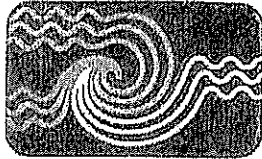


Correspondence with PUD staff 2009 & 2010 Regarding Recycled Water Pricing Study



December 21, 2010

Mr. Roger Bailey
Director
City of San Diego
Public Utilities Department
9192 Topaz Way, MS 904A
San Diego, CA 92123

Subject: Metro Wastewater JPA 2011 Work Plan

Dear Mr. Bailey:

As late as this may be, on behalf of the Metro TAC, let me formally welcome you to your new position as Director of the Public Utilities Department. We look forward to working with you on the myriad of regional wastewater issues that face the City of San Diego and the Metro participating agencies (PAs). As we have a 35% financial interest in the Metro system, any decisions that the City of San Diego makes regarding wastewater issues affects our rate payers as well. To be successful, decisions require the City and the PAs to work together to generate viable concepts and determine how those concepts can be funded to maximize the value to all parties at the lowest cost to our rate payers.

There are two open issues to which we would like to bring your attention that directly affect our two agencies (San Diego and Metro JPA).

1. **Allocation of Revenues from the South Bay Water Reclamation Plant.** Attached are three letters regarding this issue. The first two are from our attorney. They explain the revenue sharing contained within the Regional Wastewater Disposal Agreement. You will note that these letters are over two years old and, to date, this issue has not been resolved. The third is a letter dated July 29, 2010 to Alex Ruiz: we (the PAs) are still waiting to have our request from that letter acted on. As you will note in the third paragraph of the letter to Alex Ruiz, the City owes the PAs over \$1.5 million in revenues from the sale of reclaimed water. Although the PAs are currently accruing interest on the monies the City is holding, we feel urgency in resolving this issue as several of the PAs, as well as the JPA's attorney, feel the City is in breach of the terms of the 1998 Regional Wastewater Disposal Agreement. We would like to have a meeting within the next month to discuss this matter and resume the long overdue negotiations to resolve this issue.
2. **Recycled Water Pricing Study.** In January 2009, City staff provided a draft Recycled Water Pricing Study that had been prepared several years earlier and had only been somewhat updated. It was the City staff's intention to implement the rates recommended by the study. The City proposed a "unitary rate" for all customers and did not take into account the difference between a retail customer and a wholesale

The Joint Powers Authority – Proactively Addressing Regional Wastewater Issues

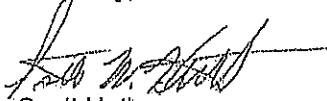
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customer. The PAs thoroughly reviewed this study as the outcome of this study has major impacts on us financially. On one hand, any increase in the reclaimed water rate would benefit us financially. On the other hand, the unitary rate is unfair to the City's wholesale customers who have spent substantial money on putting in their own infrastructure. For the purposes of this discussion, we are defining wholesale customers as the City of Poway, Otay Water District, and Olivenhain Municipal Water District. Two of these customers are also PAs.

In response to our comments, City staff agreed to have the consultant revise the study and prepare wholesale versus retail rates. The study was promised to be completed in September 2010 and it was also promised that the PAs would have several months to review and comment. We understand that City staff received the draft report in November and that we will be provided with a draft in early January 2011. We want to make sure that we have adequate time to review the study as had been originally promised and that both Metro TAC and the JPA can review and provide policy recommendations on its content. We are also concerned that revenue continues to be lost from the sale of reclaimed water at the current rate of \$350 per acre foot.

As stated earlier, we would like to meet with you sometime within the next month to discuss these matters and, especially, to move forward on resolving Issue 1 above. I look forward to us working together. Please call me at your earliest convenience at (619) 522-7312 to establish a date for our meeting. Thank you for your consideration.

Sincerely,



Scott Huth
Metro TAC Chairman

Attachments: 1) March 19, 2008 letter from Paula de Sousa to Thomas Zeleny
2) November 24, 2008 letter from Paula de Sousa to Thomas Zeleny
3) July 29, 2010 letter from Scott Huth to Alex Ruiz

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Paula C. P. de Sousa
(619) 525-1328
Paula.deSousa@bbklaw.com
File No. 60409.00001

March 19, 2008

VIA ELECTRONIC MAIL

Thomas C. Zeleny
Deputy City Attorney
City of San Diego
San Diego City Attorney's Office
1200 Third Avenue, Suite 1200
San Diego, CA 92101

Re: Metro JPA: Revenues for Sale of Reclaimed Water

Dear Tom:

Thank you for taking the time to speak with me last week regarding the allocation of revenues from the sale of reclaimed water from the South Bay Water Reclamation Plant ("South Bay Plant"). As we discussed, the Participating Agencies are interested in confirming with the City of San Diego, that revenues from the sale of by-products of all Metro Wastewater facilities, and the sale of capacity, are credited to the Metro System, and therefore the Participating Agencies, pursuant to the terms of the Regional Wastewater Disposal Agreement ("Agreement"). The concern is that revenues from the sale of reclaimed water and capacity in the South Bay Plant were not credited to the Participating Agencies pursuant to the terms of the Agreement.

The Agreement quite clearly treats revenue from the sale of reclaimed water from North City Water Reclamation Plant ("North City Plant") differently from similar revenues derived by the sale of by-products of other Metro Wastewater Facilities. Specifically, Agreement Section V.B.2.a.(2), defines, in part, a "Metro System Revenue" for purposes of determining the Participating Agencies "Annual Sewer System Charge," as follows:

All compensation from the sale or conveyance or transfer of any Metro System by-products, including but not limited to electrical energy, sludge products, and Reclaimed Water excepting therefrom any receipts allocated pursuant to subsection 2.a.(3) below.

Subsection 2.a.(3) requires revenues from the sale of reclaimed water from the North City Plant, be credited as a Metro System Revenue as follows:

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Thomas C. Zeleny
March 19, 2008
Page 2

... first be used to pay for the cost of the Reclaimed Water Distribution System, then the cost of Operation and Maintenance of the Tertiary Component of the North City [Plant] that can be allocated to the production of Reclaimed Water, and then to the Metro System.

The difference between revenues identified from the sale of reclaimed water from the North City Plant and other Metro System Revenues is that the San Diego Water Department paid for the Reclaimed Water Distribution system, and for the cost of operation and maintenance of the Tertiary Component of the North City Plant and, thus, was entitled to utilize revenue received from the sale of reclaimed water toward those expenses, before any revenue was allocated to the Metro System.

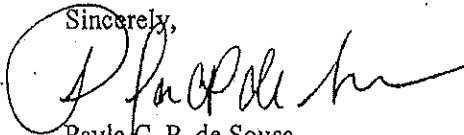
Under the Agreement, Metro System Revenues are used to offset the Sewer System Charges the Participating Agencies pay the City.

The Agreement between the City of San Diego and the Otay Municipal Water District calls for Otay to pay both a substantial capacity fee (\$3.6 million), and to pay \$350 per acre-foot for the reclaimed water. Since Metro Sewer paid for the South Bay Plant, and pays for the operation and maintenance of the entire South Bay Plant, including the Tertiary Component, Metro Sewer should receive both the capacity fees charged to Otay to purchase capacity in the Plant, and the revenues received from Otay for sale of the reclaimed water.

Pursuant to our discussion, you will speak with representatives of both the San Diego Metro Wastewater Department and the Water Department to determine whether the revenues from the sale of reclaimed water, including any capacity reservation fees that may have been paid by purchasers of reclaimed water, were appropriately credited the Participating Agencies as Metro System Revenues offsetting Metro System Charges, and that such revenues are credited correctly in the future. In the event the revenues were not appropriately credited, the Participating Agencies desire to review documentation on the appropriate credit, as well as establishing a date on which the credit can be expected.

I look forward to working with you to resolve this issue.

Sincerely,



Paula C. P. de Sousa
of BEST BEST & KRIEGER LLP

PDS:mod

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File No. 60409.00001

November 24, 2008

VIA FAX & U.S. MAIL

Thomas C. Zeleny
Deputy City Attorney
City of San Diego
San Diego City Attorney's Office
1200 Third Avenue, Suite 1200
San Diego, CA 92101

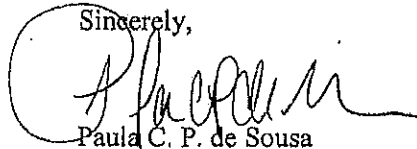
Re: Metro JPA: Revenues for Sale of Reclaimed Water

Dear Tom:

This letter serves as a follow-up to a previous letter regarding the allocation of revenues from the sale of reclaimed water from the South Bay Water Reclamation Plant ("South Bay Plant"). Based on our review of documentation we received from the City, we confirmed that the Participating Agencies have not been credited for revenues associated with the sale of by-products of all Metro Wastewater facilities in accordance with the terms of the Regional Wastewater Disposal Agreement ("Agreement")—in particular the sale of reclaimed water from the South Bay Plant and capacity reservation fees collected related thereto.

We imagine that accurately reflecting credits associated with the sale of all Metro System by-products, including, but not limited to, reclaimed water and/or capacity reservation fees, would be of the utmost importance to the Metro Wastewater Department and the City's wastewater ratepayers. I look forward to working with you to resolve this issue in advance of invoking the dispute resolution provisions of the Agreement.

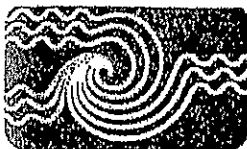
Sincerely,



Paula C. P. de Sousa
of BEST BEST & KRIEGER LLP

PDS:mod

METRO WASTEWATER JPA
www.metrojpa.org



276 Fourth Avenue, Chula Vista, CA 91960: 619-476-2557
Ernest Ewin, Chairman

July 29, 2010

Mr. Alex Rulz
Interim Director
City of San Diego
Public Utilities Department
9192 Topaz Way, MS 904A
San Diego, CA 92123

SUBJECT: Metro JPA – Revenues for Sale of Reclaimed Water

Dear Mr. Rulz:

This letter is to follow up on our telephone discussion from two weeks ago regarding the allocation of revenues from the sale of reclaimed water from the South Bay Water Reclamation Plant (SBWRP). As you were unaware of this issue when we discussed it on the telephone, I am attaching two letters from Metro JPA's attorney, Paula de Sousa, to Deputy City Attorney, Tom Zeleny, which clearly summarize the issues.

Our subcommittee, Metro TAC, met several times with City staff to discuss this matter in 2009. These discussions were tabled to allow for a more pressing issue to be resolved – the City's request for the Participating Agencies (PAs) to participate in the Metro debt service coverage and operations reserve. This issue was mutually resolved in time to provide assurance to the bond rating agencies of the PAs' participation and to assist the City in gaining favorable bond ratings for the 2010 series of wastewater debt refundings. In March 2010, we discussed with Rod Greek the resumption of a City staff/Metro TAC small subcommittee to resolve the reclaimed water revenue allocations. However, because of turnovers in staff, these meetings have not resumed.

As part of the negotiations in 2009, we constructed a revenue and expense model, which we submitted to staff for review. As of August 2009, the estimated revenues from the SBWRP were \$4.2 million with the PAs' share being approximately \$1.5 million. Although the PAs are currently accruing interest on the monies the City is holding, we feel urgency in resolving this issue as several of the PAs, as well as the JPA's attorney, feel the City is in breach of the terms of the 1998 Regional Wastewater Disposal Agreement.

We are requesting a meeting for next month to resume discussions on this issue and successfully resolve the allocation of revenues from the sale of reclaimed water, following a similar cooperative process as was used to resolve the debt service coverage/operations reserve protocol. As Lee Anne Jones-Santos currently is filling Rod Greek's former position and is familiar with this issue and the Regional Agreement, we thought that she may be a good addition to the workgroup. We feel that a small workgroup of three City staff members and an

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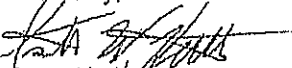
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Alex Ruiz
July 29, 2010
Page 2 of 2

equal number of PA representatives is the most productive as learned during our mutual resolution of the debt service coverage/operations reserve issues.

I look forward to us working together to move forward on this issue. Please call me at your earliest convenience at (619) 522-7312 to establish a date for our next meeting.

Sincerely,



Scott Huth
Metro TAC Chairman

C: Jay Goldstone
Ann Sasaki
Metro TAC

100





December 7, 2009

Jim Barrett
City of San Diego
Metro Wastewater Director
9192 Topaz Way
San Diego, CA 92123

Dear Mr. Barrett:

Thank you for providing the City's comments to us regarding our comments on the City's draft Recycled Water Pricing Study. We have circulated the City's October 2009 comments to MetroTAC members and have compiled their responses and attached them to this letter. Please address these in the next draft of the Recycled Water Pricing Study.

We understand from the City's comments at the November 2009 MetroTAC meeting that the City has asked its consultant to address the difference between wholesale and retail customers and we look forward to reviewing the next version of this concept. When you include the Metro JPA members in discussions of options, better decisions are made that benefit all stakeholders and the region as a whole.

The City's originally proposed unitary rate has been of major concern to the participating agencies. While the general consensus is that the suggested rate is equitable for your retail customers as their only alternative is to purchase irrigation water from the City, it is inequitable to wholesale customers who have put in their own distribution systems. Enacting a unitary rate for all reclaimed water sales disincentivises wholesale customers to purchase the City's reclaimed water. In addition excessive pricing to your wholesale users, as suggested by the pricing study, contradicts the stated purpose of the City's current \$2 million Recycled Water Study, specifically the goal to increase reclaimed water usage.

To summarize our main points: (1) Given Metro JPA members' financial stakes in the Metro System and the production costs of reclaimed water it is our expectation that the PA's will have adequate time to review the next draft and any changes that might come from that review; and (2) the rates must be fair and equitable to all parties, and set at appropriate levels that balance the facilitation of increased use of reclaimed water per the City's agreement with the environmental community (and the subsequent \$2 million Recycled Water Study), while providing additional monies to operate the system.

Sincerely,

Scott Huth
MetroTAC Chairman

Attachment A

Cc: Marci Steirer, Rod Greek

The Joint Powers Authority Proactively Addressing Regional Wastewater Issues

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Attachment A

Summary of MetroTAC Comments on October 28, 2009 City Response Regarding Recycled Water Pricing Study

1. Before the City of San Diego continues with this study The City should meet with its wholesale customers and create a unitary contract that is equitable to all parties. Satisfied wholesale customers are an almost no cost source for increased recycled sales for both plants. In addition excessive pricing to your wholesale users, as suggested by the pricing study, contradicts the stated purpose of the City's current \$2 million Recycled Water Study, specifically the goal to increase reclaimed water usage.
2. Enacting a unitary rate for all reclaimed water sales disincentivises wholesale customer to purchase the City's reclaimed water. All of your wholesale customers have raw water available and have put in their own distribution systems, thus why should they pay the City more than another alternative? Thus the City should develop a separate wholesale rate tied to some other equitable alternative for your wholesale customers. We understand from the City's comments at the November 2009 MetroTAC meeting that the City has asked its consultant to address the difference between wholesale and retail customers and we look forward to reviewing the next version of this concept.
3. The City's draft pricing study shows the reclaimed utility making a profit after a few years. This could potentially jeopardize CWA and MWD credits. Please revise the report to include all wastewater costs in addition to water costs so that the City does not risk CWA reading it and taking the credits away just because all costs are not shown. From information you have provided us we have prepared the annual capital and O&M costs for you to include in the City's report that are for tertiary capital facilities and the production cost between secondary and tertiary for reclaimed water.

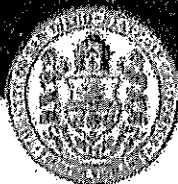
Summary of All Expenses By Year

| | | Tertiary Debt Service North | Tertiary Debt Service South Bay | Tertiary O&M Cost NCWRP (Acre Feet) | Tertiary O&M Costs SBWRP (Acre Feet) | Total Annual |
|----------------------|------------------------|--------------------------------|---------------------------------------|---|--|--------------------------|
| | Pay-Go Capital | City (estimated) | (estimated) | | | |
| 2003 | \$16,233,488.00 | \$ 20,531,000.00 | | \$ 517,117.69 | | \$ 37,281,605.69 |
| 2004 | | \$ 20,531,000.00 | | \$ 602,888.36 | | \$ 21,133,888.36 |
| 2005 | \$ 1,423,122.15 | \$ 20,531,000.00 | | \$ 596,958.25 | | \$ 22,551,080.40 |
| 2006 | | \$ 20,531,000.00 | | \$ 721,377.18 | | \$ 21,252,377.18 |
| 2007 | \$ 212,217.13 | \$ 20,531,000.00 | \$ 12,077,000.00 | \$ 1,399,911.45 | 267,949.14 | \$ 34,488,077.72 |
| 2008 | \$ 493,829.18 | \$ 20,531,000.00 | \$ 12,077,000.00 | \$ 825,498.93 | 883,849.73 | \$ 34,811,177.84 |
| 2009 | \$ 508,439.00 | \$ 20,531,000.00 | \$ 12,077,000.00 | \$ 908,098.74 | 893,938.59 | \$ 34,918,476.33 |
| Total to Date | \$18,871,095.46 | \$ 143,717,000.00 | \$36,231,000.00 | \$ 5,571,850.61 | \$ 2,045,737.46 | \$ 206,436,683.53 |

Omitting \$35 million dollars per year from the City's costs because they are being borne by the Metro System wastewater customers does not give a true picture of what it costs to produce and distribute reclaimed water. Please show all the cost in the final report including wastewaters' so that it does not look like the City is making a profit. When CWA does its audits, net costs should never be positive or the credits will be revoked. Please insure City staff understands the process so that this valuable funding source is not removed.

4. Rod Greek stated at the MetroTAC November meeting that the Recycled Water Pricing Study was due to be completed as a "Final Draft" by the end of December 2009. As Metro Member Agencies we have a 35% stake in the revenues and the \$34 million per year of expenses to produce reclaimed and thus should have input into the final rates that the City establishes. The City did not consult the participating agencies when the reclaimed water rate was adjusted to \$350 per acre foot and therefore have delayed the PA's repayment of the debt service associated with the original optimized system. We have also not been consulted regarding the revenue loss to us by not indexing the reclaimed water rate on an annual basis. We have substantial financial interest in the City correctly pricing reclaimed water, especially to the City's wholesale customers such as Otay and Poway who are already paying an average of \$203 per acre foot to just produce the reclaimed water the City is selling to them (i.e. the difference between secondary and tertiary).

5. Avoiding duplication of charges is a basic concept in any rate study. Charging a base charge is an accepted practice but when the same costs are collected via the commodity charge, this is a duplicate charge. These include meter reading and maintenance, customer service, etc. Your draft study includes these costs in both the commodity charge and the base charge.



THE CITY OF SAN DIEGO

August 26, 2009

Manny J. Magana, Assistant General Manager
Otay Water District
2554 Sweetwater Springs Boulevard
Spring Valley, CA 91978-2004

Dear Mr. Magana,

I am in receipt of your letter dated July 6, 2009 regarding the City of San Diego's (the City's) Recycled Water Rate Draft Pricing Study (the "Study"). The City is grateful for the thought and effort that was put into this review and appreciates your input as a valued customer.

In discussing the current proposed Study, consideration must be given to the history of the City's Recycled Water Program (the "Program"). The Program was created by the City's Water Utilities Department to comply with wastewater regulations and conditions, with virtually no existing customer base. Indeed, even after 10 years of effort and current drought conditions, the City's recycled water customer base remains limited, and the Program continues to expend significant effort to expand its customer base.

Please keep in mind that the Study attempts to reconcile competing issues and concerns, including financial self-sufficiency for the Program, rate simplicity and transparency, and equity in treatment of customers, all while preparing for future replacement, rehabilitation, and expansion of its distribution infrastructure. Your organization's comments will be helpful as the Program proceeds with its development of a rate proposal.

Comment 1:

We believe that the City needs to reevaluate its rate-setting process and obtain a more accurate and comprehensive rate study to support its proposed recycled water rates. The current version of the draft study does not accurately reflect the cost of providing the recycled water service, as required under the provisions of the California State Constitution. The draft study also fails to address relevant provisions of the Regional Wastewater Agreement between the City and the Metro Participating Agencies...and fails to address relevant provisions of the recycled water contracts the City has with its wholesale customers. As a result, there are substantial inconsistencies between the information and conclusions of the study and the provisions of the City agreements that concern the recycled water system.



Page 2

Mr. Manny J. Magana

August 25, 2009

The City recognizes that the draft study is dated, and disclosed this upon provision of the report to the Participating Agencies (PAs) for their review. In addition to required updates to several areas, certain policy decisions must be revisited and inserted into the rate model. These revisions and enhancements will hopefully improve the quality of the final draft report.

The goal of the recycled water rate case is to achieve a revenue-neutral Program. Metro PA-related costs were accounted for in the sewer rate case and were therefore not included in the recycled water rate calculation.

Comment 2:

The draft study acknowledges the Regional Wastewater Agreement and the flow of recycled water revenues and incentives for the North City and South Bay plants. However, in the cash flow analysis, the draft study omits the required repayment to the Metro PAs of a portion of the system revenues.

While physically there are two distinct water reclamation and distribution systems, one in North City and the other in South Bay, the City views it as one regional water reclamation system. This is consistent with other systems, such as water treatment and distribution or wastewater collection, transport and disposal, wherein multiple and distinct pump stations, mains and treatment plants are viewed as one system. As such, all revenues realized from the sale of recycled water, in any part of the system, continue to accrue to the Water Fund, and will do so until such a time as all water-funded infrastructure, operations and maintenance, and marketing expenses for the entire system have been paid off.

Once all expenses incurred by the Water Fund for recycled water infrastructure have been paid off, and assuming the sales price of the product exceeds its production costs, revenues above and beyond production costs will begin to accrue to the Metro Sewer Fund and will be distributed consistent with subsection V.B.2.a.(3) of the Regional Wastewater Disposal Agreement (the "Metro Agreement"). It is impractical to expect that such accrual of revenues to the Sewer Fund would precede full cost recovery by the Water Fund for its expenditures on behalf of the recycled water infrastructure.

Comment 3:

The costs to produce the recycled water are currently being paid by wastewater customers of the City and by the Metro PAs, not by the City's water customers. This subsidy to the recycled utility should be included and quantified in the recycled water rate study.

The costs of primary and secondary wastewater treatment are costs that are appropriately borne by wastewater customers.

Page 3

Mr. Manny J. Magana

August 25, 2009

Tertiary costs resulted from obligations of the Ocean Pollution Reduction Act of 1994 and an EPA assistance program that provided funding for the North City Water Reclamation Plant. Section III.C of the Metro Agreement relieves the PAs of the tertiary operations and maintenance costs when such costs can be solely attributed to the production of "repurified water", defined in the Metro Agreement as "water which, as a result of advanced treatment of reclaimed water, is suitable for use as a source of domestic (or potable) water supply".

Tertiary costs are currently included in the sewer rate case through 2012. Transferring tertiary costs to the Water Fund will also result in an upward pressure on recycled water rates to the PAs.

Comment 4:

The draft study assumes that all customers should pay the same rate. However, not all customers have contributed equally to fund the costs of the system. Thus, requiring all customers to pay equal rates on a going-forward basis would lead to unjust enrichment. Wholesale customers that have paid for the system expansions required to provide service to those agencies should not continue to pay toward costs for the City of San Diego's system as a whole. The cost of service analysis should properly account for the costs and contributions of the retail and wholesale customers and, within the wholesale customers, for the additional contributions of the Metro PAs.

While not all the agreements that the City has with its larger volume customers are the same, the postage stamp approach to pricing is an acceptable practice in the industry (see AWWA M1 Principles of Water Rates, Fees and Charges). The City has utilized this approach because the Program customer base is small (with 446 customers, compared to almost 268,000 potable customers). Use for recycled water is largely uniform, with nearly all customer usage being irrigation. This provides the City simplicity in conferring pricing on all customers.

Developing additional customer classes yields no benefit to the City. The PAs have greatly benefited from avoidance of lawsuits and sewer service charges that would have been the result of mandated upgrades of the Point Loma Treatment Plant. The City's potable water ratepayers, conversely, have funded the construction, operation, maintenance and management of the recycled water distribution system that resulted from OPRA regulations, which is a significant benefit to the PAs.

Comment 5:

The study should clearly explain why the City is entitled to charge wholesale customers that have paid capacity fees, that maintain their own distribution system and that contribute a share of the cost of the optimized system through Metro PAs contributions additional capacity charges. Without a clear nexus between costs and benefits, such charges would be in violation of Article XIID of the California Constitution and other applicable laws.

Page 4
Mr. Manny J. Magana
August 25, 2009

It is recognized that the City negotiated agreements with different large users differently but the wastewater system and the recycled water distribution systems are separate infrastructures with regional benefits. Capacity fees paid to one system do not grant access to the benefits of the other system. The rate determination for each system has been done separately up to this point.

With the exception of temporary construction customers, recycled water customers have been and continue to be charged capacity fees which are included in the Recycled Water Rate Case and help reduce revenue requirements overall. Capacity fees are charged once construction is complete and a permanent system connection established. Article VIII D of the California Constitution does not apply to capacity fees or to wholesale customers. **

Comment 6:

The draft study indicates that the City's major goal is to make the recycled water utility financially self-sufficient. This position is restated many times in the draft study, but ignores that the recycled water system is a mandatory system, a system that would never be built if it was to be financially self-sufficient. The idea that the recycled water system, which was basically built to support and benefit the potable and sewer systems, should be self-sufficient is incorrect. The benefits to both the sewer and the potable customers of the City are too substantial to be ignored. The draft study recognizes this, but then fails to build it into the rate structure.

The Recycled Water Rate Case recognizes the recycled water system as mandated. That is why the City has approached rate development with a "shared pain" approach. The PAs must recognize that absent the recycled water system, the existing rate structure, and existing customers, the requirements and mandates imposed on the wastewater system may have gone unmet.

Comment 7:

The study also fails to define the mandated costs and how they must be paid by the appropriate customer base. This failure to define which customers have benefited by the recycled system and therefore which costs should be borne by the various sewer, potable, and recycled customers leaves rates to be driven by some other objective than equity. If such pricing were to go into effect, the use of the City produced recycled water on a wholesale basis would not be economically feasible nor a financially sound business practice.

Dividing the limited customer base into customer classes (wholesale or irrigation) is a debatable matter. Because the use for recycled water is primarily for irrigation, it is appropriate to charge a uniform rate. This is ultimately a policy decision and the City still finds one rate to be most practical.

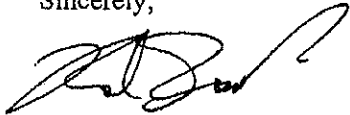
Page 5
Mr. Manny J. Magana
August 25, 2009

With regard to a discussion of who benefits, both municipal and PA customers receive benefit from the cost avoidance related to secondary treatment at Point Loma. A small subset of the PAs, being among the largest recycled water users, have benefited from the reliability of a new water supply, and a less expensive product that is not subject to conservation and drought pricing. Not using City-produced recycled water would require agencies to build additional facilities to develop local water resources, and to import more expensive water that is subject to drought restrictions and pricing, ultimately increasing the commodity cost to that agency.

The current Recycled Water Rate Case seeks to reasonably apportion costs in a simple manner but also recognizes that recycled water can never be priced more than potable under the current industry practice.

As the City continues to refine the Recycled Water Pricing Study, we will work with various stakeholder groups, including the Participating Agencies, to ensure adequate input from all affected parties. Your continued feedback and suggestions are welcomed throughout this process.

Sincerely,

A handwritten signature in black ink, appearing to read 'Rod Greek', with a stylized flourish at the end.

Rod Greek
Deputy Director
Public Utilities Department



...Dedicated to Community Service

2564 SWEETWATER SPRINGS BOULEVARD, SPRING VALLEY, CALIFORNIA 91978-2004
TELEPHONE: 670-2222, AREA CODE 619

www.otaywater.gov

July 6, 2009

Marsi Steirer, Deputy Director
City of San Diego
Water Resources & Planning Division
600 B Street, Suite 600
San Diego, CA 92101-4518

RE: City of San Diego Recycled Water Rate – Draft Pricing Study

Dear Ms. Steirer:

Thank you for providing a draft copy of the City of San Diego's recycled water rate study. As the largest user of City produced recycled water, we have an inherent interest in the City's pricing procedures. This letter is to express our concerns with the goals, composition and direction set forth in the draft study.

We believe that the City needs to reevaluate its rate setting process and obtain a more accurate and comprehensive rate study to support its proposed recycled water rates. The current version of the draft study does not accurately reflect the cost of providing the recycled water service, as required under the provisions of the California State Constitution. The draft study also fails to address relevant provisions of the Regional Wastewater Agreement between the City and the Metro Participating Agencies (Metro PAs), and fails to address relevant provisions of the recycled water contracts the City has with its wholesale customers. As a result, there are substantial inconsistencies between the information and conclusions of the study and the provisions of the City agreements that concern the recycled water system.

Some key issues we noted are as follows:

- a. The draft study acknowledges the Regional Wastewater Agreement and the flow of recycled water revenues and incentives for the North City and South Bay plants. However, in the cash flow analysis, the draft study omits the required repayment to the Metro PAs of a portion of the system revenues.
- b. The costs to produce the recycled water are currently being paid by wastewater customers of the City and by the Metro PAs, not by the City's water customers. This subsidy to the recycled utility should be included and quantified in the recycled water rate study.
- c. The draft study assumes that all customers should pay the same rate. However, not all customers have contributed equally to fund the costs of the system. Thus, requiring all customers to pay equal rates on a going forward basis would lead to unjust enrichment. Wholesale customers that have paid for the system expansions

required to provide service to those agencies should not continue to pay toward costs for the City of San Diego's system as a whole. The cost of service analysis should properly account for the costs and contributions of the retail and wholesale customers and, within the wholesale customers, for the additional contributions of the Metro PAs.

- d. The study should clearly explain why the City is entitled to charge wholesale customers that have paid capacity fees, that maintain their own distribution system and that contribute a share of the cost of the optimized system through Metro PAs contributions additional capacity charges. Without a clear nexus between costs and benefits, such charges would be in violation of Article XIII D of the California Constitution and other applicable laws.

The draft study indicates that the City's major goal is to make the recycled water utility financially self-sufficient. This position is restated many times in the draft study, but ignores that the recycled water system is a mandated system, a system that would never be built if it was to be financially self-sufficient. The idea that the recycled water system, which was basically built to support and benefit the potable and sewer systems, should be self-sufficient is incorrect. The benefits to both the sewer and the potable customers of the City are too substantial to be ignored. The draft study recognizes this, but then fails to build it into the rate structure.

The study also fails to define the mandated costs and how they must be paid by the appropriate customer base. This failure to define which customers have benefited by the recycled system and therefore which costs should be borne by the various sewer, potable, and recycled customers leaves rates to be driven by some other objective than equity. If such pricing were to go into effect, the use of City produced recycled water on a wholesale basis would not be economically feasible nor a financially sound business practice.

In summary, all of these issues and more need to be resolved before a true cost of service study can be completed and ultimately used as a basis for adjusted recycled water rates. As requested by MetroTAC, we will be providing our specific concerns to Karyn Keese of PBS&J for compilation with other comments on the draft study.

On behalf of the Otay Water District, thank you for the opportunity to provide the City with our initial comments on the draft study. As noted above, we will submit further comments and plan to take an active role as this matter moves forward. We are available to meet with City staff, if you wish, to discuss our concerns in more detail.

Sincerely,



Manny J. Magaña
Assistant General Manager
Otay Water District

cc: Rod Greek, Public Utilities Deputy Director
Darlene Morrow-Traver

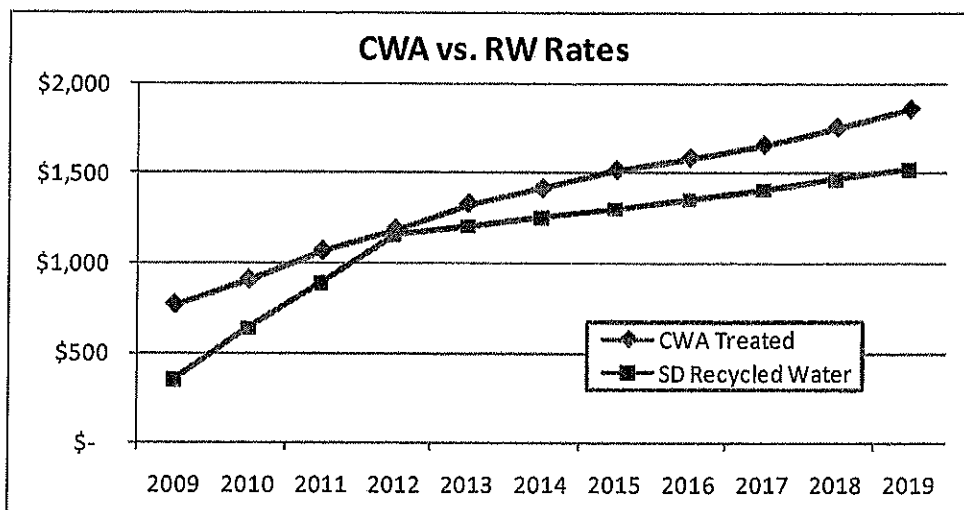
Response to Comments for Draft Recycled Water Pricing Study

MetroTAC August 14, 2009

The following graphic illustrates the basic problem with the recommendations for a unitary rate contained in the draft recycled water study. As shown on the graphic, your wholesale customers will pay more for recycled water than their other water alternatives. Each one of them can and does purchase treated and/or untreated water from the County Water Authority (CWA). While this study supports new rates for the City's retail customers whose only other alternative is to buy irrigation water from the City at the City's cost loaded rate, it does not address the more complex issues of your wholesale customers. For the purposes of this review, we are defining wholesale customers as the City of Poway, Otay Water District, and Olivenhain Municipal Water District.

Response: Under the market driven approach, the City will need to consider the alternatives supplies that are less expensive than the City's rate. If raw water is available, the City would have to consider pricing recycled water below the cost of raw water to ensure the sale of recycled water to an agency or lose that sale.

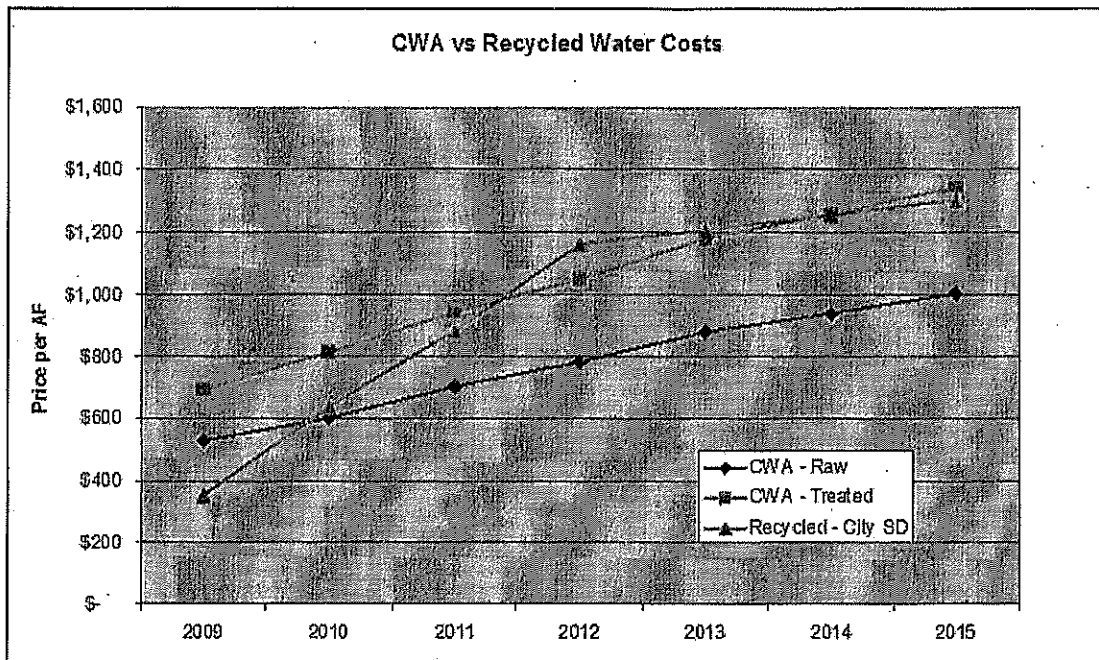
Wholesale customers, with the exception of Olivenhain, can only purchase **treated** water from CWA (not untreated). The chart and table below show the rates for CWA Treated and the recommended City of San Diego recycled water at 75% of the potable irrigation rate, currently at \$3.309/hcf (\$1,441/af). The treated CWA rates are the most current draft rates provided by David Shank at CWA. The rates include the melded M&I supply cost, treatment cost, transportation, storage, and customer service costs. The graph shows that at no point are the recommended recycled water rates cost more than its alternative, CWA treated water. The rates are shown in calendar year.



| \$/acre-foot | 2009 | 2010* | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|-------------------|--------|--------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| CWA Treated | \$ 766 | \$ 905 | \$ 1,065 | \$ 1,186 | \$ 1,329 | \$ 1,416 | \$ 1,517 | \$ 1,586 | \$ 1,659 | \$ 1,757 | \$ 1,860 |
| SD Recycled Water | \$ 348 | \$ 636 | \$ 884 | \$ 1,159 | \$ 1,207 | \$ 1,255 | \$ 1,307 | \$ 1,359 | \$ 1,411 | \$ 1,468 | \$ 1,529 |

*From David Shank, 2010 rates include

M&I Melded Supply rate of \$ 532, treatment rate of \$215, storage rate of \$61, customer service of \$30 and transportation of \$67 per ac-ft



It should be noted that the objective of the rate study is to calculate the cost of service for the entire recycled water system, not the cost of service for any individual customer or customer class. It was a policy decision to treat the recycled water system as a single unitary system, where all customers would equally share in the cost of providing service. If the objective was to calculate the cost of service for each customer class, then the resulting rates would be different. However, this would be a policy decision, which, at the moment the study was done, was to calculate a unitary rate for the entire system for simplicity purposes.

General Comments:

1. The study does not accurately provide for cost of service, which is required under Proposition 218 for the City's wholesale customers. It also does not address provisions within the Regional Wastewater Agreement with the Metro Participating Agencies (PAs) and conflicts in the recycled water contracts the City has with its wholesale customers. There are inconsistencies between the study and the agreements that surround the City of San Diego's recycled water system. All of these issues need to be resolved before a true cost of service study can be completed for the City's wholesale customers and ultimately used as a basis for their adjusted recycled water rates.

Response: It is our understanding that Proposition 218 does not apply to wholesale customers (City counsel to verify). It is only required for retail customers who are property owners and end users of the water. The final study will address all the

provisions within the Regional Wastewater Agreement with the PAs and any contracts the City has with its wholesale customers. This may result in different rates for Poway and Olivenhain.

Examples of these inconsistencies' follow:

- a. The Regional Wastewater Agreement is clear as to the flow of recycled water revenues and incentives. Item 4 on the following pages provides the language for the North City Plant. The recycled water revenues and incentives for the South Bay plant are covered in (pg 15) Section 2.a.(2): Metro System Revenues shall include "all compensation or receipts from the sale or other conveyance or transfer of any Metro System by-products, including, but not limited to, gas, electrical energy, sludge products, and RECYCLED WATER..." The study needs to address that 35% of the revenues and incentives are paid back to the PAs.

Response: It is expected that recycled water revenues would accrue to Metro after the Reclaimed Water Distribution System costs are paid off. The model assumes that there will be a single rate for the recycled system and that the prior costs incurred by water will be recovered. The current agreements with Otay and Olivenhain state that these agencies would pay the cost of the recycled water as set by the City Council. The recycled water rate study calculates the cost of water based on recovery of the City's investment in the recycled water system.

The concept of the unitary system is partly a policy matter as well as one that is established under the current agreements. The wastewater system is considered to be a unitary system. Agencies that discharge to South Bay are treated no differently than agencies discharging to Pt Loma or North City. That concept has been accepted by all agencies by the current wastewater agreement.

- b. The study assumes that all customers are going to pay the same rate. However, Poway has a different contract from the other wholesale customers. If Poway is going to continue to have a different contract then their revenue needs to be considered an offset and the total water sales needs to be reduced by the amount of recycled water they purchase.

Response: By agreement Poway would qualify for a different rate than the remaining customers. In the rate study, charging Poway the rate by agreement would result in an increased rate to the remaining customers.

- c. The costs to produce the recycled water are currently being paid for by wastewater customers, not water customers. This contribution to the recycled utility needs to be clearly included and quantified in this report.

Response: Section 3.1.1 discusses this. A table of the operating costs can be included in the appendix.

- d. The cost of service analysis needs to be broken between retail and wholesale customers as well as between wholesale customers who are Metro PAs. The study needs to discuss that the City does not have one standard contract with its

wholesalers. For instance Poway is paying 1.83 times the cost of any other San Diego retail or wholesale customer.

Response: The decision to calculate separate rates for different customer classes conflicts with the original objective of the study. Thus, ultimately, the City will have to decide on the approach for the final study.

- e. Two of the wastewater wholesale customers are Metro PAs (Poway and Otay). They are already paying for their share of the production costs for recycled water (tertiary) through their Metro quarterly payments. Since this is the case, what can the City legitimately charge them for that does not violate Proposition 218? For instance, wholesale customers have provided their own distribution system and pay for its ongoing O&M. They are paying their share of the current debt service through their Metro quarterly payments. There is no need for them to pay for future capital expansion projects as they are not causing the system expansion.

Response: All PAs are paying for the operation of wastewater system including the tertiary system. Under the unitary system costs are shared equally by all users. Otay gets a credit from MWD/CWA for its investment in its distribution system.

- f. There appears to be conflicts in the wholesale agreements. An example of this is found in the Wholesale Agreement with Poway. Section 12 on Page 4 of 8 reads: "San Diego agrees to construct or cause to be constructed, AT NO COST TO POWAY, all component facilities of the Distribution System required to deliver recycled water from the North City Water Reclamation Plant, herein called "NCWRP", to the point of connection with Poway, including but not limited to pump stations, wet well, pumps, pipelines, meters, controls, and other facilities within the limits of the boundaries of San Diego; and San Diego shall also be solely responsible for all costs incurred by the operation and maintenance of these conveyance facilities". Poway is currently paying the debt service on the Optimized System through their Metro quarterly payments, and per their contract it appears they should not be.

Response: Poway's rates are specified in the agreement.

The comments received fall into the following basic categories:

1. The study identifies the need but fails to define a reasonable basis to allocate costs among Potable, Sewer, and Recycled customers.

Response: The study seeks to identify the costs of the recycled water system to calculate the recycled water rates. Currently the costs borne by the wastewater system are per the Regional Wastewater Agreement. The City Water Department is bearing most of the costs of serving recycled water.

2. The report fails to provide a reasonable basis for setting wholesale rates, falling back on the presumption that the burden of full cost recovery should fall solely on the recycled customers.

Response: This goes back to the objective of the study, which was to calculate rates for the entire system, assuming that all customers will share equally in the cost of the whole system. This is implicit in the agreements where, with the exception of Poway, Otay and Olivenhain agreed to pay the same rates as the City's retail customers.

3. The report fails to adequately justify the Unitary Cost approach it is selecting.

Response: See 2 above. The unitary system follows the approach on the Metro Wastewater System. Additionally, Section 6 of the report states that the rate development for the study considered two major objectives, one of which is that the rates should be relatively easy to implement and simple to explain to customers. The rationale is that since most of the recycled water customers used the water for irrigation purposes and have similar usage characteristics, a unitary rate structure would simplify the process of administration and customer service. Thus, the recycled water system is treated as an integrated system.

4. Wholesalers and their part in building the distribution system are acknowledged but when it comes to setting a unitary cost structure the report is silent.

Response: See above regarding unitary structure.

5. There is double charging to the wholesale users, especially the Metro PAs for the production, O&M for the distribution system, debt service, etc.

Response: The calculated rates do not include costs for producing recycled water which are borne by all wastewater customers in the region who all benefit as the City aims to meet the conditions of the grant received for the recycled water systems.

6. No rationale is provided for the 14 year debt term.

Response: The 21 years represent the remaining period left in the \$37 million debt payment. The model assumed recycled water would take over the debt service and repay the entire \$37 million debt issue to potable water.

The 14 years represent the time frame during which the water enterprise recovers its costs. After 14 years the recycled water rates will allow Metro to recover operating costs for tertiary treatment. It is assumed that the total capital costs contributed by water are recovered in that time frame. This will be clarified in the report.

7. The City is proposing a pricing system that is a disincentive for their largest users. This appears to be contradictory to the City's desire to expand the recycled system. It would seem that incentive pricing for wholesale users is a lot less expensive for expansion of the recycled system and has no regulatory hurdles.

Response: The recommended rates at 75% of the potable irrigation water rates are still lower than its alternative, which is CWA treated rates. Thus, recycled water is still a more economical alternative for irrigation purposes. Moreover, recycled water provides a more reliable water source, which is a substantial benefit to recycled water users.

Page-Specific Comments:

Page 1: The study identifies the need but fails to define a reasonable basis to allocate costs among Potable, Sewer, and Recycled customers. The study accurately identifies this vital issue but fails to provide any rationale, process, or substantiation. For instance, who currently pays for the maintenance of the backbone system? Metro? Muni? Water? Wholesale? Retail? And conversely who actually benefits from these costs and should actually be paying for them. The study needs to drop back and look at AWWA guidelines, etc. and the definition of cost causative.

Response: The study identifies the costs to serve recycled water customers considering the Regional Wastewater Agreement. The City has the option (as a matter of policy) to decide if it wants to recover the investments made into the recycled water system. The grant conditions required the City (as operator of the wastewater system) to meet specific targets to sell recycled water and the City. The cost required to meet those conditions are reasonably borne by wastewater customers or recovered from recycled customers. There is no reason for potable water customers to bear all those costs if the recycled water customers can reasonably share in them.

Page 2: The optimized system costs were not paid for by water. Please see Attachment A showing project cost as sources and uses of funds. Of the \$70 million project costs, \$36.8 were paid for from a bond issue and \$12.5 million from grants. Payment for these facilities is outlined in the Regional Wastewater Disposal Agreement (Metro Agreement) between the City of San Diego and the participating agencies of the Metropolitan Sewage System, (pg 15) Section 2.a.(3) as follows:

“ the distribution of the revenue from the sale of Reclaimed Water from the North City Water Reclamation Plant, including incentives for the sale of Reclaimed Water, shall be FIRST used to pay for the cost of the Reclaimed Water Distribution System, then the cost of the Operation and Maintenance of the Tertiary Component of the North City Water Reclamation Plant that can be allocated to the production of Reclaimed Water, and then to the Metro System.”

Please supply us with a copy of the debt service schedule so that we can determine how much of the cost of the optimized system has been repaid. Information provided in February 2008 by the City shows \$11.9 in recycled water incentives from MWD and CWA and North City Water Sales of \$7.3 million from 2003 to May 2008. Please bring these figures up to date so that they can correctly be applied to the debt service.

Response: The total RW system cost is given below.

EXPENDITURES

| | | |
|---------------------|-----------|--------------------|
| OPTIMIZED SYSTEM | \$ | 69,801,302 |
| RETROFITS | \$ | 14,903,660 |
| ALL OTHER RECLAIMED | \$ | 52,764,817 |
| TOTAL | \$ | 137,469,779 |

GRANTS

| | | |
|----------------------------|-----------|--------------------|
| Optimized System | \$ | 14,280,824 |
| Non Optimized System | \$ | 11,279,854 |
| TOTAL | \$ | 25,560,678 |
| TOTAL NET OF GRANTS | \$ | 111,909,101 |

| | | |
|---------------------------------------|----|------------|
| Net Optimized System City Funded | \$ | 55,520,478 |
| Amount Financed via bonds | \$ | 37,000,000 |
| Amount Optimized System Cash Financed | \$ | 18,520,478 |
| Amount RW System Cash Financed | \$ | 74,909,101 |

The costs included in the calculation of rates exclude all grant funding. The City's current rates are not adequate to full cost of the recycled water system. The balance is recovered from potable water and wastewater is not credited for tertiary treatment costs.

Page 2: The original cost of the optimized system was \$70.3 million. We presume that additional monies have been spent since that time. These need to be broken out to do the analysis correctly. Page 8 states that this number is \$52.8 million.

Response: See table above. All the costs incurred in the recycled water system, excluding grants are included.

Page 2: It should be noted that the participating agencies were never consulted in 2001 when the City decided to lower their rates from 90% of potable water to \$0.80 per HCF. In addition San Diego has not raised rates to retail customers since that time. This means lost revenues to the Participating agencies.

Response: The City lowered rates to encourage more users to join in so that it could meet the sales targets as required by the conditions of the grant. Given the current water situation, it is reasonable to price the recycled water to market conditions within the cost of providing service and recovery of past capital costs. The City may opt to forego past investments at the City's option.

Page 3: States that two new retail connections were made in 2008. Who are the customers, what rate are they paying; did they pay a capacity fee, and what new capital facilities were put in to serve them and who paid for them?

Response: There were several (number to follow) retail customers that connected in 2008. Since they are being granted access to system capacity, all new customers will pay capacity fees based on the previously Council approved rates that are the same as potable customers. If the customer

is converting from potable to recycled water and “killing” or reducing their potable connection, then no additional capacity fee is charged.

Page 3: Please provide a detail of the \$8.8 million in O&M/capital costs discussed on this page.

Response: Costs are shown in Table 4-1 and Table 3 in Appendix on page B-4.

Page 3: The study incorrectly labels its largest customers as irrigation customer instead of wholesale customers. Page 17, 2.5.2, says that most customers of the recycled water system are irrigation customers with similar characteristics, and therefore there is no need to develop separate rates for different classes. This is an oversimplification and fails to address the inequities in the method which cause non-compliance with cost vs. benefit requirements.

Response: The recycled water is used mostly for irrigation purposes. The decision to have a single rate in the whole system is based on the recycled water agreements (except for Poway) and as a matter of policy.

Page 3: Section 1.1.2. Identifies a 14 year amortization of the prior investment made by potable customers. Potable customers are being reimbursed for payment into the recycled system without a justification being provided as to how potable water customers must share in the cost of the recycled system.

Response: The 14 years represent the time frame during which the water enterprise recovers its costs. After which the recycled water rates will allow Metro Wastewater to recover operating costs for tertiary treatment. It is assumed that the total capital costs contributed by water are recovered as debt payments in that time frame. This will be explained in the report. The premise for the recycled water rates is that recycled water should support itself with the exception that wastewater bears the burdens as required by the Regional Wastewater Agreements with the Water Department recovering its investments in the recycled water system.

Page 5: Does the City really get incentives from CWA at the SBWRP? If so how much has been collected to date.

Response: Yes, the City does receive incentives from CWA for usage to customers other than Otay. The amount collected to date is ~~XXXXX~~. These incentives are factored into the recycled water rates.

Page 5: The study acknowledges that “other considerations” need to go into the calculation of rates but these are undefined.

Response: Other Considerations are described in the Executive Summary under sections titled Observations and Recommendations.

Page 7: Section 1.3. **Rate stabilization reserve is not defined.** What is the target level?

Response: There was no mention of rate stabilization reserve in this section. It is mentioned in Section 1.4, item 11. The target is set at 10 percent of the commodity revenue.

Page 7: Item 3: New distribution system expansion costs should not be borne by wholesale users and these costs should be excluded from their rate.

Response: New users pay connection fees to offset costs. The sale of additional recycled water provides a benefit to all customers by reducing the rates. To the extent that connection fees are

not adequate to cover capital costs, existing users bear these costs in anticipation of recovering these costs at a future date. This is common practice for an enterprise fund.

Page 7: How was the \$46 per AF of avoided costs determined?

Response: \$46 in savings was obtained from the plant operators as a result of cost savings in chemicals and pumping costs as described. It is mentioned in the study but not considered in the rates.

Page 7: Consultant states the recycled water system “provides the City with an alternate water supply that is relatively inexpensive...and allows the City greater flexibility to add customers”. This only benefits the water system not the Metro system that is paying for the costs of tertiary treatment to provide the recycled water.

Response: The Metro system was required to build the recycled water treatment plants and to beneficially reuse the water produced per the EPA grant conditions. The Water Department has been bearing a significant portion of the costs of constructing and operating the recycled water system. Metro has saved its users the costs of going to full secondary by construction of the recycled facilities.

Page 7: Section 1.3. Item 5 states “By substituting recycled water for potable water, the City is in effect creating capacity in its potable system that can become available for new users. This benefits the City’s potable customers with a more reliable system with additional capacity and therefore provides a basis for their continued participation in the recycled water system.

Response: There is a benefit to the City which is not free of costs. The City has made significant investments in the recycled water system and there are impacts on the potable system from losing sales to recycled water. In addition, the recycled water system will accrue benefits from connection fees from converting potable to recycled water users.

Page 7: Section 1.3. Item 5. a. The City defines this capacity as “relatively inexpensive.” This is inconsistent with other statements regarding the high cost of the recycled system.

Response: The recycled water system is relatively inexpensive as compare to other potential water sources such as desalination especially as cost of building the tertiary facilities was required as a condition of the secondary treatment waiver and therefore a sunk cost.

Page 7: Section 1.3. Item 7 simply states that the tertiary treatment costs are currently being paid by sewer customers but this will change. This is not tied to any rationale related to the obligation sewer has to this system.

Response: Recycled water will start paying for the tertiary treatment costs when the recycled water rate revenue exceeds the costs of paying of the O&M, debt payment costs related to the optimized system and the Water Departments investments in the system. This occurs in 14 years.

Page 8: Capacity fees require a nexus study. Please provide a copy of this. How does the \$3,047 compare with capacity fees charged other customers? What does the City consider one EDU to be (gallons)?

Response: The capacity fees are calculated in another study and based on 500 gpd of usage per EDU. The capacity fees are the same as for potable water.

Page 8: No. 7: This needs to be expanded to say that “all past investments to the potable water system” only include the non-grant and bond funded costs associated with the optimized system. All other costs are paid for by water customers.

Response: Ok. The premise of the study is to make the recycled water system self sustaining.

Page 8: No. 2: We disagree with the statement that all users should pay the same rate. All retail customers should pay the same retail rate and all wholesale customers should pay a wholesale rate. Wholesale customers should not be required to pay for any of the distribution system costs, O&M, capital costs, or debt service as they have put in their own distribution system and maintain it in the case of Poway and Otay. And, as PAs they are already paying for the costs of the optimized system as well as the costs to treat to tertiary. Thus it would seem that there are little costs that can be recovered from these two wholesale customers. We agree that OMWD should pay more as they are not PAs and thus do not share in Metro costs. But is \$25 enough?

Response: The existing agreements (except Poway) call for the same rates as those in the City – no differentiation between retail and wholesale customers. The \$25 per ac-ft was not evaluated in the study and is based on the agreement.

Page 8: Section 1.4.3. The study says the potable irrigation rate is \$3.107 as of January 2009.

Response: Table ES-1 reflects the rates on July 1, 2008. It was not updated for the January 2009 rate, which was \$3.107. This will be corrected.

Page 10: Table ES-1 States that the 2009 Potable irrigation rate is \$2.784. The same inconsistency is on pages 34 and 38.

Response: See above.

Page 10: No. 8: We agree with this statement except it needs to be expanded to make sure that “past investments” means only the debt service on the optimized system. Also, how was 2021 determined?

Response: Past investments include everything. 2021 is the end of the 14-year period from 2007 when the report was prepared.

Page 11: Section 1.4. **Rate stabilization reserve is not defined.** Item 11 states no target reserve level, only an annual funding level of 10% of revenue.

Response: Ten percent of commodity revenue is the target reserve level. We will define rate stabilization reserve in the final draft.

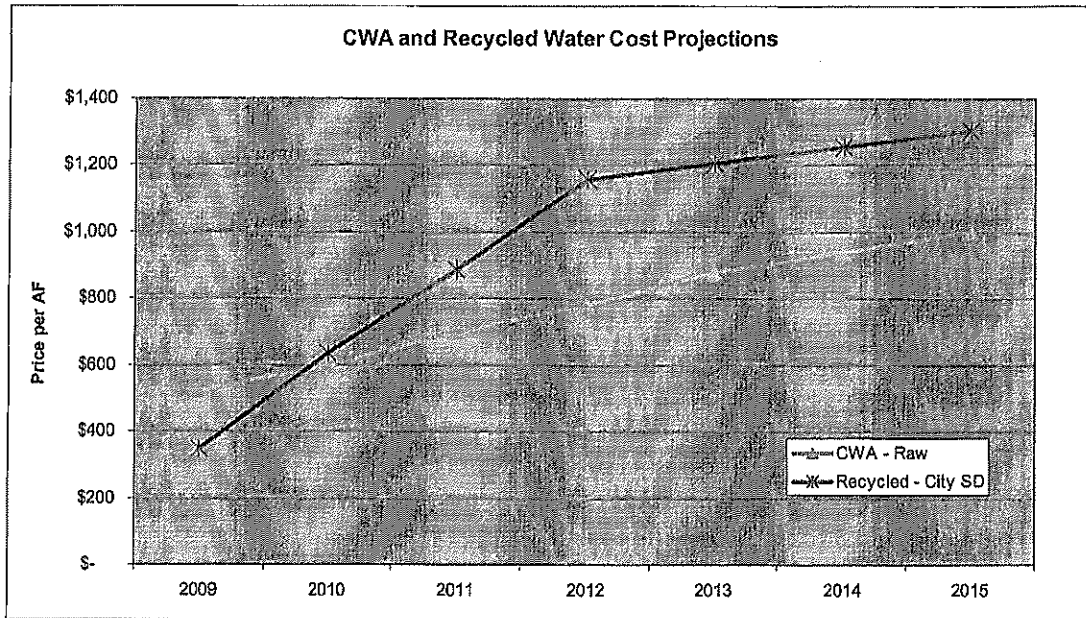
Page 15: Please note that the Optimized System debt service is being paid for by wastewater customers not water customers.

Response: The comment is not accurate, the Water Enterprise fund issued the bonds used for the optimized system, and is currently paying for debt service.

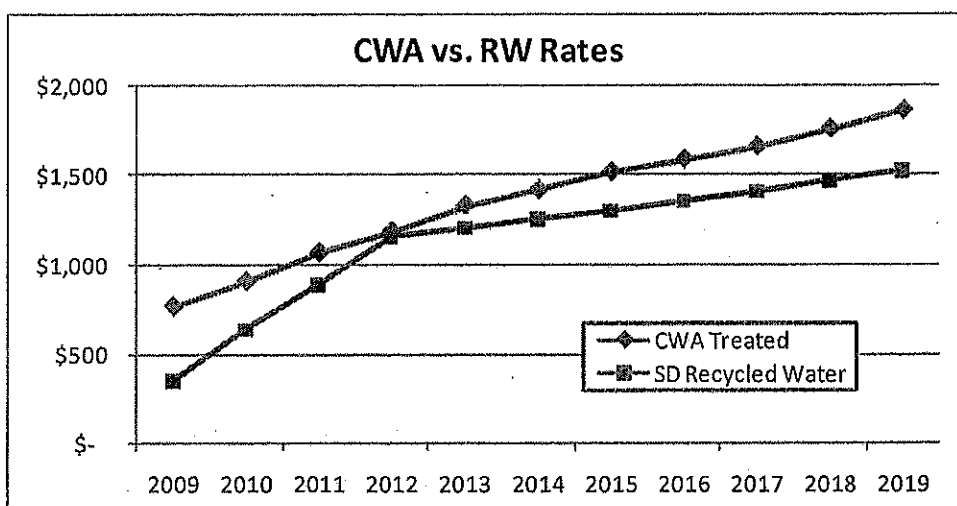
Page 16: While the cost sharing discussion appears to be correct, a discussion of the revenue sharing needs to be included in this section. Attachment B includes the revenue sharing requirements per the Regional Wastewater Disposal Agreement.

Response: Revenue sharing with Metro Wastewater begins after 14 years and will be included in report.

Page 17: Whose potable water rates are those? San Diego's or CWA untreated water. An alternative for wholesale recycled water customers is untreated CWA water. All of the wholesale customers have the ability to replace recycled water with untreated water. The following graph shows that, at the rates contained within the report, the wholesale customers would be smarter to switch to untreated water from a cost standpoint. An alternative the study should explore is pegging the recycled water rate to CWA untreated water.



Response: The potable rates are San Diego's irrigation rates. The alternative for wholesale recycled customers, with the exception of Olivenhain, is **not** untreated CWA water, but **treated** instead. The following graph shows the treated CWA water and the recommended recycled water rates at 75 percent of potable irrigation rates.



Page 18: Section 2.5.3. The Regional Wastewater Disposal Agreement needs to be included under the listed Agreements.

Response: Will include.

Page 18: Section 2.5.3. This study appears to be in violation of Prop. 218 first and second bullet points in regards to proposed charges to wholesale customers.

- Revenues derived from fees may not exceed the funds required to provide the service
- The amount of the fee may not exceed the proportional cost of the service attributable to the parcel upon which the fee is imposed

Response: Proposition 218 only applies to retail customers, not wholesale. Under the unitary system the rates do not exceed the cost to provide service.

Page 18: Section 2.5.3. Last paragraph states that it is not unreasonable for potable rates to support the recycled water system, conflicting with the full cost recovery concept this study repeatedly purports. We agree with consultant's statement especially in light of the benefits to the potable water customers of having an alternative water supply to imported water.

Response: The report states that it is not unreasonable for water rates to support the recycled water system in the **short run** and recover costs in the long run. Full cost recovery for a young system, like recycled water, would result in very high recycled water rates, which would not be practical to any customers. Thus, in the short term, potable water would support the system until it can become self sufficient.

Page 21: Section 3.1.1. Last sentence first paragraph should read as per the actual contract language:

" the distribution of the revenue from the sale of Reclaimed Water from the North City Water Reclamation Plant, including incentives for the sale of Reclaimed Water, shall be FIRST used to pay for the cost of the Reclaimed Water Distribution System, then the cost of the Operation and Maintenance of the Tertiary Component of the North City Water Reclamation

Plant that can be allocated to the production of Reclaimed Water, and then to the Metro System."

Response: Will include as appropriate.

Page 21: Section 3.1.1. What part of the pricing model shows the costs of tertiary? What amount is being used for the cost between secondary and tertiary?

Response: Treatment costs are shown in Table 3 in Attachment B of the report. However, since the study assumes MWWD will continue to pay for tertiary treatment costs until 2021, the cost was \$0 for recycled water system during the period shown in the table. Costs were given by City's staff and engineers familiar with the system.

Page 21: Section 3.1.2. What part of the pricing model shows the costs for Demineralization?

Response: Demineralization costs were given by City's engineers. Since recycled water would not bear this cost until 2021 and only when necessary, this was not included in the pricing model until 2021.

Page 21: Section 3.1.3. What parts of the distribution system(s) require pumping? Split costs between wholesale and retail customers. Are these pumping costs paid by water or MWWD?

Response: The pumping costs from the NC and SB plants are paid by MWWD. Additional pumping necessary to deliver recycled water to delivery points are paid by Water.

Page 21: Section 3.1.4. Please break these costs into the different categories discussed. Also they seem high for 400 customers. What are similar water costs per customer on the potable side?

Response: These were costs given by City staff in the format shown.

Page 21: Section 3.1.5. Please break these costs into the different categories discussed. Also they seem high for 400 customers. What are similar water costs per customer on the potable side?

Response: The recycled water system is a new system; thus costs would be higher than a mature system like the potable system. These costs would be better compared on a hot basis.

Page 23: Section 3.2.2. There is no stated rationale provided for the 14 year debt term. A 14 year debt payment is not consistent with the assets life cycle, creating a greater than necessary annual payment. A 30 year term is much more realistic. What is the policy on debt terms?

Response: Recycled water did not actually issue debt itself. The Water Department issued the \$37 million debt to help pay for the recycled water system. It was issued in 1999 for a 30-year term. The pricing model assumes recycled water would repay water department for the entire debt issue in the remaining years, which is 21 years in 2008.

The 14 years represent the time frame in which the water enterprise recovers its costs and after which Metro starts to recover operating costs for tertiary treatment from recycled water rates. It is assumed that the total capital costs contributed by water are recovered as debt payments in that time frame.

Page 25: Section 4.1. This is a common practice to treat water like water but it is not cost of service based.

Response: The City's base charges include costs of customer service, meter reading, etc and include a portion of the cost for providing capacity. It is reasonable to assume that the recycled water meters will bear similar costs as the pot bale water meter, a practice common in the industry.

Page 25: Section 4.2.1. The study acknowledges the payment of capacity fees by its wholesale customers, to compensate for the construction of production and distribution capacity, so why should the wholesale customers pay for additional capacity if they've already paid for it initially. Assuming the fee was set correctly in accordance to AB1600, the wholesale customers already paid for this cost, and the burden of new distribution should be paid for by the customers that benefit from the expanded distribution, not the customers that have already paid. Additionally, if the Metro PAs paid for the production facilities, the only cost that should be included in the calculation of the capacity fee paid by wholesale customers is the cost which benefits them. AB1600 requires that there is a nexus between cost and benefits. We would like to see the City's calculation of capacity fees for each of the wholesale customers to determine if the calculation meets the nexus requirement of AB1600.

Response: The capacity fee is paid for by new customers only. Existing customers who already paid the capacity fee do not need to pay for it again.

Page 26: Section 4.2.2. Which retail or wholesale customer water sales from the SBWRP are we receiving credits on? Total water sales?

Response: SBWRP receives CWA credits on all billable recycled water sales from SBWRP except to Otay.

Page 26: Section 4.2.1. "...the recycled water system should get credit for retail customers connecting to the recycled water system since they are releasing capacity in the potable water system...". This is a true statement but it also shows that the true beneficiary of the recycled system is the City's existing and future potable water customers. Thus the 14 year repayment to the potable water customers is not necessary.

Response: All recycled water customers benefit more from the recycled water system as it provides them with a cheaper and more reliable water source. The beneficiary is not just the City's existing and future potable water customers.

Page 26: Section 4.2.2. The study states that the credit agreements terms for the NCWRP and SBWRP plants will expire early if the cost of producing recycled water becomes lower than the cost of purchasing water from MWD. Is this really true? A review of the contracts is necessary to substantiate this statement.

Response: This is true. It would not make sense for MWD to continue to give credits for producing recycled water if the cost to produce it is lower than the cost of purchased water. The credits were meant to be incentive to encourage recycled water facilities.

Page 27: Table 4-1. Using 450 customers, the annual O&M per year is \$6,700 per customer. Isn't this a bit high? What are these same costs per customer on the City's potable side?

Response: The recycled water system is a new system, thus costs would be higher than a mature system like the potable system. Those costs would be better compared on \$/hof basis.

Page 29: Figure 5-2. Although I like the concept I do not think that figure is correct. The figure should show that the PAs share of say 35% of incentives come back as an offset to operating costs. What SD does with their part of the revenues and incentives is up to you.

Response: Figure 5-2 only shows the projections of operating costs. The credits are shown separately.

Page 29: The study shows energy cost projected to increase 8% a year for 24 years, through 2033. For the past 10 years the average increase is closer to 6.5%. How was the 8% determined? Also the energy costs shown here are for the distribution cost, which is a cost that should not be bore by the wholesale customers, as they have their own distribution system energy costs.

Response: Eight percent is a conservative estimate since in recent years, energy costs have increased significantly compared to previous years. Using a 10-year average would not reflect the recent spike in energy costs. Since the objective of the study is to treat the recycled system as an integrated system, costs were not separated between retail and wholesale customers.

Page 29: Figure 5-2 highlights how the O&M costs are placed into the rate setting but there is no justification for this significant change other than it is a choice to repay potable for their investment. There should be a cause and benefit analysis as to who should pay, but there is none provided.

Response: Under the market approach, recycled water rates are set to recover costs (including past investments by potable water). There is no reason for potable water to continue subsidizing recycled water especially under the current water situation.

Pages 32: Section 6.0. The study suggests that a simple, equitable rate should apply to all customers, and labels all recycled customers as irrigation customers, yet everywhere else in the study, customers such as Otay and Poway are labeled as wholesale customers. To justify the unitary method solely on the basis of a simple rate structure is fine for retail customers but not for wholesale customers.

Response: Since most users of recycled water, retail and wholesale, used recycled water for irrigation purposes, the term irrigation customers is used. The unitary method is chosen because the recycled water agreements imply a common rate for all users.

Pages 32 and 33: Section 6.1. The study identifies cost of service based rates which are lower than the recommended rates. Figure 6-1 shows the calculated cost of service which much lower than the recommended rate, set at 75% of the potable irrigation rate for retail customers in the outer years. How is this practical and meets the requirements of Proposition 218?

Response: The recycled water rates seek to reimburse the water enterprise contributions of prior years. The study also said that costs are estimates and should be revised and updated within a few years. The operating reserves would not be positive until 2021. At 75 percent of the potable irrigation rate, the recycled water system cannot payoff the water enterprise contributions in the first few years, as shown by Figure 7-1.

Page 32: Section 6.0. The City restates its desire to make recycled water financially self sufficient. This position is restated many times in this report and ignores that this was a

mandated system, a system that would never be built if it was to be financially self sufficient. That this system could ever have any expectation of self sufficiency is incorrect

Response: ~~To the extent possible, the recycled water system should become financially self sufficient.~~

Page 33: Section 6.2. The study recommends Market-Driven rates, but it fails to recognize the Market-Driven rates for its wholesale customers. What the study does not address is the Market-Driven rates for wholesale customers. The recommended recycled water rate in 2012 is \$2.66 or \$1,158.70 per acre foot. According to the latest projected rate of variable potable water cost from SDCWA for 2012 is \$1,050 per acre foot. This is 10.4% higher than the Market-Driven rate for this set of customers, not 75% less.

Response: The recommended recycled water rate in 2012 is \$2.66 per hcf, which is 75 percent of the City of San Diego's potable irrigation water rate, not SDCWA. The alternative for wholesale customers, with the exception of Olivenhain, is treated CWA water, which, according to the latest projected rate, for 2012 is \$2.72 per hcf. However, in 2013, the difference is greater: \$3.05/hcf for CWA water and \$2.88/hcf for recycled water. That is almost 10 percent lower.

Page 33: Figure 6-1. The recommended recycled water rates are higher (blue bars) than the cost of service rates starting in 2013. What are the actual numbers driving this table. There is a definite Prop 218 problem with the recommended rates. The repayment back to SD water customers could be pushed off a couple years and I am sure that the current rates would be closer to the 2013 rates and cost of service. The assets being financed by the water customers have a useful life of at least 40 years. Why is the payback not tied to the useful life of the distribution system versus the 14 years used in this study? What is magic about 14 years? Also this graph is a bit dangerous because it shows that starting in 2013 the revenues will be higher than the cost of service and the City could loose their MWD and CWA credits.

Response: See comments to Pages 32 and 33: Section 6.1. Credits from MWD and CWA are based on costs not revenues.

Page 34: Table 6-1. How are the recommended rates calculated? They are not 75% of the number show as irrigation. Whose irrigation rates are those? The City's? CWA's?

Response: The recommended rates are 75 percent of the City of San Diego potable irrigation water rates. The irrigation rates are escalated at 4 percent per year to account for rising costs and inflation of the potable water system.

Page 34: Last line, first full paragraph: What numbers are being used to calculate this?

Response: ~~Not sure what this refers to.~~ See Table 9 in Appendix – Operating Reserves.

Page 34: Last sentence: This alternative should be explored. I believe all wholesale customers have access to raw water. That is one reason that there should be a difference between wholesale and retail rates.

Response: According to our understanding, only Olivenhain has access to untreated CWA water, or raw water.

Pages 35 to 37: Section 7.1. The study states that as part of the revenue requirements the establishment of reserves for recycled water was outlined. Does the City follow a Counsel approved reserve policy?

Response: Yes

Page 36: Section 7.1.2. 20% of what number goes into the replacement reserve?

Response: Twenty percent of capital costs are set aside in the replacement reserve.

Page 35: Figure 7-1 shows the negative cash flow or shortfall in revenue but fails to explain that this is only created because the water customers are being reimbursed for a cost. Again this reimbursement seems counter to the benefit received. No study, process, definition, or quantification is provided to justify this action.

Response: Water customers subsidized recycled water customers in the past and are being reimbursed under the plan.

Page 37: Section 7.2. The report states that this pricing structure should help the potable water system. But again, restates that the money spent by the City's potable customers will be returned. The recycled customers end up paying the debt that benefited both potable and sewer customers.

Response: Potable water customers have been subsidizing recycled water system. If rates are implemented the potable water system will receive its due share of its past contributions.

Page 37: Section 7.2. **The study describes the impact on Potable Water.** It describes how recycled should repay the potable system, with interest, and how potable loses water sales revenues. What this section fails to address are the benefits of selling recycled water. One benefit is the cost is virtually zero to produce recycled water compared to purchasing potable water. Yes, potable sales are reduced, but so are the purchases of very expensive water compared to low cost recycled water. Another benefit to the potable system is that as the volume of purchases from SDCWA and MWD are reduced, overtime the fixed charges from these agencies will also be reduced. Finally, for each acre foot sold of recycled water (assuming the cumulative net cost of each system, SBWRP and NCWRP, are not positive) the City receives incentives of \$250 and \$200 from MWD and SDCWA. These credits recognize the expense of building and maintaining recycled systems.

Response: The potable water system is currently subsidizing recycled water after considering all these factors.

Page 37: First line: This sentence needs to be revised to tell who is actually supporting the recycled water system. It should read "The potable and wastewater customers, including the participating agencies, have been supporting the recycled water system since the program's inception....." Then the section needs to be expanded to show the split between potable water and wastewater customer's contributions. This concept needs to be used throughout the study including section 7.3.

Response: The wastewater system is a net beneficiary in avoided secondary treatment capital and operating costs as a result of the recycled water system.

Page A-1: Inflation and Cost Assumptions, No. 11. **The study states Distribution System costs are distributed between North City and South Bay based on the percentage of distribution**

system infrastructure in the respective service areas. Why doesn't the City use actual cost of these systems instead of an allocation method?

Response: The study states that the distribution system costs are based on **estimated delivery**, not on the percentage of distribution system infrastructure. This refers to the energy costs.

Page A-1: Inflation and Cost Assumptions, No. 12. The study states that no MWD reimbursements are received for South Bay. Why doesn't the City receive MWD credits for South Bay? Do they not qualify? What is MWD's reason for not allowing credits at SBWRP?

Response: To follow