operate as a waiver thereof, or as an acquiescence in any breach, nor shall any single or partial exercise of any right, power or remedy hereunder preclude any other or further exercise thereof or the exercise of any other right, power or privilege

(e) Any provision of this Lease which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction.

(f) This Lease shall be construed, governed and applied in accordance with the laws of the State of California, without regard to the conflicts of law principles thereof.

(g) In connection with this Lease, Company and City hereby agree that any action, proceeding, or dispute regarding this lease shall be filed in the Superior Court of the State of California, in and for the County of Monterey. Nothing in this paragraph shall be construed as a waiver of Company's rights under California Code of Civil Procedure section 394.

(h) **Mandatory Non-binding Mediation.** If a dispute arises out of, or relates to this Agreement, or the breach thereof, and if said dispute cannot be settled through normal contract negotiations, the Parties agree to first endeavor to settle the dispute in an amicable manner, using mandatory non-binding mediation under the Construction Industry Mediation Rules of the American Arbitration Association before having recourse in a court of law. The expenses of witnesses for either side shall be paid by the party producing such witnesses. All other expenses of the mediation, including required travel and other expenses of the mediator, and the cost of any proofs or expert advice produced at the direct request of the mediator, shall be borne equally by the Parties, unless they agree otherwise. Any resultant agreements from mediation shall be documented in writing. All mediation proceedings, results, and

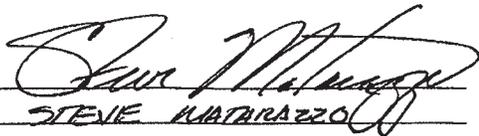
documentation shall be inadmissible for any purpose in any legal proceeding (pursuant to California Evidence Codes sections 1115 thru 1128), unless such admission is otherwise agreed upon in writing by both parties. Mediators shall not be subject to any subpoena or liability, and their actions shall not be subject to discovery.

(i) This Lease may be executed in any number of counterparts, each of which shall be an original, and such counterparts together shall constitute but one and the same instrument.

IN WITNESS WHEREOF, City and Company hereto have each caused this Lease to be duly executed and delivered in their name and on their behalf, respectively, as of the day and year first written above.

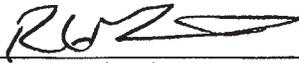
City:

CITY OF SAND CITY

By:   
Name: STEVE NATARAZZO  
Title: CITY ADMINISTRATOR

Company:

CALIFORNIA AMERICAN WATER

By:   
Name: Robert Maclean  
Title: President

## SCHEDULE X

Definitions

“Actual Knowledge” means actual knowledge of (i) an Authorized Officer or (ii) any other officer or official whose responsibilities include administration of the transactions contemplated by the Lease.

“Affiliate” of any specified Person means any other Person directly or indirectly controlling or controlled by or under direct or indirect common control with such specified Person or, in the case of a specified Person which is a partnership, any general partner of such partnership. For purposes of this definition, “control” when used with respect to any specified Person means the power to direct the management and policies of such Person, directly or indirectly, whether by contract, through the ownership of voting securities or the power to appoint and remove directors or trustees, or otherwise; and the terms “controlling” and “controlled” have meanings correlative to the foregoing.

“Approved Plans” means the plans for the Project Improvements, in the form existing as of the date hereof, a copy of which have been received and approved by Company.

“Authorized Officer” means with respect to Company, the chief financial officer, any vice president, the treasurer or any assistant treasurer of the Company, or any other officer of the Company designated by the Company as an Authorized Officer of the Company from time to time, and with respect to City, any official or any officer whose responsibilities include Administration of this transaction.

“Bankruptcy Code” means Title 11 of the United States Code, as amended, or any successor statutory provisions.

“Basic Rent” has the meaning set forth in Article 3 of the Lease.

“Basic Term” has the meaning set forth in Article 2 of the Lease.

“Basic Term Commencement Date” means the Completion Date or, if such day is not the first day of a calendar month, the first day of the calendar month next succeeding the Completion Date.

“Business Day” means a day when banks are open for business in California.

“Code” means the Internal Revenue Code of 1986, as amended from time to time, or any successor statute.

“Complete” or “Completion” means that (a) the materials and equipment for the Project Improvements have been installed and checked for alignment, lubrication, rotation and hydrostatic and pneumatic pressure integrity, (b) the electrical systems have been installed and tested, (c) the electrical continuity and ground fault tests and mechanical tests and calibration have been completed, (d) the instrumentation has been loop checked, (e) the Project Improvements have been flushed and cleaned out as necessary, (f) the Project Improvements are

ready to commence start-up and testing, (g) the Project Improvements have been constructed substantially in accordance with the Approved Plans, including, without limitation, the specifications applicable thereto, and (h) the Project Improvements are capable of operating safely. The following shall not prevent certification of Substantial Completion, but shall be remedied, cured or resolved within sixty (60) days after the Basic-Term Commencement Date:

- (i) any redundant part or piece of equipment which is missing or inoperable which does not affect the safe operation of the Project Improvements;
- (ii) any disputed contract issue which has been submitted for arbitration;
- (iii) any non-conforming item which has been agreed to be corrected and the material placed on order which does not affect the safe operation of the Project Improvements; or
- (iv) any punchlist items which will not prevent start-up of the Project Improvements.

“Completion Date” means the date, if any, on or before the Outside Completion Date, on which the following have occurred: (i) Substantial Completion has been achieved, and (ii) Company has satisfactorily completed all start-up commissioning for the Project Improvements.

“Construction Period” means the period of time from the Closing Date to the Basic Term Commencement Date.

“DB Contract” means the Contract for Water Supply Project, Water Treatment Facilities for Brackish Water to Domestic Water, Sand City, California” by and between City and the DB Contractor, as originally executed or as the same may from time to time be supplemented, modified, amended or replaced in accordance with the applicable provisions thereof and the approval of the Company.

“DB Contractor” means CDM Constructors, Inc., and any successors and permitted assigns thereof.

“Economic Abandonment” has the meaning set forth in paragraph (c) of Article 11 of the Lease.

“Engineer’s Operations and Maintenance Manual” shall mean and refer to the instructions and procedures for the operation, maintenance and repair of the Project Improvements which are delivered to Company on the Basic Term Commencement Date. The Engineer’s Operations and Maintenance Manual shall not be changed after the Basic Term Commencement Date without the review and approval of City.

“Environmental Indemnity Party” has the meaning set forth in paragraph (b) of Article 10 of the Lease.

“Environmental Laws” means and includes, but shall not be limited to, the Resource Conservation and Recovery Act (42 U.S.C. § 6901 et seq.), as amended by the Hazardous and

Solid Waste Amendments of 1984, the Comprehensive Environmental Response, Compensation and Liability Act (42 U.S.C. § 9601 et seq.), as amended by the Superfund Amendments and Reauthorization Act of 1985, the Hazardous Materials Transportation Act (49 U.S.C. § 1801 et seq.) the Toxic Substances Control Act (15 U.S.C. § 2601 et seq.), Clean Air Act (42 U.S.C. § 7401 et seq.), the Clean Water Act (33 U.S.C. § 1251 et seq.) the Federal Insecticide, Fungicide and Rodenticide Act (7 U.S.C. § 136 et seq.), the Occupational Safety and Health Act (29 U.S.C. § 651 et seq.) and all applicable federal, state and local environmental laws, including obligations under the common law, ordinances, rules, regulations, private agreements (such as covenants, conditions and restrictions) and publications, as any of the foregoing may have been or may be from time to time amended, supplemented or supplanted, and any other federal, state or local laws, including obligations under the common law, ordinances, rules, regulations, private agreements (such as covenants, conditions and restrictions) and publications, now or hereafter existing relating to regulation or control of Hazardous Substances or environmental health and safety.

“Environmental Permits” means all permits, licenses and any other authorizations to conduct operations at the Leased Property that are required under any and all applicable Environmental Laws.

“Fair Market Rental Value” means an amount equal to the fair market rental value that would be obtained in an arm’s-length transaction between an informed and willing City and an informed and willing Company, in either case under no compulsion to rent, and neither of which is related to the City, calculated as the value of the Leased Property for its use at its present location determined on the basis of the value of the Land Parcel subject to existing governmental zoning and use restrictions and with regard to the value of the Project Improvements.

“Final Determination” means, with respect to a private letter ruling or a technical advice memorandum of the Internal Revenue Service, written notice thereof in a proceeding in which the Company had an opportunity to participate and otherwise means written notice of a determination from which no further right of appeal exists or from which no appeal is timely filed with any court of competent jurisdiction in the United States in a proceeding to which the Company was a party or in which the Company had the opportunity to participate.

“GAAP” means generally accepted accounting principles as in effect in the United States of America at the time of application.

“Governmental Action” means all permits, authorizations, registrations, consents, approvals, waivers, exceptions, variances, orders, judgments, decrees, licenses, exemptions, publications, filings, notices to and declarations of or with, or required by, any Governmental Authority, or required by any Legal Requirements, and shall include, without limitation, all citations, environmental and operating permits and licenses that are required for the use, occupancy, zoning and operation of the Project Improvements.

“Governmental Authority” means any foreign or domestic federal, state, county, municipal or other governmental or regulatory authority, agency, board, body, commission, instrumentality, court or quasi-governmental authority or any political subdivision thereof.

“Hazardous Substances” means (i) those substances included within the definitions of or identified as “hazardous substances”, “hazardous materials”, or “toxic substances” in or pursuant to, without limitation, the Comprehensive Environmental Response Compensation and Liability Act of 1980 (42 U.S.C. § 9601 *et seq.*) (“CERCLA”), as amended by Superfund Amendments and Reauthorization Act of 1986 (Pub. L. 99-499, 100 Stat. 1613) (“SARA”), the Resource Conservation and Recovery Act of 1976 (42 U.S.C. § 6901 *et seq.*) (“RCRA”), the Occupational Safety and Health Act of 1970 (29 U.S.C. § 651 *et seq.*) (“OSHA”), and the Hazardous Materials Transportation Act, 49 U.S.C. § 1801 *et seq.*, and in the regulations promulgated pursuant to said laws, all as amended; (ii) those substances listed in the United States Department of Transportation Table (40 CFR 172.101 and amendments thereto) or by the Environmental Protection Agency (or any successor agency) as hazardous substances (40 CFR Part 302 and amendments thereto); (iii) any material, waste or substance which is or contains (A) asbestos, (B) polychlorinated biphenyls, (C) designated as “hazardous substance” pursuant to Section 311 of the Clean Water Act, 33 U.S.C. § 1251 *et seq.*, (33 U.S.C. § 1321) or listed pursuant to Section 307 of the Clean Water Act (33 U.S.C. § 1317); (D) flammable explosives; (E) petroleum products and substances; (F) radioactive materials; and (iv) such other substances, materials and wastes which are or become regulated as hazardous, toxic or “special wastes” under applicable local, state or federal law, or the United States government, or which are classified as hazardous, toxic or as “special wastes” under federal, state or local laws or regulations.

“Indemnified Parties” means the City or Company, as applicable, and all shareholders, officers, directors, employees, attorneys and agents of any of the foregoing, and any Person holding any beneficial interest in any of the foregoing.

“Indenture” means the Indenture of Trust, dated as of August 1, 1997, from Issuer to Indenture Trustee, as originally executed or as the same may from time to time be supplemented, modified, amended or replaced in accordance with the applicable provisions thereof and of the Operative Documents.

“Land Parcel” means the land situated in Monterey County, California, more particularly described in Schedule A to the Lease.

“Leased Property” means the Project Improvements, together with the Land Parcel, as further defined in Paragraph 1.a.

“Legal Requirements” means all applicable laws, rules, orders, ordinances, regulations and requirements and conditional permissions now existing or (except to the extent any exemption or so called “grandfathering” provision is available) hereafter enacted or promulgated, of every government and municipality and of any agency thereof having jurisdiction over the Company, City or the Leased Property, relating to the ownership, use, occupancy, maintenance or operation of the Leased Property, or the improvements thereon, or the facilities or equipment thereon or therein, or the streets, sidewalks, vaults, vault spaces, curbs and gutters adjoining the Leased Property, or the appurtenances to the Leased Property, or the franchises and privileges connected therewith or the transactions contemplated by the Lease, including but not limited to the operation of the Lease Property in the manner described in Article 4 and including, without

limitation, all applicable building laws, health codes, safety rules, handicapped access, zoning and subdivision laws and regulations and Environmental Laws.

“Lien” means any mortgage, pledge, security interest, production payment, encumbrance, lien or charge of any kind whatsoever. For the purposes of the Lease, any Person shall be deemed to own subject to a Lien any asset which it has acquired or holds subject to the interest of a City or vendor under any capital lease or other title retention agreement relating to such asset.

“Outside Completion Date” has the meaning set forth in Article 2 of the Lease.

“Permitted Encumbrances” means, with respect to the Leased Property: (a) rights reserved to or vested in any municipality or public authority to condemn, appropriate, recapture or designate a purchaser of the Leased Property; (b) any Liens thereon for taxes, assessments and other governmental charges and any Liens of mechanics, materialmen and laborers for work or services performed or material furnished in connection with the Leased Property, which are not due and payable, or the amount or validity of which are being contested as permitted by Article 6 of the Lease; and (c) Liens granted by City in connection with any bonds issued to fund the Project, as long as such lender receiving such lien has granted Company satisfactory rights of non-disturbance.

“Person” means an individual, a corporation, a partnership, an association, a joint stock Company, a trust, an unincorporated organization, a governmental body or a political subdivision, a municipal corporation, a public corporation or any other group or organization of individuals.

“Project Improvements” has the meaning set forth in Article 1 of the Lease.

“Prudent Industry Practices” means any of the practices, methods and acts engaged in or approved by a significant portion of the municipal water treatment and supply industry operating in the immediate area surrounding the Leased Property during the Term of this Agreement. Prudent Industry Practices are not to be interpreted, construed or limited to the optimum industry practices, methods or acts, but rather as a range of acceptable practices, methods or acts consistent with the duties and obligations of Contractor under this Agreement.

“Regulations” means the applicable proposed, temporary or final Income Tax Regulations promulgated under the Code, as such regulations may be amended and/or supplemented from time to time.

“Sublessee” means the Lessee or any other Person who is lessee of the Project Improvements and sublessee of the Demised Premises pursuant to a Sublease.

“Subsidiary” means any corporation or other entity of which securities or other ownership interests having ordinary voting power to elect a majority of the board of directors or other persons performing similar functions are at the time directly or indirectly owned by the Company.

“Term” means (a) the Basic Term which may be effected pursuant to Article 2 of the Lease or (b) such shorter period as may result from earlier termination of the Lease as provided therein.

“Term Termination Date” means the last day of the Basic Term, as applicable.

“Termination Date” has the meaning set forth in paragraph (c) of Article 2 of the Lease.

“Work” means all items of work required by the Design/Build Contract and the Approved Plans necessary to design, acquire, construct and install the Project Improvements.

**SCHEDULE A**

**LEGAL DESCRIPTION**

For the

**SAND CITY DESALINATION PLANT FACILITY LAND PARCEL  
LANDS OF THE SAND CITY REDEVELOPMENT AGENCY**

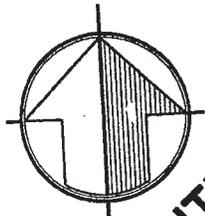
ALL THAT REAL PROPERTY LOCATED IN THE CITY OF SAND CITY, COUNTY OF MONTEREY, STATE OF CALIFORNIA DESCRIBED AS FOLLOWS:

BEING LOTS 2, 4, 6, 8, 10, AND 12, AND THE SOUTHERLY 10.00 FEET OF LOTS 1, 3, 5, 7, 9, AND 11 OF BLOCK 17, "MAP OF EAST MONTEREY" FILED OCTOBER 18, 1887 IN VOLUME 1 OF CITIES AND TOWNS, AT PAGE 22, IN THE OFFICE OF THE COUNTY RECORDER FOR THE COUNTY OF MONTEREY, CALIFORNIA.

CONTAINING 12,750 S.F. MORE OR LESS

EFFECTS:

APN 011-243-002 AND A PORTION OF APN 011-243-006



ROUTE 1  
STATE OF CALIFORNIA

GRAPHIC SCALE



( IN FEET )  
1 inch = 40 ft.

ELDER AVENUE

BLOCK 17

1 3 5 7 9 11 13 15 17 19

LAND PARCEL LEASE LINE

10.00'

150'

(1-CT-22)

85'

2 4 6 8 10 12 14 16 18 20

REY STREET

CITY OF SEASIDE  
CITY OF SAND CITY

SHASTA AVENUE



Creegan+D'Angelo  
INFRASTRUCTURE  
ENGINEERS

225 Cannery Row, Suite H  
Monterey, CA 93940  
Tel (831) 373-1333  
Fax (831) 373-0733

www.cdengineers.com

SCHEDULE 'A'

SAND CITY DESALINATION FACILITY  
LANDS OF THE SAND CITY

9/25/07 REDEVELOPMENT AGENCY 1"=40'  
707003 SHEET 2 OF 2

## SCHEDULE B

Basic Rent

<u>Payment Due Date</u>	<u>Amount</u>	<u>Year Applicable to</u>
<u>2008</u>	<u>\$850,000</u>	<u>Year 15</u>
<u>2009</u>	<u>\$850,000</u>	<u>Year 1</u>
<u>June 15, 2010</u>	<u>\$850,000</u>	<u>Year 2</u>
<u>June 15, 2011</u>	<u>\$850,000</u>	<u>Year 3</u>
<u>June 15, 2012</u>	<u>\$850,000</u>	<u>Year 4</u>
<u>June 15, 2013</u>	<u>\$850,000</u>	<u>Year 5</u>
<u>June 15, 2014</u>	<u>\$850,000</u>	<u>Year 6</u>
<u>June 15, 2015</u>	<u>\$850,000</u>	<u>Year 7</u>
<u>June 15, 2016</u>	<u>\$850,000</u>	<u>Year 8</u>
<u>June 15, 2017</u>	<u>\$850,000</u>	<u>Year 9</u>
<u>June 15, 2018</u>	<u>\$850,000</u>	<u>Year 10</u>
<u>June 15, 2019</u>	<u>\$850,000</u>	<u>Year 11</u>
<u>June 15, 2020</u>	<u>\$850,000</u>	<u>Year 12</u>
<u>June 15, 2021</u>	<u>\$850,000</u>	<u>Year 13</u>
<u>June 15, 2022</u>	<u>\$850,000</u>	<u>Year 14</u>
<u>2023</u>	<u>\$0</u>	<u>Year 15</u>
<u>June 15, 2024</u>	<u>\$7,000</u>	<u>Year 16</u>
<u>June 15, 2025</u>	<u>\$7,000</u>	<u>Year 17</u>
<u>June 15, 2026</u>	<u>\$7,000</u>	<u>Year 18</u>
<u>June 15, 2027</u>	<u>\$7,000</u>	<u>Year 19</u>
<u>June 15, 2028</u>	<u>\$7,000</u>	<u>Year 20</u>
<u>June 15, 2029</u>	<u>\$7,000</u>	<u>Year 21</u>
<u>June 15, 2030</u>	<u>\$7,000</u>	<u>Year 22</u>
<u>June 15, 2031</u>	<u>\$7,000</u>	<u>Year 23</u>
<u>June 15, 2032</u>	<u>\$7,000</u>	<u>Year 24</u>
<u>June 15, 2033</u>	<u>\$7,000</u>	<u>Year 25</u>
<u>June 15, 2034</u>	<u>\$7,000</u>	<u>Year 26</u>
<u>June 15, 2035</u>	<u>\$7,000</u>	<u>Year 27</u>
<u>June 15, 2036</u>	<u>\$7,000</u>	<u>Year 28</u>
<u>June 15, 2037</u>	<u>\$7,000</u>	<u>Year 29</u>
<u>June 15, 2038</u>	<u>\$7,000</u>	<u>Year 30</u>
<u>2039</u>	<u>\$0</u>	<u>Year 31</u>

**SCHEDULE C****Sand City Brackish Water Desalination Facility  
ACCEPTANCE TESTING****PURPOSE**

The purpose of the Acceptance Test Plan is to provide standards and a protocol that are accepted by both California American Water and the City of Sand City as demonstrating that the Brackish Water Desalination Facility (Facility) complies with the performance and reliability requirements specified in the Engineer's Design Report (Design Report) prepared by CDM and dated March 28, 2008. The Acceptance Test is a prerequisite for California American Water to accept the facility under Paragraph 5 of the Amended and Restated Lease.

**TEST OBJECTIVES**

Provided that during the Testing Phase the Facility is operated and maintained pursuant to the requirements of the Engineer's Operations and Maintenance Manual, the Acceptance Test shall demonstrate:

- (i) The Facility and its equipment perform in a manner that substantially complies with the design for the Facility;
- (ii) Facility equipment operates approximately at the nominal ratings established by the equipment manufacturer for the equipment;
- (iii) The pretreatment system can reliably produce a sufficient quantity of treated water at a quality that meets the membrane system supplier's reverse osmosis (RO) system feed water specifications so that the Facility can produce up to 0.3 mgd of Product Water with one (1) primary RO equipment train in service;
- (iv) The pretreatment system can reliably produce a sufficient quantity of treated water at a quality that meets the membrane system supplier's RO system feed water specifications so that the Facility can produce 0.28 million gallons of Product Water on days when RO racks are rotated.;
- (v) The Facility can reliably meet the Product Water quality standards contained in the Engineer's design report (Tables 2-3 & 2-8) provided incoming feed water quality matches the membrane manufacturer's specifications;
- (vi) The Facility has achieved the specified Product Water production capacity, the Product Water Quality Standards, and has not exceeded the Maximum Chemical Utilization Rate detailed in Section 4 of the Engineer's Design Report.
- (vii) The Facility Maximum Electricity Utilization Rate shall not exceed 5,524 kWh per million gallons or 1800 kWh per acre foot for the entire duration of the Acceptance Test.

In addition, the Acceptance Test shall confirm the accuracy and precision of Facility instrumentation and provide a verification of the information obtained from the Facility's PLC system that is used for the test.

**TEST SEQUENCE AND SCHEDULE**

The Acceptance Test shall be conducted by the City of Sand City and California American Water over a fourteen (14) day consecutive period to verify pretreatment system and Facility performance criteria are satisfied. The Acceptance Test period shall be preceded by a fourteen (14) consecutive day run-in period during which the Facility maintains a Product Water output of 0.30 mgd with one (1) primary RO equipment train in service. The Acceptance Test shall commence immediately at the end of the fourteen (14) consecutive day run-in period. Together, the fourteen (14) consecutive day run-in period and the fourteen (14) day Acceptance Test shall constitute a single twenty-eight (28) day reliability demonstration.

### **FACILITY ACCEPTANCE CRITERIA**

Facility Acceptance criteria:

(i) General:

- a. The Facility is operated and maintained pursuant to the requirements of the Engineer's Operations and Maintenance Manual for the entire duration of the twenty-eight (28) day reliability demonstration;
- b. The Facility and its equipment performs in a manner consistent with the Design Report; and

(ii) Pretreatment system effluent water quantity, quality and delivery conditions:

a. Effluent Quantity:

1. The pretreatment system can reliably produce a sufficient quantity of RO system feed water at a quality that meets the membrane supplier's RO system feed water requirements so that the Facility can produce up to 0.30 mgd of Product Water for a fourteen (14) consecutive day period during the Acceptance Test;
2. The Acceptance Test commences immediately after the completion of the fourteen (14) consecutive day run-in period;
- b. RO system feed water requirements (to be adjusted as necessary if new membranes from another manufacturer are installed):
  1. Turbidity < 1 NTU;
  2. SDI < 4.0;
  3. pH 3.0 – 10.0 standard units;
  4. TDS range – 17,000 to 28,000 mg/L
- c. Delivery Point – Feed water Sample Station

(iii) Product Water quantity, quality and delivery conditions;

a. Product Water Quantity:

1. 0.30 mgd at a quality that meets the Product Water Quality Standards for fourteen (14) consecutive day period during the Acceptance Test; and
- b. Product Water Quality – meets all California Department of Public Health requirements for drinking water and shall comply with the Product Water

- Quality Standards (contained in the Engineer's Design Report – Tables 2.3 & 2.8);
- c. Delivery Point – Prior to blending with system water
- (iv) Product Water treatment efficiency pursuant to the Engineer's stated design parameters for:
- a. Facility electricity consumption shall not exceed 5,524 kWh per million gallons, excluding building loads;
  - b. Treatment process chemical consumption (Section 4);
- (v) Environmental Compliance – Compliance with permit conditions provided in the California Department of Health (CDH) Drinking Water Permit, California Coastal Development Permit, Concentrate Disposal Permit, Sanitary Sewer Discharge Permit, and the Monterey Bay Unified Air Pollution Control District - Air Permit for Emergency Generator
- (vi) Facility Operation and Maintenance;
- a. For the entire duration of the fourteen (14) consecutive day run-in period before the Acceptance Test and the fourteen (14) day Acceptance Test, the Facility shall be operated and maintained such that the Facility is in full compliance with all operating parameter provisions established by equipment manufacturer's warranties at all times;
  - b. Except for rotation of RO trains, maintenance activities that result in a decrease in Product Water output below 0.30 mgd during the fourteen (14) day Acceptance Test period or a decrease in Product Water output below 0.30 mgd during the fourteen (14) consecutive day run-in period before the Acceptance Test shall constitute a failure condition;
  - c. A ten percent (10%) decrease in normalized permeate flow, a ten percent (10%) decrease in normalized permeate quality, or a ten percent (10%) increase in normalized pressure drop as measured between the feed and concentrate headers for any RO membrane train during the twenty-eight (28) day reliability demonstration shall constitute failure conditions; and
  - d. The need for any CIP operations or more than one (1) cartridge filter replacement operations to maintain the conformance with manufacturer's recommendations for equipment operation during the fourteen (14) day Acceptance Test shall constitute a failure condition.

### TEST PREREQUISITES

Test prerequisites shall include:

- (i) A certification that all instruments needed for the test are functional and calibrated and that the Facility PLC system is fully functional and all PLC, and analyzer information has been verified;
- (ii) The facility shall be permitted in accordance with California Department of Health requirements and authorized to produce drinking water for human consumption;

- (iii) Baseline RO Membrane data for normalization calculations was obtained within 48 hours of initial operation of each of the membrane trains; and
- (iv) A fourteen (14) day run-in period pursuant to the requirements above has been successfully completed without the need to perform CIP operations or more than one (1) cartridge filter replacement operation in order to maintain the conformance with manufacturer's recommendations for equipment operation.
- (v) At least one (1) well from the Bay well field and one (1) well from the Tioga well field are operating simultaneously to provide feed water for operation of the facility.

### KEY ACCEPTANCE TEST FEATURES

Key Acceptance Test features are presented below:

- (i) A log specifically prepared for the Acceptance Test, and approved by California American Water prior to the fourteen (14) day run-in period shall be maintained.
- (ii) PLC readings taken from centralized control system displays shall be verified by readings taken from process-mounted instruments or, as applicable, laboratory analysis.
- (iii) The total Facility power consumption, excluding building loads, shall be determined based on the kilowatt hour readings from a PQM monitor (or equal).
- (iv) Product Water flow shall be measured at the discharge of the product pumps and prior to blending.
- (v) Product Water quality shall be measured by taking water samples before and after blending and shall be within the parameters stated in the Engineer's Design Report (Tables 2-3 and 2-8).
- (vi) All Facility maintenance activities shall be logged for the duration of the fourteen (14) day run-in period prior to the Acceptance Test and the fourteen (14) day Acceptance Test.
- (vii) All analytical testing shall be conducted by California American Water staff or an agreed certified lab to demonstrate that Product Water Quality Standards are met.
- (viii) Chemical consumption measurements shall be completed according to Engineer's Operations and Maintenance Manual. For chemical consumption, the following parameters shall be reported:
  - a. Chemical grade (as delivered);
  - b. Dosing rate, mg/l;
  - c. Solution concentration (as dosed); and
  - d. Storage tank levels, deliveries, and changes in inventory amounts;
- (ix) Maintenance activities during the fourteen (14) day run-in period and the fourteen (14) day Acceptance Test shall be logged and reported.

### Notes:

1. As applicable, data shall be normalized by the City of Sand City, its Engineer, or California American Water in accordance with membrane manufacturer's procedures.

**ACCEPTANCE TEST REPORT**

Within twenty (20) days following conclusion of the Acceptance Test, the City of Sand City shall furnish California American Water with the Acceptance Test Report. The Acceptance Test Report shall present all data, calculations, and other information obtained in the course of the Acceptance Test. All calculations used or prepared by the City of Sand City shall be sufficiently documented in the Acceptance Test Report so that they can be independently verified.

(END OF ATTACHMENT A)

# **ATTACHMENT B**

**BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF CALIFORNIA**

In the Matter of the 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.

A.10-04-019  
(Filed April 12, 2010)

**SETTLEMENT AGREEMENT BETWEEN CALIFORNIA-AMERICAN WATER  
COMPANY AND THE DIVISION OF RATEPAYER ADVOCATES**

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August 10, 2012

**BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF CALIFORNIA**

In the Matter of the 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.

A.10-04-019  
(Filed April 12, 2010)

**SETTLEMENT AGREEMENT BETWEEN CALIFORNIA-AMERICAN WATER  
COMPANY AND THE DIVISION OF RATEPAYER ADVOCATES**

**I. RECITALS**

- A. On November 5, 2007, California-American Water Company (“California American Water” or “CAW”) and the City of Sand City (“Sand City”) entered into a lease in order to operate the Sand City Desalination Plant, a reverse osmosis desalinization facility with a projected annual capacity of 300 acre-feet (“AF”) per year constructed by the City.
- B. In Application (“A.”) 08-01-027, filed January 30, 2008, California American Water sought authorization to include the costs of water purchased from the Sand City Desalination Plant under the November 5, 2007 lease agreement in its 2009 test year revenue requirement.
- C. In Decision (“D.”) 09-07-021, issued on July 9, 2009, the Commission rejected CAW’s request, without prejudice.
- D. On October 30, 2009, California American Water entered into an amended lease. Consistent with D.11-03-048, which authorized California American Water to acknowledge in its tariff a water moratorium in its Monterey District, the October 30, 2009 lease agreement allows Sand City access to no more than 206 AF per year for new connections within its jurisdiction.
- E. On April 12, 2010, California American Water filed an application for an order authorizing recovery of costs associated with the October 30, 2009 lease agreement as well as the direct testimonies of Eric J. Sabolsice, Jeffrey M. Dana, and Steve Matarazzo. California

American Water is currently operating the Sand City Desalination Plant and delivering water to the Monterey District for the use of District customers.

F. On May 14, 2010, the Division of Ratepayer Advocates (“DRA”) protested California American Water’s application to recover the Sand City Desalination Plant costs from ratepayers.

G. On May 27, 2010, California American Water replied to DRA’s protest.

H. On September 30, 2010, the assigned Commissioner issued a ruling setting the schedule and requiring California American Water to file and serve supplemental information on the issues set forth in the ruling no later than October 18, 2010. The Commissioner permitted DRA to file and serve a written response to the supplemental information no later than October 25, 2010.

I. On August 4, 2011, Administrative Law Judge (“ALJ”) Maribeth A. Bushey issued a proposed decision denying all costs associated with the October 30, 2009 lease agreement.

J. On September 7, 2011, CAW and DRA provided comments to the proposed decision.

K. On September 14, 2011, both parties provided reply comments to the proposed decision.

L. On September 28, 2011, California American Water filed a Motion to Offer Testimony into Evidence. California American Water submitted the direct testimonies of Eric J. Sabolsice, Jeffrey M. Dana, and Steve Matarazzo. DRA protested CAW’s motion on October 13, 2011 and California American Water responded to the protest on October 24, 2011.

M. On November 10, 2011, the Commission withdrew the proposed decision and on December 2, 2011, ALJ Bushey issued a revised proposed decision allowing California American Water recovery of some of the costs associated with the Sand City Desalination Plant from ratepayers.

N. On December 19, 2011, Sand City filed, with the Commission, a Motion Requesting Party Status. ALJ Bushey granted Sand City’s Motion on December 27, 2011.

O. On December 29, 2011 and January 3, 2012, California American Water and DRA filed and served their opening and reply comments to the revised proposed decision, respectively.

P. On February 3, 2012, Commissioner Michel P. Florio issued an amended scoping memo

setting aside the Revised Proposed Decision and reopening the record to address legal and policy arguments on the appropriate price for water delivered from the Sand City Desalination Plant to the Monterey District for use in reducing Carmel River withdrawals. Commissioner Florio asked both parties to file and serve an evidentiary presentation addressing the issues raised by the amended scoping memo no later than March 2, 2012. The amended scoping memo also granted CAW's September 28, 2011 motion and received into evidence the direct testimonies of Eric J. Sabolsice, Jeffrey M. Dana, and Steve Matarazzo.

Q. On March 2, 2012, DRA filed and served its evidentiary presentation. California American Water served its evidentiary presentation on the proceeding's parties, and subsequently filed it with the Commission on March 6, 2012. In his supplemental testimony included in the compliance filing, Mr. Jeffrey M. Dana noted that CAW initially underestimated property tax costs in its original application due to the challenges in estimating the amount it would owe in taxes until the tax assessor completed the property's valuation.

R. On March 16, 2012, DRA filed and served its response to California American Water's presentations and testimony served on March 2, 2012 and filed on March 6, 2012. On March 30, 2012, CAW served and filed a Motion for Cross-Examination as well as its response to DRA's March 2, 2012 evidentiary presentation and its March 16, 2012 response. Sand City also served and filed its response to DRA's and CAW's March 2, 2012 evidentiary presentation as well as a response to DRA's March 16, 2012 response.

S. On April 13, 2012, DRA served and filed a Motion to Strike Portions of the Testimony of California American Water and Sand City. On April 27, 2012, California American Water filed and served a response to DRA's April 13, 2012 Motion to Strike.

T. On May 30, 2012, ALJ Bushey issued a ruling setting the date for cross-examination.

## **II. GENERAL**

A. Pursuant to Article 12 of the Commission's Rules of Practice and Procedure, DRA, and California American Water (collectively, "the Parties"), desiring to avoid the expense, inconvenience and the uncertainty attendant to litigation of the matters in dispute between them,

have agreed on the terms of this Settlement Agreement (“Settlement Agreement”) which they now submit for approval.

B. Because this Settlement Agreement represents a compromise by them, the Parties have entered into each stipulation contained in the Settlement Agreement on the basis that its approval by the Commission not be construed as an admission or concession by any Party regarding any fact or matter of law in dispute in this proceeding. Furthermore, the Parties intend that the approval of this Settlement Agreement by the Commission not be construed as a precedent or statement of policy of any kind for or against any Party in any current or future proceeding. (Rule 12.5, Commission's Rules on Practice and Procedure.)

C. The Parties agree that no signatory to the Settlement Agreement assumes any personal liability as a result of their agreement. All rights and remedies of the Parties are limited to those available before the Commission.

D. The Parties agree that the Settlement Agreement is an integrated agreement such that if the Commission rejects or modifies any portion of this Settlement Agreement, each Party must consent to the Settlement Agreement as modified, or either Party may withdraw from the Settlement Agreement.

E. The Parties agree to use their best efforts to obtain Commission approval of the Settlement Agreement. The Parties shall request that the Commission approve the Settlement Agreement without change and find the Settlement Agreement to be reasonable, consistent with the law, and in the public interest.

F. This Settlement Agreement may be executed in counterparts, each of which shall be deemed an original, and the counterparts together shall constitute one and the same instrument. Each of the Parties hereto and their respective counsel and advocates have contributed to the preparation of this Settlement Agreement. Accordingly, the Parties agree that no provision of this Settlement Agreement shall be construed against any Party because that Party or its counsel drafted the provision.

### III. RECOVERY OF COSTS OF THE SAND CITY DESALINATION PLANT

- A. As described below, the Parties agree that the Commission should authorize California American Water's request to increase its Monterey District revenue requirement to reflect the costs of operating (including annual lease payments, as imputed as "fixed costs", made to Sand City or its successor in interest), maintaining, and delivering water to customers from the Sand City Desalination Plant.
- B. The Parties agree that California American Water shall file as part of its next general rate case ("GRC") a showing that any costs and/or assets used in operating the Sand City Desalination Plant and authorized by this Settlement Agreement are not also included in any other authorized revenue requirement.
- C. The Parties agree that in its next GRC, California American Water will report on programs it has instituted and other efforts to reduce the use of potable water for landscape irrigation in the Monterey District. The report should address:
1. Project, additional alternative sources of irrigation water, and/or customer education used to reduce potable water demand;
  2. Other innovative programs, projects, pilots, experiments, or other measures that may be reasonably designed to reduce the use of potable water for landscape irrigation.
- D. The Parties agree that California American Water is authorized to file and serve a Tier 2 Advice Letter establishing the Sand City Desalination Plant Purchased Water Surcharge. California American Water will calculate the surcharge based on the total annual authorized costs of initially \$779,872 divided by the total projected sales of all systems able to avail themselves of water from either the Carmel River or the Seaside Basin. This results in a surcharge on all units of water sold for these systems of \$0.155 per Ccf, or \$0.0155 per 10 Cf.
- E. The Parties agree that California American Water 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:

1. Only costs for actual water delivered, measured in AF, may be included.
2. The price per AF of water delivered shall be set at \$2,599 per AF until the effective date of the next GRC. Below is the calculation for the Sand City Desalination Plant Purchased Water Balancing Account. The fixed cost is 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
Operation, Maintenance, and Repair Costs	
Repair Costs	\$122,764
Other O&M	\$86,012
Actual Purchased Power	\$156,374
<b>COST TOTAL</b>	<b>\$779,822</b>

Annual Plant Production	300 AF
Price per AF	\$2,599

Fixed Cost: The Parties agree that this amount shall not change for each year of the 31-year lease agreement, 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.

Operation, Maintenance, Repair, and Other Variable Costs: The Parties agree that the Commission shall use the amounts specified above as the base amount for 2012. It is acknowledged that the agreed price of \$2,599 per AF proposed in this settlement does not include all known costs of

operating the facility, including property taxes, which were omitted from the original application. Therefore, in future GRCs, California American Water shall review the facility's actual operating expenses (including taxes) and propose a revised price per AF to be recovered in rates in each successive GRC.

Actual Purchased Power: The Parties agree that this amount shall be forecasted in each GRC and trued-up annually to actual costs incurred.

Annual Plant Production: The Parties agree that California American Water shall use actual annual plant production in determining the Sand City Desalination Plant Purchased Water Surcharge. The Parties agree that 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.

3. The Parties agree that California American Water may include in the balancing account all water delivered from and after the date of this settlement.

F. The Parties agree that California American Water is authorized to include in the Sand City Desalination Plant Purchased Water Balancing Account \$2,599 per AF for water delivered to the Monterey District system from the Sand City Desalination Plant prior to this settlement's effective date. The Sand City Desalination Plant Purchased Water Balancing Account includes costs incurred after April 2010 and is limited to the costs California American Water tracked in the Cease and Desist Order memorandum or balancing account. California American Water 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 AF, must be priced at \$2,599 per AF 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 consistent with the Commission's recovery of balancing accounts, but not to exceed a period ending as of December 31, 2014. The surcharge shall be calculated in a manner consistent with the recovery of other purchased water balancing accounts, including that the costs will be recovered uniformly on all units of water billed to customers. For the period prior to the effective date of this settlement, 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 AF. From and after the effective date of this settlement, the interest rate on such amounts shall be as specified for other amounts recorded in the Sand City Desalination Plant Purchased Water Balancing Account.

In calculating the recoverable amount of costs for any given year, the maximum production capability of the facility (presently 300 acre-feet) shall be used to determine the recoverable cost per acre-foot. For any year in which the actual quantity of water delivered into the system exceeds the maximum production capability of the facility, the actual quantity of water delivered into the system will become the maximum production capability of the facility for that and all subsequent calculations. The following example illustrates these calculations for a hypothetical year in which the actual quantity of water delivered into the system is less than the maximum production capability of the facility.

<b>Example</b>	
(1) Fixed Cost (not to change)	\$414,672
(2) Actual Prudent and Reasonable Operations, Maintenance, and Repair Costs	\$400,000

(3) Actual Purchased Power	\$150,000
(4) Cost Total [(1) + (2) + (3)]	\$964,672
(5) Maximum Production Capability	300 af
(6) Recoverable Price per Acre-foot [(4)/(5)]	\$3,215/af
(7) Actual quantity of water delivered into system	250 af
(8) Total Recoverable Costs [(6)*(7)]	\$803,750

G. The Parties recommend that the Commission close A.10-04-019 as the Parties addressed all the relevant and outstanding issues in this Settlement Agreement.

**IV. CONCLUSION**

This Settlement Agreement was executed by the Parties as of the date first set forth below.

August \_\_, 2012

DIVISION OF RATEPAYER ADVOCATES

By: \_\_\_\_\_  
Joseph P. Como, Acting Director

August 10, 2012

CALIFORNIA-AMERICAN WATER COMPANY

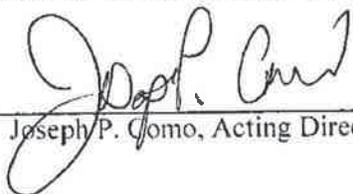
By: Robert MacLean  
Robert MacLean, President

**IV. CONCLUSION**

This Settlement Agreement was executed by the Parties as of the date first set forth below.

August 14, 2012

DIVISION OF RATEPAYER ADVOCATES

By:   
Joseph P. Como, Acting Director

August \_\_, 2012

CALIFORNIA-AMERICAN WATER COMPANY

By: \_\_\_\_\_  
Robert MacLean, President