

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA



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In the Matter of the Application of
California American Water Company
(U 210 W) for a Certificate of Public
Convenience and Necessity to
Construct and Operate its Coastal
Water Project to Resolve the Long-
Term Water Supply Deficit in its
Monterey District and to Recover All
Present and Future Costs in
Connection Therewith in Rates.

Application 04-09-019
(Filed September 20, 2004;
Amended July 14, 2005)

OPENING BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES

MONICA McCRARY
Attorney for the
Division of Ratepayer Advocates
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-1288
Email: mlm@cpuc.ca.gov

DIANA BROOKS
MAX GOMBERG
RICHARD RAUSCHMEIER
NIHAR SHAH
JOYCE STEINGASS
LINDSEY FRANSEN
LYNN MAACK
Division of Ratepayer Advocates
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-1445
Email: dsb@cpuc.ca.gov

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Pursuant to Rule 13.11 of the California Public Utilities Commission's ("Commission") Rules of Practice and Procedure and the schedule set by Administrative Law Judge Minkin, the Division of Ratepayer Advocates ("DRA") files its Opening Brief on the Settling Parties'¹ Motion to Approve Settlement Agreement. The Settlement Agreement includes two Implementing Agreements, a Water Purchase Agreement ("WPA") and an Outfall Agreement.

I. DRA SUPPORTS THE REGIONAL PROJECT BUT DOES NOT SUPPORT REQUIRING CAL AM RATEPAYERS TO SUBSIDIZE DEVELOPMENT AT THE FORMER FORT ORD

As DRA set forth in its Comments on the Settlement Agreement, DRA supports a regional desalination project that based upon a public-private partnership with a diverse

¹ The Settling Parties are California American Water Company ("Cal Am"), Monterey County Water Resources Agency ("MCWRA"), Marina Coast Water District ("MCWD"), Monterey Regional Water Pollution Control Agency, Surfrider Foundation, The Public Trust Alliance, and Citizens for Public Water.

group of beneficiaries, and that includes effective cost controls, fair representation and equitable allocation of costs and risks among beneficiaries.

In fulfilling its duty to Cal Am ratepayers, DRA must attempt to ensure that the Regional Project is fair to Cal Am customers and does not result in unacceptable costs and risks being allocated to Cal Am ratepayers. The Water Purchase Agreement, however, is a one-sided agreement that shifts the costs and risks of the desalination plant almost entirely to Cal Am ratepayers. Cal Am's tenuous position of having to obtain a new water supply to comply with the State Water Resources Control Board (SWRCB) Cease and Desist Order ("CDO") and avoid having its shareholders pay fines has resulted in Cal Am agreeing to a Regional Project that lacks adequate cost protections for its ratepayers.

It is DRA's responsibility to Cal Am ratepayers to assure that they are not subsidizing other ratepayers, or, more importantly, subsidizing the future development of the former Fort Ord. MCWD has a legal obligation to provide water to meet the water needs identified in the Fort Ord Reuse Authority Base Use Plan.² MCWD needs to develop an additional 2,700 acre-feet a year beyond existing supplies to fulfill its legal obligation.³

Cal Am ratepayers should not bear the costs of Fort Ord development and growth. DRA's recommendation seeks to place the costs associated with the desalination plant capacity necessary for the development of the former Fort Ord on MCWD, the party that will be supplying water to the former Fort Ord.

DRA is also concerned that the Settlement Agreement allows MCWD to expand the Regional Project to provide for future growth in its service territory at the expense of Cal Am's ratepayers. The Settlement Agreement has been craftily drafted to appear to require Commission approval for plant expansion when in fact no such requirement

² MCWD/Lowrey 13 RT 1246.

³ MCWD Ex. 306, p. 4.

exists.⁴ The Commission must modify the Settlement Agreement to ensure that Commission approval and renegotiation of the Water Purchase Agreement will be required if the Desalination Plant is expanded. The agreement should be revised to ensure that Cal Am ratepayers receive the benefits of economies of scale and do not subsidize growth and development through plant expansion.⁵

II. WHAT WILL THE PROJECT COST CAL AM RATEPAYERS?

Since MCWD issued testimony on August 20, 2009, the cost of this project has increased significantly. In August of 2009, MCWD estimated the total capital costs of the Regional Facilities at \$187,600,000 and represented that it would cost \$2,290 per acre foot.⁶ MCWD stated that this estimate assumed that it would borrow money at a 5.15% interest rate over 30 years.⁷ This estimate did not include reductions associated with state or Federal grants which would make the Regional Project “even less costly to the ratepayers.”⁸

Today, less than one year later, Regional Project capital cost estimates have risen to \$297,470,000.⁹ MCWD no longer estimates product water costs at \$2,290 per acre-

⁴ MCWD Ex. 301, p. 21. The Parties have defined “Substantive Amendment” as “any amendment to this Agreement that will result in . . . an increase in the capacity. . .” MCWD Ex. 301, emphasis added. This definition does not prevent an increase in capacity that does not result in “any amendment to this Agreement.” Unless an expansion of the plant requires an amendment to the Agreement, no CPUC review is necessary to assure the Cal Am ratepayers are fairly treated and not subsidizing future development. As written, the WPA would allow MCWD to expand the plant and enter into separate agreements with other parties without any CPUC approval required. Cal Am ratepayers would not be reimbursed for the costs of the underlying facilities, nor would the Product Water costs to Cal Am be reduced for the economies of scale that could result from an expanded desalination plant.

⁵ MCWD Ex. 301, p. 2. Article H states that “this Agreement does not contemplate or address any elements other than ‘Phase I of the Regional Project.’” Another sentence should be added that says, “Any expansion of the desalination plant beyond Phase I of the Regional Project requires a Substantive Amendment to this Water Purchase Agreement.”

⁶ MCWD Ex. 306, p. 29, Table 11. MCWD identified only brine disposal cost as not being included in this estimate, because the costs were not yet available.

⁷ Id. at p. 28.

⁸ Id at p. 29. DRA notes that its recommend cost cap of \$2,200 is consistent with the Parties’ first estimates without grants.

⁹ MCWD Ex. 301, Exhibit C.

foot. Instead it provides six scenarios with a range of costs during the first year of operation from \$3,220 to \$5,550 per acre-foot for Product Water.¹⁰ The only scenario comparable to MCWD's initial August 2009 estimate that did not include grants results in a \$5,550 plant cost per acre-foot.¹¹ MCWD's five other scenarios resulted in costs ranging from \$3,220 to \$3,880 plant cost per-acre-foot. These scenarios are based on the unsupported assumption that 73 to 90 percent of the plant costs could be financed with State Revolving Fund loans.¹² These five estimates are all calculated using capital costs of \$48 to \$70 million less than the requested cost cap.¹³ MCWD's lowest cost estimate of \$3,220 per-acre-foot assumes it will obtain \$80 million in grants even though it did not present any evidence regarding the availability or likelihood of these funds.

MCWD had previously determined that \$3,115 per-acre-foot was too costly for desalinated water for its own ratepayers,¹⁴ but its lowest cost estimate for the Regional Project now exceeds this number.

When the costs of the Cal Am facilities are added to the Regional Project cost estimates, the potential expense of this project to Cal Am ratepayers is astonishing. Adding Cal Am facility costs to the six cost scenarios presented by MCWD in rebuttal testimony results in a per-acre-foot desalinated water cost to Cal Am ratepayers of \$4,700 to \$7,100.¹⁵ The Parties even present a scenario showing estimated costs as high as \$9,600¹⁶ per acre-foot. While this scenario reflects the expected financing costs if Cal Am were to be an independently rated company, the Cal Am witness testified that even

¹⁰ MCWD Ex. 319, p. 23.

¹¹ Id. at p. 21.

¹² Ibid.

¹³ Id at p. 21.

¹⁴ DRA Ex. 201, p. i. states the cost of water from a MCWD stand-alone desalination plant would cost \$3115 per acre- foot, which Mr. Heitzman testified was "too costly." MCWD/Heitzman 12 RT 1162.

¹⁵ Cal Am/MCWD/MCWRA Ex. 113.

¹⁶ Ibid.

this scenario did not necessarily represent a “worst-case scenario” as it was uncertain whether any impacts of debt equivalence were captured.¹⁷

To approve this agreement, the Commission must find that it will result in just and reasonable rates to Cal Am ratepayers. DRA is hard pressed to determine how the Commission can make such a finding when the Parties’ own cost estimates vary so dramatically. Costs at the highest level estimated by Cal Am would result in a tripling of Cal Am’s revenue requirement and a tripling of rates.¹⁸ Had the cost per acre-foot been included in the contract, the Commission could make that determination and approve the contract. However, here that cannot be done. Without a per-acre-foot cost cap, the Commission will need to find that costs up to the maximum possible under the agreement, whatever those may be, will result in just and reasonable rates. This type of finding is not possible, because, unless modified, the Water Purchase Agreement requires Cal Am ratepayers to pay for the cost of Product Water no matter how high those costs may be. In essence, the WPA is the worst kind of a contract; one that places an unlimited cost responsibility on Cal Am’s ratepayers.

Without a realistic cost cap and a cost cap that encourages cost containment, MCWD will have little incentive to control costs, especially because under the WPA, it receives water under its Agreed Allocation at \$148 per acre-foot, and its contribution to Regional Project capital costs is capped at \$22 million over the entire term of the Water Purchase Agreement. DRA notes that MCWD has no problem in establishing a cost cap and fixed water cost for its share of the agreement but opposes similar protections for Cal Am’s customers.

¹⁷ Cal Am/Stephenson, 14 RT 1592.

¹⁸ The Cal Am current revenue requirement is approximately \$43 million. DRA Ex. 202, p. 5-38. The Parties’ Scenario A, their highest estimate, results in a first-year incremental revenue requirement of \$86.6 million. Together, these amounts represent a revenue requirement of \$129.6 million, or 3 times the current revenue requirement. Cal Am/MCWD/MCWRA Ex. 113.

III. THE COMMISSION MUST ADOPT A COST CAP TO ASSURE JUST AND REASONABLE RATES

A. A per-acre-foot cost cap is necessary to assure rates are just and reasonable.

As DRA discussed in its Comments on the Settlement Agreement issued on April 30, 2010, Public Utilities Code (“P.U. Code”) §§ 451, 454 and 728 require the Commission to ensure that Cal Am’s rates are just and reasonable. For the Commission to make a finding that Cal Am’s rates are just and reasonable it must know what the desalination project will cost and generally how it will affect Cal Am customers’ rates. However, the Commission will not be able to make such a determination if there is no cost cap or a “capital cost cap” which does not include all of the costs of the project, as recommended by the Parties.

The Proposed Settlement Agreement unlawfully prevents the Commission from carrying out its statutory duty to ensure that rates are just and reasonable because its provisions require the Commission to find that all MCWD and MCWRA costs, (no matter how high), are reasonable and prudent.¹⁹ Regional Desalination Project costs incurred by MCWD and MCWRA are included in the cost of Product Water charged to Cal Am.²⁰ Costs, such as the operational expenses, general and administrative expenses, and litigation expenses are *unbounded* and lack sufficient controls. These expenses are all included in the cost of Product Water charged to Cal Am ratepayers with no reasonableness or prudence review by the Commission.²¹ Even Cal Am’s own costs would be excluded from reasonableness review and would be deemed reasonable upon Commission approval of the Settlement.²²

¹⁹ Settlement Agreement § 10.1.

²⁰ See April 30, 2010 Comments, page 64 for full discussion of the legality of the deemed reasonable provision.

²¹ Settlement Agreement § 10.3. Pursuant to the proposed Settlement Agreement, the product water costs are recovered from Cal Am ratepayers through rates by means of the authorized Modified Cost Balancing Account, which is not reviewed for reasonableness.

²² Settlement Agreement § 10.2; MCWD Ex. 301, § 11.2(d). To the extent that Cal Am incurs costs

DRA does not dispute that it would be easier to complete the Regional Project without a cap on the price of water – spending money is always easier when no boundary conditions exist. However, the benefits that ensue from having an upper bound on the maximum amount customers will pay for water easily outweigh the concerns and inconvenience of working within a budget. Because the estimate of construction costs presented in Exhibit C of the Settlement Agreement admittedly portrays only a fraction of the total costs imposed on customers through the price of product water, it is critical to establish an all-inclusive cost estimate to gauge the prudence and reasonableness of the project as a whole. This can only be accomplished by establishing a per-acre-foot cost cap. Anything less presents Settling Parties with a blank check and runs the risk of the Commission ultimately authorizing the development of the country’s most expensive water supply.

Establishing a per-acre-foot price cap, which the Commission would need to review if such cap were exceeded, would create an appropriate customer safeguard and a worthwhile management incentive. At a point when so many of the costs affecting the ultimate price of product water remain unknown or un-quantified, a comprehensive cost cap for water leaving the plant is the only means of protecting Cal Am ratepayers from the automatic pass-through of unbounded expense and cost allocations. Given the size of the project and its unusually large effect on Cal Am’s Monterey rates, a firm cost cap is a necessary means of inserting cost control into the development process.

B. The Parties’ proposed cost cap and their recommendation for no cost cap will not protect ratepayers.

DRA recommends that the Commission adopt a per-acre-foot cost cap on the cost of Product Water purchased by Cal Am under the Water Purchase Agreement. In contrast, the MCWD recommends that the Commission adopt no cap at all,²³ or a \$297 million “capital cost cap,” which does not include all costs of the project, or even all of

relating to its obligations under the Water Purchase Agreement (“WPA”), these costs will be charged to MCWD and MCWRA and billed back to Cal Am’s customers through the cost of Product Water.

²³ MCWD/Fogelman 15 RT 1758-59.

the capital costs, since it excludes interest during construction. MCWD witness Mr. Heitzman indicated that “[i]f the Commission imposes a cap, the cap should be set at a level that is unlikely to be exceeded.”²⁴ Presumably this is how the Parties have set their \$297 million cost cap -- at a level that is so high that it would never be exceeded. A cost cap should be used to help contain costs. A cost cap that is so high that it would never be exceeded has no purpose.

C. The Parties’ proposed cost cap places no limits on O&M costs and includes atypical costs such as litigation

The Parties’ proposed cost cap places no cap on the operation costs of the project once complete. The Water Purchase Agreement allows MCWD to pass numerous types of costs on to Cal Am ratepayers without any limit. These costs include all operation and maintenance (“O&M”) expenses,²⁵ all Regional Desalination Project Related Expenses,²⁶ and all litigation costs.²⁷ O&M costs are usually two-thirds of total costs of desalinated water,²⁸ with half of this amount for energy costs and the other half for operating costs. This is a significant cost that is left uncontained.

It is troubling that while the amount of these unbounded costs, like litigation-related costs, are not yet known, the Parties have attempted to assure that there is no limit to what Cal Am ratepayers will be required to pay because they have inserted a clause to the Agreements that deems all such costs, regardless of what they are or how high they may be, as reasonable and prudent upon approval of the agreement by the Commission.²⁹ Having MCWD pay its full 16.2% share of litigation costs will provide equity and an

²⁴ MCWD Ex. 305, p. 18.

²⁵ MCWD Ex. 301 § 11.1, & definition of O&M costs, p. 16.

²⁶ MCWD Ex. 301, p. 20 definition of Regional Desalination Project Related Expenses. See also the definition of O&M Expenses which includes litigation costs described in WPA § 14.2. See also the definition of MCWD O&M Costs which includes all Regional Desalination Project Related Costs.

²⁷ Prior to Acceptance, litigation costs are classified as “Pre-Acceptance Defense Costs,” and reimbursed to the Parties from any indebtedness, which MCWD now proposes should not be capped. After Acceptance litigation costs are classified as “Regional Desalination Project Related Expenses” and recovered from ratepayers as unbounded O&M costs. MCWD Ex. 301, § 14.2.

²⁸ DRA Ex. 204, p. 18.

²⁹ Ex. MCWD 363, §§ 10.1. & 10.2.

incentive to keep those costs reasonable. Litigation and other O&M costs would be capped if the Commission adopts DRA's recommended \$2,200 per acre-foot cost cap, because DRA's cap includes both capital and O&M costs.

What the parties are requesting is for the Commission to allow them an unlimited budget for all Product Water costs. All organizations, both public and private, work within a budget. Parties have not explained why they should be exempt from working within a budget or why their budget should be set so high that it would never be exceeded. The Commission should not make an exception for this project and throw sound accounting, financial and management practices such as budgeting and working within a budget, out of the window, especially when doing so will be at Cal Am ratepayers' expense.

The Scoping Memo in this proceeding rightfully stated that the Commission would look to P.U. Code § 1005.5 when reviewing the costs of this project. Section 1005.5 requires the Commission to determine a maximum cost that is reasonable and prudent when certifying new or additional construction greater than \$50 million for gas and electric companies.³⁰ While § 1005.5 does not specifically apply to water corporations, it is appropriate for the Commission to require a cost cap for this unprecedented water supply project to assure that Cal Am ratepayers are protected. DRA is not aware of any other Class A water project that even comes close to the estimated cost of this project. Cal Am ratepayers' rates will double or triple from just this project alone. To protect ratepayers, the Commission must set a "maximum cost determined to be reasonable and prudent for the facility," and this "maximum cost" must include all costs, not just those the parties want to include.³¹

This agreement may last 94 years. The Cal Am ratepayers should not be expected to write a blank check to obtain much-needed water. A cap on these operation and

³⁰ Scoping Memo, p. 7.

³¹ The Commission has adopted per unit cost caps for energy projects where the cost included both capital and O&M costs. See D.09-06-049, Ordering Paragraph 1, "Costs in excess of \$3.85 per watt subject to a reasonableness review."

maintenance costs is both needed and necessary to protect Cal Am ratepayers and assure just and reasonable rates. As written, the WPA makes Cal Am's ratepayers the ultimate deep pocket for any and all costs associated with the Regional Project. This is not only unreasonable, it violates long-standing Commission rate-making principles and applicable statutes.

D. DRA's recommendation of a cost cap of \$2, 200 an acre-foot is based on reliable data used by the U.S. Bureau of Reclamation

DRA's recommendation of a cost cap of \$2,200 an acre-foot is based on data from the Water Desalination Report,³² which was used by experts from the United States, Bureau of Reclamation in their report to DRA.³³ The Bureau of Reclamation ("Reclamation") has extensive experience with desalination plant construction and costs and is familiar with costs of desalination projects both in the United States and abroad.³⁴ As one can see from its detailed analysis, Reclamation is familiar with the typical costs of desalinated water and found the data published in the Water Desalination Report useful and reliable in making cost comparisons and showing a range of expected costs in its report to DRA.³⁵ It is common in estimating the cost of a project at a conceptual or feasibility level to make such comparisons to other projects to provide an idea of the range of expected costs. DRA used a subset of this same data as part of its analysis in making its recommendation regarding a cost cap of \$2,200 per acre-foot.³⁶

Moreover, DRA's recommendation of \$2,200 per acre-foot is within the range of the Parties' own cost estimate. On February 16, 2010, the parties informed the State Water Resources Control Board that the cost of the Regional Project ranged from \$1,700

³² DRA Ex. 202, p. 1-1 to 1-5.

³³ DRA/Shah 14 RT 1492.

³⁴ DRA Ex. 205.

³⁵ DRA Ex. 204, p. 15-18.

³⁶ DRA/Shah 14 RT 1492.

an acre-foot to \$2,200 per acre-foot.³⁷ In addition, MCWD’s witness, Mr. Lyndel Melton, indicated that the costs would be \$2,290 an acre-foot not including the effects of grants or State Revolving Fund Loans.³⁸

It appears that Parties are proposing an artificially high cost estimate only to ensure that any cost cap set by the Commission is “unlikely to be exceeded.”³⁹ DRA believes the \$2,200 per-acre-foot desalinated water cost is achievable. To the extent that the Parties believe the \$2,200 an acre-foot cost is too low, DRA has identified a number of ways that the parties may be able to reduce the capital costs of the project. For example, the Bureau of Reclamation recommends that the desalination plant be competitively bid.⁴⁰ Reclamation demonstrated the benefits of a competitively-bid desalination plant where the bids ranged from \$75 million to \$132 million and the low bid was 57% below the highest bid.⁴¹

As discussed in more detail below, the Parties may be able to reduce costs by eliminating a second pass. A pilot project could speed up implementation and reduce financing costs, while slant wells could reduce transfer cost, O&M cost and litigation risks and costs. Any reduction in the base cost would translate into a corresponding reduction in any multipliers such as the contingency and implementation costs.

E. Impact of cost cap of project financing

Regarding the impact of a per-acre-foot cost cap on financing, DRA witness Mr. Rauschmeier acknowledges there will be an impact.⁴² The whole purpose of a cost cap is to guide the decisions that are made so as to lower the overall cost of a project. However, without a definitive financing plan for the project put forth by Settling Parties, it is impossible to adequately assess what the impact will be. In his testimony, Mr.

³⁷ DRA Ex. 202, p. 1-6 and 1-7.

³⁸ MCWD Ex. 306, p. 29, DRA Ex. 202, p. 1-6.

³⁹ MCWD Ex 305, p. 18.

⁴⁰ DRA Ex. 204, p. 17.

⁴¹ Id.

⁴² DRA/Rauschmeier, 14 RT 1674-75.

Rauschmeier contests the assertion that given the myriad financing and delivery options available, the prudent exercise of establishing a cost cap would render the project's successful advancement in jeopardy.⁴³ It is hard to imagine that any financing limitation resulting from a reasonable cost cap limitation would be less preferable than a project without limits, without cost boundaries, and without controls over the ultimate price of water.

IV. MARINA COAST WATER DISTRICT MUST PAY ITS FAIR SHARE OF THE REGIONAL PROJECT

A. The Water Purchase Agreement presents an asymmetrical transfer of cost to Cal Am ratepayers.

Reading the terms of the Water Purchase Agreement, one can only conclude that not all water is created equal. Although the Product Water from the desalination plant is being derived from the same sources and subject to the same treatment, the cost of the water produced by the project varies greatly depending on whom you are. Up to some indeterminate time⁴⁴ when according to MCWD it may actually “need” water, the \$148 per acre-foot that MCWD pays for desalinated water will be at most only 5% of the cost that Cal Am ratepayers will incur for the same desalinated water.⁴⁵

Even worse, the fractional cost that MCWD will pay is pegged not to the actual cost to produce desalinated water, but rather to the disparate cost of pumping and treating its own groundwater.⁴⁶ Far from being a true partner with a proportional share in the cost and benefits of a regional partnership, MCWD will be insulated from the actual costs to produce desalinated water and will have little incentive to control these costs, because it will be safe in the knowledge that the actual costs will be borne by a group without voice or recourse under the terms of the agreement—the Cal Am ratepayer.

⁴³ Id.

⁴⁴ MCWD/Heitzman 12 RT 1128 lines 11-13.

⁴⁵ Cal Am/MCWD/MCWRA Ex. 113, Scenario 6: Cost of Water to CAW = \$3,200.

⁴⁶ MCWD Ex. 301, Exhibit F: MCWD Variable Extraction Cost Determination Methodology.

This cost burden on the Cal Am ratepayer is assessed via transfer costs. **Transfer costs are the additional water costs that Cal Am ratepayers will absorb to offset the lower price MCWD will pay relative to the actual cost of desalinated water from the plant.**⁴⁷ Simply put, transfer costs are a subsidy from Cal Am ratepayers to MCWD. Because MCWD's share of the Regional Project capital costs is capped at a maximum of \$22 million and the price MCWD will pay for water prior to taking a permanent allocation is unrelated to actual plant costs, any increase in the costs of desalinated water due to financing issues, budget overruns, legal challenges, or other desalination-related expenses will be transferred entirely to the Cal Am ratepayer. DRA estimates that transfer cost could be as much as \$8.8 million annually⁴⁸ and the Parties estimate total transfer costs ranging from \$4.4 million to \$10.6 million annually.⁴⁹

One might argue that the only possible justification for using transfer fees to provide MCWD with an indefinite period of subsidized water supplies would be if there truly was no documented need for additional water by the Marina Coast Water District now or in the future. However, the evidence in the record demonstrates that is not the case. Numerous documents demonstrate MCWD's need for water. There are reports.⁵⁰ There are letters.⁵¹ There are technical memoranda.⁵² There are monitoring plans.⁵³

⁴⁷ DRA Ex. 202, pg. 4-32, Footnote 44.

⁴⁸ DRA Ex. 202, p. 4-33 estimates transfer costs at \$1,000 per acre-foot. 8,800 acre-feet x \$1,000 per acre-foot = \$8.8 million.

⁴⁹ Cal Am/MCWD/MCWRA Ex. 113, using Scenario 6 (lowest) and Scenario A (highest).

⁵⁰ DRA Ex. 201: MCWD Desalination Facility Basis of Design Report, dated March 2007.

⁵¹ MCWD Ex. 378 p. 1: Communication re Water Supply Permitting, dated October 22, 2008; MCWD Ex. 272, p. 1-2.

⁵² MCWD Ex. 376 pp. 1-2: Technical Memorandum No. 31.003-004 (TM 4), dated April 22, 2009; MCWD Ex 379, p. 2 & 4.

⁵³ MCWD Ex. 379: MCWD Letter re Approval of Sampling Plan for Desalination Treatment Plant Water Supply Permitting, dated December 22, 2008.

There is even the testimony of MCWD's own witness detailing potential contamination and the effects on current supplies if such contamination occurs.⁵⁴

Nevertheless, if one could somehow set aside all the evidence to the contrary and accept the MCWD assertion that it does not currently have a need for additional water,⁵⁵ MCWD should still pay for its right to a future, guaranteed, uncontaminated water supply from the Regional Desalination Plant for the future development of Fort Ord. If there were no Regional Project, MCWD would still need to develop a new water supply to meet Fort Ord water needs and would need to do so before development in Fort Ord began. As Mr. Heitzman, the General Manager of MCWD, testified, "when you are a water purveyor . . . your job is to stay ahead of development and/or call a moratorium."⁵⁶

Assuming one can suspend one's sense of equity and equality long enough to accept MCWD's exemption from paying project financing and capital costs, the exemption from paying the plant's marginal⁵⁷ operating expense stretches the bounds of credulity. While financing, capital, and even the fixed operating costs could arguably be considered capacity payments, the marginal operating expense is a purely variable cost with a direct relationship to the amount of water produced. Allowing the price MCWD pays for desalinated water to be anything below the marginal or incremental variable cost of producing such water results in unacceptable, unsupportable and unparalleled cost subsidies from Cal Am ratepayers.

DRA continues to support a regional project and partnership where partners pay amounts proportional to the percentage of water actually produced and actually received. DRA advocates for a revision to the Water Purchase Agreement to ensure that MCWD does not "transfer" its proportionate share of project capital and reserve costs to Cal Am ratepayers. Cal Am ratepayers should not be subsidizing water capacity costs for future

⁵⁴ MCWD/Lowrey 13 RT 1263 lines 24-28 and 1264 lines 1-14. MCWD/Trussell 15 RT 1735 lines 2-13.

⁵⁵ MCWD/Heitzman 12 RT 1130 lines 7-9.

⁵⁶ MCWD/Heitzman, 12 RT 1160.

⁵⁷ The marginal or incremental variable cost would be the actual cost at the time of production for the costs associated with energy, chemicals and outfall volume charges.

development on the former Fort Ord. As discussed below, DRA recommends MCWD pay its proportionate 16.2%, share of project capital costs and reserves from Project Acceptance. It is up to MCWD to decide how to allocate these costs between its current and future ratepayers in consultation with the Fort Ord Reuse Authority and to determine the appropriate source of funds for making the payments.

Further, DRA recommends additional modifications to the Water Purchase Agreement to ensure that Cal Am ratepayers do not pay the incremental production costs of leaving water in the Salinas Basin for MCWD's benefit. In addition to reducing the cash subsidy flowing North from the Peninsula, making the actual incremental cost of desalination the price per acre-foot that MCWD pays for its Agreed Allocation would establish a much-needed yet disturbingly absent link between the actual costs of desalination and the costs for which MCWD is responsible.

B. The Commission should not allow a Facilities Fees Limit to artificially determine the maximum amount MCWD will contribute to the costs of the Regional Project.

Until the indeterminate time when MCWD might take a permanent allocation, the costs that MCWD must pay under the Water Purchase Agreement bear absolutely no relationship to the actual costs that will be incurred to produce desalinated water. Compounding upon this inherent inequity, the Water Purchase Agreement places only a nominal value upon MCWD's maximum contribution via a limit on the facilities fees and further de-couples MCWD's financial responsibilities from the benefits it will receive from the project.

A careful reading of the Water Purchase Agreement's convoluted definition and calculation of Facility Fees, Facility Fees Limit,⁵⁸ and the corresponding impacts on other MCWD costs reveals that the \$22 million cap that has been set as the nominal facility fees limit will most certainly serve as the *maximum* amount MCWD will *ever* pay towards the total cost of the Regional Project during the potential 94-year term of the

⁵⁸ MCWD Ex. 301, p. 10 & §§ 11.4 & 11.14.

contract. This is indefensible given that a Regional Project would alleviate MCWD's need to spend at least \$42 million⁵⁹ in estimated capital costs to construct its own "urgently needed" desalination facility.⁶⁰ Moreover, the terms of the Water Purchase Agreement allow MCWD to achieve what has thus far been denied the Cal Am ratepayer—a known and guaranteed dollar amount of financial responsibility.

While the concept of facility fees may have originally been intended to lower overall project costs through application of developer contributions prior to project completion, the undeniable result here is an artificial cap upon MCWD financial obligations regardless of the quantity of water it receives or benefits it accumulates.

In deference to the barest minimum of equitable cost allocation, the Commission should modify the WPA to remove the pre-determined, nominal fees limit of \$22 million. Instead of a "fees limit," DRA recommends that MCWD pay its full pro rata share, or 16.2% of the Regional Facilities Debt Service and Reserve Fund and a fair share of the O&M costs. More specifically, DRA recommends that MCWD pay for its fair share of capital and reserve costs based upon its Permanent Allocation of 1,700 AFY and any additional water requested and received.⁶¹

DRA also recommends that MCWD pay its fully-allocated O&M cost for all water received under its Agreed Allocation⁶² but no less than the incremental desalination production costs. Additionally, DRA recommends that MCWD pay its fair share of 16.2% of the post-Acceptance litigation costs, which the Water Purchase Agreement

⁵⁹ DRA Ex. 201, pg. 13-2: MCWD Desalination Facility Basis of Design Report, dated March 2007.

⁶⁰ MCWD Ex. 376, p. 2: Technical Memorandum No. 31.003-004 (TM 4), dated April 22, 2009.

⁶¹ Section 11.5(a) of the WPA should be deleted and §11.5(b) modified to require MCWD to be responsible for its Proportional Share of Debt Service (1,700 AF + any additional water requested and received by MCWD divided by 10,500.) from Project Acceptance.

⁶² Under the WPA, § 11.6.a, MCWD is responsible only for paying its chemical and electricity costs of producing water before taking its Permanent Allocation, currently shown as \$148.49 in Exhibit F of the WPA. MCWD's fully-allocated O&M costs would include categories such as labor, administrative and general office costs and maintenance, repairs, etc.

conceals within the project's O&M costs.⁶³ These costs should be tracked separately and charged proportionally to each Party based upon the amount of water to which each Party is entitled.

Through its participation in the Regional Desalination Project, MCWD will receive exclusive access to 1,700 AF of high-quality desalinated water. This reliable water supply will also allow MCWD to reduce pumping in the Salinas Basin, benefiting the Salinas Basin through aquifer recharge and MCWD wells through reduced use. It is reasonable for MCWD to pay for its pro rata share of capacity in the Regional Desalination Project. Moreover, with an equitable stake in the project, MCWD will have the proper incentive to ensure project costs are contained.

C. Cal Am ratepayers should not pay for MCWD's costs associated with its efforts to build its own stand-alone desalination plant.

The Water Purchase Agreement unfairly reimburses MCWD for its prior costs associated with its efforts to build its own, stand alone desalination plant.⁶⁴ According to MCWD witness Trussell, MCWD was still pursuing its own three million gallon per day ("MGD") desalination plant in October of 2008⁶⁵ and as late as December 2008 as evidenced by documents presented to the California Department of Public Health seeking water supply permitting.⁶⁶ This December 2008 memorandum sent to the Department of Public Health indicated that MCWD needed "to expedite this project, so that MCWD can

⁶³ MCWD Ex. 301, WPA § 14.2 states that Pre-Acceptance Defense Costs are included in the Indebtedness of MCWD and MCWRA. If MCWD pays its fair share of the indebtedness, it will also be paying its fair share of the Pre-Acceptance Defense costs. The Post-Acceptance Defense costs are treated differently and are included in O&M costs. See footnote 26.

⁶⁴ MCWD Ex. 301, p. 18. The Water Purchase Agreement defines "Pre-Effective Date Costs and Expenses" to include "all of MCWD's and MCWRA's legal, staff and consulting fees and expense and any other costs or expenses incurred prior to the Effective Date, in connection with analysis and development of a desalination project in Monterey County commencing with the Regional Urban Water Augmentation Project (not including the recycled water component thereof) and continuing through CAW's efforts to develop the Coastal Water Project."

⁶⁵ MCWD/Trussell 15 RT 1716, lines 3-14.

⁶⁶ MCWD Ex. 379, p. 2 states "the initial desalination facility would have a daily production capacity of 3

continue to meet the water supply needs of the Marina Coast community.”⁶⁷ MCWD’s witness testified that this description of the “urgency” of the project was not based on his independent judgment but based on “instructions from RMC.”⁶⁸

In fact, a Technical Memorandum prepared as late as in March 2009 and finalized in June 2009 acknowledges that MCWD was developing a desalination facility “to provide additional water supplies to the Marina Coast community” and that MCWD had an “urgent need to supply additional treated water to their customers”⁶⁹

For MCWD to claim that it does not currently need additional water and therefore should not be responsible for the same desalination costs as Cal Am, while simultaneously arguing for recovery of previous MCWD desalination project expenses from Cal Am ratepayers through the Regional Project’s cost of water, defies all reason and logic. DRA is familiar with the aphorism “having one’s cake and eating it too,” but what is proposed in the Settlement Agreement is akin to “owning the bakery, eating the cakes, and having someone else pay for the cakes you ate yesterday, eat today, and will eat tomorrow.”

Immediate replenishment of the MCWD coffers through the Regional Project’s indebtedness, as is proposed in the Water Purchase Agreement,⁷⁰ is a considerable benefit to MCWD which can only be supported if the Regional Project has evolved from the previous MCWD desalination project. In which case, the Regional Project would be successfully achieving the goals of the previous project and providing for needed additional water supplies—supplies for which MCWD should pay the same amount as all others receiving water from the Regional Desalination Project.

mgd with a potential total annual water production of 3,000 AFY.”

⁶⁷ MCWD Ex. 379, p. 4, emphasis added.

⁶⁸ MCWD/Trussell, 15 RT 1720, lines 1-11.

⁶⁹ MCWD Ex. 376, pp. 1-2, emphasis added.

⁷⁰ MCWD Ex. 301, pgs. 14, 39, 40: MCWD Pre-Effective Date Costs and Expenses.

At a minimum, DRA advocates that a date certain of January 1, 2009 be established and that only MCWD's direct costs from that time associated with its involvement in the Regional Project be permitted to flow through to the ratepayers of the Monterey Peninsula. A January 1, 2009 start date is fair to Cal Am ratepayers because the formal Phase II proceeding began in February 2009 and at that point MCWD & MCWRA became involved in the CPUC-led proceeding.⁷¹ Furthermore, as the evidence demonstrates, as late as December 2008, MCWD was still corresponding with the California Department of Public Health concerning water supply permitting of its own stand-alone desalination plant.⁷²

DRA's recommendation is generous considering that all of Cal Am's past costs of participating in the Regional Project are being tracked in the Coastal Water Project memorandum account for collection from only Cal Am ratepayers through Surcharge 1, even though MCWD substantially benefits from these expenditures as well.

V. CAL AM RATEPAYERS SHOULD NOT PAY FOR AN UNNECESSARY SECOND PASS

DRA supports designing the Regional Project to meet the California Department of Public Health notification level for Boron of 1 mg/L.⁷³ However, DRA opposes requiring Cal Am ratepayers to pay for second-pass treatment of Product Water to meet the needs of MCWD's customers and Agricultural community. The Water Purchase Agreement would do that by requiring a treatment to a higher standard than required by CDPH.

In addition to requiring that the desalination plant meet all state, local, and federal rules and regulations relating to primary and secondary standards for domestic water quality and monitoring regulation,⁷⁴ the Water Purchase Agreement states that MCWD

⁷¹ Administrative Law Judge's Ruling Setting a Pre-Hearing Conference to Discuss Scope and Schedule for Phase 2, February 11, 2009.

⁷² MCWD Ex. 379.

⁷³ DRA/Shah 14 RT 1515, lines 3-4; 1522, lines 8-10.

⁷⁴ MCWD Ex. 301 § 9.7(a).

recognizes that Product Water may require treatment to meet reasonable standards of acceptance to MCWD's customers...⁷⁵ The Water Purchase Agreements further states that a second-pass treatment of the Product Water may be necessary to meet the reasonable standards of acceptance to customers and that the Parties may implement a margin of safety that exceeds the current minimum legal requirements for boron.⁷⁶

The current CDPH notification level for boron of 1 mg/L allows boron levels of up to levels of 1.44 in the Product Water. This flexibility exists because the regulation is written as 1 mg/L without a decimal place and requires rounding to the nearest integer.⁷⁷ The rounding effectively relaxes the boron notification level to 1.44 mg/L as confirmed by Dr. Trussell.⁷⁸

The primary issue, according to MCWD witness Dr. Trussell, is not whether the Regional Project will meet the CDPH notification level but whether there is the potential for adverse impacts on landscaping because plants are more sensitive than people to boron.⁷⁹ To address plant sensitivity, the Parties have established a boron water quality goal of 0.5 mg/L for the project,⁸⁰ a level far stricter than the CDPH notification level which allows boron of up to 1.44 mg/L.

The evidence in the record demonstrates that it may be possible to reliably achieve a boron level below 1 mg/L without a second pass. During evidentiary hearings, MCWD's witness Dr. Trussell testified that the City of Santa Cruz and Soquel Creek Water District were considering three possible designs for its desalination plant, one of which was a high-rejection membrane or combination hybrid membrane without a second

⁷⁵ Id. at § 9.7(b).

⁷⁶ Ibid.

⁷⁷ DRA Ex. 208, p. TM3-3.

⁷⁸ MCWD Ex. 371, p. 5, lines 10-12; MCWD/Trussell 15 RT 1702 lines 4-9; DRA Ex. 208, p. TM3-3.

⁷⁹ MCWD Ex. 371, p. 5.

⁸⁰ MCWD Ex. 371, p. 7,

pass.⁸¹ Dr. Trussell testified that this design would result in a boron level just below the standard, although he indicated that the consultants have suggested a second pass with any possible design in case they began to approach the standard.⁸²

A review of City of Santa Cruz and Soquel Creek Water District Technical Memorandum on boron finds Dr. Trussell partially correct. The Technical Memorandum finds that a single-stage Reverse Osmosis (“RO”) configuration with a hybrid membrane design was selected for the preliminary design phase with no second pass.⁸³ However, the technical memorandum recommended that the “design should include the potential to retrofit a partial 2nd pass RO system into the proposed facility in case more stringent boron, bromide, or chloride goal is required in the future.”⁸⁴ In fact, the pilot testing by the City of Santa Cruz and Soquel Creek Water District confirmed that observed boron concentrations in the permeate after a single pass showed levels between 0.7 mg/L and 1.0 mg/L for three different single-pass RO system configurations.⁸⁵

Astonishingly, when MCWD commissioned RMC to prepare a Desalination Facility Basis of Design Report for MCWD’s planned stand-alone desalination plant, RMC concluded that the plant would be designed “to meet the current California Notification Level for Boron of 1 mg/L”⁸⁶ and would have had a level of boron in the permeate at 1.2 mg/L.⁸⁷ The schematic diagram indicates that the RO system was being designed without a second pass.⁸⁸

Every indication is that a second pass is not necessary to meet the CDPH notification levels for boron. A pilot test as discussed below would make this

⁸¹ MCWD/Trussell 15 RT 1709-1710.

⁸² MWCD/Trussell 15 RT 1710.

⁸³ Ex. DRA 208, p. TM3-8.

⁸⁴ Ex DRA 208, p. TM3-8, emphasis added.

⁸⁵ Ex. DRA 208, p. TM3-4.

⁸⁶ Ex. DRA 201, p. 5-1 lines 4-5.

⁸⁷ Ex. DRA 201, p. 5-4, Table 5-2.

⁸⁸ Ex. DRA 201, p. 5-2.

determination. The cost of the RO equipment for the two-pass plant is approximately one-third greater than for a one-pass plant.⁸⁹ This would add to the base construction cost and be further multiplied by various contingency and allowances, and results in a significant cost increase over a single-pass plant.⁹⁰ In fact, the cost of the RO equipment in the August 14, 2009 Joint Comparison Exhibit including a second pass is \$31 million.⁹¹ One third of this base cost is \$10.3 million. Adding the Parties' 30% implementation adder to the Parties' 25% contingency allowance⁹² and compounding that with the Parties' 17.5% "allowance for the high end of design,"⁹³ results in the \$10.3 million base costs rising to \$18.7 million.⁹⁴ Such savings are significant and well above the alleged costs associated with any possible delay from conducting a pilot test.

Given the high cost of this project, DRA objects to Cal Am ratepayers paying for a second pass to meet a boron goal below the CDPH notification level because of possible effects it may have on some types of plants, DRA is concerned that this decision is being driven by the agricultural interests seeking to reduce the level of boron in the recycled water that is used for irrigation.⁹⁵ If MCWD needs the Product Water to be treated to a stricter standard than legally required, MCWD should pay for the associated costs or work with MCWRA to recoup them from those who benefit. Cal Am ratepayers should not be harnessed with this additional cost.

⁸⁹ MCWD/Trussell 15 RT 1721-1722.

⁹⁰ DRA/Leitz 15 RT 1745-1750.

⁹¹ Cal Am Ex. 108, Project Cost Comparison spreadsheets, p. 5.

⁹² Cal Am Ex. 108 uses a 30% implementation cost and a 25% contingency, i.e. 55% increase over base construction cost.

⁹³ MCWD Ex. 301, Exhibit C uses a 17.5% allowance for the high end of design compounded with the construction costs including implementation and contingency. These multipliers (17.5% with 55% for implementation and contingency) add up to $1.55 \times 1.17 = 1.82$ i.e. 82%.

⁹⁴ $\$10.3 \text{ million} \times 1.82 = \18.7 million .

⁹⁵ MCWD Ex. 319, p. 30, lines 19-21.

VI. PILOT TESTING AND CONTINGENCY PLANNING IS NECESSARY

A. The Commission should require the Parties to conduct a year-long pilot test for the Regional Project as recommended by the U.S. Bureau of Reclamation.

DRA recommends that the Commission adopt the United States Department of the Interior, Bureau of Reclamation recommendation that the Parties conduct a year-long pilot test of the proposed water treatment equipment for the Regional Project using water from test wells.²⁶ A year-long pilot can be conducted within the time frame of the State Water Control Board Cease and Desist Order (“CDO”). DRA recommends the Commission modify the Settlement to require the Parties to conduct a pilot project and update groundwater modeling and final desalination feed water well design.²⁷ The Parties should confirm that the brackish water pumping in seawater-intruded coastal aquifer will actually work as planned and reliably deliver the amount of water needed for a reasonable price.

B. The Pilot Project would reduce risks and keep the project on a critical path to meet CDO requirements.

DRA supports the Bureau of Reclamation’s recommendation to conduct a pilot test because it will help reduce risks to Cal Am ratepayers and will help keep the project on a critical path. Although a pilot project *may* increase the project timeline, it may also reduce it. While the Parties argue that a year-long pilot would add a year-long delay to the Regional Project or delay the project significantly,²⁸ MCWD witness Dr. Trussell acknowledged that pilot testing can sometimes actually speed up the implementation of a

²⁶ DRA Ex. 204, p.9.

²⁷ The final desalination feed water well design should include exact location, size, projected yield, depth, spacing and drawdown of the wells, an analysis of the expected percentage of groundwater to be pumped, an estimate on the timing and cost of moving, replacing, re-drilling or drilling new wells, an operational plan and a density-driven analysis of impact of the feed water pumping on seawater intrusion in the Salinas Groundwater Basin.

²⁸ MCWD Ex. 319, p. 30; MCWD/Melton 12 RT 1189.

project.⁹⁹ Even under the worst-case scenario where portions of the project did not move forward on a parallel track to the pilot testing, the Regional Project could still be completed by the CDO's December 31, 2016, deadline for ending illegal withdrawals from the Carmel River. The Parties believe that the project will take 3.5 years to complete.¹⁰⁰ Assuming a Commission decision by year-end, a 4.5-year time line would result in project completion by 2015, well ahead of the CDO deadline.

It is precisely DRA's concern over the urgency of implementation of a water supply solution in the face of the CDO that leads DRA to support the Bureau of Reclamation's recommendation for pilot testing. It is imperative that the Regional Project not be delayed as a result of design errors, equipment failures or scale formation that may arise because pilot testing was not conducted. As DRA witness Dr. Shah testified, inadequate pilot testing was one of the reasons why multiple iterations of plants had to be implemented at Tampa Bay.¹⁰¹ MCWD witness Dr. Trussell agreed that there was not sufficient pilot testing done with the Tampa Bay plant.¹⁰²

C. The pilot project is necessary to determine the appropriate site-specific design for the Reverse Osmosis treatment equipment.

A pilot project is necessary to determine the appropriate site-specific design for the Reverse Osmosis treatment equipment. In the Bureau of Reclamation's report to DRA, Reclamation states:

The groundwater taken in by the wells at either the North Marina or the Regional Project will differ from that at the Moss Landing site. It can be expected to be anaerobic. This means that iron would be in the ferrous (Fe^{++}) state and manganese, which frequently accompanies iron in terrestrial deposits and consequently in groundwater, would be in the manganous (Mn^{++}) state. Manganese is a concern since

⁹⁹ MCWD/Trussell 15 RT 1696.

¹⁰⁰ Ex. MCWD 319, p. 21, lines 9-14 & 21.

¹⁰¹ DRA/Shah 14 RT 1489.

¹⁰² MCWD/Trussell 15 RT 1696.

manganous ion is not as easily oxidized as ferrous ion. Chlorine, in sufficiently high concentration, should take care of this problem. There is the probability of contamination by other species like calcium, magnesium, bicarbonate and sulfate in relatively higher proportions than are normally found in seawater. These are scale forming materials that, in high enough concentrations, can adversely affect the performance of the RO membranes. We believe that piloting the desalting facility would be a wise course and would be worth the time and expense. Not to do so would be a risky procedure.¹⁰³

The U.S. Bureau of Reclamation has extensive experience and expertise in desalination projects throughout the world. Mr. Leitz, the sponsor of the Bureau of Reclamation Report and the author of this recommendation, has worked on desalination projects for well over 30 years.¹⁰⁴ The Bureau of Reclamation's recommendation should be given great weight.

As noted by the Bureau of Reclamation, a pilot project will also help determine whether or not a second pass is required to meet the California Department of Public Health ("CDPH") notification level for Boron. As the Bureau of Reclamation stated:

It is important to note that boron concentration in the feedwater of the Moss Landing pilot project is not necessarily the same as the boron concentrations that will exist in the feedwater for either the North Marina or Regional Project alternatives. A comparison of the feedwaters for at least several months after the test wells have come to steady state will indicate whether a second pass is required in the RO system for a project located somewhere other than Moss Landing. This can be confirmed during a desalination pilot test.¹⁰⁵

DRA's witnesses Dr. Shah and Mr. Leitz from Reclamation re-iterated this recommendation during evidentiary hearings, emphasizing the need for a pilot project to

¹⁰³ DRA 204, p. 9, emphasis added.

¹⁰⁴ DRA Ex. 205.

¹⁰⁵ DRA Ex. 204, p. 11, emphasis added.

decide whether or not a second pass is required to meet the CDPH notification level for Boron.¹⁰⁶

D. A Pilot Project Could Substantially Reduce Project Costs.

The Bureau of Reclamation estimates a pilot project for the Regional Project would cost \$1.5 million if the pilot unit from Moss Landing is refurbished and used for the testing.¹⁰⁷ Given that Cal Am ratepayers have paid for the Moss Landing pilot project equipment as part of the Surcharge 1, there is no reason that this unit should not be reused for their benefit.

The Parties do not disagree with the Bureau of Reclamation's estimate, but argue that an adder of \$8 million should be included due to the alleged year delay in the project.¹⁰⁸ However, as discussed above, pilot testing can speed-up implementation.¹⁰⁹ Moreover, pilot testing can also result in reduced plant costs. As discussed above, the Parties can determine whether a second pass is necessary to meet the CDPH notification level for boron through pilot testing.¹¹⁰ If not needed, not implementing a second pass could result in \$18.7 million in capital cost savings. Under the Settlement Agreement, it is Cal Am ratepayers that will shoulder the costs associated with failures and delays that may result from Parties' decision to move forward without pilot testing. Unless the Parties are willing to accept the costs associated with this decision, the Commission should not accept the Parties' decision to risk moving ahead without adequate pilot testing at Cal Am ratepayer's expense.

¹⁰⁶ DRA/Shah 14 RT 1523 and DRA/Leitz 15 RT 1746.

¹⁰⁷ DRA Ex. 204, p. 9. Bureau of Reclamation estimates "\$1 million for moving, reconfiguring to simulate the plant as designed and startup, and \$0.5 million for operation." This amounts to only 0.5% of the estimated capital costs of \$297 million.

¹⁰⁸ MCWD Ex. 319, p. 30.

¹⁰⁹ MCWD/Trussell 15 RT 1696.

¹¹⁰ DRA Ex. 204 pp. 10-11, §§ 2.1.4 and 2.1.5.

E. A Source Water Contingency Plan is needed.

DRA also recommends the Commission modify the Settlement to require the Parties to develop a Source Water Contingency Plan¹¹¹ done by an independent engineering firm overseen by MPWMD and paid for as part of the Regional Desalination Project initial costs.

The Contingency Plan should look at intake facility alternatives in case neither the slant wells nor vertical wells are feasible after the test well protocol is completed; and for future contingency in case the performance and impacts of the intake wells are not satisfactory. In addition, the Contingency Plan should develop capital cost estimates for several alternatives, as well as operations and maintenance costs, and compare the life-cycle costs with the life-cycle costs of vertical and slant wells.¹¹²

VII. THE COMMISSION SHOULD REQUIRE THE REGIONAL PROJECT INTAKE WELLS TO BE SLANT WELLS UNLESS THEY ARE FOUND INFEASIBLE IN TESTING

DRA recommends that the Commission require the Parties to *design* the intake facilities of the Regional Project to maximize the fraction of seawater in the intake, by requiring that the intake wells be slant wells, unless found infeasible in testing. The use of slant wells would minimize the risk of project failure, litigation and delay and reduce the subsidy of MCWD by Cal Am ratepayers.

¹¹¹ The DRA recommended contingency plan goes to the desalination feed water design alternatives, should the test wells prove infeasible.

¹¹² This analysis should take into consideration the additional monitoring of the Salinas Basin required, the amount of additional water (if any) that must be produced to offset an export of water from the Salinas Basin, electricity, frequency of well replacement, reliability, risk of project failures, legal risks, permitting requirements and any other feasibility issues.

A. Costs to Cal Am ratepayers should be considered in the intake well decision, and Cal Am should have a say in that decision.

The Settlement Agreement requires MCWRA to drill at least one vertical and one slant test well and to analyze test well data to determine whether the water that would be delivered to MCWD as its Agreed Allocation will comply with Legal Requirements.¹¹³

Essentially, all MCWRA will need to determine at the test well stage is whether the percentage of groundwater in the source water from each of the types of wells will allow the project to comply with the Agency Act. As long as the test wells will comply with the Agency Act, MCWRA, alone, makes the decision on which type of well to use for the project. There is nothing in the Water Purchase Agreement that requires MCWRA to consider the cost to Cal Am ratepayers of operating each type of well, or consider the additional costs associated with Agency Act compliance for each type of well, or consider the litigation risks that may result from selecting the type of well. There is nothing in the Water Purchase Agreement giving Cal Am or any representative of the Cal Am ratepayers a voice in that decision.

1. Success of the Regional Desalination Project depends on the percentage of groundwater in the source water mix

Under the Water Purchase Agreement, the amount of water that must be left in the Salinas Basin to comply with the Agency Act is delivered to MCWD and is referred to as the "MCWD Agreed Allocation."¹¹⁴ The MCWD Agreed Allocation is equal to the average percentage of groundwater in the source water mix. For example, if the average percentage of Salinas Basin water is 16.2%, then the amount of water that must stay in

¹¹³ MCWD Ex. 301, §8.2(a) Test wells will be converted to operational Brackish Source Water Wells.

¹¹⁴ MCWD Ex. 301, § 9.3.a. The Water Purchase Agreement requires the Regional Facilities to be operated in such a way that the project would return desalination water to MCWD in a percentage equal to the percentage of Salinas Basin water, as indicated by the salinity of the source water. Because MCWD is within the Salinas Basin, water delivered to MCWD is considered water left in the basin. MCWRA would measure the salinity of the source water by sampling the TDS levels of the brackish water from each source water well and use that data to determine the average percentages of seawater and Salinas Basin water in the source water mixed on a quarterly basis.

the basin with MCWD, or the MCWD Agreed Allocation, would be 1,700 acre-feet per year (16.2% of 10,500 AFY). If the average percentage of Salinas Basin water is 6%, then the MCWD Agreed Allocation would be 562 AFY -- 1,138 acre-feet a year less.¹¹⁵ Because the percentage of groundwater in the source water mix can have tremendous cost implications to Cal Am, DRA recommends the Commission require any Settlement to include a formula for defining both the annual and five-year average percentage of Salinas Basin water.¹¹⁶

2. Minimizing the groundwater percentage in the desalination source water by using slant wells lowers costs to Cal Am ratepayers.

Whether a well draws 6% groundwater or 16% groundwater greatly affects the costs and risks of the project to Cal Am ratepayers, and the amount of water that must stay in the Salinas Basin with MCWD. The more desalinated Product Water that has to be left in the Salinas Basin and provided to MCWD at \$148 an acre-foot – an amount significantly less than the incremental cost of \$740 per acre-foot for energy, chemicals and brine disposal to produce the desalinated water – the more Cal Am ratepayers have to pay.¹¹⁷ If the Regional Project used slant wells, it would reduce the amount of desalinated water that must be left in the Salinas Basin with MCWD by 1,138 acre feet per year, resulting in a savings of \$674,000 annually.¹¹⁸ By using a desalination feed water source that also extracts groundwater, the Regional Project must produce a

¹¹⁵ MCWD Ex. 301, Exhibit E, shows a formula: “(seawater salinity)(Percentage of seawater) + (inland water salinity)(Percentage of Salinas Basin water) = brackish water salinity.” If the value in Ref. Ex. B, Vol 3, App. E, p. 22/E-29 for Slant Well TDS is used of 33,000 in the Example in Exhibit E, the result is a groundwater percentage of 6%.

¹¹⁶ See DRA’s redlined edits to Section 9.3 b of the Water Purchase Agreement dated May 27, 2010 which specify this formula: Annual average percentage of Salinas Basin Groundwater = 1 - [(weighted average TDS of Brackish Source Wells - measured TDS of Salinas Basin Water)/(TDS of seawater - measured TDS of Salinas Basin Water)]. This formula comports with the examples in the WPA, exhibit E.

¹¹⁷ MCWD Ex. 320, Totals for energy, chemicals and brine disposal divided by plant production of 10,500 AFY to derive \$740 per acre-foot estimate.

¹¹⁸ 1,138 AFY * \$740/AF incremental cost – 1,138 AFY * \$148/AF (MCWD payment)

percentage of *extra* desalinated water which is left in the Salinas Basin with MCWD to comply with the Agency Act. This is water Cal Am customers pay for but do not receive. If feasible, it would be prudent to minimize this consequence of the intake design, as the groundwater modeling results are just that – models – and what happens in actuality may be quite different, and the groundwater percentage could be higher than modeled.

While having vertical intake wells that extract approximately 15% groundwater would still allow Cal Am to receive its needed 8,800 AFY allocation, using vertical wells has a cost impact to the Cal Am ratepayer. Groundwater modeling done for the FEIR shows a lot of variability in the TDS concentrations used to determine the percentage of groundwater in the brackish source water from year-to-year for vertical wells, with very little variability for slant wells.¹¹⁹ This variability in the percentage of groundwater adds to the risk and costs borne by Cal Am ratepayers.¹²⁰ Along with the additional costs to produce water that must be left in the Salinas Basin, the use of vertical wells also results in added costs for making changes to wells to keep the groundwater percentage below 16.2%. The Water Purchase Agreement indicates that changes may be made in “supply, including but not limited to modifying brackish source water well operations; replacing, moving, re-drilling, or drilling new brackish source water Wells; or determining whether curtailment of delivery of some quantity of brackish source water will ensure such compliance.”¹²¹ The Water Purchase Agreement requires the MCWRA and the Parties to

¹¹⁹ Reference Ex. B, FEIR, Volume 3, Appendix Q: Appendix A, page Q-23. GeoScience February 26, 2009 Report shows predicted variation in groundwater percentages from modeling results of Regional Project Scenario 4f. “..the wells all produce water with fluctuating TDS concentrations (ranging from approximately 21,300 mg/L to 34,500 mg/L) throughout the 56-year period.” See also FEIR, Volume 3, Appendix E: GeoScience, North Marina Ground Water Model Evaluation of Potential Projects, July 25, 2008, chart on page E-29 showing TDS levels varying between approximately 31,000 TDS and 34,000 TDS.

¹²⁰ MCWD Ex. 301, § 8.2.c discusses operations to meet the Agency Act, and requires MCWRA to operate the brackish source water wells in a way to maximize the percentage of seawater in the brackish source water. It indicates that if MCWRA concludes that compliance with requirements of the Agency Act with respect to exportation of groundwater from the Salinas Groundwater Basin is not reasonably ensured, the Parties to the WPA shall meet and confer to determine whether or not changes in the supply of brackish source water are required to ensure compliance with the Agency Act and/or to ensure that the MCWD Agreed Allocation does not exceed 1,700 AFY when the Cal Am allocation is 8,800 AFY.

¹²¹ MCWD Ex. 301, § 8.2 c.

develop a plan of action paid for by the Reserve Fund. There have been no estimates of costs to implement such plans, nor any groundwater modeling done that would establish the efficacy of such an operational approach.

Therefore, the criteria for selecting the final source well design configuration should be based on the cost-effectiveness to the Cal Am ratepayer over the term of the Agreement and the ability of the project to meet Agency Act requirements.

Slant wells are also less costly to operate than vertical wells. The August 14, 2009, Joint Cost Comparison exhibit shows that the estimated annual energy costs for the Regional Project with vertical wells is \$1,190,000.¹²² The same comparison exhibit shows that the energy costs for the North Marina Alternative, which uses slant wells, is \$807,455.¹²³ Compounded over the 94-year term of this agreement this difference becomes even more substantial. This is despite the fact that the North Marina Alternative has an 11 MGD capacity as compared to the 10 MGD Regional Project. This is a significant annual benefit of \$382,545 per year in energy costs, not even accounting for the difference in capacity.

When the operational savings are considered together with the cost savings from reducing the amount of water needed to be left in the Salinas Basin (\$674,000/year), using slant wells should result in approximately \$1.1 million a year in immediate savings. There would be further costs if MCWRA had to move or re-drill the vertical wells before the end of their useful life, or if the vertical wells resulted in a reduction in Cal Am's allocation below 8,800 AFY or result in costly litigation.

Because the Water Purchase Agreement requires one slant and one vertical test well, both of which will become production wells, DRA estimates the maximum differential in costs for four additional slant wells versus four additional vertical wells to be \$8.3 million based on calculations of per-well costs in Cal Am Exhibit 108.¹²⁴

¹²² Cal Am Ex. 108 Project Cost Comparison Spreadsheets, p.7.

¹²³ Cal Am Ex. 108 Project Cost Comparison Spreadsheets, p.11.

¹²⁴ Exhibit 108.

Another benefit of slant wells is that they allow the plant to be run at less than full capacity. For example, with 6% groundwater in the source water mix, the total output from the desalination plant could be 9,400 AFY enough to provide 8,800 AFY to Cal Am and 562 AFY to MCWD. This would leave Cal Am with some operational flexibility. For example, if there were a buyer willing to pay the fully-loaded price, Cal Am could take the additional water at incremental cost and sell it to offset its fixed costs. Or, if Cal Am is required to pay its water debt to the Seaside Basin Water Master, it would have the flexibility to do that with desalinated water.¹²⁵ The added operational flexibility that Cal Am would have to obtain up to an additional 1,100 AFY of Product Water at an incremental cost of \$740 per acre-foot would be worthwhile. This is just the opposite of the situation under vertical wells where Cal Am has no option to purchase additional water at incremental cost, and could find itself in the situation of not even being able to take its full 8,800 AFY allocation.

Finally, should the courts determine that Agency Act limitations on exportation of groundwater from the Salinas Basin applies to the actual quantity of groundwater pumped by the desalination source water wells and not the equivalent fraction of Product Water developed from that source water, then the Regional Desalination Project would still be feasible with slant wells,¹²⁶ while becoming infeasible with vertical wells. Thus, slant wells provide Cal Am ratepayers protection against this risk.

3. Risk to viability of the Regional Desalination Project from Agency Act Exportation Prohibition lessened by use of slant wells.

Limiting the amount of groundwater that must remain in the basin also reduces the risk of project failure and the litigation risk. If the plant is operating at a capacity of

¹²⁵ Reference Ex. B, FEIR, Volume 5, 14.1-106

¹²⁶ The Regional Project could produce approximately 9,362 AFY of Product Water. If 6% of the source water is Salinas Basin water then approximately 562 AFY would stay in the Salinas Basin through delivery to MCWD. If the courts found the definition of groundwater to require that the actual quantity of groundwater pumped remain in the Salinas Basin, the quantity required to remain with MCWD would be closer to 1,124 AFY. This amount would still allow Cal Am to take its full 8,800 AFY allocation.

10,500 AFY and the percentage of Salinas Basin water in the Source Water exceeds 16.2%, Cal Am will be unable to receive 8,800 acre-feet.¹²⁷

Although the Water Purchase Agreement has a clause that states that for the first five years the amount of water coming from the Salinas Basin will be deemed not exceed 15%, regardless of what that percentage actually may be, this clause is only likely to increase the risk of litigation. While this may assure that Cal Am will get its full annual 8,800 acre feet of water during the first five years of the contract, it is also more likely to lead to a lawsuit challenging whether the Project actually complies with the Agency Act. Under the Water Purchase Agreement, the costs of defending such a lawsuit are born entirely by Cal Am ratepayers

After the first five years the Water Purchase Agreement provides for a rolling five-year average in determining the percentage of Salinas Basin Water used to determine the MCWD Annual Allocation.¹²⁸ This provision should smooth out some of the variability; however, Cal Am ratepayers are still at risk of not receiving the full 8,800 AFY needed, as well as paying increasing costs per acre-foot for the water they do receive. Finally, Cal Am would need to supplement its reduced allocation of desalinated water with water from other sources, such as additional pumping in Seaside, which would include the variable cost of pumping as well as payment of Seaside Basin Replenishment Fees.

DRA recommends that not only should the desalination source water wells be operated in such a way as to maximize the percentage of seawater in the brackish source water, but also the final source well configuration should be *designed* to maximize the percentage of seawater.

DRA recommends that the Commission modify the agreement to require the parties to use slant wells as the intake wells if testing determines that they are technically

¹²⁷ Should the percentage of groundwater exceed 16.2% as shown in the FEIR, Cal Am may not be able to receive the full 8,800 AFY needed. For example, if there were 20% groundwater in the source water mix, 20% of the product water would have to remain in the Seaside Basin, or 2,100 (20% of 10,500 AFY) This would leave a maximum of 8,400 AFY for Cal Am. (10,500 AFY – 2,100 AFY) and presents a risk to Cal Am.

¹²⁸ The legality under the Agency Act of using a rolling five-year average to determine the amount of water that must stay in the Basin is unknown.

feasible. Slant wells would draw less groundwater than vertical wells, minimize the cross-subsidy from Cal Am ratepayers to MCWD ratepayers, minimize the risk of project failure and reduce litigation risks.

VIII. IF CAL AM ELECTS NOT TO TAKE ITS 8,800 AFY ALLOCATION, THE UNALLOCATED WATER SHOULD NOT BECOME THE PROPERTY OF MCWD, AND IF CAL AM SELLS IT TO MCWD, MCWD SHOULD PAY FULL PRICE

Under the Water Purchase Agreement, Cal Am may elect to receive less than its 8,800 AFY allocation. This decision could be due to increased conservation or acquisition of additional water supply. Section 9.5 of the WPA specifies that MCWD has the right to take this water, and that “To the extent MCWD decides not to take and receive any additional Product Water under this Section 9.5 in excess of the MCWD Annual Allocation, the Parties, in consultation with the Advisory Committee, shall explore opportunities for the sale of such excess Product Water to third parties ...”¹²⁹

As DRA set forth in its redline edits to the WPA filed on May 27, 2010, Product Water that is part of Cal Am’s Allocation should belong to Cal Am, and Cal Am should be able to sell that water to a buyer willing to pay the highest price, but not less than the incremental cost of water. If Cal Am elects not to take its full 8,800 acre-feet a year allocation for its customers, MCWD should not be entitled to the excess water. If MCWD wishes to obtain the excess water and Cal Am does not have a buyer willing to pay more, Cal Am could sell the excess water to MCWD.

IX. MPWMD AND THE MONTEREY PENINSULA CITIES SHOULD BE PART OF THE REGIONAL PROJECT GOVERNANCE

The Commission should modify the Water Purchase Agreement to assure that Cal Am ratepayers have adequate representation on Regional Desalination Project decisions. One way to assure this is for MPWMD and the Monterey Peninsula Cities (“Cities”) to

¹²⁹ MCWD Ex. 301, p. 49.

have a decision-making role on a modified version of the Regional Project Advisory Committee.

A. MPWMD and the Cities represent ratepayers and have a different perspective than Cal Am on issues pertaining to water supply operations on the Peninsula

Under the Water Purchase Agreement, the Advisory Committee has responsibilities for guiding both the project construction and operations phases.¹³⁰ Although Parties, and not the Advisory Committee, have decision-making authority, the Parties' technical experts on the Advisory Committee will provide them with recommendations on a wide range of important issues. Parties have claimed that MPWMD does not belong on the Advisory Committee because they are not signatories to the WPA and allege it has failed to produce a water supply.¹³¹ This argument sidesteps the importance of having Cal Am's ratepayers fully represented in the decision-making process.

The Water Purchase Agreement is a 34-year agreement and could be renewed for up to 60 years after that. Significant issues could arise over the 94 years of the agreement that could impact cost, water quality, or other aspects of the desalinated water supply that will provide nearly two-thirds of the total supply for the Monterey Peninsula. DRA recommends that both MPWMD and the Cities be considered Parties with a vote under the WPA for matters determined in consultation with the Advisory Committee. It is important for MPWMD and the Cities to have voting rights on Advisory Committee issues as they possess different areas of technical and managerial expertise and have different political perspectives. MPWMD has expertise managing the Aquifer Storage and Recovery ("ASR") project and would provide input on the quantity, quality and timing of Product Water to be diverted to the ASR system. The Cities, on the other hand, could provide input on reviewing water quality decisions, aesthetics, and opportunities

¹³⁰ MCWD Ex. 301, pp. 35-36.

¹³¹ MCWD Ex. 305, p. 21; MCWRA Ex. 501, p. 8.

for the sale of Product Water.¹³² In addition, if the desalination facility is expanded to provide additional water to the former Fort Ord or other areas, new operations parameters may need to be set. The expertise of both MPWMD and the Cities will help ensure Cal Am ratepayers receive equitable treatment when those decisions are made.

Although both MCWRA and Cal Am represent Cal Am ratepayers to some degree, they also represent other constituencies whose interests can conflict with ratepayer interests. Cal Am must also represent its shareholder interests, and MCWRA must represent the interests of the agricultural community and other members of Zone 2C (including MCWD). MPWMD and the Cities have Cal Am ratepayers as nearly their entire constituency and do not have the same potential conflicts as the other agencies or entities. MPWMD's and the Cities' participation as Parties for Advisory Committee matters (as set forth in Sections 6.4 and 6.5 of the WPA) would ensure that Cal Am ratepayer interests are better served throughout the potential 94 years the WPA is in effect.

MPWMD and the Cities must have Party status for them to influence Advisory Committee decisions because Parties, not the Advisory Committee, make decisions under the WPA. The WPA language states, "The Parties, in consultation with the Advisory Committee shall: . . ." ¹³³ Disputes between Parties over Advisory Committee matters are referred to an independent third party whose decision is binding upon the Parties.¹³⁴ With Party status for Advisory Committee matters, MPWMD and the Cities will be able to take disputes with Cal Am, MCWD or MCWRA to an independent third party for resolution. This authority would provide Cal Am ratepayers with both a voice and a vote on important decisions that will impact water quality and cost, and which the Commission will no longer review.

¹³² Water quality decisions, aesthetics, and opportunities for the sale of Product Water are all responsibilities of the Advisory Committee.

¹³³ MCWD Ex. 301, p. 36.

¹³⁴ Id., p. 37-38.

X. THE COMMISSION SHOULD EXAMINE OPERATIONS AND MAINTENANCE OF THE PLANT IN A FUTURE PHASE OF THIS PROCEEDING.

DRA recommends that the Commission establish a future phase of this proceeding to establish criteria necessary to ensure a fair, equitable, and accountable Operations and Maintenance (“O&M”) contract and contractor selection process. The Regional Desalination Project construction schedule allows sufficient time for Settling Parties to develop, and for the Commission to review and approve, operations and maintenance criteria and requirements.¹³⁵

A. The Settlement and Water Purchase Agreement lack necessary detail on operation of the Regional Project.

The Settling Parties have structured the Water Purchase Agreement to allow recovery of all O&M expenses through an un-capped price of Product Water. Until MCWD takes its permanent allocation, Cal Am ratepayers will be responsible for all O&M costs associated with the desalination plant. O&M expenses, however, are addressed only in a few paragraphs of the WPA, stating only that operations and maintenance will be performed either by the agency owning the facility or by a contract service provider.¹³⁶ The Water Purchase Agreement is silent on how the O&M contractor will be selected, what performance standards the operator must meet, how risks will be mitigated, or how operations and maintenance costs will be controlled.

Various options exist for structuring operations and maintenance activities and controlling costs. Such structures include: a) plant owner-operated (b) competitive bid

¹³⁵ The WPA milestones demonstrate that the Settling Parties will dedicate efforts toward obtaining financing, procuring contractors, and beginning plant construction over the period 2010 through 2014. MCWD Ex. 301, § 4.9. This schedule indicates that there is adequate time within the project schedule for more due diligence to be performed regarding the operational phase.

¹³⁶ MCWD Ex. 301 § 3.1 states, “MCWD will design and construct, in consultation with Cal Am and MCWRA, a water desalination plant (the “Desalination Plant”), to be owned and operated by MCWD and located on the MCWD Real Property, for the purpose of desalinating Brackish Source Water such that the resulting treated water is Product Water.”

of plant O&M to a contract service provider; c) various project delivery frameworks such as Design-Build-Operate; and d) single-source award to a selected contractor.

Various options also exist for structuring O&M contracts. O&M contracts can be structured as a fixed-cost-plus-variable-cost, or fixed-cost with some limited element of increase tied to specifically defined indices, or one that contains some financial incentives based on meeting performance goals. O&M contracts could also be structured so that price risks are kept by the plant owner or transferred to the contract service provider. Consequently, there is some price optimization potential in the yet-to-be-developed O&M Agreement that could yield cost savings or limit risks to Cal Am ratepayers.

Under the WPA, as owner of the desalination plant, MCWD is responsible for determining who will operate the plant and under what terms and conditions. This determination will require developing bid packages; soliciting Requests for Qualifications and Requests for Proposals to ensure qualified contractors exist to operate the plant; developing decision criteria for bid evaluation; evaluating the bids; negotiating the best and final offer for plant operations; managing the O&M contract; and overseeing contractor compliance. However, nothing in any of the Agreements requires MCWD to follow such procedure or even discusses how key determinations will be made. For instance, there is nothing in the Agreements discussing what qualifications MCWD will require of the plant operator.

While the Water Purchase Agreement set decision criteria for selecting the Project Manager, it did not address decision criteria for the Plant Operator. The Settlement and Water Purchase Agreement lack any discussion of what decision criteria will be used to pick the successful bidder. Will it be the lowest price? The lowest lifecycle cost over the life of the plant? Will it be the best value across several criteria? Under what situations and whose authority will MCWD decide to award the contract to a sole source?

Similarly, the Settlement and Water Purchase Agreement lack any discussion of how the O&M contract will be designed. Will it contain cost controls that will optimize the utilization of electricity and minimize the costs of electricity? Will all costs of O&M

flow through to Cal Am ratepayers, or will the operator be at risk for any costs? Will it be a fully-reimbursable contract, will the contract be designed as a fixed-lump-sum contract, or will some part of the costs be fixed and others variable? Will the contract be designed with incentives and pressures to motivate optimum contractor performance or include performance guarantees similar to other contracts? Will the contract price be fixed over time, or will there be certain price escalators included in its design for labor, chemicals, fuel or electricity? Who bears the risk for these cost or price changes, Cal Am ratepayers or the contractor? Who is best situated to bear the risk and are there ways to design the contract to mitigate some of these risks or shift the risks to help control the costs?

Because the Settlement Agreement and Water Purchase Agreement do not present any provisions related to O&M cost controls, risk mitigation, contractor selection, and performance standards as is standard in other desalination and water treatment O&M contracts, the Agreements shift all O&M cost risk onto Cal Am ratepayers.

According to the Bureau of Reclamation Review Comments on Coastal Water Project and Alternatives, desalination costs are typically distributed one-third each to energy, other operating costs, and capital amortization.¹³⁷ Therefore, the efficient and cost-effective operation of the desalination facilities is key to keeping overall costs down.

Although there is currently no O&M contract or O&M service provider, the Parties estimate total annual O&M costs at \$12,900,000.¹³⁸ DRA estimates annual Plant O&M Expenses of \$14,270,000 and determined the O&M cost will be \$1,300 per acre-foot to Cal Am customers.¹³⁹ Unlike other desalination facilities where desalinated water is produced to augment existing supply, the Regional Desalination Project will be providing a replacement water supply for approximately two-thirds of the Monterey

¹³⁷ DRA Ex. 201, p. 19,

¹³⁸ MCWD Ex. 320, p. 13, Table 3.

¹³⁹ DRA Ex. 202, p. 4-31 to 4-33. DRA assumed that the first year of operations will be 2015 and escalated the parties O&M cost estimate of October 2012 to 2015.

District water supply.¹⁴⁰ Therefore, high desalinated water costs will not be buffered by large quantities of lower-priced water from other water purveyors or sources. Instead, the Product Water cost will be priced much higher than the price of existing water, becoming a major cost driver for customer rates.

Because the Cal Am ratepayers foot the bill for this plant and will rely upon it for as many as 94 years of operation, developing consumer protections and cost savings for the O&M phase of the plant is critical. As the critical water supply source for the Monterey Peninsula and its surrounding area, the Regional Desalination Project warrants cautious, careful and thoughtful selection of an experienced, qualified operator to protect the integrity of Cal Am ratepayers' potential \$500 million investment in the desalination facilities.

Because the Project Facilities' operations and maintenance are crucial to overall project success and will have a dramatic effect on Cal Am customer rates, DRA recommends the Commission carefully consider this issue in a separate phase of this proceeding. The subsequent phase of the proceeding would determine the criteria that should be in an Operation and Maintenance contract and the criteria for the contractor selection process. DRA recommends the Commission convene a workshop to gather Parties' input on the scope of this phase.

XI. CAL AM-ONLY FACILITIES

A. The Commission should adopt a cost cap for the Cal Am-Only Facilities of \$86.6 million.

DRA recommends that the Commission adopt a cap on the capital expenditures for the Cal Am-Only Facilities at the "most probable" cost estimate¹⁴¹ rather than the

¹⁴⁰ Per the State Water Resources Control Board's Order 95-10 and the Seaside Basin Adjudication, Cal Am's legal rights to Carmel River water and Seaside Basin groundwater are 3,376 acre-feet and 1,494 acre-feet respectively. Cal Am's 8,800 acre-feet a year share of the Product Water from the Regional Desalination Project is nearly twice the amount of water available from Cal Am's other two sources.

¹⁴¹ Most Probable Capital Cost With Contingency = [Base Construction Cost + Post Effective Date Implementation Costs + ROW Easement and Land Acquisition Cost + Environmental Mitigation Measures costs + Project Contingency (25%)].

mid-point of the medium and high scenarios of \$106,875,000 as recommended by Cal Am.¹⁴² DRA further recommends that the Commission reduce the most probable cost estimate from \$95 million to \$86.6 million.¹⁴³

DRA's recommended cost reductions total \$8.4 million and include:

- Reducing the Aquifer Storage and Recovery System ("ASR") Project cost estimate by \$3.25 million;
- Reducing the Terminal Reservoir Project cost estimate by \$4 million;
- Eliminating a 25% Contingency on ROW Easement and Land Acquisition, thereby Reducing the Project Cost Contingency by \$850,000; and

DRA also eliminated the Pre-Effective Date Implementation Costs and Expenses of \$36,900,000 currently being recovered through the Coastal Water Project Surcharge I. These costs were included in the most recent CWP Project Cost Comparison¹⁴⁴ but were not requested by Cal Am in its request, so are not included in the \$8.4 million in adjustments recommended by DRA.

DRA adjustments result in a "most probable" cost estimate of \$86.6 million.¹⁴⁵ DRA used the table of calculations provided by the CWP Project Cost Comparison of April 15, 2010, as the data source and calculated a Most Probable Capital Cost with Contingency of \$86.6 million by applying the DRA adjustments to the Base Construction Costs and Project Cost Contingency.

¹⁴² MCWD Ex. 363, p.10, § 8.1.3. Cal Am recommends a cost cap of \$106,875,000.

¹⁴³ Based upon the rebuttal testimony of Cal Am, DRA has adjusted its recommended cost cap for the Cal Am facilities upward to \$86.6 million.

¹⁴⁴ MCWD Ex. 320, Exhibit LWM-14, Project Cost Comparison, dated April 15, 2010.

¹⁴⁵ Using the total capital cost of \$95 million from the Settlement Agreement, Attachments 3 and 4 cost estimates for Cal Am-Only Facilities. (MCWD Ex. 363.)

	PARTIES (CWP Project Cost Comparison 4/15/2010)	DRA Adjustments
Escalated Capital Costs		
Intake Wells and Pipeline		\$ -
Desalination Facility		\$ -
Product Water Pipeline (To Tie-in Structure)		\$ -
MCWD/CSIP Delivery		\$ -
CAW Facilities-- Base Construction Cost	\$ 53,300,000	\$ 53,300,000
less DRA adjustments		
ASR Phase 2 Project reduction		\$ 3,250,000
Terminal Reservoir Reduction		\$ 4,000,000
Subtotal of DRA adjustments		\$ 7,250,000
Adjusted Base Construction Cost	\$ 53,300,000	\$ 46,050,000
Implementation Costs	\$ 14,500,000	\$ 14,500,000
Implementation Costs Incurred to Date	0	\$ -
Pre-effective Date Costs and Expenses	36,900,000	\$ -
MRWPCA Outfall Capacity Charge	0	\$ -
ROW Easements and Land Acquisition	\$ 3,400,000	\$ 3,400,000
Environmental Mitigation Measures (at 1% of adjusted capital costs)	\$ 1,081,000	\$ 791,500
Capital Costs (Excluding Contingency)	\$ 109,000,000	\$ 64,000,000
Project Contingency (25% of capital costs)	22,700,000	\$ 16,000,000
Less DRA adjustments to Project Contingency exclude 25% contingency on Land Acquisition		\$ 850,000
DRA Adjusted Project contingency		\$ 15,150,000
DRA Reduction to environmental mitigation		\$ 289,500
Adjusted Capital Cost	132,000,000	\$ 79,150,000
Total DRA Reductions (rounded)		
		\$ 8,400,000
PARTIES REQUESTED TOTAL CAPITAL COSTS in Settlement Agreement	95,000,000	\$ 95,000,000
Most Probable Capital Cost with Contingency	132,000,000	\$ 86,600,000
High End of Accuracy Range (DRA used +25%)	156,000,000	\$ 108,250,000
Low End of Accuracy Range (DRA used -15%)	118,000,000	\$ 73,610,000

1. The Commission should reduce the Aquifer Storage and Recovery System estimate.

DRA reduced the Aquifer Storage and Recovery System (“ASR”) project cost estimate by \$3.25 million because the cost estimate for this project remains uncertain and the existing evidentiary record is not sufficiently detailed to justify the \$27 million estimate. The cost estimates for the ASR Project Phase 2 are conceptual level estimates and will continue to evolve and be refined until the design is finalized in September 2011.

DRA considered the actual unit costs experienced by MPWMD during the Phase 1 ASR Project to develop its cost cap estimate. MPWMD actual costs of a similar project provide a reasonable means to estimate future costs of Cal Am’s Phase 2 ASR project. Because the Phase 2 ASR project occurs in the future, DRA escalated the costs to the mid-point of the future construction period (2012).

DRA's lower cost cap for the Phase 2 ASR project ensures that Cal Am is motivated to pursue further cost reductions in these capital investment projects. If Cal Am can adequately justify a construction cost higher than DRA's proposed cost cap, then the entire cost will be recognized in rate base. Conversely, if costs end up being lower, then this related amount will be reflected in rate base.

2. Ratepayers should only pay for the cost to construct the Terminal Reservoir aboveground.

DRA recommends that the Commission authorize Cal Am to recover in rates, at the appropriate time, the costs to construct the Terminal Reservoir aboveground rather than underground. There is nothing in the evidentiary record that justifies the additional cost to install the two Terminal Reservoir storage tanks underground. Furthermore, the Final EIR scope that was certified was the aboveground design for the Terminal Reservoir, and the Final EIR adopted several acceptable mitigations that satisfactorily mitigate the aesthetic concerns about the tank.¹⁴⁶

The Bureau of Reclamation found that constructing the Terminal Reservoir aboveground in accordance with the Final EIR, would reduce the base construction costs by \$2.2 million.¹⁴⁷ Applying implementation costs, escalation, contingency, and the range of accuracy adjustments to this base construction cost and rounding it off, results in a final adjustment of \$4 million.¹⁴⁸

Although the City of Seaside has indicated a preference to place the reservoir underground, its preference was related solely to aesthetic issues.¹⁴⁹ However, as DRA witness Ms. Steingass testified, the "Final EIR had at least three mitigations suggested for

¹⁴⁶ Reference Exhibit B, pp 3-19, 3-20, 3-34, 3-35, & 12-27.

¹⁴⁷ DRA Ex, 204, p. 25.

¹⁴⁸ $2.2\text{million} * 1.55 * 1.125 = \3.83 million .

¹⁴⁹ Cal Am Ex. 109, p, 2.

mitigating the aesthetic impact of the tanks. And, you know, there are above-ground tanks built throughout the state of California in many communities.”¹⁵⁰

Moreover, as Ms. Steingass testified,

When DRA evaluates a capital investment project in a case like this, one of the considerations among many others is, is the project needed, are the -- has the utility clearly identified, explained, and justified the costs, are the costs reasonable, what is the ratemaking proposed, and which customers should bear the costs.

I think the issue of whether the terminal reservoir should be above ground or below ground really comes to who should bear the costs of it being buried.

I'm not clear that there's any justification that relates to safe or reliable service that says that the tanks should be buried. And so consequently, the residential customers and other customers that we advocate for as DRA should not bear the cost to bury the tank.

Now, the utility, as they negotiate with the City of Seaside in the permitting process as the project affects the City of Seaside, the utility has the opportunity to negotiate settlement terms and conditions. If one of them involves the costs of burying the tank, the Commission rules allow for treat- -- ratemaking treatment to cover those costs where the City of Seaside could provide funding for that. I didn't know whether it's called a facilities fee or a special facilities fee, but something of that nature could be crafted.

So I think there are other alternatives the utility and the City of Seaside could consider, but DRA did not discuss those in our testimony because our position is that based on the scope of work in the Final Environmental Impact Report identifies that the tanks be built above ground. We felt there was nothing in the record that clearly identifies, explains, and justifies why the tanks should be buried. And we don't believe ... the costs of burying the tank, ... since we don't know that it contributes to the safe and reliable service levels for utility

¹⁵⁰ Id, at p. 1464, lines 21-25.

customers, we don't feel the residential and other customers that we advocate for should bear those costs.¹⁵¹

Given the already high costs of the project, and the determination in the FEIR that the project can be built above ground, DRA recommends that the Commission authorize Cal Am to recover in rates, at the appropriate time, the costs to construct the Terminal Reservoir aboveground rather than below ground

3. The Commission should eliminate the 25% contingency on ROW easement and land acquisition, thereby reducing the project cost contingency by \$850,000

DRA recommends that the Commission remove the 25% contingency adder that Cal Am included on some ROW easement and land acquisition estimates. Cal Am has not justified why it is reasonable to add a 25% contingency to easements and land acquisitions. Real estate acquisitions are not subject to the inaccuracy that can exist on construction projects because they can be based upon other “comparable” purchases. Moreover in today’s market, the level of uncertainty associated with right-of-way acquisition has been markedly reduced, and inflated land values are unlikely.

4. Cal Am’s pre-effective date costs should not be considered when setting the cost cap because the costs are being recovered through Surcharge 1.

The most recent cost exhibit presented by the Parties includes a line for “Cal Am pre-effective date costs and expenses”.¹⁵² Because these costs are tracked and recovered through Cal Am’s Surcharge 1, DRA excludes the \$36,900,000 of Cal Am Pre-effective Date Costs and Expenses from its analysis. These costs are not added to the Cal Am revenue requirement as they are recovered through the surcharge.

¹⁵¹ DRA/Steingass 14 RT 1462, lines 4-28, 1463, lines 1-15.

¹⁵² MCWD Ex. 320, Exhibit LWM-14, Project Cost Comparison, dated April 15, 2010.

5. Cal Am should update the project cost contingency percentage as the project becomes more certain to assure reasonableness.

Although not resulting in a cost adjustment at this time, DRA recommends that the Commission require Cal Am to modify the final project cost contingency percentage as the cost of the project becomes more certain to assure that the contingency reserve is not excessive. A reduction of the contingency rate as the project becomes more certain will provide an additional ratepayer safeguard to control costs and will assist determining cost reasonableness should costs exceed the cap.

Cal Am's current contingency estimate is based on level of development comparable to a conceptual Class 4 estimate according to the Association for the Advancement of Cost Engineering ("AACE"). As the project design moves forward, cost will become more certain, and the needed contingency factor will decrease. Cal Am's witness Mr. Schubert's testimony confirmed this, stating: "As a general engineering practice, a contingency allowance is reduced as the project scope and design becomes more defined and as more project unknowns become known."¹⁵³

DRA recommends that Cal Am update the contingency rate when it has a bid/tender or control estimate. An appropriate time to update the contingency rate is during contract negotiations with the successful (or selected) contractor. DRA recommends that the Commission require Cal Am to either a) set the contingency rate at less than or equal to the lower AACE Class 2 cost contingency or b) explicitly justify an alternate method for setting the final cost contingency.

Cal Am witness Mr. Schubert agreed that reductions to the contingency percentage would likely occur as Class 2 and Class 1 estimates are made.¹⁵⁴

Give the level of uncertainty in the current cost estimates, DRA recommends this modification to assure that when better estimates are developed, Cal Am does not attempt

¹⁵³ Cal Am Ex. 105, p. 11, lines 20-23.

¹⁵⁴ Cal Am Ex. 105, p. 11, lines 20-23.

to justify future expenses using a contingency factor that is only appropriate early in the estimating process. When conducting future reasonableness reviews, the Commission will need to know what the appropriate contingency rate is at the bid tender Class 2 level to adequately review such costs for reasonableness.

6. The Commission should require Cal Am to meet regularly with the Commission to update it on the progress of the project.

DRA recommends that the Commission modify the Settlement Agreement to require Cal Am to update DRA and Division of Water and Audits on the evolving design and cost estimate of the Cal Am-only facilities, including the Phase 2 ASR Project. This modification will help ensure that Cal Am identifies, explains, and justifies the project costs and will assist in future reviews for prudence.

As discussed in more detail in Section XII.A below, DRA supports the idea expressed in the Agreement that only prudently incurred costs of the Cal Am facilities are recovered from ratepayers, but the parties have not presented a process for such a prudence review, as discussed below. Adopting a process where the Commission can review the Cal Am-only facility costs for prudence after they occur provides ratepayers with a substantial safeguard, and receiving periodic updates will assist in future reviews.

7. DRA agrees with Cal Am's proposed four-percent escalation rate and the capitalization of legal expenses directly related to the capital investment.

DRA accepts the approach used by the Parties to apply a flat (or constant) 4% escalation factor for construction costs. In rebuttal testimony, Cal Am clarified that it did not rely on a specific Engineering News Record (ENR) Construction Cost Index for purposes of capital projects but instead used a lesser, reasonable estimate of four percent :

DRA also now accepts Cal Am's recommendation to capitalize legal expenses to the project when the legal expenses are directly related to the capital investment project, as stated in the Uniform System of Accounts ("USOA"). As Cal Am pointed out in its rebuttal testimony:

Capitalization of legal expenses is a practice accepted in the CPUC Uniform System of Accounts for Class A water utilities (USOA”), which expressly identifies “Law Expenditures” as components of construction costs [footnote omitted]. According to the definition of the USOA, Law Expenditures include the general legal expenditures incurred in connection with the construction and the court and legal costs directly related there to other than law expenses included in “protection,” item 7, and in “injuries and damages,” item 8. By the Commission's own adopted definition, legal expense should be included in the project if they are incurred to construct the project. Thus, as part of the typical items that California American Water would include with the plant it constructs, the cost estimate for the California American Water Facilities includes legal costs.¹⁵⁵

XII. CAL AM-ONLY FACILITIES RATEMAKING

A. Cal Am seeks to create a new form of Advice Letter that would depart from General Order 96B requirements and is unlawful.

DRA opposes Cal Am’s proposal to recover the cost of the Cal Am-only facilities through a new type of advice letter process that departs from General Order 96B requirements. Instead, DRA recommends that the Commission require Cal Am to seek recovery of the Cal Am-only facility costs through a once-a-year, Tier 3 advice letter or application that allows DRA sufficient time to perform the necessary prudence review of the facility costs as required by the Settlement Agreement.

The Settlement Agreement allows Cal Am to file advice letters twice a year to incorporate the annual project spending on the Cal Am-only facilities, including AFUDC, into ratebase. The Settlement requires the Commission to process the advice letters within 30 days.¹⁵⁶ Under the terms of the Settlement, if the Commission does not process the advice letter within the requisite time, the revenue requirement impact as filed in the

¹⁵⁵ Cal Am, Ex. 103, p. 13.

¹⁵⁶ MCWD Ex. 363 § 9.4.1. DRA notes that the Parties propose that Cal Am’s advice letters be processed within 30 days and effective in 45 days. However, Cal Am’s witness did not know why the Settlement Agreement states that it will be processed in 30 days. Cal Am/Stephenson 12 RT 1091.

advice letter would automatically be implemented by Cal Am, subject to true-up.¹⁵⁷ Once the Cal Am-Only facilities are completed, Cal Am would file a final advice letter to place the full return on and recovery of all plant investment, *including prudent costs above the cap*, into base rates and base revenue requirements and rates.¹⁵⁸ The Settlement requires the Commission to process this final advice letter in 60 days.¹⁵⁹

Although Cal Am’s witness Mr. Stephenson testified that Cal Am was proposing that the advice letters be treated like Tier 2 advice letters under General Order 96B, a review of Cal Am’s proposal demonstrates that that is not the case.

While Mr. Stephenson testified that the advice letters could be suspended by the Water Division, the settlement indicates that the revenue requirement as filed by Cal Am “shall be implemented subject to true-up”¹⁶⁰ if the advice letter is not processed within the time frame specified.

Although the Settlement Agreement states in numerous places that only “prudently” incurred costs could be placed into rate base through the advice letter process,¹⁶¹ the Settlement Agreement does not address who would conduct the prudence review or what the prudence review would involve. When testifying, Cal Am witness Stephenson seemed to clarify that the so-called prudence review would be done by Division of Water and Audits and it would just be making sure that the “costs are applicable to the particular project.”¹⁶²

If Cal Am’s intent was to have these advice letters processed as a rate base offset under the procedures established in Resolution W-4749, then that intent is not fulfilled,

¹⁵⁷ Id. at § 9.4.2.

¹⁵⁸ Id. at § 9.4.3.

¹⁵⁹ Ibid.

¹⁶⁰ Id. at § 9.4.2, emphasis added.

¹⁶¹ Settlement Agreement §§ W, 9.3, & 9.4.3.

¹⁶² Cal Am/Stephenson 12 RT 1092.

because this process does not review costs for prudence. Under the rate base offset, Tier 2 advice letter process, DWA reviews the invoices and expenses only for accuracy.¹⁶³

Reviewing invoices for accuracy or for their applicability to a particular project is a far cry from a prudence review. Determining whether or not an expense is prudent requires judgment and is more than a ministerial act that can be determined by Division of Water and Audits under the ratebase offset procedures of Resolution W-4749. A Commission resolution or decision is necessary to find that the expenditures were prudently incurred. This is especially the case for costs above the Commission-authorized cap.

To assure that only prudently incurred costs are recovered, the Commission must modify the settlement to require Cal Am to file its recovery requests as either a Tier 3 advice letter or through an application. A Commission determination is necessary to determine whether the costs of the Cal Am facilities are prudently incurred as required by the Settlement. Simply put, the potential expenses that would be placed in rates via this Advice Letter process mandates a significant level of Commission scrutiny and judgment that a ministerial process does not afford.

B. In light of the Settlement Agreement’s unorthodox ratemaking treatment for Cal Am facilities, the application of an AFUDC rate at the utility’s weighted average cost of capital challenges the very premise of “prudent and reasonable.”

In the Settlement Agreement, Cal Am asks the Commission to approve an AFUDC rate set at the utility’s weighted average cost of capital to compensate investors for the borrowing costs during the period between project costs accumulating and being placed into rates at the utility’s full rate of return. While Cal Am would like this borrowing period to be six months at a rate equal to the utility’s full rate of return, DRA

¹⁶³ Resolution W-4749, p. 2.

advocates for a one-year period at a borrowing rate more closely associated with the time period during which borrowing would occur.

To permit Cal Am's short-term capital expenditures to accumulate carrying costs in excess of the utility's short-term borrowing costs when full recovery of these costs at the utility's authorized rate of return is all but guaranteed each year under the terms of the Settlement Agreement would be adding insult to injury. Already a significant departure from the long-standing regulatory concept of "used & useful," Cal Am's proposed new category of advice letters for placing project costs into rates prior to project completion would significantly mitigate almost all uncertainty and risk associated with recovery of spending on Cal Am facilities. It is inconceivable that any rate above DRA's recommended short-term borrowing percentage could be justified.

DRA recommends that the Commission adopt a risk-adjusted¹⁶⁴ **two-year** corporate borrowing rate to compensate Cal Am for the **one-year period** in which Cal Am will incur carrying costs.¹⁶⁵ While Cal Am seeks to recover these costs and project spending in customer rates with semi-annual filings, DRA's recommended annual filing with a carrying-cost percentage equal to a similarly-rated company's two-year borrowing costs¹⁶⁶ is a more reasonable method of allowing alternative rate recovery prior to project completion while minimizing the financing costs that are passed through to ratepayers.

C. Allowing Cal Am to self-determine the capital structure applied to the project for ratemaking purposes would establish a dangerous precedent where utilities could circumvent cost of capital proceedings and achieve equity positions beyond what are authorized.

The Settlement Agreement's unique language defining Cal Am's "equity used" to finance facilities should cause the Commission pause and alarm. The formulaic definition found in the Settlement Agreement would effectively allow the management of

¹⁶⁴ Risk-adjustment based upon the published rating of Cal Am parent company American Water Works.

¹⁶⁵ DRA Ex. 202, pg. 35, 11-18.

¹⁶⁶ DRA's testimony presented the then-current two-year borrowing cost of BBB-rate issuance at 2.46%

Cal Am to self-determine the equity percentage that the utility would be able to achieve in financing Cal Am facilities.¹⁶⁷ Although the rebuttal testimony of Cal Am witness Mr. Stephenson states that the Settlement Agreement¹⁶⁸ references Cal Am's forecasted 50/50 debt-to-equity ratio that it would use to finance the project,¹⁶⁹ DRA could find no such reference. During hearings Mr. Stephenson testified that right now Cal Am is considering a 50 % equity stake, and it may be a different rate.¹⁷⁰

Cal Am should not be permitted to evade previous or future Commission decisions determining an appropriate capital structure and equity percentage. Cal Am's equity portion for ratemaking purposes, and thus the percentage of project facilities for which investors earn a profit, should be consistent and defined in tangible, unambiguous terms to coincide with the percentage authorized by the Commission in the then-current cost of capital decision.

D. Ensuring the financial health of Cal Am does not equate to negating the benefits of a public agency partnership through acknowledgment of the irresolute effects of debt-equivalence.

Although the Settling Parties have agreed to determine the issue of debt equivalence in a separate application, DRA notes with concern the travesty that would occur should the possible cost advantage Settling Parties have attributed to the Regional Project be completely overturned because the Commission prematurely acknowledged a financial impact associated with Cal Am's involvement in the Regional Project.

¹⁶⁷ MCWD Ex. 363, pg. 12, section 9.1.7: "Equity Used."

¹⁶⁸ During hearings, it was indicated that the reference to the WPA in Mr. Stephenson's testimony should have been to the Settlement Agreement. 12 RT 1104.

¹⁶⁹ Cal Am Ex. 103, p. 14.

¹⁷⁰ Cal Am/Stephenson 12 RT 1104 lines 5-17.

XIII. ADDITIONAL RATEPAYER PROTECTIONS ARE NECESSARY TO PROTECT THE RATEPAYERS IN THE EVENT THE REGIONAL DESALINATION PROJECT IS NOT COMPLETED

At the conclusion of evidentiary hearings, ALJ Minkin asked the parties to brief a number of issues, including what protections are in place for ratepayers if the Regional Project is unable to be permitted and built.¹⁷¹ Under the Water Purchase Agreement, if the Regional Project is not completed, Cal Am is responsible to reimburse MCWD and MCWRA for all costs and expenses incurred in connection with the Regional Project.¹⁷² For this reason, the Commission needs to adopt additional ratepayer protections to assure that Cal Am's Monterey district ratepayers do not end up paying for another abandoned water supply project.

A. Ratepayers should not pay for MCWRA & MCWD costs if there is no final Water Purchase Agreement

If MCWRA, MCWD, or both reject Commission modifications to the settlement, Cal Am will have to spend additional money to implement one of its projects. This burden should not be increased by adding on up to \$14 million in agency costs for a project that will not be built.¹⁷³

Just as utilities are not guaranteed recovery for abandoned project costs, the agencies, acting as applicants, should bear the risks of losing their investments to date if they reject Commission modifications. Cal Am ratepayers should not be responsible for the costs of abandoned projects of these other agencies. In addition to being fair, making the MCWRA and MCWD cost recovery from ratepayers contingent on Regional Project adoption gives the agencies an added incentive to accept reasonable Commission modifications to the settlement.

¹⁷¹ ALJ Minkin, 15 RT 1767-77.

¹⁷² MCWD Ex. 301, WPA § 7.4.

¹⁷³ MCWD Exhibit 301, Exhibit C.

B. Cal Am shareholders should bear some of the costs for additional development of the FEIR alternatives

In the event the Regional Project is not completed, DRA recommends that the Commission evaluate in another phase of this proceeding whether it is appropriate for Cal Am shareholders to bear some of the costs of implementing a different water supply solution.

In D.06-07-027, the Commission adopted a stipulation between DRA and PG&E that creates a 90/10 split between ratepayers and shareholders for up to \$100 million in costs above the stipulated cost cap.¹⁷⁴ A similar mechanism could apply here in the event the Regional Project is not completed and the Commission approves one of Cal Am's projects. The additional costs required to implement either the Moss Landing Project or the North Marina Alternative would be akin to a PG&E overrun on costs to implement the Smart Meter project adopted in D.06-07-027.¹⁷⁵ A defined split would provide ratepayers additional protection and give Cal Am an incentive to minimize the additional costs necessary to complete a project.¹⁷⁶

C. Cal Am shareholders should bear the cost of overcoming legal challenges related to Monterey County Code Chapter 10.72.

Monterey County Code Chapter 10.72.030(B), which states the need for desalination facilities to be publicly owned, was passed in 1989.¹⁷⁷ Cal Am's projects were developed and submitted to the Commission in 2004 with full knowledge of the code prohibiting private entities from owning desalination facilities. Cal Am made a

¹⁷⁴ D.06-07-027, pp. 13-15.

¹⁷⁵ The implementation costs here refer to all of the costs included under the implementation allowance in the August 14, 2009, Joint Cost Comparison, Cal Am Ex. 108.

¹⁷⁶ These reasons were cited by the Commission in D.06-07-027 in support of its decision. In this proceeding, the added advantage of a defined split for project costs is reducing the time for project completion and thus increasing Cal Am's ability to comply with the CDO.

¹⁷⁷ Monterey County Code, Chapter 10.72.030.

management decision that these projects could be feasible despite the code. As Cal Am stated during Phase I of the Coastal Water Project proceeding in 2006, “we believe the county will not stand in the way of this project. That’s what we believe.”¹⁷⁸ Thus, Cal Am and not ratepayers should bear costs associated with challenges to its ownership of either project based upon Section 10.72. Faith-based beliefs do not provide a justification for imprudent assumptions or inappropriate cost recovery.

XIV. THE COMMISSION SHOULD ALLOW 90 DAYS FOR THE DEVELOPMENT OF ALTERNATE REGIONAL DESALINATION SCENARIOS IN THE EVENT THE REGIONAL DESALINATION PROJECT IS NOT COMPLETED

At the conclusion of evidentiary hearings, ALJ Minkin also asked the parties to brief the issue of what alternatives the Commission should consider if it proposes modifications to the Settlement Agreement that the Settling Parties decline to accept.¹⁷⁹ As stated above, DRA supports the Regional Project with certain modifications. DRA hopes that the Settling Parties will accept modifications that result in a fair and reasonable allocation of risks and costs among Parties.

If the Settling Parties decline to accept Commission modifications to the Settlement, DRA would suggest that the ALJ allow up to 90 days for Parties to develop alternate arrangements for a regional desalination project. DRA recommends that the Commission hold a workshop(s) to allow Settling Parties to further discuss the modifications proposed by the Commission and the reasons for declining them, and to allow Parties to explore other possibilities such as a Joint Powers Authority of the Cities that could own or manage the project. If after 90 days consensus still cannot be reached, DRA recommends that the Commission move forward with certifying the North Marina Alternative.

¹⁷⁸ A.04-09-019 Phase I, 2 RT 71, lines 19-20.

¹⁷⁹ ALJ Minkin, 15 RT 1767-77.

Although both the North Marina Alternative and the Moss Landing Project could face public opposition and litigation, DRA contends that the North Marina Alternative is the better choice if the Commission is to choose between the two Cal Am-owned projects in the FEIR. The North Marina Alternative is the environmentally superior alternative¹⁸⁰ and would likely cost less than the Moss Landing Project.¹⁸¹ DRA must emphasize that it makes this recommendation at the request of the ALJ for the Parties to address this issue. DRA continues to support a fair and equitable Regional Project.

XV. THE SETTLEMENT UNLAWFULLY BINDS FUTURE COMMISSIONS

The proposed Settlement Agreement’s provisions “deeming” all future costs reasonable automatically upon Commission approval of the agreement unlawfully bind future Commissions from determining whether rates are just and reasonable.

In the Diablo Canyon decision, the Commission addressed the Commission’s inability to approve settlements that bind future Commissions. “[T]he general rule of law is that no legislative body can limit or restrict its own power or that of subsequent legislatures.”¹⁸² The Commission exercises its legislative powers when it sets rates.¹⁸³ The proposed Settlement Agreement seeks to automatically incorporate into rates all costs classified under the settlement as Regional Desalination Project costs, unlawfully restricting any future Commission’s ability to review cost for reasonableness and exercising its legislative power to set rates.

As the Commission stated in its Opinion Modifying the Proposed Settlement in the *PG&E Bankruptcy* case:

In light of the constitutional requirement that the Commission actively supervise and regulate public utility rates [citation omitted] and the statutory requirements under the §§451, 454,

¹⁸⁰ FEIR, p. 7-63.

¹⁸¹ Cal Am Ex. 104, Exhibit L, and Cal Am Ex. 108.

¹⁸² *Re Pacific Gas & Electric Co.*, (D.88-12-083) 30 CPUC 2d 189, 223.

¹⁸³ *Id.*

728 that the Commission ensure that the public utilities' rates are just and reasonable [citation omitted] the Commission must retain its authority to set just and reasonable rates during the nine-year term of the settlement and thereafter.

The regulation of utilities is one of the most important of the functions traditionally associated with the police power of the states. [Citation omitted.] This Commission's authority to regulate public utilities in the State of California is pursuant to the State's police power. [Citation omitted] The California Supreme Court has held that "it is settled that the government may not contract away its right to exercise the police power in the future." [Citation omitted.]

The Commission cannot be powerless to protect PG&E's ratepayers from unjust and unreasonable rates or practices during the nine-year term of the proposed settlement. "The police power being in its nature a *continuous* one, must ever be reposed somewhere, and cannot be barred or *suspended* by contract or irrevocable law. It cannot be bartered away even by express contract." [Citation omitted.]¹⁸⁴

If the Settlement Agreement is approved without modification, it will unlawfully restrict the Commission's power to protect Cal Am ratepayers from unjust and unreasonable rates or practices during the possible 94-year Agreement.¹⁸⁵ DRA

¹⁸⁴ *Opinion Modifying the Proposed Settlement Agreement of PG&E*, (D.03-12-035), p. 28 emphasis in the original. In D.03-12-035, the Commission exercised its regulatory authority and struck Paragraph 6 in the proposed bankruptcy settlement. Paragraph 6 was intended to limit the Commission's ability to restrict PG&E and PG&E Corporation from declaring and paying dividends or repurchasing stock. The Commission found that Paragraph 6 was "unreasonable and contrary to the public interest, because it would restrict the Commission from ruling against PG&E concerning allegations of unreasonable dividend or stock repurchasing practices." D.03-12-035, COL 8. DRA notes that while the PG&E Bankruptcy case did approve the provision of the settlement that established a regulatory asset of \$2.2 billion to be added to PG&E's ratebase and which affected future rates, that situation is far different from the case here. In the PG&E Bankruptcy decision, the Regulatory Asset comprised only 5.4 percent of PG&E's retail electric rates and the Commission was able to find the regulatory asset was just and reasonable. Here the Product Water costs could amount to as much as 62 percent of Cal Am's customer rates and no similar finding can be made here as these yet-to-be incurred, and often unknown costs, are reasonable. However, the Commission can find DRA's proposed per-acre-foot cost cap reasonable based upon the record.

¹⁸⁵ The WPA has an initial term of thirty-four years and six automatic renewals of ten additional years. (WPA, §§ 2.2, 2.3)

estimates that 62 percent of Cal Am's revenue requirement for the Monterey District will be from the costs associated with the Regional Desalination Project.¹⁸⁶

DRA recommends that the Commission delete from the Settlement Agreement and WPA all provisions that deem Regional Desalination Project expenses reasonable upon Commission approval of the overall Agreement. As discussed above, DRA recommends that the Commission adopt a cost-per-acre-foot cost cap as a reasonable, not-to-exceed cost of water that can be charged to Cal Am ratepayers. This price per-acre-foot can be reviewed by future Commissions for reasonableness, as this may change during the possible 94-year term of the agreement.

XVI. CONCLUSION

DRA recommends the Commission modify the Settlement Agreement and Water Purchase Agreement as discussed above and as presented in DRA's Modifications to the Proposed Settlement Agreement filed on May 27, 2010.

Respectfully submitted,

/s/ MONICA MCCRARY

Monica McCrary
Staff Counsel

Attorney for the Division of Ratepayer
Advocates

California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-1288
Fax: (415) 703-2262

July 2, 2010

¹⁸⁶ Cal Am's current Monterey District revenue requirement is \$43 million. By adding \$69 million, the total revenue requirement would become \$112 million, excluding surcharges. \$69 million/\$112 million = 62%.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of “**OPENING BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES**” in **A.04-09-019** by using the following service:

E-Mail Service: sending the entire document as an attachment to an e-mail message to all known parties of record to this proceeding who provided electronic mail addresses.

U.S. Mail Service: mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on **July 2, 2010** at San Francisco, California.

/s/ CHARLENE D. LUNDY

Charlene D. Lundy

**SERVICE LIST
A0409019**

venskus@lawsv.com
rmcglathlin@bhfs.com
georgeriley@hotmail.com
dave@laredolaw.net
mlm@cpuc.ca.gov
mfogelman@friedumspring.com
sleeper@manatt.com
nelsonp34@hotmail.com
dcarroll@downeybrand.com
steller@rtmmlaw.com
jgeever@surfrider.org
connere@west.net
carrie.gleeson@amwater.com
robert.maclean@amwater.com
tim.miller@amwater.com
tmontgomery@rbf.com
Gregory.Wilkinson@bbklaw.com
jason.Ackerman@bbklaw.com
lflowrey@nheh.com
ffarina@cox.net
weeksc@co.monterey.ca.us
stecllns@aol.com
nisakson@mbay.net
Glen.Strasky@LosLaurelesHOA.com
bobmac@qwest.net
jim@mcwd.org
manuelfierro02@yahoo.com
erickson@stamlaw.us
bobh@mrwpca.com
catherine.bowie@amwater.com
john.klein@amwater.com
andy@mpwmd.dst.ca.us
darby@mpwmd.dst.ca.us
heidi@laredolaw.net
tgulesserian@adamsbroadwell.com
James.M.Reilly@amwater.com
ezigas@esassoc.com
dhansen@friedumspring.com
selkins@friedumspring.com
lweiss@manatt.com
ldolqueist@manatt.com
lmelton@rmcwater.com
scorbin@surfrider.org
swilliams@poseidon1.com
joyce.ambrosius@noaa.gov
kobrien@downeybrand.com
abl@bkslawfirm.com
dstephen@amwater.com
bca@cpuc.ca.gov
ang@cpuc.ca.gov
cjt@cpuc.ca.gov
dsb@cpuc.ca.gov
jzr@cpuc.ca.gov
jws@cpuc.ca.gov
llk@cpuc.ca.gov
mzx@cpuc.ca.gov
mml@cpuc.ca.gov
nks@cpuc.ca.gov
pva@cpuc.ca.gov
rkk@cpuc.ca.gov
rra@cpuc.ca.gov
steve@seacompany.org
cem@newsdata.com
michael@rri.org
Audra.Hartmann@Dynergy.com

