

Item 24



Ron Weitzman, President • Harvey Billig, Vice President • George Schroeder, Secretary-Treasurer

July 7, 2011

Monterey Peninsula Water Management District
P.O. Box 85
Monterey, CA 93942

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MPWMD

RE: July 18 Meeting

Dear Members of the Board:

In preparation for the above meeting enclosed are ten copies of the Water Plus Proposal to the district regarding the acquisition of Cal Am. for distribution to the members of the board, counsel and clerk.

The proposal covers many matters relating to the subject, but attention is specifically directed to the chart on Page 6 and the footnotes explaining it on Page 7 which define the elements of the savings to the ratepayers resulting from the acquisition.

We look forward to the discussion with you of this important matter.

Sincerely,

A handwritten signature in black ink, appearing to read "G. Schroeder".

George Schroeder

WATER PLUS PROPOSAL TO THE MONTEREY PENINSULA

WATER MANAGEMENT DISTRICT

Water Plus proposes to the Monterey Peninsula Water Management District (hereinafter identified as “the District”) that it, as authorized by §118-328 and §118-397 of its enabling legislation, take steps as soon as possible to purchase the local private water company (hereinafter identified as “Cal Am”), even by eminent domain if necessary.

Reasons

After noting that “a privately owned water supplier ... does not have the facilities [or] the ability to perform functions which are normally performed by public agencies, including the ability to raise sufficient capital for necessary public works [and] contract with ... federal and state agencies for financing of water projects and supplying of water ...,” §118-2 of the District’s enabling legislation concludes that the formation of the District is necessary “to prevent waste or unreasonable use of water supplies ... and to conserve and foster the scenic values, environmental quality, and native vegetation and fish and wildlife and recreation” on the Monterey Peninsula and in the Carmel River basin. Besides the assurance of an adequate local water supply, the principal focus of the legislation is environmental protection

coupled with the stewardship of limited water resources. These were reasonable concerns in the 1970's following the severe drought preceding the legislation, and in the years since then, except for securing a new source of water for drought protection, the District has addressed these concerns well.

The legislation reflects no concern for the cost of water, however. This is noteworthy because cost has now become a major concern of local ratepayers, a concern that, with the advent of desalination, rivals in importance the original concerns motivating the formation of the District. In fact, cost is what Water Plus has identified as the Water Buffalo in the Room, and cost in fact dominates the reasons that the District should now proceed to purchase Cal Am.

The primary concern originally motivating many Water Plus members to form a municipal or a county water district is that Peninsula water rates are soon expected to rise as much as four hundred per cent largely to buy properties valued at hundreds of millions of dollars, such as shareholder equity and a desalination plant, that Peninsula ratepayers will pay for but neither own nor control if a public water district does not replace Cal Am.

This concern encompasses the first two of the following reasons for the District to purchase Cal Am.

- 1. The purchase of Cal Am by the District may very likely be the only way that Peninsula ratepayers can have any**

control over the expenditure of their money to pay for the Regional Desalination Project, including the cost of the project and the interest on the bonds to fund it, totaling upwards of \$500 million.

- 2. Much of the money borrowed to fund Cal Am capital improvements, such as the removal of the San Clemente Dam and at least parts of the Regional Desalination Project, goes to its shareholders. Because of Cal Am's capital structure, 52% debt and 48% equity, shareholders are authorized to receive 10.2% rate of return on their 48% portion of every capital improvement, paid for entirely by ratepayers.**

These percentages are all determined by the California Public Utilities Commission, with each capital improvement increasing the value of the company while leaving the debt-equity capital structure (52% debt and 48% equity) unchanged.

Cal Am, together with the Marina Coast Water District and Monterey County, proposes to borrow many hundreds of millions of dollars in the next several years to fund such improvements, with almost half augmenting shareholder equity but all paid for by Peninsula ratepayers.

As an example, the table below shows the effect of the removal of the San Clemente Dam on ratepayer bills.

COST IN DOLLARS OF REMOVAL OF SAN CLEMENTE DAM	
TOTAL COST OF DAM REMOVAL*	137,000,000
SHAREHOLDER EARNINGS & DEBT COMPONENT (TOTAL)	-42,000,000
TAX COMPONENT	-18,000,000
NET AMOUNT TO BE FINANCED (OVER 20 YEARS)	77,000,000
COST OF DAM REMOVAL ON AN AVERAGE MONTHLY BILL†	
SHAREHOLDER COMPONENT (FINANCED AT 10.2%)	\$9.04
DEBT COMPONENT (FINANCED AT 6.48%)	+ \$7.45
TOTAL	\$16.49
TAXES ADDED BACK	+\$1.88
TOTAL COST OF DAM REMOVAL ON A MONTHLY BILL	\$18.37
*ASSUMING NO GIFTS OR GRANTS	†ASSUMING 40,000 RATEPAYERS

Note. Shareholder component is 48% & debt component is 52% of \$77,000,000.

Source: David Stephenson of Cal Am (dollar amounts) & Richard Rauschmeier of CPUC (percent values)

Cal Am claims that the amount to be financed for dam removal is only \$49 million, but that is the cost of buttressing the dam, not removing it. Although Cal Am assumes that the difference between \$77 million and \$49 million is going to be paid by state and federal agencies to remove rather than to buttress the dam, that assumption is questionable because of the current severe financial difficulties of the state and federal governments.

3. By purchasing Cal Am, the District can assure continuation of its concern and care for the Carmel River and its immediate environment.

4. Cal Am has been a failing business for the past five or six years, not only providing no return on investment to its shareholders but also needing money from its parent company to remain afloat. According to private-utility lobbyist Jack Hawks (Monterey Herald, 30 August 2010), Cal Am “lost a total of \$2.5 million between 2005 and 2009,” and according to its 2010 financial statement Cal Am’s parent company, American Water Works, is currently in debt almost \$6 billion. American Water Works has recently divested its holdings in Arizona and New Mexico. With a credit rating of BBB, the entire company is in serious financial trouble, and its local inefficiency is obvious to anyone who cares to look. Cal Am’s ratepayer bills are currently ten times the national average, according to the U. S. Geological Survey, and 13 times the bills of neighboring, publicly-owned Marina Coast, whose credit rating is AA-. Now, if ever, is the right time to buy Cal Am.

5. The local cost of water is due to rise so dramatically, up to 400%, that it is certainly going to put residents and businesses in economic jeopardy. Exacerbating the problem is the current tiered rate structure instituted to encourage conservation. The local hospitality industry and military institutions will be particularly at risk because their large water use puts them at the top tiers with rates likely to increase substantially more than the average 400% to

accommodate lower percentage increases for limited-income households at the bottom tiers. The most recent Base Realignment and Closure decisions almost sent the Naval Postgraduate School to a location having a considerably lower cost of living than ours. The upcoming dramatic increase in water rates is even more likely now to send that school and the Defense Language Institute elsewhere. One of the only ways to avert this danger is for a local public agency like the District to purchase Cal Am and gain control over the local cost of water.

6. The table below shows what savings ratepayers might expect following the purchase of Cal Am by a public agency.

ESTIMATED AVERAGE MONTHLY COST IN DOLLARS			
Cost item	Ownership		Savings
	Private	Public	
Shareholder earnings ¹	10.45	0.00	10.45
Taxes (total) ²	9.76	0.00	9.76
Debt portion of bill ³	7.20	5.55	1.65
External administration ⁴	21.81	9.02	12.79
MPWMD (8.375%) ⁵	7.55	0.00	7.55
Citizens Premium ⁶	1.87	0.00	1.87
Purchase of Cal Am ⁷	0.00	6.60	-6.60
Eminent domain ⁸	0.00	0.05	-0.05
SUB-TOTAL	58.64	21.22	37.42
Currently unaffected expenditures	31.56	31.56	0.00
TOTAL MONTHLY BILL ⁹	90.20	52.78	----

¹Shareholder earnings were determined by multiplying the 10.2% rate of return by the 2009 shareholder equity of \$49.2 million and then dividing by 12 months and by 40,000 ratepayers.

²Total taxes were estimated from Table 2-1 of Cal Am's rate case application A.10-07-007 by multiplying the proposed total taxes by 78.5% to determine what the present total taxes would have been if Cal Am had not gone into debt, the 78.5% being the present revenue (\$43,294,100) percentage of the proposed revenue (\$55,159,400).

³The debt portion of a bill was determined by multiplying the debt component (\$53.3 million) of the 2009 rate base by 6.48% under private and by 5.00% under public ownership. (The CPUC authorizes Cal Am to charge ratepayers 6.48% on non-shareholder portions of debt.)

⁴The cost of external administration was determined from Table 2-1 by summing the payments to the California and New Jersey ("Service Company") offices of American Water Works and dividing by 12 months and by 40,000 ratepayers. The sum, prior to the divisions, amounted to 24% of the present revenue. To estimate what the cost might be for comparable services (e.g., litigation, insurance, public relations, and financial management) under public ownership, the Salvation Army percentage of 10% (uninflated by such expenditures as million-dollar salaries in the upper echelons of management) was applied to the present revenue.

⁵The Monterey Peninsula Water Management District has received 8.375% of a bill to help fund mediation work on the Carmel River habitat under contract with Cal Am. An administrative law judge has proposed to the California Public Utilities Commission to eliminate that fee, and the CPUC has recently adopted that proposal. If the MPWMD purchases Cal Am, it will likely be able to cover this expenditure through savings from administrative consolidation (e.g., one general manager instead of two).

⁶As a local Cal Am division, the Monterey district pays a portion of the acquisition premium for the purchase of Citizens Utility by American Water Works. A public owner would not have that obligation.

⁷The effect on a monthly bill of the purchase of Cal Am was estimated by amortizing the shareholder portion (48%) of the 2009 rate base of \$102.5 million for 30 years at 5% and dividing the total monthly payment by 40,000 ratepayers. The rate base, which corresponds closely to a 2005 appraisal of Cal Am by Beacon Valuation Group, LLC, is taken as a working assumption of the current value of Cal Am. Ratepayers are already paying the debt portion (52%).

⁸Attorneys for Water Plus have estimated the cost of eminent domain to be \$400,000, including \$300,000 in attorney fees and \$100,000 for an appraisal together with court appearances. Amortized over 30 years at 5%, this estimate amounts to five cents on an average monthly water bill.

⁹The average total monthly water bill of \$90.20 under private ownership was determined by dividing the total present annual revenue of \$43,294,100 by 12 months and by 40,000 ratepayers. The average is much higher than the median monthly water bill of around \$38 because the bill distribution is skewed far to the upper end.

Although the total average monthly bill under private ownership is \$90.20, the median bill is around \$38 because the bill distribution is skewed far to the upper end.

In contrast to \$90.20, the total average monthly water bill under public ownership is, according to the table, only \$52.78, which is 58.5% of the larger bill.

Applying this 58.5% to the \$38 median bill shows that, under public ownership, this bill may be reduced to \$22.23, even after taking into account the cost of purchasing Cal Am.

Citing Felton as an example, some people have claimed that the estimated cost of \$102.5 million might be too low since, at Felton's cost of around \$10,770 per connection, Monterey's cost for 40,000 connections would be \$430.8 million! If such a simplistic method of estimating cost were valid, then why would a professional appraisal cost as much as \$100,000? In fact, it is not valid.

American Water Works has just sold its holdings in Arizona and New Mexico, with 174,000 connections, for \$470 million, or \$2,701 per connection. Multiplication of that \$2,701 by our local 40,000 connections yields \$108 million for the cost of Cal Am, an amount far lower than the Felton estimate and much closer to the \$102.5 million used here as a working assumption.

7. The following table shows the effect of upcoming capital improvements on an average monthly water bill.

EFFECT OF UPCOMING CAPITAL IMPROVEMENTS ON AN AVERAGE MONTHLY WATER BILL		
Cost item	Ownership	
	Private	Public
Current bill ¹	90.20	52.76
Removal of dam ²	18.37	12.70
Proposed rate hike ³	33.55	4.40
Regional Desal Project ⁴	122.49	46.46
Debt equivalency ⁵	72.16	0.00
TOTAL	336.77	116.32

¹From the preceding table.

²The entry for private ownership is from the first table. The entry for public ownership was determined by amortizing the \$77 million cost of the dam's removal for 20 years at 5% and dividing the total monthly cost by the 40,000 Cal Am ratepayers. The resulting \$12.70 amounts to little more for removing the dam under public ownership than the average ratepayer cost of buttressing it under private ownership which, amortizing \$49 million for 20 years at 8.03%, is \$10.28 per month. (The CPUC authorizes Cal Am to charge ratepayers an overall 8.03% for loans on capital improvements.)

³The proposed rate hike, compounding the three separate annual percentage increases proposed by Cal Am, amounts to an increase of 37.2% over current rates. Applying that percentage to the \$90.20 current average monthly bill yields the value shown in the table under private ownership. In contrast to the compounded 37.2% proposed by Cal Am, the CPUC's Division of Ratepayer Advocates has proposed percentage increases that, compounded, amount to only 4.88%. Applying that percentage to the \$90.2 current average monthly bill yields the value shown in the table under public ownership. A public owner would not request from the CPUC a rate increase as large as the one proposed by Cal Am because (a) the CPUC would have no authority over a public owner and (b) the principal reason for the increase, according to the Division of Ratepayer Advocates, is to restore Cal Am's ability to provide its shareholders with the earnings authorized for them. While presently receiving no earnings, in fact, shareholders can expect to receive at least \$5,018,400 (10.2% of the 2009 shareholder equity of \$49.2 million) if the CPUC adopts Cal Am's proposed increase, the \$5,018,400 being about half of that increase (\$11,865,300).

⁴The Regional Desalination Project is currently trying to obtain a bond in the amount of \$415 million to cover the cost of the project. Division of that \$415 million by the 8,800 acre-feet to be sold to Monterey Peninsula ratepayers yields \$4,716 per acre-foot, which is 235.8% of the current \$2,000 cost per acre-foot to local ratepayers. Multiplication of the current monthly average of \$90.20 by 235.8% and subtracting \$90.20 from the result yields the \$122.49 incremental value of the project cost shown in the table under private ownership. The value in the table under public ownership was determined similarly but with the \$2,200 per acre-foot cap proposed by the Division of Ratepayer Advocates substituted for the \$4,716 and the current rate of \$52.76 being used instead of \$90.20 in the final subtraction.

⁵The Settlement Agreement for the Regional Desalination Project indicates that Cal Am intends to apply to the CPUC for authorization to consider its payments to Marina Coast for water to be the equivalent of debt payments on a capital improvement. According to the Division of Ratepayer Advocates, the earnings that Cal Am shareholders would receive from this debt equivalency would amount to an increase of \$1,600 per acre-foot in the cost of desalinated water. Division of that \$1,600 by the current \$2,000 and multiplication of the result by the current \$90.20 yields the \$72.16 shown in the table for debt equivalency.

According to this table, upcoming capital improvements will raise the current \$90.20 average monthly water bill to \$336.77, an increase of 373%. Application of that percentage to a median \$38 water bill raises it to \$141.74. That is an increase of almost \$104 a month, an increase that gets us no more water than we currently have.

What does an increase of \$104 a month mean? If you drive 12,000 miles a year and get 25 miles per gallon, an increase in water rates of \$104 a month means the same thing as an increase of \$2.60 in the cost of a gallon of gas! Under public ownership, the increase would be only \$11.00 a month, or an increase of less than 28 cents per gallon of gas.

Some Q & A

- 1. Is the average monthly Peninsula water bill around \$38, as Cal Am claims? No. That may be the median (half the bills are higher and half lower), but it is not the average, generally understood in this case to be the total annual revenue from ratepayers divided by 12 months and then divided by the number of ratepayers. The result, using data available in 2010: \$90.20.**

- 2. Though the CPUC regularly approves a rate structure that enables Cal Am to pay its shareholders, as well as income and property taxes, does Cal Am always do so? No. For a number of years now, Cal Am has used that money for other purposes, deemed unnecessary by the CPUC.**
- 3. Is the percentage that Cal Am pays lenders equal to the percentage that it charges ratepayers for the same loans? No. The CPUC authorizes Cal Am to charge ratepayers 8.03% for loans on capital improvements though Cal Am may pay lenders less than this percentage.**

Procedure

The procedure that the District is to follow to purchase Cal Am is described as the procedure to carry out a project or works in the legislation enabling the establishment of the District. The steps in outline form appear to be as follows:

- 1. Resolve to adjust the District's boundaries to coincide with Cal Am's boundaries and submit the resolution to the Local Agency Formation Commission (LAFCo) for approval.**
- 2. Obtain a new professional appraisal of the value of Cal Am. The consistency of the 2009 rate base with**

a 2005 professional appraisal obtained by Water Plus members sets the value of Cal Am at \$102.5 million, at least as a working assumption. Water Plus attorneys have estimated the cost of the new appraisal, including the appraiser's participation in possible condemnation proceedings, to be no greater than \$100,000.

- 3. In accordance with §118-601 - §118-611, resolve to submit a revenue bond proposal for the purchase of Cal Am to the electorate within the boundaries approved by LAFCo, the denomination of the bond being sufficient to cover the cost of Cal Am determined by the appraisal plus any incidental costs such as the cost of bond counsel and possible eminent domain proceedings.**
- 4. If a majority of the electorate (§118-611) approves of the bond, make an offer to purchase Cal Am for the amount determined by the appraisal.**
- 5. If Cal Am refuses the offer, initiate condemnation proceedings to force the purchase at the appraised value. Water Plus attorneys have estimated attorney costs for the plaintive in condemnation proceedings for a utility to be no greater than \$300,000.**
- 6. If the court determines a value higher than the appraised value, decide whether to seek additional**

funding authority from the electorate or to abandon the effort to purchase Cal Am.

7. If the decision is to proceed to purchase, sell the authorized bonds, secured by ratepayer revenue, and purchase Cal Am.

Independent Consultation

Water Plus submits this proposal for examination at a public workshop, the time and place of which are to be determined by the District. Alternatively or in addition, Water Plus offers to help pay for an independent consultant, selected by the LAFCo executive officer, to examine this proposal and provide the results of the examination to the District to help inform its action. Water Plus believes, in the best interests of the ratepayers, that the District's purchase of Cal Am should go forward expeditiously while interest rates remain low.

**--Ron Weitzman, President
Water Plus**

6 April 2011