



**APPENDIX H**  
August 15, 2011 Letter to Cal-Am

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## MARINA COAST WATER DISTRICT

11 RESERVATION ROAD • MARINA, CA 93933-2099

Home Page: [www.mcwd.org](http://www.mcwd.org)

TEL: (831) 384-6131 • FAX (831) 883-5995

### DIRECTORS

WILLIAM Y. LEE

President

DAN BURNS

Vice President

HOWARD GUSTAFSON

KENNETH K. NISHI

JAN SHRINER

August 15, 2011

### VIA FEDERAL EXPRESS AND EMAIL

Robert MacLean

President

California American Water Company

1033 B Avenue, Suite 200

Coronado, CA 92118

[rmaclean@amwater.com](mailto:rmaclean@amwater.com)

Anthony J. Cerasuolo

Vice President, Legal – Operations

California American Water Company

1033 B Avenue, Suite 200

Coronado, CA 92118

[acerasuolo@amwater.com](mailto:acerasuolo@amwater.com)

Jan S. Driscoll

Allen Matkins

501 West Broadway, 15<sup>th</sup> Floor

San Diego, CA 92101

[jdriscoll@allenmatkins.com](mailto:jdriscoll@allenmatkins.com)

**Re:** Letter Initiating Good Faith Negotiations (“Letter”) Pursuant to Section 19.2 of that certain Water Purchase Agreement by and among Marina Coast Water District, a County Water District (“MCWD”), Monterey County Water Resources Agency (“MCWRA,” together with MCWD, the “Agencies”) and California American Water Company (“CAW,” together with MCWD and MCWRA, the “Parties” and, each individually, a “Party”) dated as of April 6, 2010, including as subsequently modified and updated by the Parties pursuant to a filing with the California Public Utilities Commission (“CPUC”) as of August 31, 2010 entitled “Marina Coast Water District’s Notice of Filing of Conformed Copy of Water Purchase Agreement Containing Previously-Announced Revisions Acceptable to the Signatories” (collectively, the “WPA”) with an “Effective Date” of January 11, 2011.

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Dear Rob:

We hereby refer to the WPA referenced above. Capitalized terms not otherwise defined herein are defined as set forth in the WPA.

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At the outset, MCWD wishes to restate its previously articulated position. MCWD believes that the Regional Desalination Project implementing agreements are valid, legally enforceable, and not subject to challenge in a court of law. As we know, "time is of the essence" for this project, and, as found by the CPUC, the Regional Desalination Project constitutes the only feasible alternative to achieve timely compliance with the State Water Resources Control Board's Cease-and-Desist Order (Order WR 2009-0060) deadline. The citizens of the Monterey Peninsula and Monterey County deserve no less than the project partners moving forward with the Regional Desalination Project promptly and in good faith. We encourage our partners to join us in using the dispute resolution process of the WPA as an opportunity to cure or resolve pending disputes and to move forward expeditiously with the project as presently configured. However, if partner MCWRA concludes it is unable or unwilling to move forward as a project partner, we submit that it should use the dispute resolution process of the WPA as an opportunity to negotiate the terms of its withdrawal from the Regional Desalination Project.

On behalf of MCWD, this Letter constitutes formal written notice to each of MCWRA and CAW of MCWD's intention to initiate the dispute resolution provisions contained within Article 19 of the WPA with respect to on-going and unresolved disputes between MCWD and CAW in connection with the WPA. Specifically, MCWD believes that CAW has taken actions which constitute a failure to perform its obligations under the WPA. These disputes and disagreements between MCWD and CAW have arisen with respect to the following matters:

First, CAW has failed to satisfy its obligation under Section 7.5 of the WPA which requires that "[o]n or before the Effective Date, CAW shall obtain a letter of credit in form, on terms and from an issuer reasonably acceptable to MCWD and MCWRA in the amount of \$12,000,000.00 (the 'Letter of Credit')." The Letter of Credit serves as a fundamental component of the agreements under the WPA and was designed to allay the concerns of both Agencies in case of an Event of Default by CAW under the WPA. Unfortunately, CAW failed to obtain and implement the Letter of Credit by the January 11, 2011 Effective Date.

Second, Section 7.1(c) of the WPA sets forth the terms and conditions governing the establishment and operation of a Line of Credit Agreement between and among the WPA parties. On January 11, 2011, each of MCWD, MCWRA and CAW entered into a CAW Line of Credit Agreement (the "Line of Credit") reflecting the requirements of the WPA. On June 17, 2011, MCWD submitted a second draw request under the Line of Credit in order to cover additional expenses related to the development, financing and construction of the Regional Desalination Project. CAW refused to fund the draw request based on a number of invalid reasons articulated in a letter dated July 6, 2011. Following further discussions with CAW, MCWD agreed to extend CAW's time to honor the second draw request under the Line of Credit until August 12, 2011 and, as requested by CAW, voluntarily reduced the amount of the request to \$1,000,000. CAW again failed to meet the obligation to fund the draw request, as modified, and as of the date of this Letter has not provided additional funding to MCWD under the terms of the Line of Credit and as required by the WPA.

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Third, CAW and MCWRA were jointly responsible for cancelling the Community Involvement Forum ("CIF") meeting that was originally scheduled for June 15, 2011. Section 6.7 of the WPA requires that a CIF meeting be held each quarter as a means for the public, other stakeholders and the parties to the WPA to communicate openly regarding all relevant issues related to the design and development status of the Regional Desalination Project. Over the objection of MCWD, both CAW and MCWRA cancelled the CIF meeting based on their concern that the focal point of the CIF meeting would be the Project Management Agreement due to the recent conflict of interest revelations concerning Stephen Collins as opposed to gathering and providing information about the Regional Desalination Project. MCWD's General Manager sent an email on June 14, 2011 to CAW and MCWRA which clearly stated that MCWD believed that "the intent of Forum is that there is open communication between the Project and the Forum. This open communication can be great news, good news and/or bad news but should be open, transparent and timely information sharing as described in the WPA." Despite MCWD's objection, the CIF meeting was cancelled.

Fourth, MCWD is in receipt of CAW's letter dated August 12, 2011 (the "Default Letter") pursuant to which CAW states that "this letter constitutes written notice under WPA Section 20.1(b)(ii) that *the Agencies have defaulted in their performance of their material covenants, agreements or obligations under the WPA.*" [Emphasis added.] Specifically, CAW asserts in the letter that each of the Agencies are in default as they have failed, by May 11, 2011 (i.e., 120 days following the Effective Date), to obtain all or a portion of the financing for the Project Facilities. Initially, MCWD would like to point out that CAW's assertion that MCWD is subject to a default under the WPA pursuant to Section 20.1(b)(ii) is in fact a breach by CAW of its own obligations under the WPA. The language in Section 19.1 of the WPA is clear that "[e]xcept as set forth in Sections 19.5, 20.1(a) and 20.1(b)(i), no dispute shall give rise to an Event of Default under this Agreement until the dispute resolution procedures of this Article 19 have been completed." At this point in time the Parties have not even commenced the dispute resolution process with respect to the issue of financing. Notwithstanding the foregoing, MCWD appreciates CAW's sincere desire to resolve any potential issues in order to allow the Regional Desalination Project to move forward in an expeditious manner. However, MCWD wants to make it clear that the grounds upon which CAW has asserted a default on behalf of the Agencies is erroneous on its face as MCWD has already fulfilled the financing requirement set forth in the WPA. We would like to direct CAW's attention once again to our letter dated August 9, 2011 (a copy of which has been attached to this Letter as Exhibit A), wherein it was made clear that MCWD was troubled by CAW's statements that "there has yet to be financing of the Project costs" under the WPA and refuted some of CAW's points on this matter. As you will recall, back in May, when this issue was first raised, there was a clear assessment by all of the Parties that the Agencies draw of funds under the Line of Credit constituted financing for purposes of the one hundred and twenty (120) day requirement. It appears that recent developments with respect to the Regional Desalination Project involving the alleged California Government Code § 1090 violation have caused CAW to not only disregard prior discussions and agreements between the Parties with respect to the Agencies' satisfaction of the requirements set forth in Section 7.1(a), but also to unilaterally decide that it has the authority to determine what does or

does not constitute “financing” under Section 7.1(a) of the WPA. Further, the facts articulated in the Default Letter are not entirely forthcoming. For example, the language in Section 7.1(a) makes it clear that the obligation of MCWD to obtain financing associated with the Project Facilities within one hundred and twenty (120) days of the Effective Date is “*subject to market conditions.*” [Emphasis added.] As CAW is well aware, markets related to tax-exempt municipal debt dramatically declined in the first quarter of 2011 and caused the Parties to begin to seek alternatives, including project financing and the use of the Line of Credit. CAW was not only privy to discussions in the first quarter of 2011 related to this issue, but concurred in the decision to utilize Line of Credit as a means of financing the Project Facilities. Additionally, CAW has been privy to numerous drafts of the Conceptual Level Financing Plan (“Financing Plan”) referenced in its Default Letter and provided comments to those drafts over the past few months. These drafts of the Financing Plan repeatedly expressed that the “initial tranche” of financing for the Project Facilities would be achieved by drawing upon the Line of Credit. Despite this fact, CAW did not deem it necessary to comment on this aspect of the Financing Plan until its July 6, 2011 letter. MCWD also assumes that CAW is aware that the Financing Plan was already presented to the MCWD Board of Directors (the “Board”) on July 12, 2011 and that the Board received the Financing Plan by motion on a unanimous vote. The intention behind the Financing Plan has always been to obtain the maximum financing of the Project Facilities at the lowest overall total cost given then existing and anticipated market conditions. Utilizing the Line of Credit as an interim financing measure was always seen as the best means by the Parties to achieve this goal. Regardless, if MCWD needs to seek other financing alternatives which may be of a shorter-term and at a higher interest rate, then it can do so. It is unfortunate that doing so will ultimately result in greater costs to the ratepayers of both MCWD and CAW. Ironically, in the Default Letter, CAW has focused on its role as a water utility regulated by the CPUC that it has a “duty to its ratepayers to ensure all expenses incurred are prudent business expenses.” It is worth pointing out that this duty does not, however, grant CAW additional oversight rights with respect to imposing new or different conditions with respect to the financing of the Project Facilities than those that are set forth in the WPA.

Finally, in addition to the various disputes and disagreements addressed above, MCWD is concerned that CAW has undertaken actions which may constitute a breach of its implied covenant of good faith and fair dealing. The covenant imposes on each party to the WPA the duty to refrain from doing anything which would render performance of the WPA impossible by any act of their own, and also the duty to do everything that the contract presupposes that each party will do to accomplish the WPA’s purpose. Breach of specific provisions of the WPA is not a necessary prerequisite to a breach of the implied covenant of good faith and fair dealing. With this in mind, MCWD wishes to reiterate its concerns that in addition to issues raised in this Letter, that CAW and its representatives have potentially taken actions which may be deemed as being in violation of this covenant, including CAW’s execution of a confidentiality agreement and participating in secret discussions with a number of the Monterey Peninsula Cities regarding matters associated with the future of the Regional Desalination Project.

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MCWD wishes once again to reiterate its position that it believes in the validity and enforceability of the WPA and the other project agreements and will take all necessary steps to support, defend and implement those agreements. Moreover, while MCWD deems each of the disputes and disagreements raised in this Letter as being of considerable impact, it is indisputable that the cumulative effect of these disputes and disagreements is essentially to undermine, and potentially halt, the development of the Regional Desalination Project. These disputes and disagreements having been noted, MCWD looks forward to your response and commencing with good faith negotiations between the Representatives of the WPA parties in accordance with the provisions of Article 19 of the WPA.

MCWD hereby reserves all of its rights under all agreements and applicable law.

Sincerely,

A handwritten signature in black ink, appearing to read "Jim Heitzman", with a long horizontal line extending to the right.

Jim Heitzman,  
General Manager  
Marina Coast Water District

Cc: Curtis V. Weeks, General Manager, MCWRA  
Charles McKee, County Counsel, MCWRA  
Kevin O'Brien, Downey Brand LLP

**EXHIBIT A**

**August 9, 2011 Letter from MCWD to CAW**

[Please See Attached]



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TEL: (831) 384-6131 • FAX (831) 883-5995

**DIRECTORS**  
WILLIAM Y LEE  
President

DAN BURNS  
Vice President

HOWARD GUSTAFSON  
KENNETH K. NISHI  
JAN SIIRINER

August 9, 2011

Robert MacLean  
California American Water Company  
1033 B Avenue, Suite 200  
Coronado, CA 92118

Dear Rob:

We are in receipt of your letter of July 6, 2011 ("Letter") in connection with Marina Coast Water District's ("MCWD's") June 17, 2011 draw request ("Draw Request") under the CAW Line of Credit Agreement ("Line of Credit"). Following our recent discussions regarding the Draw Request, I am writing to inform you that MCWD is amenable to California American Water's ("Cal-Am's") request that the amount of Draw Request be reduced from \$3,500,000 to \$1,000,000 which should be adequate to fund short-term expenses to be incurred by MCWD in connection with the implementation and development of the Regional Desalination Project ("Project") in accordance with the terms of the Water Purchase Agreement ("WPA"). MCWD reserves its right to request additional draws under the Line of Credit in accordance with the terms of the Line of Credit. Although MCWD has agreed to a reduction in the amount of the Draw Request, your Letter raised a number of additional points which need to be addressed.

First, it is important to point out that MCWD did not agree to "defer" its Draw Request as indicated in your Letter. Rather, MCWD's prior letter dated June 30, 2011 stated that MCWD agreed to "grant Cal-Am an extension to its obligations under Section 4(a)" of the Line of Credit to fund any draws as promptly as possible, but not more than 10 days after delivery of the Draw Request. With that in mind, coupled with MCWD's agreement to reduce the amount of the Draw Request, it is our expectation that Cal-Am will be able to fund the Draw Request immediately and, in any case, by Friday, August 12<sup>th</sup>.

Second, MCWD is troubled by the statement in your Letter that in Cal-Am's opinion "there has yet to be a financing of the Project costs." Although it is true that the subject of treating the first draws by the public agencies under the Line of Credit as the commencement of financing under the WPA was addressed directly at the May 16, 2011 meeting of the Advisory Committee, this issue had been discussed numerous times previously and it is my recollection that the representatives of each of the WPA parties – as party representatives and not as members of the Advisory Committee – agreed that the financing requirement in Section 7.1(a) of the WPA had

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been met. As we all know, the Advisory Committee has no authority over the WPA Parties and only the representatives of the WPA parties could reach such an agreement. Furthermore, drafts of the proposed financing plan have been circulating for weeks and have contained references that the first tranche of financing the Project under the WPA occurred with the initial draws by the public agencies upon the Line of Credit. Finally, there is nothing in the WPA which could be characterized as excluding the Line of Credit (or any form of financing obtained from Cal-Am) from being treated as a source of financing. Regardless, MCWD is pleased that Cal-Am is still committed to moving forward with the Project and providing continued assistance to both of the public agencies in implementing a financing plan that is designed to obtain the maximum financing of the Project at the lowest overall total cost given both existing and anticipated market conditions as well as other factors.

Third, MCWD understands Cal-Am's position that Cal-Am is not required to allow the public agencies to use any of the \$17,500,000 CAW Loan (the "Loan") except under circumstances as contemplated by the WPA. However, there is nothing in the WPA which excludes the Loan from being utilized as a means of financing that would ultimately reduce the overall costs of the Project and the rates to be paid by Cal-Am's customers. As discussed previously by the WPA parties – based on current market conditions and status of Project permitting – the purpose of the Loan was to reduce the overall "weighted average cost of the indebtedness" for the Project. Nevertheless, if Cal-Am is unwilling to allow the public agencies to use the Loan to reduce the overall costs for the Project that ratepayers will be responsible for paying, MCWD will instead seek other financing alternatives which may be of a shorter-term and at a higher interest rate. These other alternatives that MCWD may pursue can be utilized as intermediary financing until permitting issues are resolved and MCWD is able to implement the next phases of the financing plan. Obviously, MCWD will keep Cal-Am apprised of the process of obtaining these alternative financing sources and would be open to any less costly means of providing funding for the Project that Cal-Am may suggest, including the Loan.

Fourth, as was discussed at the meeting held on Thursday, July 7<sup>th</sup>, it appears that following the Effective Date approximately \$1,200 in legal expenses charged to MCWD in connection with the Ag Land Trust litigation in the first quarter of 2011 were paid utilizing funds from MCWD's first draw request under the Line of Credit. Based on the language in Section 14.2 of the WPA, MCWD intends to reverse these charges. MCWD has not utilized any other funds from the first draw request under the Line of Credit towards Ag Land Trust Litigation expenses. In the absence of receiving separate approval from Cal-Am or until allowable in accordance with the provisions of Section 14.2 of the WPA (e.g., if Pre-Acceptance Defense Costs are not permitted by the terms of any Indebtedness), MCWD does not intend to apply any future funds from draws under the Line of Credit, including this Draw Request, against Ag Land Trust litigation expenses. For informational purposes only, please be advised that since the Effective Date, Ag Land Trust litigation expenses are approximately \$150,000 and, as Regional Desalination Project Related Expenses under the WPA, will be reimbursable either from Non-CAW Financing or from the cost of the Product Water.

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Fifth, I have attached as Exhibit A to this letter your request for an update of MCWD's Pre-Effective Date Costs and Expenses incurred on or after January 1, 2010. As stated in my June 17, 2011 letter, it is MCWDs' understanding that MCWRA's Pre-Effective Date Costs and Expenses are approximately \$2.2 million. Assuming that amount is correct, it is evident that the reduced Draw Request amount of \$1,000,000 is clearly in compliance with the provisions of Section 5 of the Line of Credit.

Finally, you stated in your Letter that the Line of Credit requires "that specific information be provided with respect to the draw request and limits the use of such funds to the management of financial liquidity directly related to the implementation of the Project." While requirements do exist under the Line of Credit, your Letter has inaccurately asserted that our Draw Request has failed to comply with these requirements. Section 4(a) of the Line of Credit only calls for each draw request to "state the amount of the Draw requested, the intended purpose or purposes for which the Draw will be used, all types of borrowings (including durations of borrowings) and interest rate elections the borrower would be required to make in requesting a draw." The Draw Request submitted on June 17<sup>th</sup> satisfied each and every one of these required elements. Furthermore, it is worth noting that the Draw Request was almost identical in form and substance to the first draw request submitted by MCWD that met with Cal-Am's approval. With this in mind, Cal-Am lacks a valid basis under the Line of Credit to deny funding the Draw Request and should do so immediately. Nonetheless, MCWD understands Cal-Am's general desire for additional information in connection with the funds drawn under the Line of Credit as well as its own obligations to report on the use of draws. With both of those goals in mind, and in order to move the development and implementation of the Project forward in compliance with the terms of the WPA, MCWD is currently in the process of compiling the information requested in your Letter and hopes to have it for your review by next week.

If you have any questions or would like to discuss any of the above, please let me know.

Sincerely,



Jim Heitzman  
General Manager  
Marina Coast Water District

**EXHIBIT A**

**Pre-Effective Date Costs and Expenses**

[SEE ATTACHED]

**MARINA COAST WATER DISTRICT  
REGIONAL DESALINATION PROJECT  
SUMMARY OF PRE-EFFECTIVE DATE COSTS**

|   | <u>Amount<br/>Updated thru<br/>January 10, 2011</u> |
|---|---|
| CPUC Related Legal and Consulting Costs | \$ 2,142,952  |
| Consulting Expenses                     | 6,280,976   |
| MCWD Staff Costs                        | <u>663,469</u>                                      |
| <b>MCWD Costs</b>                       | <b>\$ 9,087,397</b>                                 |

