

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 an Order Authorizing  
Recovery of Costs for the Lease of the  
Sand City Desalination Facility and  
Associated Operating and  
Maintenance Costs.

Application 10-04-019  
(Filed April 12, 2010)

**COMMENTS  
OF THE DIVISION OF RATEPAYER ADVOCATES  
ON THE PROPOSED DECISION IN A.10-04-019**

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**I. INTRODUCTION**

Pursuant to Rules 14.3(b) of the California Public Utilities Commission's ("Commission") Rules of Practice and Procedure ("Rules"), the Division of Ratepayer Advocates ("DRA") hereby files comments on Administrative Law Judge ("ALJ") Bushey's Revised Proposed Decision ("RPD") in Application 10-04-019, California American Water Company's ("Cal Am") application for an order authorizing recovery of costs for the lease of the Sand City Desalination Plant and associated operating and maintenance costs.

In Decision 09-07-021, the Commission found that Cal Am had not satisfied its burden of proving that the original Sand City lease was reasonable and prudent. The Commission allowed Cal Am to file another application to justify including the Sand City Desalination Plant in the revenue requirement. Cal Am filed the instant application, with an amended lease, on April 12, 2010. A new PD was issued that once again concluded that the lease was neither reasonable nor prudent. After comments and extensive lobbying, a RPD was issued on December 2, 2011. This RPD again found that the lease was neither reasonable nor prudent (Conclusion of Law, "COL", 1), and as such, Cal Am

cannot, under PU Code 451 and 454, recover the costs associated with the lease. Inexplicably, however, the RPD then allows Cal Am to recover all of its lease costs, but calls this recovery a “proxy” for purchased water costs. Thus, the RPD is internally inconsistent, contains numerous legal errors, and engages in the kind of legal legerdemain that cannot withstand close scrutiny. Simply put, because it is fraught with both legal and logical inconsistencies and errors the RPD cannot be adopted by the Commission unless the Commission’s intention is to simply allow Cal Am to recover expenses that are not legally justified.

## **II. THE RPD CORRECTLY FINDS THAT CAL AM FAILED TO MEET ITS BURDEN OF PROVING THAT THE TERMS OF THE AMENDED LEASE WERE REASONABLE AND PRUDENT, PURSUANT TO D.09-07-021**

The RPD repeatedly and accurately finds that the amended lease is neither reasonable nor prudent. While the Amended Lease requires Cal Am to produce 300 acre-foot/year regardless of cost, it also requires Cal Am to redirect 206 AF a year to new and expanded use customers. Despite this requirement Cal Am inappropriately seeks to pass 100% of the costs on to its current ratepayers, even though they will only receive 31.3% of the water provided pursuant to this lease. Additionally, under the amended lease, Cal Am, and therefore Cal Am’s ratepayers, are solely responsible for all operating, maintenance, and capital replacement costs. (COL 1, 2).

Although Cal Am claims that the lease will help alleviate its water supply shortage, the RPD correctly finds that “the primary purpose of the Sand City Desalination Plant, residential and commercial development in Sand City, does not assist Cal-Am in its obligation to reduce withdrawals from the Carmel River...” (RPD, p. 23-24.) As discussed above, the RPD correctly finds that only 31.3% of the supply from the Sand City desalination plant is dedicated to current customers, therefore only 31.3% of that supply produced at Sand City will reduce the current draw on the Carmel River. As such, the RPD explicitly, repeatedly, finds the Amended Lease to be unjust and unreasonable, and denies Cal Am any recovery for the Amended Lease.

### III. LEGAL ERROR

#### A. The RPD Commits Legal Error By Relying On Facts Not In The Record

A fundamental flaw in the RPD is that it finds the Amended Lease unreasonable but then uses that same unreasonable lease costs as the basis for allowing rate recovery (see COL 2 vs. COL 6). The RPD finds, correctly, that the lease is neither reasonable nor prudent and therefore that all costs associated with the lease should be denied pursuant to PU Code 451 and 454. Then the RPD proceeds to allow Cal Am to recover the exact amount it is seeking under the lease, calling it a reasonable proxy for purchased water costs, although nothing in the record supports the notion that the lease is an appropriate proxy. The RPD contains no justification for its analysis of purchased water costs, or its finding that the amount sought under the lease is a reasonable proxy of such. Rather, the RPD adopts Cal Am's proposed number, which includes the cost of producing and supplying water *as well as* lease payments, and somehow divines (without offering an iota of justification) that these combined payments represent a reasonable figure for purchased water costs alone.

The RPD's statement on p. 30 that it "does not rely on the Amended Lease terms as the basis for the [fixed cost]" is illogical. The "fixed cost" is exactly the same as the lease terms. The lease terms set Cal Am's payments; however, the RPD offers no logical nexus between these lease terms and its finding that the lease terms represent a reasonable proxy for the cost of purchased water. To the contrary, the RPD devotes multiple pages to describing how the entire Amended Lease is unreasonable. In essence, the RPD is a document at war with itself. It offers no support for its conclusion that Cal Am's proposed accounting for its lease payments "is a reasonable proxy for fixed costs over the expected life of the plant." (p. 30).

Furthermore, the RPD offers no justification for why ratepayers should pay the lease payments ('fixed costs') for a lease that the express language of the RPD finds unreasonable. As stated above, the fixed costs proposed by Cal Am and adopted in the RPD **include lease payments.** (RPD, p. 19.) By finding that ratepayers must pay the

fixed costs as a reasonable proxy for purchased water, the RPD is forcing ratepayers to pay for a lease that the RPD finds unreasonable. The RPD offers no justification for why ratepayers should “compensate” Cal Am for the ‘fixed costs’, ‘escalated costs’, and 100% of the purchased power costs when existing ratepayers are only receiving 31.3% of the benefit (Finding of Fact “FOF” 6).

Additionally, the RPD ignores the fact that Cal Am neglected to include a provision in the Amended Lease making it contingent on Commission approval, and instead rewards Cal Am for this oversight. By failing to make the Amended Sand City Lease subject to Commission approval, Cal Am took the risk that the Commission may not find the lease to be just or reasonable, such that under PU Code 451 and 454, Cal Am may not be able to recover its Amended Lease payments. The RPD recognizes the inadvisability of the lease by unequivocally finding that the lease is neither just nor reasonable, and finds that, under PU Code 451 and 454, Cal Am cannot recover for the lease.

Disjointedly, the RFD then engages in a complete breach in its internal logic when it finds that, since the lease was not subject to Commission approval and Cal Am is in fact producing water for the system, Cal Am should recover the cost of the lease as if the lease itself were approved. This is an abuse of the Commission’s discretion, and it creates a dangerous precedent. This decision essentially encourages utilities to enter into contracts that are not reasonable, just, or prudent, knowing that the Commission may allow them to recover regardless of their imprudence, provided that power or water is flowing into the system.

The RPD commits legal error by failing to reconcile its finding that the Amended Lease is unreasonable with its “ersatz” ratemaking approach that relies upon finding costs included in the Amended Lease reasonable. The RPD’s approach would have ratepayers pay for the plant’s water at a unit cost of \$2,599/acre-foot. Unfortunately the record has no substantiation that this incremental cost of water is reasonable. It would be more reasonable to charge ratepayers the lowest cost for 94 acre-feet of incremental supply

(including thorough demand-side measures). DRA would support a limited reopening of the record to enable the Commission to determine this value.

**B. The RPD Commits Legal Error by Giving Weight to Comments not Addressing Legal or Factual Error, in Violation of Rule 14.3**

Comments shall focus on factual and legal or technical errors in the proposed or alternate decision and in citing such errors shall make specific references to the record or applicable law. **Comments which fail to do so will be afforded no weight.** (emphasis added). (Rule 14.3(c)).

Here, Cal Am included in its comments to the PD an alternate ratemaking proposal, a proposal that was extraneous to the record, not subject to cross examination, discovery, or testimony and thus inadmissible as a source of authority for the decision. However, despite the clear language of Rule 14.3(c), not only was Cal-Am's alternate ratemaking proposal given weight, it was adopted in its entirety. Given that DRA relied on the Commission to adhere to its own rules, DRA did not address this new proposal when Cal Am presented it in comments to the PD, believing that the proposal would be given no weight. For the RPD to adopt this untested, un rebutted new proposal after the record is closed, without allowing DRA a reasonable opportunity to test it, rebut it, or present its own alternative, is a blatant due process violation. The RPD's reliance on the alternate proposal set forth in the original comments is fatal legal error.

**C. The RPD Commits Legal Error by Violating DRA's Due Process Rights**

Due process requires that parties be given notice and opportunity to be heard. There must be due notice and an opportunity to be heard, and the procedure must be consistent with the essentials of a fair trial, and the Commission must act upon the evidence and not arbitrarily. (*Railroad Commission of California v. Pacific Gas & Electric Co.* (1938) 302 U.S. 388, 393.)

Here, virtually none of the due process protections set forth nearly 70 years ago were followed. In its protest DRA asserted its intention to serve testimony, and requested evidentiary hearings. The Assigned Commissioner's Scoping Ruling ("ACR") denying both requests is not, in itself, a due process violation, but it did result in an incomplete and one-sided record. This, coupled with this RPD, violates DRA's due process rights by denying its right to be heard. The RPD relies upon Cal Am's application and testimony while denying DRA the opportunity to present its own testimony. The RPD accepts Cal Am's assertions about the cost of water, its ability to determine terms of the lease, etc, as fact, (RPD footnote 15, *passim*) while denying DRA the opportunity to analyze or rebut these assertions, let alone offer potentially more reasonable and cost effective alternatives. This violates the due process rights of DRA, and more importantly, Cal Am's ratepayers, whom DRA was statutorily created to advocate for.

The record is utterly silent (save for Cal-Am's inappropriate opening comments on the PD) with regard to Cal Am's alternate ratemaking proposal. In fact, in its testimony, Cal Am argues for a completely separate proposal (see Dana testimony, p. 3-5). This is another example of how DRA is harmed by the denial of due process. DRA did not have the opportunity to challenge Mr. Dana's analysis through testimony or in evidentiary hearings. The RPD's reliance on Cal Am's alternate proposal presented in its comments on the original PD, comments that conflict with the RPD's findings regarding the reasonableness of the Amended Lease is both a technical and legal error.

DRA was denied due process by not having the opportunity to test any of the claims Cal Am made in its response to the ACR. DRA was allowed the opportunity to respond to those ACR comments, but not given the opportunity to present its own case. The RPD quotes from Cal Am's comments on the ACR extensively, and the RPD's ratemaking methodology is based in part on Cal Am's ACR comments. (See RPD, footnotes 28, 29, 36, *passim*). In addition, the RPD's bases its cost recovery estimates on figures Cal Am presented in testimony. DRA did not have the opportunity to challenge this new evidence.

**D. The PD Commits Legal Error And Is Internally Inconsistent By Finding That A 31 Year Lease Term Is Not Justified, Then Approving Cost Recovery for 31 Years.**

The RPD finds that a 31 year lease term is not justified but then approves cost recovery for 31 years. (Contrast COL 1 with COL 6).

Cal-Am persists in its willingness to accept, and then seek to transfer to ratepayers, all risks of operating the Desalination Plant over the 31-year term of the Amended Lease. As set forth in the Commission's analysis of the initial lease

in D.09-07-021, this one-sided risk allocation obligates Cal-Am to produce 300 acre-feet per year of water regardless of cost. The long-term financial and environmental risks of the Sand City Desalination Plant are significant, and the risk allocation terms have the effect of making Cal-Am, or its ratepayers, a guarantor of plant production. Placing these risks exclusively on Cal-Am or its ratepayers, especially where Cal-Am is only reliably entitled to 31.3% of the

plant output to reduce Carmel River withdrawals, is not reasonable. (RPD, p. 27-28.), and

The scoping memo, however, focused on Cal-Am's expanded 31-year obligation to the City to produce 300 acre-feet/year of water regardless of cost, which had been rejected by the Commission in the 2009 decision as creating excessive risk even when the obligation was limited to 15 years. Cal-Am offered no risk analysis in support of the term extension. DRA provided an analysis that showed Cal-Am facing a short-term supply deficit pending the Coastal Water Project being placed in service, and that Cal-Am had not fully evaluated all options to meet a short-term need. (RPD, p. 26-27.)

The full force of the State Water Resources Control Board's Cease and Desist Order goes into effect January 1, 2017. The Seaside Basin Adjudication requires Cal Am to cease all excess pumping by 2021. A comprehensive water supply solution will have to be in place in the next 10 years, rendering the 300 acre-feet/year produced at Sand City

unnecessary. There is simply no justification for having ratepayers pay for the Sand City plant's costs beyond a 10-year timeframe. The RPD recognizes that a 31 year lease is unreasonable, yet requires ratepayers to pay its costs for the entire 31 years. A potential remedy is to allow rate recovery for 10 years only. (This is roughly equivalent to having current ratepayers pay only the 31.3% of the costs associated with replacement water).

**E. The RPD Commits Legal Error And Is Internally Inconsistent By Excluding Management And Capital Costs, But Allowing Recovery For Capital Costs.**

The RPD aims to exclude management and capital costs (RPD, p. 28), but allows recovery for capital replacement costs (\$122,764 for major repair and replacement).

Management labor expense and capital costs are significant components of revenue requirement. These expensive resources, funded by ratepayers, should be deployed to projects that reliably and cost-effectively serve ratepayer interests. Here, the Sand City Desalination Plant does little to advance ratepayer interests in decreasing withdrawals from the Carmel River, but greatly increases financial and operational risk. We conclude that deploying management and capital resources to procure the Amended Lease also fails to meet applicable standards for reasonable and prudent utility actions. Consequently, we deny Cal-Am's request for approval of the Sand City Desalination Plant Lease. (RDP, p. 28)

The \$122,764 is not part of standard O&M, but rather for replacing the reverse osmosis membranes and other key pumps and energy recovery devices that are the central part of the desalination process. (See Sabolsice testimony, p. 6, lines 16-21<sup>1</sup>). Because the RPD is silent about purchased water costs, and does not have any citation to the record as to what should be included in any calculation for purchased

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<sup>1</sup> DRA objects to the RPD's references to Cal Am's prepared testimony as the testimony is not in the record and DRA was not afforded an opportunity to test or rebut that testimony, however the RPD nonetheless relies on this testimony.

water, including expensive, major capital recovery costs in purchased water costs is legal error.

Regarding management costs, Cal Am states that it will not charge any labor costs to ratepayers but will staff the plant for 4 hours/day, 365 days/year (See Sabolsice testimony, p. 5, lines 11-16). This staff time could have been used elsewhere in the Cal Am system, and some amount of management oversight will be required for the operations of the plant. The RPD commits legal error by failing to disallow management costs associated with Cal Am's operation of the plant.

**F. The RPD Commits Legal Error By Not Requiring Cal Am To Collect Connection Fees To Offset Plant Costs.**

The RPD finds that 68.7% of the plant's capacity is for growth but does not require Cal Am to collect connection fees or facilities fees to offset the plant cost. The RPD discusses connection fees from page 33 to page 37, and finds that Section 3(c) of the Amended Lease allowing Sand City to charge connection fees is void (see COL 12). The RPD fails, however, to require Cal Am to charge connection fees. Instead, the RPD effectively creates a new tariff for Cal Am's future Sand City customers (p. 32) based on the cost the RPD finds reasonable for the plant. The RPD does not review or justify this arrangement and therefore the Commission has no assurance that new Sand City customers will pay a reasonable amount for water, as required under 451 and 454.

Additionally, the RPD commits legal error by not assigning 100% of the lease cost to developers through facilities fees. Pursuant to Cal Am's Tariff Rule 15, if more than 50% of Sand City's design capacity is intended for the growth, the entire cost should be borne by developers through facilities fees. (See D. 11-07-057, *Order Granting Application Of Division Of Ratepayer Advocates, Modifying Decision 10-11-035, And Denying Application Of Golden State Water Company For Rehearing Of Decision, As Modified, p. 17-19*).

The purpose of Rule 15 is to ensure that existing customers do not subsidize new development. If Cal Am built this new water supply rather than leasing it, Rule 15 would require developers, rather than existing customers, to fund the project through facilities

fees. As discussed above, the RPD finds that 68.7% of the plant's capacity is for growth, and the RPD finds that primary purpose of Sand City is for growth. The RPD makes customers responsible for all lease costs (although the RPD calls these costs "fixed costs"), all O&M, and all major capital improvements for the Sand City Desalination Plant for 31 years. These costs will be borne entirely by existing customers, who do not need this new water supply, until that development occurs. The fact the Cal Am chose to lease this new water supply, instead of building it, should not create a loophole that compels existing customers to subsidize growth. The RPD errs by failing to address this issue, and by failing to offset any of the costs, 68.7% of which are for new development.

**G. The RPD Commits Legal Error by Allowing Retroactive Ratemaking.**

The RPD would authorize retroactive ratemaking by allowing Cal Am to recover costs incurred prior to the Commission's decision. On p. 31 the RPD states its intent to compensate Cal Am for water deliveries from the plant prior to the Commission's decision. The RPD offers no justification for why it is reasonable to compensate Cal Am for costs incurred before the Commission's decision. This is especially glaring given that in the prior proceeding (D.09-07-021) and in this proceeding the Commission has found that the lease terms are unreasonable. Cal Am created the delays by not justifying its lease the first time it asked for Commission approval, and further convoluted the situation by not making the lease subject to Commission approval. Again, this was a risk taken by the company; Cal Am should not be rewarded for its imprudence and substandard showing simply because the Commission's second decision comes after the plant has begun operations.

The Sand City plant costs are not properly recordable in any memorandum or balancing account. Cal Am has already made the claim that it has authorization to track the costs in a memorandum account in its application (see Application p. 18, footnote 50). However, that alleged authorization is based solely on Cal Am's assertion that Sand City is related to the CDO, rather than explicit Commission authorization. The RPD correctly finds that "the primary purpose of the Sand City Desalination Plant, residential

and commercial development in Sand City, does not assist Cal-Am in its obligation to reduce withdrawals from the Carmel River...” (RPD, p. 23-24.) Therefore Cal Am does not have Commission authorized to track Sand City costs in a memorandum account. This is an issue that should not be decided by Water Division via Advice Letter, as the RPD allows, but in a proceeding so that evidence can be presented and tested regarding any claim Cal Am makes that it had authorization to track the Sand City Desalination Plant costs.

#### **IV. CONCLUSION**

The fundamental tension in the RPD is balancing an appropriate disallowance for Cal Am's imprudent lease with a reasonable ratepayer contribution for water being delivered. The RPD fails to disallow any costs associated with the lease, however. The RPD appears to adopt a proxy purchased water mechanism because it is expedient, not because it is either reasonable or right. The ratepayers deserve a justified, cost-based, review of what they will be expected to pay for these purchased water costs, especially considering that the customers are obligated to pay them for 31 years, regardless of future long term water solutions. The Commission has other vehicles available to it to balance these competing policy goals. One would be to make current ratepayers solely responsible for the 31.3% of the water permanently allocated to the entire Monterey system (see DRA's response to Cal Am's comments on the Assigned Commissioner's Ruling, p. 13, filed on October 25, 2010)

The RPD makes an unsupported and arbitrary finding of fact that the alternative cost proposal is a reasonable proxy for the cost of water throughout the life of the lease while inappropriately denying DRA the opportunity to test the underlying assumptions behind this proposal via testimony and cross examination. Instead, the RPD accepts one party's untested numbers as fact, without allowing DRA the opportunity to challenge or even properly review this proposal. If the Commission is determined to allow Cal Am recovery for the water being produced at Sand City, *both parties* must be afforded the opportunity to present evidence as to the appropriate mechanism for assessing those costs.

While DRA agrees with the RPD's finding that the lease is neither reasonable nor prudent, the RPD should be rejected in its entirety and the original PD should be adopted. As it currently stands the RPD is fraught with legal error and internal inconsistencies and must be rejected by the Commission.

Respectfully submitted,

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