

DATE ISSUED: May 5, 2004

REPORT NO. 04-099

ATTENTION: Honorable Mayor and City Council  
Docket of May 11, 2004

SUBJECT: Water Supply and Franchise Agreements with the  
California-American Water Company

### SUMMARY

#### Issues:

1. Should the City enter into an agreement with the California-American Water Company and the City of Coronado to amend and modify agreements for the sale and delivery of water?
2. Should the City enter into a Water Service Franchise Agreement with the California-American Water Company?

#### Manager's Recommendations:

1. Authorize the City Manager to enter into an agreement with the California-American Water Company and the City of Coronado to amend and modify agreements for the sale and delivery of water.
2. Grant a water service franchise to the California-American Water Company and authorize the City Manager to execute a Water Service Franchise Agreement with the California-American Water Company.

Other Recommendations: The City of San Diego Public Utilities Advisory Commission (CPUC) recommended the execution of these agreements. The CPUC also recommended a clarification to the water supply agreement which has been implemented.

Fiscal Impact: Water sales revenue from California-American Water Company to the Water Department Fund will increase by approximately \$1.9 million in fiscal year 2005 and the Water Fund will also receive a payment of approximately of \$1.8 million for retroactive price adjustments. The General Fund will receive a 2% franchise fee represented by an initial lump sum payment of \$1.25 million and quarterly payments after

Cal Am recoups the initial payment. At current rates, franchise fees are estimated at \$88,000 annually.

## BACKGROUND

The City of San Diego has maintained a water supply relationship with the California American Water Company (Cal Am) and its predecessors since 1912. Cal Am is a privately owned public water utility regulated by the California Public Utilities Commission.

In the early 1900's, in an effort to secure a more plentiful and reliable water supply, the City was in the process of acquiring various rights and water systems from the Southern California Mountain Water Company (SCMWC) including the system referred to as the Morena, Barrett, and Otay system. This system was originally developed in the 1880's and also served the Coronado Water Company (CWC) (a predecessor to Cal Am), which served Coronado, Imperial Beach and other portions of the South Bay. As a part of the consideration in acquisition of the water system, the City agreed to assume SCMWC's obligation to supply the CWC with the water it needed to serve its customers from the Morena, Barrett and Otay system pursuant to rates negotiated periodically. The CWC was later acquired by the California Water & Telephone Company, which was in turn acquired by Cal Am in 1966. For the purpose of simplification, all further references in this report shall be to Cal Am.

The City's obligation to supply water to Cal Am under the Agreement of 1912 has been addressed by several subsequent agreements and various issues have been subject to litigation and arbitration. The most recent and significant agreement occurred in 1960 and that agreement has since been amended eight times to either revise the service territory or establish new rates. Since June 2000, rates have remained unchanged pursuant to an interim agreement pending the development of new comprehensive water supply and franchise agreements.

Some of the more significant conditions and developments in the water supply arrangement with Cal Am are as follows:

### Local Water Supply

The agreement was previously amended to allow the City the flexibility to meet its supply requirement to Cal Am from any of its local water sources instead of being limited to the Morena, Barrett, and Otay system. However, the supply requirement is still limited to that which is locally produced. Because Cal Am and portions of its service territory are not members of the County Water Authority (CWA), the City may not sell them water imported from the Metropolitan Water District (MWD) via CWA.

### Service Territory

Cal Am currently serves the cities of Coronado and Imperial Beach, unincorporated areas in the South Bay, as well as a portion of the City of San Diego. The City of San Diego currently has approximately 8,100 customers served by Cal Am, comprising nearly 40 % of all Cal Am customers. At the time of the 1912 agreement, the Cal Am service territory did not include portions of the City of San Diego. However, the 1960 agreement, as well as a 1955 agreement

with Cal Am provided for the extension of their service territory into areas that had since been annexed by the City.

Included in the consideration to Cal Am for providing service to areas within the City, it was agreed that the City would not compete with Cal Am by providing water service to any of the areas served by Cal Am prior to July 1, 2004, unless by eminent domain the City would acquire the facilities of Cal Am. The City further agreed that if at any time it chose to provide water service within the Cal Am service territory, the City would purchase the associated Cal Am facilities.

### Water Rates

As provided in the succession of agreements associated with the City's obligation to provide water to Cal Am, water rates have been periodically negotiated to reflect the City's cost to produce, treat and deliver water from local sources. Depending on the period of time in history and the changing circumstances, consideration was given to a variety of factors including water rights and obligations, size and location of the service territory, source of water, safe yields of local water, minimum purchases, cost allocations, and pricing methodologies, to mention a few. In essence the negotiated water rates have generally reflected a wholesale water rate for the cost of producing potable water that also included a pricing component reflecting a value placed on a quantity of local water itself.

Until 1997, the wholesale water rate charged to Cal Am by the City was made pursuant to a methodology that pegged the wholesale rate as a percentage of the City's prevailing retail commodity rate. However, the City made a significant change in its pricing methodology rendering this approach obsolete. Substantial portions of increases in the cost of water service were being passed on to consumers in the form of additions to the base fees in lieu of proportionate increases to the commodity charge. Accordingly, a new pricing arrangement was necessary for adequately recovering the cost of service to Cal Am. Accordingly, since May 2000, per an interim agreement, Cal Am has been paying at the rate of \$1.20 per HCF subject to retroactive adjustment when the City agrees to a new methodology.

### City of Coronado

As referenced earlier, the development of the original water systems in the 1880's and the associated water contracts and obligations, included water service to Coronado. In 1937, the City of Coronado initiated litigation against the City of San Diego when San Diego moved to terminate the water supply arrangement pursuant to the 1912 agreement. As a result of that and related litigation, the court determined that Coronado had a vested right to receive water per the original agreements. In that Coronado may be impacted by the terms of this proposed agreement, it is therefore a signatory to this agreement.

### Ownership

In January 2002, Cal Am filed an application with the California Public Utilities Commission (CPUC) seeking authorization for Cal Am's parent company, American Water Works Company, Inc., to be acquired and controlled by a foreign corporation. The City protested that merger based on the concern that Cal Am management would no longer be locally controlled,

recommending denial by the CPUC. The City withdrew its protest in support of the Office of Ratepayer Advocates' Settlement Agreement on the condition that the management of Cal Am have full authority with regard to any decisions concerning Cal Am's relationship with the City, including decisions related to water supply or franchise agreements.

## DISCUSSION

A proposed Water Supply and Delivery Agreement and a Water Service Franchise Agreement have been negotiated with Cal Am to principally address the issues of the water supply rate methodology and expiration in 2004 of the non-competition provision of the 1960 agreement. Under each agreement additional terms and conditions are addressed and clarified to essentially supersede the corresponding provisions of all previous agreements for a term of 25 years.

The City considered the option of acquiring the assets of Cal Am and providing water service to the areas within the City, as well as all of Cal Am's service territory. This course was not deemed to be in the best interest of the City at this time.

### Water Supply and Delivery Agreement

The Water Supply and Delivery Agreement provides that for a period of 25 years the City will deliver specified quantities of water to meet Cal Am's service territory demands at negotiated rates. The principal terms and conditions of the agreement are as follows:

Water Rates and Methodology - The current interim rate charged to Cal Am of \$1.20 per HCF is increased to \$1.36 per HCF retroactive to January 1, 2003. The revised rate is thereafter increased each year by an additional 6% on July 1 of 2003 (\$1.44/ HCF), 2004 (\$1.53/HCF), 2005 (\$1.62/HCF), and 2006 (\$1.71/HCF).

For years after 2006, and for the remaining term of the agreement, rates will be re-determined based on a specified methodology, which includes consideration for operating and capital improvement costs associated with the treatment, storage, and transmission of water to Cal Am. Excluded costs are those specifically associated with retail sales activities such as metering, billing and collection as well as costs associated with the production and delivery of reclaimed water. Other administrative and operating costs are allocated proportionately.

Based on these rates, it is expected that Cal Am's retail rates to its customers will remain approximate to those of City of San Diego customers. In FY 2002, prior to the proposed price increases to Cal Am, a typical single family household within the City of San Diego using 14 HCF per month was paying a \$30.07 compared to a similar Cal Am customer of \$31.39. Pursuant to the series of rate increases adopted by the City Council in April of 2002, City customers are receiving approximate 6% annual increases through FY 2006.

Similarly, as noted, the rate charged to Cal Am will also increase by 6% each year over this same period. Depending on the level of increases experienced by Cal Am for other portions of its costs to serve its customers, the net impact to customers may be greater or less than 6% annually. Based on the new rates Cal Am customers are expected to receive a larger adjustment initially, in order to recognize the new water price as well as the retroactive price adjustment and an additional 2% franchise fee.

Minimum and Maximum Deliveries - The proposed agreement provides for both a minimum and a maximum quantity of water for delivery to Cal Am each year. To ensure that the City recovers its basic costs associated with the ability to provide service, a minimum purchase quantity of 60% of its average deliveries is established. On a “take or pay” basis, if Cal Am fails to purchase the minimum quantity of water, it must compensate the City for the lost revenue. A maximum quantity is also established at 120% of its average deliveries. The proposed agreement also provides that subject to availability, the City may sell an additional quantity of water at a rate that approximates the City’s full retail price. The commensurate rate identified for FY 2003 was \$1.83 / HCF and subject to increase at the rate of 6% for each year thereafter.

Reclaimed Water Sales - Pursuant to the proposed agreement, the City has the right to directly market and sell reclaimed water within the service territory of Cal Am. To the extent that potable water services are converted to reclaimed water, the contact delivery quantity requirements are adjusted accordingly.

#### Franchise Service Agreement

The proposed Franchise Service Agreement provides Cal Am the ability to exclusively provide water service to certain areas of the City for a period of 25 years. The principal terms and conditions of the agreement are as follows:

Service Conditions and Service Area - The franchise grant to Cal Am provides the exclusive rights to construct, operate, and maintain a water system within the public right of ways of the City of San Diego that are located in Cal Am’s service territory. The specific area within the City is detailed in the attached map.

Cal Am is further required to observe all federal, state, City, and water industry practices related to the construction, operation, and maintenance of its facilities in the right-of-way. Additionally, the proposed agreement provides for customer services standards, including water quality, to ensure that service expectations meet or exceed those defined pursuant to the California Public Utilities Code (CPUC) and the orders of the California Public Utilities Commission. Rates are specified to be uniform throughout the service territory and rate-setting practices must also conform to the CPUC.

Additional provisions of the proposed Franchise Service Agreement address violations of the franchise grant allowing for specified liquidated damages and the ability to revoke the franchise.

Franchise Payments to the City of San Diego - The proposed agreement provides that Cal Am is to pay to the City, 2% of the gross receipts it derives from providing water services within the City. Cal Am is further required to pay an initial lump sum cash payment of \$1,250,000 to the City within 60 days after execution of the agreement. Until Cal Am recoups this lump sum, it will retain the 2% franchise fees it collects from its City customers. Thereafter, Cal Am will provide for quarterly payments to the City.

Based on current sales, franchise fees generate approximately \$88,000 annually. Accordingly, depending on the growth in gross receipts by Cal Am, it is estimated that it will take approximately 10 to 12 years for Cal Am to recoup the initial lump sum payment.

## Revenue Impacts

Water Supply and Delivery Agreement - Per the existing interim water rate agreement, the total annual revenue from Cal Am approximates \$6.7 million based on sales at the rate of \$1.20/HCF. Based on the new contractual rate for FY 2005 revenues are estimated to be \$8.6 million. Upon execution of the agreement, a retroactive adjustment is due for rate revisions back to January 1, 2003. This one-time adjustment is estimated to be approximately \$1.8 million. All revenue under the Water Supply and Delivery Agreement is deposited to the Water Fund 41500.

Water Service Franchise Agreement - Under the present agreements, no separate financial consideration is generated for Cal Am's use of the public rights-of-way for provision of water service within the City of San Diego. Under the proposed agreement a 2% franchise fee would be payable to the General Fund of the City of San Diego. At the present rates, the franchise fees are estimated to generate approximately \$88,000 annually. A lump sum initial payment of \$1,250,000 is payable within 60 days after the agreement is executed. No annual franchise fees would be received from Cal Am until the lump sum payment has been recouped.

## Conclusion

The proposed Water Supply and Delivery Agreement and the Franchise Service Agreement amend and supplement previous agreements with Cal Am for a 25-year term. The Water Supply and Delivery Agreement, provides for specified quantities of water to be delivered to Cal Am as well as defines wholesale rates through FY 2007 and provides the methodology for determining rates for the remaining term of the agreement. The Franchise Service Agreement grants Cal Am the exclusive right to provide water service to areas within the City and payment to the City of San Diego of a 2% franchise fee.

## ALTERNATIVE

Do not authorize the City Manager to enter into the agreements with Cal Am at this time. This is not recommended due to the loss of revenue to the City.

Respectfully submitted,

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Larry Gardner  
Water Department Director

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Richard Mendes  
Deputy City Manager

GARDNER/CWY

Attachments: 1. [Map – Cal-Am Water Service Area](#)  
2. [Summary of Terms of Proposed Agreements with Cal-Am](#)  
3. [Estimated Initial Rate Impacts of Proposed Agreements to Cal-Am Customers Compared to City of San Diego Customers](#)