WESTERN WATER COMPANY

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Western Water Company
Statement for the State Water Resources Control Board

Public Workshop on Water Transfers
May 4, 2000

The State Water Resources Control Board's (the Board) Public Workshop Regarding Water Transfers has been designated to receive:

1) *Comments and suggestions to assist the Board in updating the Guide to Water Transfers (the Guide) (format, analysis, methods to reduce time, other suggestions); and*
2) *Comments on any other aspect of the water transfer process, including proposals for the modification of statutorily imposed water transfer approval criteria.*

INTRODUCTION

Western Water Company (The Company) appreciates the opportunity to comment to the Board on the issues which the Company believes continue to limit the implementation of a well-regulated and vibrant water transfer market in the State of California. We hope this workshop provides a strong basis for much-needed reform in the way transfer requests are received, reviewed and acted upon by the Board. From our perspective as independent water wholesalers, the Board has a responsibility to clarify the legal and regulatory frameworks for decisions on such transfer requests to implement voluntary, willing seller/willing buyer water sales.

WATER TRANSFERS ARE CRITICAL TO CALIFORNIA'S WATER FUTURE

Given chronic imbalances between supply and demand of our most precious resource, policy makers at both the State and federal level have emphasized the need to foster a well-regulated water market to efficiently and fairly ameliorate the effects of these imbalances. While the promise of properly limited water transfers has been oft-stated, the reality falls far short of the promise. Some transfers do occur within the State: the Board notes in the Workshop notice that in the past 10 years the Board "has approved the transfer of over 1.7 million-acre feet of water" and "all but two of the over 110 water transfer requests it has received since 1982". However, these approved transfers have never represented market transactions between equally-well-informed but unrelated sellers and buyers. Rather, Board approvals underscore the limits on market transactions since, overwhelmingly, they represent short-term, bi-lateral, in-basin agreements among the "insiders" of California water policy. Transactions between and among export project contractors in the agricultural sector of California's economy are important, but they hardly represent the kind of efficient, regulated market that will be necessary to meet the needs of the State's widely dispersed water rights holders and consumers in the years ahead. Indeed, the transfers accomplished to date have been accommodated by the Board and by the other regulatory agencies precisely because they have not represented competitive market activity. Instead, they could be better

described as "professional courtesy" among the export agencies and their contractors who have come to dominate water law, lore, policy and facilities—often in direct contravention of statute and public policy.

Until the transfer process in the State better supports inter-sector and long-distance transfers, so as to accommodate market transactions between willing sellers and willing buyers, and to allow the freedom necessary for the market to determine fair prices, California will continue to be hampered by the mismatch between water demand and supply. Further, meeting the needs of a vibrant growing economy will continue to entail divisive, expensive, and environmentally destructive new water projects, costing water consumers billions of unnecessary dollars.

INSTITUTIONAL BARRIERS TO WATER MARKETING

The Company has found that aggressive opposition to voluntary transfers from the junior appropriators, including the California Department of Water Resources (DWR) and the United States Bureau of Reclamation (USBR), and the cost of managing the burdensome regulatory processes involved in transfers, have made development of viable water transfer transactions practically and economically impossible.

Willing seller/willing buyer market transfers continue to be difficult due to the;

- Cost, complexity and instability of the transfer regulatory process;
- Anti-competitive activities of governmental water exporters and wholesalers;
- Inefficient pricing of conveyance capacity for intermittent users;
- Changing statutes and expanding regulatory interpretations; and
- Intermittent attempts to subject water transfer rights to further regulation, other barriers and burdens.

Many stakeholders will have the opportunity to address the Board today with their general comments and specific concerns regarding the transfer process currently applied by the Board. The Company's comments focus on the main issues which we believe—based on the practical experience of professional practitioners--are restricting the growth of a true water market;

1. The continued violation of the basic precepts declared as State policy since at least 1986 (see the Wheeling Statute, Water Code Sections 1810-1814),
2. Lack of clarity in the rules governing water transfers, and
3. The serious conflict of interest inherent in the dual roles currently required of the DWR–that of state facility operator and junior water rights appropriator.

Our comments conclude with (i) some specific suggestions for improving the transfer process, (ii) how the *Guide* might be used, and (iii) on specific ways in which the Board can better support the existing state policy of facilitating, rather than hindering, water transfers in the state.

Barrier Pricing of Water Transfer Facilities

Based on the Company's experience and observation, there is pent-up demand among non-contractors—both water rights owners and retail water agencies—for the available capacity in the publicly owned water conveyance systems, including the State Water Project (SWP). As officially recognized by DWR, the periodic use of such capacity is critical to making transfers happen. However, practical access to the

SWP for the non-contractors is currently blocked by DWR's barrier pricing, while substantial capacity in this public facility goes unused every year.[1] While DWR did not intend its historical pricing approach to create an economic barrier, that has been the practical effect. This economic barrier has seriously retarded development of voluntary transfers between willing sellers and willing buyers in different hydrologic basins. So far, DWR has declined requests to establish rates for unused capacity that would allow this valuable public asset to be more fully utilized to address California's water supply needs. For as long as current barrier pricing persists, the water that is temporarily in surplus in Northern California will not be brought into the transfer market, confounding California's already difficult water supply situation.

Western Water Company has made formal requests for implementation of a system of tariffs for the use of available capacity on an occasional basis by non-contractors. In addition, the Company has proposed *either* to purchase from DWR long-term, firm capacity *or* to purchase occasionally available capacity when it would otherwise be wasted. In either case, we have been prepared to pay fair compensation for the use granted. However, we resist paying the same price as for firm capacity when all we can obtain is interruptible service. Customers should not be forced to pay a second time for fixed capacity when, under current DWR policy, transferors are granted only the use of capacity left over when all other users are satisfied.

Adopting a more rational system of charges for occasionally available capacity in the SWP would:

- Insure more efficient use of the SWP;
- Comply with existing State law requiring marginal cost pricing of available capacity;
- Help to allow market forces to redress the chronic imbalance between water supply and demand in California;
- Differentiate appropriately between long-term fixed capacity and occasionally available—and otherwise wasted—capacity within the existing infrastructure;
- End the current misuse of the SWP access and pricing restrictions to preserve the Metropolitan Water District's inefficient monopoly rates;
- Reduce costs and improve choices for Southern California water consumers; and
- Foster a fair, market-based incentive to water conservation by eliminating the SWP as a market barrier to voluntary transfers.

Potential buyers, currently limited in their options by restricted access to conveyance largely as a result of pricing policies, seek the advantages of a more competitive market for water resources. These potential customers seek market choices in terms of quality of delivered supplies, flexibility in the terms under which water is made available, and enforceable contracts with third parties relating to these types of choices. These choices—available in a free market—are not available in the current environment dominated by massive water wholesalers with control over publicly funded conveyance systems.[2]

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[1] While the SWP is constrained at certain "choke points" at certain times (notably at the Banks Pumping Plant where Delta management practices often limit the system's capacity), the system has significant unused capacity in many reaches and at various times throughout the year. In fact, the SWP was designed to convey up to four million acre feet of water per year. Due to the decision not to complete the Peripheral Canal, most of the south-of-Delta reaches of the SWP have substantial available capacity, at certain times, in most years.

[2] A thorough discussion of this issue along with specific suggestions for a more equitable SWP wheeling rate for occasional transfers by non-contractors, is set out in the Company's letter to DWR Director Hannigan dated May 18, 1999. That letter is included as an attachment to this testimony.

Anti-Competitive Market Allocation under the Monterey Agreement

For a true water transfer market to operate, competitive conditions must be in place which allow for a level playing field for all entrants to that market. Such a level playing field does not currently exist in California due, in part, to the non-competitive elements of the so-called Monterey Agreement between the DWR and it's SWP contractors.

Under the terms of the Monterey Agreement, the state water contractors allocated territorial exclusivity to themselves, a direct violation of state and federal anti-trust acts. Under the Monterey Agreement—to which they are non-parties—non-contractors must seek permission from the controlling contractor to bring water into the service area—effectively shutting out viable competitors in those market areas. Inherently anti-competitive, the Monterey Agreement further solidifies the "insider only" use of the SWP, and denies the public the kind of choices it needs in terms of price, reliability, enforceability and quality of water delivery.

Conflicts of Interest between Operator and Appropriator Roles of the Agencies

One of the most significant roadblocks to a true water transfer market in California has been the conflicting actions by the project operators acting as both junior appropriators and as operators of the State's most critical public water delivery systems. The conflict and the implication of this control is captured in the famous observation by a former DWR director that the balance of power between senior water rights holders and the junior exporters could be summed up as follows: "we've got 'em by the Aqueduct."

Possible Legislative Solutions

To put limits on this inherently conflicted position, the Company supports Senator Perata's SB 1973 which promotes fairness to water consumers by allowing a neutral and knowledgeable arbitrator, the California Public Utilities Commission, to review the wheeling rates for access to available capacity in the public's water conveyance systems. Passage of the wheeling clarifications included in SB 506 sponsored by Senator Peace, and Senator Johnson's SB 521, providing for equal access to the SWP by both the Metropolitan Water District of Southern California and its customers who pay for the system, would move the State toward the kind of voluntary, willing seller/willing buyer environment so often touted as critical to the future of California water.

PRACTICAL SUGGESTIONS FOR IMPROVING THE TRANSFER APPROVAL PROCESS

Allowing Multiple Points of Use in a Transfer Petition

Traditionally, the Board staff required that a specific end-user be identified at the time of Transfer Petition filing. A better, more "market friendly " approach would be to allow specification of several potential end users, allowing for a *range* of potential users who share common characteristics. By qualifying a range of potential end users – rather than specifying a single user at the beginning of an open-ended transfer process – the petitioners would gain the benefits of a truly competitive market for the water included in the petition.

By allowing a Petition to specify several potential places of use, the Board would increase the practicality of market-based transfers. The Petition review would properly focus on the factors that support the transfer including, (i) the validity of the underlying water right, (ii) the impacts of a transfer on the area of origin, (iii) the potential for injury to the environment or to other legal water rights, and (iv) appropriate limits on season of use, temporary storage and downstream diversion. In such a scenario, the proposed potential points of diversion and all potential end users would need to exhibit characteristics that allow practical analysis of the environmental effects of the proposed transfer. However, at the conclusion of such a process, the petitioner would have water "certified for transfer" under conditions approved by the Board. Then the petitioner could market the water among the set of approved end users—generically identified, for instance, as users able to take delivery from the SWP. Once a specific negotiated transaction is completed, the ultimate place of use could be specifically identified to the Board, but this later filing would only be reviewed to assure no adverse impacts on the environment—not to reopen the issues supporting transferability.

End the Distinction Between Conserved Water and Water Available for Transfer

Based on different wording in different sections of the Water Code, Board staff and DWR staff have created an artificial distinction between control and dominion over conserved water, on one hand, and the right to transfer such water to another end user, on the other hand. This distinction was never intended and is not supported by the Water Code. The Board should clearly and explicitly articulate that conserved water is available for transfer under conditions that create no injury to the environment or other legal users of water.

In a misreading of the Water Code, various staff members have advanced the theory that a Sacramento Valley farmer, for instance, can take actions that reduce water consumption and increase efficiency of irrigation application. Under Water Code Section 1011, they admit, such conservation constitutes a beneficial use so that the underlying water right is not diminished through abandonment. The clear statutory purpose, they acknowledge, is to encourage such conservation efforts. However, proving the conservation is not enough under staff theory. Staff analysis grants only that conserved water is available to the underlying water right holder for use *on his own farm*. Under staff's analysis, the farmer who conserves has no right to transfer the water to another downstream user—unless that transfer right is found in another section of the Code. As a practical matter, this convoluted analysis benefits only the exporters and their contractors; that is, if the water is conserved but not eligible to be transferred, it stays in the system and is available to the junior appropriators—DWR and USBR—for export free of charge.

The Board should insist that a water rights holder that accomplishes water conservation under Water Code Section 1011 has the inherent right to exercise control over such water and to transfer it for value to another end user—subject only to conformance with the "no injury" rules.

Establish the Burden of Proof for Injury

The Board should end the abuse of vague "no injury rules" by implementing clear standards for claiming and proving injury. The Board should provide elemental due process for transfer proponents by requiring that objectors show standing and meet an initial burden of proof of a prospective or claimed injury.

Currently, the 'no injury" rules are unclear and subject to such varied interpretation that they represent a "chilling effect" on all potential water transfers. Literally anyone can posit a potential environmental or third-party impact of a proposed transfer and either block the transfer or make it too expensive to

complete. Thus, as a practical matter, the only transfers that get done are the "barter" transfers among neighbors and friends. Members of the traditional water community accommodate each other, but outsiders are challenged ferociously, often without substantive objection.

Use the Internet to Speed the Application and Review Process

The Board should make full use of the Internet to facilitate the rapid exchange of information supporting transfer applications and objections. Internet posting and e-mail delivery should, in most instances, replace cumbersome and time-consuming mailings and published notices. The Board should also transfer to electronic media the water rights information now captured only on paper and available only to those able to afford a Sacramento presence.

Format and Use of the *Guide*

The current iteration of the *Guide* provides useful insight into the thinking of the Board staff with regard to transfer issues. The *Guide* has also served to focus the attention of those entities attempting to accomplish transfers on the array of issues which require additional clarity and formal designation from the Board. To those ends, the *Guide* has been very useful. The Board is also to be credited for using best available technology in making the *Guide* available on the Board's internet site with internal links and cross-referencing. The *Guide* has been easy to obtain and easy to use. However, the *Guide* in its current draft also underscores what a Byzantine process has developed around water transfers. One need only look at the illustration of the "water transfer decision tree" to understand that this process desperately needs reform.

***Guide* Should be Streamlined to Reflect Real Facilitation of Transfers and Given Full Weight of Board Review and Approval**

In the most fundamental way, the current *Guide* vividly illustrates why true market transfers do not occur in California. The shear complexity of the current water transfer process, as outlined in the *Guide*, is enough to stop most potential transfers from even being proposed. The outlined process seems designed to assure statutory protection to the point of paralysis and heavily favors the exporters and junior appropriators as to devalue otherwise valuable senior water rights.

While the Foreword of the document states that "this document will not be considered binding or presumptively correct," we are, nonetheless, concerned that the document addresses several areas of undecided Board policy with regard to interpretation of water transfer issues. Nonetheless, because the *Guide* represents the latest and most comprehensive staff analysis of the issues involved with transfers, these positions are likely to be brought forward into the evidentiary hearings process as staff opinion, and from there begin to impact, if not directly influence, policy decisions at the Board level. This clarifies some parts of the process, which is useful, but also hardens and gives weight to staff opinion which, in some cases, deals directly with much-debated issues which by right should be decided by the Board itself.

Notwithstanding our concerns with the *Guide* as currently written, the Company would prefer that the water transfer rules eventually finalized in the *Guide* be regulatory in nature so that water transfer decisions can be made quickly at the staff level thereby avoiding the costly and time consuming hearing process.

Given the state of disagreement among the stakeholders involved with all aspects of water transfers in California, the issues described and discussed within the *Guide* deserve the attention of, and deliberation by, the full Board. Therefore, we recommend that the Board take the information, comments, concerns, and opinions produced through this Workshop and provide the necessary forum for debate and, ultimately, the discharge of the Board's leadership role, by turning the *Guide* into regulation. Until then, what was developed with good intentions by Board staff will potentially carry the undue weight of a *defacto* Board decision, a result which would not fully comport with current state water policy or laws.

SUGGESTED BOARD ACTIONS

While there are many impediments to the opening up of a true water market in California, the Board has the opportunity to institute changes which would make significant progress toward that end. Clearly, by the publication of this *Guide*, the Board has the opportunity to clarify the rules of water transfer. In doing so, the Board must also discharge its responsibility, under state law, to foster transfers—a role which is not fostered by the complex and burdensome process discussed in the *Guide*. In revising the *Guide*, the Board should improve the process for investigating and mitigating "injury" to other water users. Finally, we understand that the Board is the proper and final forum where water rights should and must be decided. The material conflict of interest within the State Department of Water Resources between its role as a junior exporter/project operator and its role as a regulator has stymied alternative development of water transfers and must be rectified.

Attachments: Western Water Company's Correspondence to Director Hannigan (5/18/99)

WESTERN WATER COMPANY

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Michael Patrick George
President and Chief Executive Officer

May 18, 1999

The Honorable Thomas M. Hannigan
Director
California Department of Water Resources
1416 9th Street, Room 1115-1
Sacramento, CA 95814-5515

Dear Director Hannigan:

My colleagues and I appreciated the chance to visit with Don Long and other members of your staff on April 20 to discuss conditions and charges for use of available capacity in the State Water Project ("SWP"). Pursuant to our discussion, this letter is to formally **request that the Department of Water Resources ("DWR") establish a new table of rates for all the reaches of the SWP for use by non-contractors of available capacity in the SWP**. Attached is an outline of Western Water Company's analysis of the policy, legislative, economic and competitive issues that should guide DWR's development of such rates. In the attachment we also address the two theoretical arguments against creating this new rate table.

Adopting a more rational system of charges for occasionally available capacity in the SWP will:

- Insure more efficient use of the SWP;
- Comply with existing State law requiring marginal cost pricing of available capacity;
- Help to allow market forces to redress the chronic imbalance between water supply and demand in California;
- Differentiate appropriately between long-term fixed capacity and occasionally available—and otherwise wasted—capacity within the existing infrastructure;
- End the current misuse of the SWP access and pricing restrictions to preserve the Metropolitan Water District's inefficient monopoly rates;
- Reduce costs and improve choices for Southern California water consumers; and
- Foster a fair, market-based incentive to water conservation by eliminating the SWP as a market barrier to voluntary transfers.

As more fully explained in the attachment, DWR's refusal to revise its system of charges as required by law would continue to thwart State policy favoring water transfers and will preserve its anti-competitive "barrier" price, thus insuring that available capacity will continue to be wasted. It is time to provide non-contractors with practical and economical access to the SWP, for the benefit of all California. Western Water Company is prepared *either* to purchase from

DWR long-term firm capacity *or* to purchase occasionally available capacity when it would otherwise be wasted. In either case, we are prepared to pay fair compensation for the use granted. However, our customers should not be forced to pay a second time for fixed capacity when, under current law, transferors are granted only the use of capacity left over when all other users are satisfied.

We look forward to working with DWR—as well as other appropriate stakeholders—in developing an equitable system of charges for otherwise wasted excess capacity in the SWP. I look forward to discussing with you soon how Western Water Company can cooperate with DWR to develop an appropriate and defensible methodology for establishing such rates.

Sincerely,

cc: The Honorable Gray Davis
The Honorable Mary Nichols
Mr. Donald R. Long

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Attachment to Letter of May 18, 1999 to DWR Requesting an Equitable System of Charges for Use of Available Capacity in the SWP

Stipulation to Conditions for Use

For purposes of requesting a revised system of rates for use of available capacity in the SWP, Western Water Company will stipulate to the general conditions for use of such capacity that have been developed in law, regulation or policy over the years:

- Non-Project water;
- Authorized for transfer through proceedings of the State Water Resources Control Board ("SWRCB") (unless the water originates from a pre-1914 right outside of SWRCB jurisdiction). Ordinarily such proceedings would resolve issues related to nature of the water right, claimed third-party injuries, environmental impacts, and area of origin and area of use impacts;
- Water meets DWR quality standards for introduction into the SWP;
- Transfer meets applicable California Environmental Quality Act requirements;
- No interference with contract deliveries or with DWR maintenance or emergency operating procedures; and
- Eligible only for use of capacity in the SWP when, as and if, DWR determines that such capacity is available.

Policy Background

Western Water Company seeks an on-the-record revision and clarification of SWP rates for non-contractors' use of available capacity to facilitate market-based, willing seller/willing buyer transfers. (As DWR has been notified, we are involved with a Petition before the SWRCB for a 1999 transfer of conserved water from the Natomas Central Mutual Water Company. The Petition was filed with SWRCB on April 26, 1999[3]. This transfer could serve as a vehicle for consideration of the appropriate charges for use of potentially available system capacity during 1999.)

It is and has been for some time the clearly stated policy of the State to encourage and facilitate such transfers as a means for market-based allocation of scarce and valuable water resources.[4] Indeed, water transfers are among the eight interconnected pieces to the policy development

[3] The Petition has not yet been assigned an identification number.
[4] California Water Code sections 109, 475, 1813; West's California Codes (Annotated), Notes re: Stats. 1986 ch. 918, preceding Water Code sec. 1810 et seq.

puzzle in the on-going CALFED process.[5] The need for water transfers has also been reflected in adopted policies of both federal[6] and regional[7] water agencies. DWR's former Director David Kennedy put the case effectively almost two years ago:

> Water transfers have an important part to play in water supply and reliability in California as California's population continues to grow, and competition for dependable water supplies increases. As cost and regulatory constraints limit opportunities for developing significant additional water supplies through "traditional" means, such as new reservoirs, water transfers contribute to meeting the State's demand for water. Water transfers also offer an opportunity for a shift toward "market-based" allocation of water which could encourage more efficient use of water.[8]

Western Water Company believes that it is now incumbent upon DWR to put these policies into practical effect by adopting reasonable charges for the use of available capacity in the SWP. For, as former Director Kennedy also stated, the SWP is "vital to water transfers in the State because of [its] large capacities for transporting water."[9]

There is pent-up demand among non-contractors, both buyers and sellers, for the available capacity in the SWP**. Practical access to the SWP for these non-contractors is currently blocked by DWR's barrier pricing, while substantial capacity in this public facility goes unused every year.** [10] While DWR may not have intended its historical pricing approach to create an economic barrier, that has been the practical effect. It is time to recognize that fact and establish rates for unused capacity that allow this valuable public asset to be more fully utilized to address California's water supply needs.

Those who would be sellers—including Western Water Company—must have economic access to conveyance to obtain a fair market price for their water rather than an artificial price set by a monopolist that happens to control public conveyance facilities. For as long as artificial pricing persists, the water simply will not be brought to market, confounding California's already difficult water supply situation. This is particularly indefensible as California struggles to gain agreement on a workable 4.4 Plan for reducing demands on the Colorado River.

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[5] *CALFED Bay-Delta Program, Revised Phase II Report,* December 18, 1998, pp. 71-76*; CALFED Bay-Delta Program, Water Transfer Program Plan Report,* February 1999.

[6] *Section 3405(a) of Central Valley Project Improvement Act, Section 3405 (a),* Title 34 of Pub. L. No. 102-575, 106 Stat. 4600, 1992.

[7] *Water Transfer Policy Statement,* Metropolitan Water District of Southern California (not dated) and *Water Transfer Policy,* Glenn-Colusa Irrigation District, adopted February 16, 1995.

[8] Declaration of David N. Kennedy before the Superior Court of the State of California for the County of Los Angeles, Case No. BC 164076, August 19, 1997 at 3 (paragraph 6).

[9] Ibid. at 2 (paragraph 2).

[10] While the SWP is constrained at certain "choke points" at certain times (notably at the Banks Pumping Plant where Delta management practices often limit the system's capacity), the system has significant unused capacity in many reaches and at various times throughout the year. In fact, the SWP was designed to convey up to four million acre feet of water per year. Due to the decision not to complete the Peripheral Canal, most of the south-of-Delta reaches of the SWP have substantial available capacity in most years.

Potential buyers, currently limited in their options by restricted access to conveyance largely as a result of pricing policies, seek the advantages of a more competitive market for water resources. These potential customers seek market choices in terms of:

- costs for both water as a commodity and the ancillary services available with water,
- reliability of deliveries through cycles of wet and dry,
- quality of delivered supplies,
- flexibility in the terms under which water is made available, and
- enforceable contracts with third parties relating to these types of choices.

These choices—available in a free market—are not available in the current environment dominated by massive water wholesalers with control over publicly funded conveyance systems.

As DWR has indicated, there is an identified and growing demand for water in California and in the SWP service area that cannot be met from visible "traditional" supply sources.[11] Therefore, we believe that DWR must quickly develop revised procedures and charges for more efficient utilization of available capacity in the SWP and for more efficiently managing scarce water supplies.

In this policy context, Western Water Company requests that DWR develop and publish a revised table of rates, by reach, for use of occasionally available capacity in the SWP to facilitate non-contractors' bona fide water transfers, thereby facilitating State policy on water transfers. We recognize that the request proposes that DWR depart from its historic ratemaking procedures. The current procedures provide only two rates that work in practice: one for fixed capacity charges to contractors to move project water under long-term contracts[12]and a second for priority use of available capacity to those same contractors for handling non-project water[13]. Applying the average price charges applicable to fixed capacity acts as a barrier to non-contractor use.[14] DWR—and the State of California—needs a new, third table of charges that enables a third category of use by non-contractors of occasionally and temporarily unused capacity in the SWP to facilitate market-based water transfers.

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[11] *California Water Plan Update Bulletin 160-98*, Department of Water Resources, November, 1998, ES1-2.

[12] *State Water Project Non-Contractor Use of Facilities, Table 2 – Estimated Wheeling Rate in $/AF (Modified)* which pegs the cost of conveying water the length of the SWP at $404.37/AF plus net power charges. Attached. See also, DWR *Bulletin 132-98*.

[13] *Draft Program Environmental Impact*, Implementation of the Monterey Agreement, Statement of Principles by the State Water Contractors, May 1995, Principle 8, pp 1-7. We estimate the cost to a Contractor at approximately $65.65/AF (a power charge of $227.45 offset by a power recovery credit of $161.80).

[14] Applying currently available rates and charges would theoretically produces an "all-in" conveyance charge from the Delta to a customer in San Diego of $837.02 per acre foot as follows:

- SWP use of available capacity: $404.37
- Net power cost in SWP: 65.65
- MWD postage stamp system charge: 262.00
- SDCWA system charge: 85.00

In addition, treatment charges within the MWD are now $82/AF. Adding even a modest amount for the resource cost of water would take the delivered price to more than $1,000 per acre foot in San Diego, with roughly 85% of that delivered cost accounted for by artificially high conveyance costs.

Legal Background

Western Water Company's request for a new table of rates for occasional use of otherwise unused SWP capacity is firmly grounded in current law. Under Water Code Section 480, DWR is directed to "establish an ongoing program to facilitate the voluntary exchange or transfer of water…." **Water Code Section 1810 further states that, "neither the state, nor any regional or local public agency may deny a bona fide transferor of water the use of a water conveyance facility which has unused capacity, for the period of time for which that capacity is available, if fair compensation is paid for that use…."** (As noted earlier, in making its request for a third table of charges for use of available capacity in the SWP, Western Water Company stipulates to the further conditions for use under Section 1810.)

Western Water Company appreciates that there have been alternative interpretations of "fair compensation" as used in Section 1810. We strongly assert, however, that "fair compensation" does and must reflect the nature of *occasional use of available capacity* versus the contract priority of consistent, long-term use enjoyed by the contractors. The difference in the reliability of system capacity between long-term and occasional use must be reflected in establishing "fair compensation" under Section 1810. **Western Water Company would be a buyer of either "firm" or "as-available" capacity in the SWP, but our customers cannot be forced to pay for firm capacity (including a proportional share of arbitrarily allocated capital costs for each reach) when we are accorded only available capacity.** More importantly, the statute does not permit DWR to ignore this crucial difference in the nature of the service in determining "fair compensation."

Ironically, DWR itself has taken deft advantage of the differential between on-peak and off-peak power rates to dramatically reduce SWP power costs. It is inconsistent with DWR's own practices in the deregulated energy market to stubbornly insist in the water market that an occasional user of otherwise wasted capacity in the SWP should pay a fully-allocated average cost comparable to the "on-peak" firm capacity price paid by the contractors.

Of course, the most complete, recent and thorough examination of the application of the "fair compensation" requirement for setting charges for occasional use of available capacity in a water system was rendered in the case brought by the Metropolitan Water District of Southern California ("MWD") to validate its rates for such use of its system.[15] Pertinently, the Superior Court there interpreted Section 1810 to require identification of and charge for *only* those parts of the system used in a particular transfer. From that perspective, DWR's reach-by-reach approach to establishing charges for use of the SWP for specific transfers seems more in line with legal requirements than MWD's "postage stamp" rate that was held by the Court to be invalid.

[15] *The Metropolitan Water District of Southern California vs. All Persons Interested in the Matter,* Superior Court of the State of California for the County of Los Angeles, Case No. BC 164076, Tentative Decision filed by the Honorable Laurence D. Kay on January 12, 1998.

As to the amount of the charge that may be levied as "fair compensation" for the use of available capacity under Section 1810, the Court held that, "an owner of facilities is entitled to fair compensation for the increased costs necessitated by a transferor's use of its facilities *and nothing more*."[16] Under the statute, DWR cannot collect from an occasional user of available capacity the same charge levied for permanent capacity guaranteed by contract to a long-term user. Thus, Western Water Company believes that its request for a third table of charges for such available capacity is fully supported, indeed required, by statute as recently interpreted by a fully briefed court.

Economic Underpinnings

Western Water Company's request for a third table of rates for use of available capacity in the SWP is also supported by sound economic theory**. In fact, the best reason for DWR to revise its rates for available capacity is that charging the occasional user the same rate as for fixed, long-term capacity has acted as an economic barrier to use of capacity in the system, thus thwarting the public policy of facilitating voluntary water transfers**.[17]

DWR has long used an average cost approach to establishing its rates for use of capacity in the SWP. This approach, while having the benefit of simplicity, does not produce an economically desirable outcome. From both a practical as well as a theoretical basis, DWR's historical approach leads to sub-optimal results.

From a practical perspective, in determining the proper rate to charge for access to otherwise idle capacity in the SWP, DWR must take into account the nature of the economic good it is required to fairly price. Excess capacity is a "wasting asset" that cannot be stored or used later. By definition, excess capacity must be used when it is available or lost without value forever. A good analogy is a seat on an airplane about to take off: for every empty seat on the plane, the airline loses the revenue potential of that unused capacity regardless of how much it fairly charges each of the passengers actually accommodated on the flight. No one benefits from the current waste of excess capacity in the SWP when it goes unused[18], and DWR loses the revenue it could have charged for that unused capacity forever. While DWR has viewed its task as simply recovering system costs, it has ignored the opportunity to maximize both its revenues and the benefit to the State of more efficient use of existing facilities. It is the institutional unwillingness to allow full utilization of existing capacity that, in part, drives the insatiable demand for more and larger water projects. Such projects, in turn, increase consumer costs and have significant environmental consequences.

Further, too high a rate for available capacity clearly erects an economic barrier to non-contractors' access to the SWP. A private non-contractor simply cannot economically pay the contractors' cost for long-term, fixed capacity when being accorded only the lower-priority

[16] Ibid at 8, emphasis added.
[17] See note 12, above.
[18] Except MWD which uses the artificial constraints on use of this excess SWP capacity to protect its uneconomic, invalid and unsustainable system of rates and charges. See note 17 and 18, below.

"available" capacity, after all the contractors' demands on the system have been satisfied. This is precisely the barrier that Section 1810 sought to eliminate. The effect of this price barrier, imposed by DWR's historic average cost approach to establishing rates, is twofold: (i) the waste of the available capacity in the SWP when, from time-to-time and reach-by-reach, it has been available in the past, and (ii) the lost opportunity to generate marginal revenue. (The occasional historic use by some non-contractor public agencies in the northern part of the State masks the practical effect of the price barrier since (i) public agencies simply pass on the uneconomic price to their ratepayers and (ii) they use only a small portion of the SWP system, so the inefficiencies are only a minor portion of their overall costs.)

DWR must consider optimization of use, allocation and revenue in developing a new rate table for non-contractors' use of available capacity in the SWP.

DWR's average cost approach produces predictably poor results. The benefits of marginal cost pricing are well documented throughout economic literature and practice, and departures are known to produce sub-optimal results. Marginal cost pricing produces the most efficient results both in the provision of goods and services and in their consumption.[19] DWR's average cost approach does not send the appropriate price signal, and relying solely on average cost pricing guarantees that excess capacity in its facilities will not be used in an economically efficient manner. In the case of a declining cost industry (including most capital intensive utility industries), where true marginal cost pricing may fail to produce adequate total revenue, there is a large body of economic experience to guide the selection of a second-best approach.[20]

It should be noted that Water Code Section 1810 explicitly recognizes the value of marginal cost pricing in leading to more efficient use of public water conveyance facilities by mandating that pricing approach for unused capacity. A departure from this approach to embrace average cost pricing is therefore not only economically unsound, but also in direct conflict with existing State law.

Competitive Considerations

The current table of rates, as applied to non-contractors for use of available capacity, is discriminatory and consistently benefits only a single State contractor, not its customers, and certainly not the people of California.

MWD has used its preferred access to the SWP to intimidate and control would-be competitors, including Western Water Company. Claiming the rights accorded it under the Monterey Amendments to the State Water Contract ("Monterey I"), MWD effectively limits competitors from providing choice to its captive sub-wholesalers and to the retailers and consumers they are chartered to serve. The competitive shield works as follows:

[19] *Microeconomics.* Pindyck, Robert S. & Rubinfeld, Daniel F., Prentice Hall, 1995, pp. 240-241.
[20] *Optimal Departures From Marginal Cost Pricing.* Baumol, W.J. and Bradford, D.F., American Economic Review 60, June, 1970, pp. 265-83. See also, *The Economics of Access Pricing*, Armstrong, M. and Doyle, C., Organisation for Economic Cooperation and Development (Paris, France), ch. 3, para. 2.

- MWD points to DWR's average cost pricing tables as the cost of SWP access for a non-contractor to convey water into the MWD service territory;
- MWD points to its contract right to move non-project water through the SWP at the lower melded cost rate available to it as a contractor;
- MWD offers to "exchange" water using its lower rate, but only upon acceptance of its invalidated $262/AF system charge for use of MWD facilities;
- Finally, MWD points out that a would-be competitor cannot "shop" among the other contractors for a more reasonable subvention of the contractor rate, because another provision of Monterey I prevents another contractor from wheeling water into the MWD service territory.[21]

Thus, MWD uses the existing DWR rates and contract protections to insulate itself from competition and to unilaterally prevent its customers from accessing the benefits of choice in arranging their resource supplies.

While the contractors as a class have negotiated the exclusive opportunity under Monterey I to gain access to available capacity at a deep discount, its practical benefit belongs to MWD alone. Only MWD has conceived and carried out a rate making approach that both increases costs to ultimate consumers and insulates its service territory from the discipline of competitive access. However, its contractor advantage—both in terms of access and price—in the use of available capacity in the SWP creates a formidable competitive shield for MWD. It enjoys both territorial allocation of the market and price protection from new entrants. MWD's resulting cost structure is the predictable but unsustainable result. In the private market, acquiring such protection for massive cost overruns and cost shifting would bring swift redress under the anti-trust laws. MWD acts with disregard of the anti-trust laws only out of an isolated and misplaced sense of immunity under the government action exemption from prosecution.

In the United States, we tolerate monopolies only when and to the extent necessary to serve the public convenience and necessity. In water, as with other utilities, we recognize the folly of redundant conveyance and distribution facilities. However, there is no exemption for public agencies to set rates and charges to serve their own institutional purposes, particularly when those interests are clearly outweighed by the interests of the very consumers these agencies are chartered to serve. DWR can no longer ignore these practical anti-competitive impacts of its intricate system of exclusivity and preferential rates in contravention of State law.

[21] The foregoing is not a theoretical model. Rather, this is precisely the barrier faced by Western Water Company in negotiating facilitation by MWD of a willing seller/willing buyer water sale to the Santa Margarita Water District (which transfer was completed in December, 1998).

The Myths of Sales Displacement and Free Riders

Routinely, those fighting to preserve the current discriminatory pricing regimes embedded in DWR's rate schedules advance two arguments:

- Competitors entering the protected market will displace sales required by the existing monopoly water provider to service its long-term debt; and
- It is inherently unfair for a new market entrant to gain access to conveyance or other water management infrastructure at a cost lower than the incumbent that has borne the cost of creating the facilities in the first place.

Neither of these positions is sustainable.

No Displaced Sales

It is true that a new entrant may acquire customer orders that would otherwise go to the entrenched provider (in addition to gaining orders to satisfy growth in demand). However, in the water market we deal with a commodity in long-term deficit of supply versus demand. This long-term deficit is estimated by DWR at 1.6 million AF in average water years (based on a 1995 base year) and 5.1 million AF in drought years. Even if every identified water development, management and conservation project currently under consideration were to be completed (a highly improbable, and perhaps undesirable, assumption), DWR forecasts that, by 2020, the State would still face an overall deficit in both average and dry years.[22] Therefore any displaced sale is actually more likely to bring the supply/demand equation into closer balance than to result in lost service demand on the existing provider.

In addition, where, as here, the State (and MWD) face incremental water demands beyond its identified resources, avoiding the higher cost of marginal supplies is a greater benefit than the deferral (or even loss) of incremental sales is a detriment. That is, shedding marginal load represents a net cost savings, even when deferred or lost sales are factored in.[23]

To apply this argument, let's look at MWD. MWD (as well as its customers and the environment) actually benefits from new market entrants bringing existing water resources into its service area through effective transfers. MWD avoids the expense of finding and delivering marginal supply from other sources. As MWD itself has demonstrated in its demand for federal intervention to reallocate supply on the Colorado River, the cost of supplying its marginal demand in "traditional" ways is huge. Further, in light of its massive investment in new storage capacity (not yet reflected in its water rates), MWD will be able to store more water for future shortages. Therefore, an acre foot of "displaced sales" today actually translates into greater reliability tomorrow based on storage of the water displaced from its current service burden. Particularly at this juncture—when MWD is about to add a million AF of water to storage in its

[22] *California Water Plan Update Bulletin 160-98*, Department of Water Resources, November, 1998, ES1-2.
[23] *The Absence of Economic Justification for MWD's Adding Non-Conveyance Costs to Its Wheeling Rates, Or For Its Use of "Postage-Stamp" Methodology*, Richard E. Howitt, Ph.D., August 19, 1997, at 2, included as Exhibit B to Professor Howitt's Expert Declaration in *Metropolitan Water District of Southern California vs. All Persons Interested in the Matter*.

East Side Reservoir—MWD should be grateful for water transfers that displace current demands on its system, thus liberating water to fill the Reservoir.

As to the temporary financial impact of deferring—rather than displacing—a sale, MWD is well insulated based on its long-term practice of accumulating a huge cash hoard from its water sale revenue stream. **As of the end of its most recent fiscal year, MWD had amassed a cash surplus of $428 million, including $111 million in its "water rate stabilization fund" and $172 million in its "water revenue remainder fund."**[24] Thus, MWD has adequately provided—from excess payments by its ratepayers—for any temporary financial impact of "transition" to a competitive water market. It is important to note, however, that MWD's ability to maintain its bloated cost structure and amass such excess profits is partially dependent upon the protection created by DWR's barrier pricing of excess capacity in the SWP. Even if such protection were once appropriate, it is indefensible—and illegal—in current circumstances.

No Free Riders

The argument that new market entrants should be blocked from a "free ride" on the backs of wholesalers burdened with long-term fixed contracts is equally specious and self-serving of the entrenched interests. First, it is important to note that the ratepayers, not the intermediate wholesalers, ultimately pay for the system capacity at issue here. Allocating excess capacity in their interests—not the narrower interests of MWD or Western Water Company—must be DWR's objective. Second, allowing practical and economic access to this available capacity serves the State's expressed desire for a truly price sensitive and voluntary water market. The ultimate beneficiary of efficient use of existing infrastructure capacity is the consumer and the economy, not the water seller constrained by competition. Third, it is apparent from MWD's balance sheet—and its increasing cost bloat—who has been taking the free ride. There is simply no argument for protecting an inefficient operator from effective price competition through favored access to and pricing of public infrastructure—particularly when its consistent actions increase costs without benefit to its customers.

In a healthy market, price competition drives out excess profit: there are no free rides. As demonstrated in other deregulating environments, entrenched monopolists always claim that they provide good service at acceptable cost. Only when they are forced, however, to provide competitive access to new entrants do we see costs go down and service improve.

DWR can no longer accept lame arguments about the risk of "displaced sales" or the outrage of "free rides" to avoid its duty to set rates for excess SWP capacity in accordance with existing law, policy and economic sense.

[24] *Annual Financial Report, 1997-1998,* The Metropolitan Water District of Southern California, Statement of Fund Balances.

Conclusion

Western Water Company respectfully requests that DWR develop and publish a revised third table of rates, on a reach-by-reach basis, for the occasional use by non-contractors of available capacity in the SWP. In determining such rates, we urge DWR to consider (i) the public policy in favor of facilitating voluntary water transfers to ameliorate the State's imbalance of supply and demand for water, (ii) the appropriate legal framework for establishing "fair compensation" for non-firm use of available capacity in the system which will otherwise be wasted, (iii) the economic impacts of rates on the development of a vibrant water transfer market incorporating appropriate price signals for use of precious water resources, and (iv) the anti-competitive, anti-consumer, and anti-choice impacts of applying average system cost to marginal users of available capacity in the SWP.