EXHIBIT 9-A

Monterey Peninsula Water Management District

Technical Memorandum 2013-01: The "Debt Equivalence" Issue

What is "Debt Equivalence"? and Why Should Monterey Peninsula Ratepayers Care?

In the current draft of the proposed Settlement Agreement with respect to Application No. 12-04-019 before the CPUC, Section 4.4 is titled "Debt Equivalence for the GWR Project." This section states *"The Parties acknowledge that a WPA is a contractual obligation of a significant amount of California American Water's future cash flows."* The section refers to what has been described as the "debt equivalence" issue as it relates to the potential Water Purchase Agreement (WPA) for the GWR project.

This concern arises because the WPA may take the form of a "take-or-pay" contract which is essentially an agreement whereby the buyer agrees to either: (1) take and pay the contract price for a minimum contract quantity of water each year; or (2) pay the applicable contract price for such quantity if it is not taken during the applicable year. Perhaps the most common type of off-take contract in a large scale energy or water project is the take-or-pay contract. A properly constructed take-or-pay contract provides the seller with an assured revenue stream that can be used to secure capital financing of a project. It is a form of contract that is generally understood by lenders, and it is often the most important means for a seller to secure the substantial external debt financing on limited recourse terms that such projects typically require.

The term "debt equivalence" actually refers to the manner of treatment of the future WPA payment obligations by either (a) accountants under generally accepted accounting principles or GAAP, or (b) the credit rating agencies in their analysis of the credit-worthiness of the entity. If the contract meets certain tests under GAAP it may be treated as a capital lease and booked as debt on the balance sheet, rather than as an annual operating expense, as it may in other instances. Cal-Am is also concerned that, even if not determined to be a capital lease, the future financial commitments it is making under the WPA will be viewed by the rating agencies as similar to debt (hence the term "debt equivalence"), rather than as an annual operating expense. By imputing debt in place of a take-or-pay contract the rating analysis may result in negative impacts on the company's calculated financial ratios and lower its credit rating, increasing the company's costs of borrowing.

To counteract the effects of either the increase in debt represented by a capital lease or a rating downgrade, Cal-Am will request that the CPUC allow them to treat the project as if it is in the Cal-Am ratebase and to earn a rate of return on it, thereby strengthening the Company's profitability and perceived financial ratios. However, if treated solely as debt the WPA would undermine the Company's debt-to-equity ratio, so the Company will ask the CPUC to reassign a portion of the capital lease as if it is equity for purposes of revenue recovery. This accounting treatment would raise rates in the service area.

In the District's view, at this time, it is not certain that the WPA will require treatment as "debt equivalence", nor are all such contracts treated in such a manner. This memorandum attempts to lay

out some of the background and potential avenues for analysis and treatment of the WPA going forward.

Why Should Monterey Peninsula Ratepayers Care?

Previously, during the proceeding for the now-defunct Regional Desalination Project, during the May 5, 2010 joint cost workshops hosted by the CPUC, Cal-Am presented "Additional Cost/Finance Information" which indicated that debt equivalence could cost $17.7 million annually on a $219.2 million project, or $2,011 per acre-foot, thereby adding 40% to the first year annual cost to ratepayers. During the same proceeding, in its April 21, 2010 response to Data Request CWP 54-2(a) Jeffrey Linam of Cal-Am calculated an additional $14.3 million per year would be required for debt equivalence treatment, a view that was reinforced by the DRA in its July 16, 2010 Reply Brief stating debt equivalence treatment might add $1,600 per acre-foot based on an Cal-Am's estimate of $14.3 million per year of additional revenue requirement. Hence, the potential impact of debt equivalence treatment of a take-or-pay water contract can be significant. However, to date, the potential impact of the GWR contract in this proceeding has not been estimated.

Why Should Cal-Am Care?

The Company asserts that failure to address this issue could increase financing costs of all Cal-Am projects and could also lead to impacting the Company's financial performance and its risk profile, affecting ratepayers beyond the Monterey Peninsula service area.

Further, if treated as a capital lease and booked as 100% debt, it could potentially reduce the Company's debt to equity ratio and trigger debt covenant provisions tied to the company's first mortgage bonds.

The Company will therefore seek to have all the costs associated with re-balancing its capital structure due to treatment of the WPA as debt allocated to the Monterey County District customers.

The Company also believes that under Public Utilities Code Section 727.5 the CPUC has a duty to protect the *"financial integrity of the utility."* (source: Opening Brief of Cal-Am in A.04-09-019)

This All Sounds Confusing – What Else Should We Look Out For?

To date, parties have used "debt equivalence" to mean both the rating agency method of "imputing debt" in its analysis and the inclusion of the cost of the project by the Company's auditors on the books of Cal-Am as a "capital lease" under GAAP and earning a rate of return and recovery through rates. In general, terms and phrases that get caught up in this "debt equivalence" issue include the following:

"Capital Lease"
"Financing Lease"
"commitment of future cash flows"
"Take or Pay Contract"
"Off Balance Sheet Transaction"

"Bulk Water Purchase"
"Off-Take" or "Off-Taker"
"Debt to Equity Ratio"
"imputed debt"
"CAW's financial well being"
"CAW's financial viability"
"rebalancing the capital structure"
"Debt Equivalence"
"Debt Equivalents" (see S&P 2007 report, discussed later)

What do the Current Accounting Regulations Say?

The key question: Is treatment as a capital lease required by accounting standards?

The answer to this key question will potentially be different under existing accounting standards and prospective new, revised standards expected to be implemented next year. This section takes up the analysis under existing standards.

Let's assume the WPA takes the form of a take-or-pay contract. Under traditional U.S. accounting standards, take-or-pay contracts are a form of "Commitment" in the category of "Unconditional Purchase Obligations." The Financial Accounting Standards Board ("FASB") has specific rules for determining whether an Unconditional Purchase Obligation should be treated as a Lease and whether that Lease is then a Capital Lease, and perhaps should be treated as a debt on the balance sheet. A capital lease requires the lessee to recognize the arrangement as an asset and an obligation (liability.)

Referring to FASB's codified regulations, which are called Accounting Standards Codifications or ASCs, the issue may be formulated as follows:

> ASC 405-10-05-2 indicates that Liabilities may include certain "Commitments" covered by topic 440 of the regulations.
>
> ASC 440-10-05-1 identifies a type of Commitment called "Unconditional Purchase Obligations" which under ASC 440-10-05-4 includes "take or pay" contracts.
>
> ASC 440-10-25-1 says an Unconditional Purchase Obligation can be subject to guidance in either topic 840 (Leases) or topic 815 (financial derivatives) or to neither.
>
> ASC 440-10-25-2 and -3 tell us that guidance in sections 840-10-15 and 840-10-55-26 shall be applied first to determine whether an unconditional purchase obligation is within the scope of topic 840. Here, the first topic area 840-10-15 is most relevant. **That is, a take-or-pay contract must first be analyzed to determine if it constitutes a "Lease."**
>
> ASC 840-10-15-3 says that the evaluation of whether an arrangement contains a lease shall be based on the conditions at the inception of the arrangement (i.e. initially), but as we will see later, one of the conditions is the expectation today of events over the term of the lease.

ASC 840-10-15-6 describes "Arrangements that Qualify as Leases" and centers on whether the arrangement conveys the right to use or control the property. Specifically, if any of the following conditions are met, we have a lease:

(a) Purchaser has the right to operate the property or direct others to do so.

(b) Purchaser has the right to control physical access to the property.

or

(c) Facts and circumstances show it is remote that one or more parties other than the purchaser will take more than a minor amount of the output over the term of the arrangement, and the price the purchaser will pay is neither fixed per unit nor equal to current market price.

If the WPA doesn't meet one of these three tests under 840-10-15-6 then it should not be treated as a lease, and irrelevant become the additional criteria to determine whether it is a capital lease requiring disclosure and reporting subject to the topic 840.

Here, it does not appear that a WPA in and of itself would meet tests (a) or (b). In fact, most WPAs would contain some language stating that the buyer's contractual payments under the agreement shall not in any way extend or convey any ownership interest or right to physically control any portion of the project.

The third test is often where the current regulations cause concern. In the Regional Desalination Project's case, MCWD's stated future need for water could have been evaluated as making it **less than remote** that MCWD will take **more than a minor amount of** the output **over the term** of the arrangement. In the case of GWR, it is unclear at this time if any water might be delivered to another party or if the agreement could be structured in a manner such that the purchase price requirement could offset the single off-taker issue.

If it is determined that the contract does constitute a lease, there are then 4 tests to determine if it is a capital lease. Otherwise it might be considered an "operating lease" under which the payments are simply annual operating expenses, rather than a debt.

ASC 840-10-25-1 prescribes that if any of the following tests are met, then the lease is a "capital lease."

(a) Lease transfers ownership to the lessor (buyer) by end of the lease term.

(b) Lease contains a below market purchase option.

(c) Lease term is 75% or more of the estimated economic life, with allowance for normal repairs and maintenance.

or

(d) The present value of the minimum lease payments equals or exceeds 90% of the fair market value of the property.

Obviously, the goal for development of a GWR Water Purchase Agreement is to structure terms and conditions that would allow the WPA to not be "required" to be treated as a capital lease. However, the District remains concerned that appropriate facts and assumptions are used by the Cal-Am accounting team in assessing whether the contract satisfies the tests under the relevant ASC sections.

The CPUC has precedent for treating projects both ways. For example, Pacific Gas and Electric shows both types of accounting treatment in its Annual Report. The contracts with "Qualifying Facilities" are treated as capital leases whereas take-or-pay contracts with Irrigation districts and Water Agencies are not.

What do the Proposed New Accounting Regulations Say?

The entire discussion in the previous section could be rendered moot by the "Proposed Accounting Standards Update (Revised), Leases (Topic 842) a revision to the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840),* May 16, 2013." The proposed changes are a joint effort of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to develop a new approach to lease accounting that would require assets and liabilities arising from leases to be recognized in the statement of financial position. This proposed revision is still under circulation and comments are due September 13, 2013. Therefore it is impossible to accurately predict what will be adopted. However, this section assesses how current proposal might affect a WPA for GWR. The proposed Standards are attached to this memorandum.

The first step is to determine if the contract is a lease.

> Proposed 842-10-15-2 says a lease is a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
>
> Proposed 842-10-15-3 says at inception of a contract, an entity shall determine whether that contract is or contains a lease by assessing both of the following:
>
> a. Whether fulfillment of the contract depends on the use of an identified asset (as described in paragraphs 842-10-15-5 through 15-8)
>
> b. Whether the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration (as described in paragraphs 842-10-15-9 through 15-16).

The District believes that part a. above will be met by the GWR project, as there is no alternate asset that can be substituted for the GWR project in order to deliver the product water. Hence, the next step is to determine if the contract conveys the right to control the use of an identified asset.

> Proposed 842-10-15-9 says a contract conveys the right to control the use of an identified asset if, throughout the term of the contract, the customer has the ability to do both of the following:

a. Direct the use of the identified asset (as described in paragraphs 842-10-15-10 through 15-14)

b. Derive the benefits from use of the identified asset (as described in paragraphs 842-10-15-15 through 15-16).

842-10-15-10 A customer has the ability to direct the use of an asset when the contract conveys rights that give the customer the ability to make decisions about the use of the asset that most significantly affect the economic benefits to be derived from use of the asset throughout the term of the contract.

842-10-15-11 Examples of decisions that could most significantly affect the economic benefits to be derived from use of an asset include, but are not limited to, determining or being able to change any of the following: a) How and for what purpose the asset is employed during the term of the contract; b) How the asset is operated during the term of the contract; and c) The operator of the asset.

842-10-15-12 In some contracts for which there are few, if any, substantive decisions to be made about the use of an asset after the commencement date, a customer's ability to direct the use of the asset may be obtained at or before that date. For example, a customer may be involved in designing the asset for its use or in determining the terms and conditions of the contract, so that the decisions about the use of the asset that most significantly affect the economic benefits to be derived from use are predetermined. In those cases, the customer has the ability to direct the use of the asset throughout the term of the contract as a result of the decisions that it made at or before the commencement of the contract.

842-10-15-13 A contract may include clauses that restrict a customer's use of an asset; for example, a contract may specify the maximum amount of use of an asset to protect the supplier's interest in the asset. Such protective rights that restrict a customer's use of an asset would not, in isolation, prevent the customer from having the ability to direct the use of the asset.

842-10-15-14 Rights that give a customer the ability to specify the output of an asset (for example, the quantity and description of goods or services produced by the asset) would not, in isolation, mean that a customer has the ability to direct the use of that asset. The ability to specify the output, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases services.

The District presently believes it may be possible to design a WPA which does not meet any of these 5 tests. If that is the case, the contract would not be a lease.

842-10-15-15 A customer's ability to derive the benefits from use of an asset refers to its right to obtain substantially all of the potential economic benefits from use of the asset throughout the term of the contract. A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, consuming, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products in the form of products and services. Those economic benefits also include other economic benefits from use of the asset that could be realized from a commercial transaction with a third party.

The District believes that a WPA might meet this test for the ability to derive the benefits from use because Cal-Am would obtain all of the product water. However, if some source water is diverted to the CSIP project at some point in the treatment process, then this consideration might go away.

In the end, proposed 842-10-15-9 is an "and" test where both parts must be met. If Cal-Am cannot direct the use of the identified GWR asset, then part "a" is not met and the contract will not be a lease. The goal would be to design a WPA in this manner.

FASB provides an example, "Example 5B: Contract for Energy/Power—Part B", under proposed section 842-10-55-39. Here, an electricity provider (Customer) enters into a contract to purchase substantially all of the power produced by a power plant for three years. The power plant is owned and operated by a utility company (Supplier). Supplier cannot provide power from another plant. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer. Customer had no involvement in that design. Customer issues dispatch instructions to Supplier. Those instructions detail the quantity and timing of delivery of power to Customer. Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Customer and Supplier agree to the plant's maintenance plan at the start of the contract. Customer's only decision-making authority relates to the dispatch instructions. Supplier is able to sell the power not taken by Customer to other customers.

FASB concludes "The contract does not contain a lease." It explains that although fulfillment of the contract depends on the use of the power plant, Customer does not have the right to control its use because it does not have the ability to direct the use of the plant. Supplier has that ability. Supplier has made (and will make) all decisions about how the plant operates. Customer's ability to determine when power is produced, in effect, gives it the ability to specify the output from the plant. However, without any other decision-making authority, Customer has no ability to direct the use of the plant that is used to make the power.

By analogy, if Cal-Am has no participation in the design of the GWR, nor its operations, it is quite possible that under the proposed regulations the WPA would not be a lease. Further, by producing water that will go into the ground whether Cal-Am elects to withdraw it or not, further distance from the direct use is created.

How is Accounting Treatment for "Debt Equivalence" to be Addressed?

In the Regional Desalination Project example, Section 5 of that Settlement Agreement said that a subsequent CPUC proceeding to deal with this issue "shall only be initiated once CAW determines after appropriate analysis the accounting treatment for its commitment under the WPA." This implies that Cal-Am intended to make a determination on its own and then bring the accounting treatment to the CPUC for ratepayer recovery.

The separate proceeding could occur as late as upon project completion. In that project's proceedings Cal-Am's James Kalinovich of Cal-Am in describing a hypothetical take-or-pay contract said it *"would probably be or could be recorded as a capital lease. Now, whether or not – how it's recorded is not really important here. What's important here is what is the impact on credit quality."* And *"The treatment, whether it's on the books as a capital lease, that's going to depend on the facts and circumstances at the*

time the transaction or plant goes to service and you start paying for water. At that point, our accountants will go through the whole process, they'll review all the accounting literature available at that time…" "Our accounting group will put together a white paper." In other words, there is room for interpretation as to whether the WPA constitutes a capital lease, and Cal-Am intends to internally make a recommendation for how it is treated.

In his June 9, 2010 direct testimony, Jeffrey Linam of Cal-Am when asked who actually makes the accounting treatment determination stated, *"My understanding is that American Water will – the accountants will make the determination, but ultimately the independent auditors…will review that and make a final determination."* The external auditors will ultimately provide an opinion that the Company's financial statements are consistent with generally accepted accounting practices, in so doing they will need to review the Company's treatment of the project. However, it is the District's view that by agreeing that the Company's accounting treatment is reasonable, the auditors are not saying that the method is the only or required method of treatment, nor are they saying that there are not alternate accounting treatments that might also be deemed reasonable. Further, to get an actual "opinion letter" from an auditor on the appropriate method of accounting for the WPA the Company would have to do so from a firm other than its external auditor – a requirement resulting from the Sarbanes-Oxley legislation in order to ensure "independence" of an external auditor.

As stated earlier, the District remains concerned that appropriate facts and assumptions are used by the Cal-Am accounting team in assessing whether the contract satisfies the tests under the relevant FASB guidance and that where judgment is required the intervening Parties from the Peninsula be afforded the opportunity to comment on the analysis.

The Problem With Examples

In its July 2, 2010 Opening Brief during the Regional Desalination Project proceeding, Cal-Am cited SDG&E's recovery of costs related to a power purchase agreement for the Otay Mesa Energy Center, but the similarities to the Regional Desalination Project (RDP) identified by Cal-Am, or in the case of GWR's water purchase agreement, are not persuasive nor reflect required accounting treatment. With the OMEC contract, there were certain control issues (the ability of SDG&E to dispatch the power) and a purchase option in the contract, both of which differed from the RDP and tipped the scales in terms of Primary Beneficiary and Variable Interest Entity. In fact, Sempra, SDG&E's parent company, stated *"We consolidate a variable interest entity (VIE) if we are the primary beneficiary of the VIE's activities. Our determination of whether we are the primary beneficiary is based upon qualitative and quantitative analyses, which assess:*

- *the purpose and design of the VIE;*
- *the nature of the VIE's risks and the risks we absorb; and*
- *whether the variable interest holders will absorb a majority of the VIE's expected losses or receive a majority of its expected residual returns (or both).*

SDG&E has a 10-year agreement to purchase power to be generated at the Otay Mesa Energy Center (OMEC). SDG&E supplies all of the natural gas to fuel the power plant and purchases its electric generation output (i.e., tolling). The agreement provides SDG&E with the option to purchase the power plant at the end of the contract term in 2019, or upon earlier termination of the purchased-power

agreement, at a predetermined price subject to adjustments based on performance of the facility. If SDG&E does not exercise its option, under certain circumstances, it may be required to purchase the power plant at a predetermined price. The facility owner, Otay Mesa Energy Center LLC (OMEC LLC), is a VIE (Otay Mesa VIE), of which SDG&E is the primary beneficiary. SDG&E has no OMEC LLC voting rights and does not operate OMEC. Based upon our analysis, SDG&E absorbs the majority of risk from Otay Mesa VIE under the combination of the tolling agreement and the put option. Accordingly, Sempra Energy and SDG&E have consolidated Otay Mesa VIE since the second quarter of 2007. The CPUC has approved an additional financial return to SDG&E to compensate it for the effect on its financial ratios from the requirement to consolidate Otay Mesa VIE."

Hence, every example or suggested model needs to be vetted for its similarities, as well as its differences.

Rating Agencies and Imputed Debt

The rating agencies may or may not treat a future payment obligation as a debt for analytical purposes. They are prone to do so for many varieties of off-balance sheet projects, but there are many examples where they may also treat it as an operating cost. In either case, the analytical treatment by a rating agency does not require Cal-Am's actual accounting treatment to change one way or the other. Rather, only the credit rating assigned to a financing bond issue may be affected.

In 2004 Moody's published its Rating Methodology guide titled "The Analysis of Off-Balance Sheet Exposures" where they state that take-or-pay contracts are a form of "Executory Contract" where neither an asset nor a liability is recorded on the balance sheet. Moody's might, nevertheless, in the process of providing a credit rating for such a company, adjust financial statements to recognize both assets and liabilities when it is a capital lease. But, if it is a take-or-pay contract *"Moody's factors payments under take-or-pay contracts into the analysis of future cash flows and may also adjust the balance sheet, if appropriate."* In an August 2009 report, Moody's footnoted a reference to their 2004 report in how at times it may be appropriate to add a contractual obligation to debt in its analysis.

The August 2009 Moody's report, while covering regulated electric and gas utilities is also relevant for a water utility because of similarities in regulatory practice and especially since Cal-Am has previously cited examples of debt equivalence treatment by the CPUC from California electric and gas utilities in its July 2, 2010 Opening Brief relating to the Regional Desalination Project. Moody's cites arrangements such as take-or-pay contracts, tolling agreements, long-term supply agreements, and power purchase agreements ("PPA") all of which have similar characteristics and are analyzed the same. Moody's says *"the most conservative treatment would be to treat the PPA as a debt obligation…and at the other end of the continuum, the financial obligations of the utility could also be regarded an ongoing operating cost, with no long-term capital component recognized."* The report goes on to explain many different ways such contracts can be treated as either an operating cost or as a debt obligation for purposes of their analysis. They say *"very few PPAs have been treated as lease obligations."* This report goes on to state, *"if a utility enters into a PPA for the purpose of providing an assured supply and there is reasonable assurance that regulators will allow the costs to be recovered in regulated rates, Moody's may view the PPA as being most akin to an operating cost."*

Standard & Poor's has also addressed PPAs in a May 2007 report titled "Standard & Poor's Methodology For Imputing Debt For US Utilities' Power Purchase Agreements" that was recently republished in 2013 following a periodic review completed in April 2012. In the report, S&P states they have viewed PPAs

"as creating fixed, debt-like, financial obligations that represent substitutes for debt-financed capital investments…" However, they treat capital leases (as determined by an auditor) differently than those treated as operating leases. *"PPAs that are treated as capital leases for accounting purposes will not receive PPA treatment because capital lease treatment indicates that the plant under contract economically 'belongs' to the utility."* In other words, imputed debt treatment for PPAs is reserved for contracts that are not already treated as a capital lease.

Fundamentally, however, the reader of this memorandum should note that references to PPAs are to draw attention to similar contracts. However, PPAs are in many cases not analogous to a WPA for Groundwater Replenishment.

There are also rating agency treatments that the District believes are not analogous. In his May 27, 2010 written Rebuttal Testimony for the Regional Desalination Project, Cal-Am's James Kalinovich cited the December 2007 Moody's report titled "Operating Risk in Privately-Financed Public Infrastructure (PFI/PPP/P3) Projects." This rating methodology report is not the most relevant example. The types of contracts covered by the report include those where the issuer of the debt is a limited purpose entity established to build and operate the project. At the end of the project agreement, the rights to the assets revert to the project off-taker. This is not the model being undertaken in the WPA for GWR and does not provide relevant guidance.

The District has concluded that (a) the rating agencies have not signaled that all take-or-pay contracts will be treated as debt; (b) even if a contract is treated as imputed debt, it may have no actual impact on the Cal-Am balance sheet or its debt-to-equity ratio; (c) It is quite likely that imputed debt for the WPA will have no effect on the parent American Water credit rating, hence no actual impact on the cost of capital for Cal-Am; and (d) the rating agencies have not yet released any guidance for the proposed FASB/IASB proposed revisions to accounting rules.

Further, if Cal-Am does not have a stand-alone credit rating, then there is absolutely no impact on their cost of capital. The District suggests that when the day comes that the Cal-Am subsidiary can actually demonstrate harm, i.e. an impact on its cost of capital, that is the time to consider debt equivalence for rate-making, not now. The District also recognizes that American Water is concerned that there is the future potential that any or all of their subsidiaries could enter into such take-or-pay contracts that individually are minor, but cumulatively could affect American Water's credit. The District believes that its Monterey Peninsula constituents should not agree to pay higher rates today to inoculate Cal-Am against something that may or may not happen in the future.

Wrap-Up

This memorandum is intended to be informational. The accounting landscape is obviously changing, and that will likely lead to changes in the credit rating agency treatment of contracts such as a WPA for GWR. The world is in flux. However, the District believes that certain issues are clearly defined and that, in the end, a WPA for groundwater replenishment should not result in treatment as debt for actual GAAP purposes, hence Cal-Am should work with the Monterey Peninsula community to ensure that such accounting treatment is avoided for the benefit of ratepayers.