



APPENDIX I

MCWD Letter of August 15, 2011 to MCWRA

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MARINA COAST WATER DISTRICT

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August 15, 2011

VIA FEDERAL EXPRESS AND EMAIL

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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.

Dear Curtis:

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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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 MCWRA in connection with the WPA. Specifically, MCWD believes that MCWRA, at the behest of and in coordination with the Monterey County Board of Supervisors ("Board of Supervisors") the body that oversees the agency, has taken actions that (1) constitute a failure to perform its obligations under the WPA, (2) could make it impossible for MCWD to perform its obligations under the WPA, and (3) indicate that MCWRA does not presently intend to uphold, defend or continue to perform under the WPA as promised.

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 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.

As previously addressed in the letter from Lloyd Lowrey, MCWD's District Counsel, on July 21, 2011, MCWD has been increasingly concerned about MCWRA's intentions regarding its ongoing role with respect to and participation in the Regional Desalination Project. There have been numerous indications of an intention by MCWRA to anticipatorily breach its obligations under the WPA. These concerns have manifested themselves in a number of ways, including statements that have appeared in local publications where the County Council and certain members of the Board of Supervisors both questioned the continuing validity of the Regional Desalination Project agreements and indicated that the agreements were subject to on-going restructuring and revisions. The clearest statement of MCWRA and the Board of Supervisors' position was set forth on July 7, 2011, in a letter delivered to MCWD by MCWRA's outside legal counsel (the "Repudiation Letter"). In the Repudiation Letter, MCWRA stated that the WPA, the Settlement Agreement dated April 6, 2010 by and among MCWD, MCWRA and CAW and the ancillary agreements executed in connection with the WPA – including the Project Management Agreement – were void based on conclusions stated in a factually incomplete, summary report (the "Remcho Report") commissioned by Monterey County and released to the public without consulting with the other Parties to the WPA – MCWD and CAW. Furthermore, despite MCWD commissioning and sharing a more factually complete, preliminary report (the "Markman Report") with supporting legal analysis which demonstrates that the WPA and other project agreements are not void and not subject to legal

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challenge, MCWRA has failed to either modify its position or provide more facts and share a legal analysis to support its current position. MCWRA's unsupported position repudiating the project agreements was echoed in a second letter from MCWRA's outside legal counsel dated June 20, 2011.

Unfortunately, MCWD is concerned that the positions of MCWRA and the Board of Supervisors with respect to the WPA and the other project agreements, combined with the overall conduct of MCWRA and its representatives, have resulted in unnecessary and avoidable delays to the development, implementation and construction of the Regional Desalination Project. Such delays appear to have occurred in breach of MCWRA's implied covenant of good faith and fair dealing and in violation of MCWRA's obligations under the WPA, including the requirement under Section 4.8 that "[e]ach Party shall use its good faith diligent efforts, and shall require its applicable contractors and consultants to do the same, to obtain all governmental permits and approvals required for the construction of such Party's portion of the Regional Desalination Project. Such efforts shall commence as early as practically possible." To the contrary, MCWRA and its representatives have taken actions that do not appear to reflect "good faith diligent efforts" and which may both undermine and potentially delay obtaining key permits necessary for the design, development and construction of the MCWRA Owned Facilities. The effect of these statements and actions is most notably reflected in the California Coastal Commission's decision on August 12, 2011 to delay its review of the permitting for the test wells to be utilized as part of the Regional Desalination Project which was in large part due to the conflict of interest allegations and the unsupported concerns publicly voiced by MCWRA as to the validity of the Agreements.

Additionally, MCWD is greatly concerned that MCWRA's actions, as well as its potential inactions, may directly hinder MCWD's ability to undertake its own obligations under the WPA and related project agreements. This concern is rooted not only in MCWRA and County officials making recent statements suggesting that the project agreements are void, which could undermine the ability of MCWD to finance the MCWD Owned Facilities, but also in the apparent reluctance of MCWRA to pursue aggressively the permits necessary to move the Regional Desalination Project forward. Under Section 8.2(a) of the WPA, as a condition precedent to any Authorization of Construction of any portion of the Regional Desalination Project other than a test well (i.e., either the MCWD Owned Facilities or the CAW Facilities), MCWRA must first analyze the data obtained from the drilling and pumping of one or more test wells and make a determination that the MCWD Agreed Allocation contemplated under the WPA would comply with Legal Requirements. As we all know, time is of the essence with respect to designing, developing and constructing the Regional Desalination Project and it is of vital importance that the parties work diligently in the best interests of the residents of the Monterey Peninsula to implement what the Parties and the CPUC agree is the only alternative that can feasibly meet the Cease-and-Desist Order deadline. Moreover, each and every delay with respect to the Regional Desalination Project most likely will result in increased costs which will ultimately be borne by the ratepayers.

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Finally, MCWRA and CAW 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 MCWRA and CAW 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 MCWRA and CAW 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.

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,



Jim Heitzman
General Manager
Marina Coast Water District

cc: Robert MacLean, President, CAW
Anthony J. Cerasuolo, VP Legal-Operations, CAW
Jan Driscoll, Allen Matkins LLP