Title: Interim Supply Allocation

Subject: Final Interim Supply Allocation

From: City Manager

Lead Department: Utilities

Recommendation
This report is informational only. No City Council action is required.

Executive Summary
As part of its October 2008 approval of the capital program to repair and replace the regional water delivery system, the San Francisco Public Utilities Commission (SFPUC) established a limitation on water deliveries until 2018. The restriction on water deliveries from the regional water system applies both to San Francisco and to the group of 26 wholesale customers who purchase water from the SFPUC. The 2009 Water Supply Agreement between San Francisco and the wholesale customers required the SFPUC to decide how to divide the water allocated to the wholesale customers among them by December 31, 2010. Palo Alto provided written and oral comments throughout the SFPUC’s process to develop a methodology for this decision. This report describes the process, Palo Alto’s position, and the SFPUC’s final decision on how much water each wholesale agency is allocated.

Background
The Hetch Hetchy water system delivers approximately 260 million gallons per day (MGD) of high quality potable water over a 280-mile pipeline network to water users located in San Francisco and in twenty-four cities and water districts and two private water utilities in the Bay Area. Together the 26 agencies outside of San Francisco comprise the membership of the Bay Area Water Supply and Conservation Agency (BAWSCA) and provide water to 1.7 million people, businesses and community organizations in Alameda, Santa Clara and San Mateo counties. BAWSCA and its member agencies advocate for continued delivery of safe, reliable drinking water in a cost-effective manner.

In order to enhance the ability of the SFPUC to meet goals for water quality, seismic reliability, delivery reliability, and water supply, the SFPUC is implementing its Water System Improvement Program (WSIP). The WSIP is a $4.6 billion, multi-year capital program to upgrade the SFPUC’s regional and San Francisco’s local water delivery systems. The WSIP improvements are designed to allow the SFPUC system to continue to provide high quality
water in the event of a major earthquake. The cost of the WSIP will result in steadily increasing water costs for the BAWSCA agencies.

In 2004, the SFPUC and the BAWSCA member agencies completed three planning studies to estimate the future water demand and conservation potential for each BAWSCA member agency, and provided the studies as input to the Program Environmental Impact Report (PEIR) for the WSIP. The results of these studies concluded that projected SFPUC water use for the BAWSCA member agencies would be 209 MGD in 2030, after accounting for the following:

- 25 MGD of water savings that would naturally occur within the BAWSCA service area as a result of appliance efficiency standards in plumbing codes; and
- 23 MGD of water savings and recycled water use that the BAWSCA member agencies committed to, including 10.43 MGD of recycled water and 12.77 MGD of water conservation.

In October 2007, BAWSCA committed to saving an additional 10 MGD of water purchased from the SFPUC by 2030 as part of its comments on the Draft PEIR for the WSIP, reducing the BAWSCA member agencies’ projected demand for SFPUC water to 199 MGD in 2030. As part of the development of the WSIP, the SFPUC developed level of service goals for the project. The level of service goal adopted for water quantity was to meet the region’s water supply needs until 2030 during non-drought years.

When it adopted the WSIP and certified the PEIR on October 30, 2008, the SFPUC made a unilateral decision to limit water deliveries from the SFPUC system to 265 MGD until 2018. This 265 MGD Interim Water Supply Limitation (IWSL) for the system allocates 184 MGD to the BAWSCA agencies and 81 MGD to San Francisco until 2018. This decision was made by the SFPUC despite the projections in San Francisco’s own environmental documents which projected the BAWSCA member demands would exceed the proposed 184 MGD limitation in 2018.

The section of the SFPUC’s report requesting adoption of the WSIP and the PEIR included these paragraphs explaining that the goal to meet future water supply needs would not be met:

“Staff recommends that the San Francisco Public Utilities Commission (SFPUC) adopt the Phased Water System Improvement Program (WSIP) Variant based on the determinations and findings of the Final Programmatic Environmental Impact Report (FPEIR) for the WSIP and other policy considerations.

“In March 2008, SFPUC staff requested the San Francisco Planning Department to consider a variation of the WSIP called the Phased WSIP Variant. The SFPUC identified this Variant in order to consider a program scenario that involves full implementation of all proposed WSIP facility improvement projects to insure that the public health, seismic safety and delivery reliability goals are achieved as soon as possible but phased implementation of a water supply program to meet
projected water purchases through 2030. Deferring the 2030 water supply element of the WSIP until 2018 would allow the SFPUC and its wholesale customers to focus first on implementing additional local recycled water, groundwater and demand management actions while minimizing additional diversions from the Tuolumne River. Under the Phased WSIP Variant, the SFPUC would establish an interim midterm planning horizon – 2018. If the SFPUC adopts this Variant, it would make a decision about future water supply to its customers through 2018 only, and would defer a decision regarding long-term water supply until after 2018 in light of then current information and updated analysis. All non-water supply related WSIP goals and level of service objectives would be achieved under this Variant and all individual WSIP facility improvement projects proposed in the original WSIP would be constructed.” (Emphasis in the original.)

In June 2009, the BAWSCA agencies, including Palo Alto, signed a new 25-year Water Supply Agreement (WSA) with the City and County of San Francisco (CMR 269:09). The WSA incorporated implementation of the IWSL that was imposed on the BAWSCA agencies by the SFPUC (Article 4; Section 4.01). The WSA required the SFPUC to determine how to split up the 184 MGD allocated to the BAWSCA agencies by establishing an Interim Supply Allocation (ISA) for each agency by December 31, 2010.

According to the WSA, if the 265 MGD IWSL is exceeded at any time through 2018, the SFPUC will impose an environmental enhancement surcharge on any BAWSCA agency which was using more water than its ISA, or on San Francisco if its usage was above 81 MGD. The framework for the environmental enhancement surcharge is captured in the WSA (Article 4; Section 4.04). The SFPUC is required to establish the environmental enhancement surcharge during the rate setting process for the FY 2011-2012 wholesale rates.

Discussion
The WSA captures the terms and conditions for implementation of the ISA. Of note, the BAWSCA agencies did not agree with the legality of San Francisco’s unilateral imposition of the ISA, and continue to reserve their individual rights to challenge the ISA. In the summer of 2010, BAWSCA and its member agencies attempted to collaborate on the development of an ISA allocation methodology which could be provided to the SFPUC for its consideration. However, the BAWSCA agencies were unable to reach agreement on an appropriate ISA methodology to propose to the SFPUC.

Starting in August 2010, the SFPUC met with the BAWSCA agencies and solicited input on potential ISA methodologies. One possibility put forward was each agency’s future projected demand for 2018, as presented in the BAWSCA Long Term Water Supply Reliability Phase I report of May 2010. The sum of the projected demands was equal to 182.84 MGD. Another option discussed was for the ISA for each agency to be equal to its contractual allocation from the SFPUC system, or Individual Supply Guarantee (ISG). Coincidentally, the sum of the ISGs equals 184 MGD.
Between August and December 2010, the SFPUC presented several proposed allocation methodologies to the BAWSCA membership for feedback and comment (Attachment C). During the process, Palo Alto provided three comment letters on the various proposals and the Director of Utilities attended one SFPUC meeting to deliver oral comments into the record. In addition, Palo Alto staff closely coordinated activities with the City Manager, the City Attorney’s Office and Palo Alto’s BAWSCA Director, Larry Klein. Palo Alto’s primary argument was that the ISAs should be based on the ISGs for each agency, since the ISG is the long-term contractual entitlement that defines the contractual relationship with San Francisco.

On December 8, 2010, SFPUC staff issued a proposed allocation methodology to be considered at the SFPUC meeting on December 14, 2010. After review of the proposed methodology, it was determined that the approach was not consistent with the WSA and did not properly recognize Palo Alto’s existing contractual entitlements. Staff and the City Attorney’s Office engaged outside counsel to prepare the City’s written comments on SFPUC’s December 8th draft (Attachment B) and coordinated with Council Member Klein to attend the meeting and deliver a prepared statement.

During the December 14 SFPUC meeting, SFPUC staff informed the BAWSCA agencies in attendance that the SFPUC was considering a fifth and new alternative. After reviewing the new alternative during the meeting, it was determined the new formula is more closely aligned with each agency’s ISG. Palo Alto supported the new formula as the preferred alternative to the previous allocation methodology. The SFPUC unanimously approved the new version (Attachment A).

Under the approved allocation methodology, the City of Palo Alto has an ISA of 14.70 MGD. This compares to a contractual entitlement (ISG) of 17.075 MGD and actual usage in FY 2010 of 10.99 MGD. It is unlikely that Palo Alto’s water supply needs will exceed 14.70 MGD by 2018. As a result, staff does not anticipate Palo Alto will incur any penalties for usage above Palo Alto’s ISA.

Utilities Advisory Commission
Staff provided an informational report on the IWSL to the Utilities Advisory Commission at its January 12, 2011 meeting. There was no discussion.

Resource Impact
If the water supplies provided by the SFPUC to San Francisco and the BAWSCA agencies exceed the IWSL of 265 MGD at any time through 2018, any agency over its ISA will be subject to paying the Environmental Enhancement Surcharge (EES) for any amount of water used over its ISA. Thus, if the IWSL is exceeded, and Palo Alto uses more than 14.70 MGD, it will be subject to the EES. The SFPUC will establish the EES before July 2011. Staff considers it very unlikely that Palo Alto would exceed its ISA.

Policy Implications
The IWSL was unilaterally imposed upon the BAWSCA agencies by the SFPUC and the City of Palo Alto reserves its right to challenge the legality of the imposition in the future, if necessary. Staff does not anticipate the outcome of the IWSL process will impact current policies.

**Environmental Review**
This informational report does not meet the definition of a “project” pursuant to CEQA Guidelines Section 21065, thus, no environmental review is required.

**ATTACHMENTS:**
- Attachment A: Final ISA Method (PDF)
- Attachment B: Palo Alto ISA Letter-12-8-2010 (PDF)
- Attachment C: Draft and final ISA methods (DOC)

Prepared By: Nicolas Procos, Resource Planner

Department Head: Valerie Fong, Director

City Manager Approval: James Keene, City Manager
December 16, 2010

TO: Wholesale Customers

FROM: Steven R. Ritchie, Assistant General Manager, Water Enterprise

SUBJECT: Final Interim Supply Allocations

Attached please find the Final Interim Supply Allocation adopted by our Commission on December 14, 2010. Thank you for providing feedback as we worked through the challenging process of developing the Allocations. As the Commission noted, this was not an easy decision. The Allocations were based on:

- The lesser of 2017-18 purchase projections or Individual Supply Guarantees.
- Hayward receiving its 2017-18 purchase projection.
- San Jose and Santa Clara receiving no less than as provided in Section 4.03 of the Water Supply Agreement.
- The residual amount being allocated proportionally to those customers whose purchase projections were less than their Individual Supply Guarantees.

Also attached is a detailed description of the methodology used to calculate the Allocations. We provide this to make sure there is clarity on how the Allocations comport with Section 4.03 of the Water Supply Agreement.

If you have any questions, please contact me at (415) 934-5736 or via e-mail at stditchie@sfwater.org.

Attachment:
1. Interim Supply Allocation Adopted December 14, 2010
2. Final Interim Supply Allocation Methodology

cc (w/attachments): Art Jensen, BAWSCA
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1 "Option 5" as identified in Resolution 10-0213.
2 Hayward value calculated as 184 mgd less the total of permanent customer ISG’s (161.91 mgd).
Final Interim Supply Allocation Methodology:

1. Assign initial ISA – All customers with a defined ISG were given their ISG or FY2017-18 Projected Purchases, whichever is less. Hayward was given their FY2017-18 Projected Purchases. San Jose and Santa Clara were given 4.5 mgd each less a reduction based on the aggregate average ISG reduction of customers with ISGs. The aggregate average ISG reduction is calculated by taking the total defined ISG of 161.91 less the allocated ISG to arrive at the unallocated ISG. The unallocated ISG is then divided by the number of customers with defined ISGs (23 customers).

2. Allocate the reserve to customers with defined ISGs that received less than their ISG for their initial ISA – This is completed in two steps as follows:
   a. Determine the percent share of the unallocated ISG for each customer. To calculate this number take each customer’s ISG less their ISA divided by the total unallocated ISG.
   b. Determine amount of reserve to be allocated to each customer. To calculate this number take each customer’s percent share of unallocated ISG and multiply it by the reserve.

3. Revise ISAs- Add the allocated reserve to each applicable customer’s initial ISA.

4. Check that San Jose and Santa Clara are not reduced by more than the aggregate average reduction in ISGs for those wholesale customers with defined ISGs. The average aggregate reduction is calculated by taking the total defined ISG of 161.91 less the allocated ISG to arrive at the unallocated ISG. The unallocated ISG is then divided by the number of customers with defined ISGs (23 customers). San Jose and Santa Clara’s reduction is determined by subtracting their ISA from 4.5 mgd. If their reduction and the aggregate average reduction in ISGs are not in balance, go to Step 5.

5. Allocate additional water to San Jose and Santa Clara by taking the difference between the aggregate average reduction in ISGs and the reduction of San Jose and Santa Clara. Add that difference to San Jose and Santa Clara. This will revise the reserve allocation available for the customers with defined ISGs.

6. Revise allocation of reserve for those customers whose ISA was less than their ISG – This is calculated by taking the percentage calculated in Step 2a and multiplying it by the new reserve amount.

7. Finalize ISAs – Add the new reserve value to each applicable customer’s initial ISA. Check San Jose and Santa Clara again to ensure they are not reduced by more than the aggregate average reduction in ISGs for those wholesale customers with defined ISGs.
December 8, 2010

Commissioner Francesca Vietor, President
San Francisco Public Utilities Commission
1155 Market Street, 11th Floor
San Francisco, CA 94103

Re: Establishment of Interim Supply Allocations under the 2009 Water Supply Agreement

Dear President Vietor:

On behalf of the City of Palo Alto ("Palo Alto"), we submit the following final comment letter and proposal in connection with the scheduled December 14, 2010 meeting of the San Francisco Public Utilities Commission ("SFPUC"). At this meeting, SFPUC staff will present a proposal to establish Interim Supply Allocations ("ISA") for wholesale customers served by SFPUC ("Wholesale Customers") under the 2009 Water Supply Agreement ("WSA"), including Palo Alto. SFPUC's decision on this matter has potentially serious ramifications for Palo Alto and other Wholesale Customers, as evidenced by Palo Alto's active participation in SFPUC's process to this point. However, the issues Palo Alto raised in its letters and at the ISA discussion meetings have not been adequately addressed. As time grows short until the December 14th meeting, Palo Alto is compelled to make a strong statement about the importance of preserving the rights established by the WSA.

First, the ISA is a pricing mechanism only. It does not affect the supply of water available to a particular Wholesale Customer. It is neither a water right nor a contractual right to

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1 "Water Supply Agreement between the City and County of San Francisco and Wholesale Customers in Alameda County, San Mateo County and Santa Clara County," July 2009.

2 Palo Alto has submitted two letters to SFPUC outlining in detail its concerns about early drafts of the ISA. See comment letters to SFPUC Assistant General Manager Steve Ritchie from Palo Alto Mayor Patrick Burt dated September 23, 2010 and October 14, 2010, Attachments 1 and 2 to this letter.
water. Rather, it establishes a line between two different water rates. That line is crossed when the total amount of water provided to SFPUC's wholesale and retail customers exceeds a certain amount and the amount of water provided to a particular Wholesale Customer exceeds that customer's ISA. No one will be deprived of water based on their ISA; this is a financial issue.

Second, SFPUC's legal right to impose any allocation that could interfere with the right of Wholesale Customers to purchase their full ISG at regular price has never been established and is subject to legal challenge by the Wholesale Customers. Palo Alto expressly reserved the right to challenge such a practice in the WSA (see ¶ 8.07(D)(3)) and reasserts that right here. Thanks to its aggressive conservation policies, Palo Alto does not believe it will be at risk for penalty rates under any proposed ISA methodology, but if penalty rates are assessed to it for deliveries below its ISG, an immediate challenge will result.

Finally, due to its limited risk of exposure to penalty rates, and in a good faith effort to find a solution that balances fundamental principles and rights with parties' concerns, Palo Alto is amenable to a compromise that stays largely within the status quo. This means that the City of Hayward's supposedly limitless right to water from SFPUC will be respected, and the practice of providing water to San Jose and Santa Clara based on goodwill rather than contract rights may be considered in assigning them an ISA. But other important elements of the status quo must also be respected for this peace to last, and any adverse impact from these proceedings on Palo Alto's ISG rights will result in a swift change of heart.

Without abandoning these important points, the following letter summarizes Palo Alto's concerns and proposes a compromise methodology for assigning ISAs.

1. **Background**

Palo Alto is one of 27 Wholesale Customers under the 2009 WSA. The WSA succeeds the 1984 "Settlement Agreement and Master Water Sales Contract" ("1984 Agreement"), which was created to settle a lawsuit filed by Palo Alto and other Wholesale Customers over the manner in which wholesale rates were established. The 25-year term of the 1984 Agreement expired on June 30, 2009. The WSA's 25-year term began immediately thereafter.

The 1984 Agreement established a "Supply Assurance" committing SFPUC to deliver a certain amount of water to the Wholesale Customers. It further allocated the Supply Assurance

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3 While it has often been stated during this process that Hayward's 1962 agreement with SFPUC assures it of all the water it needs on a permanent basis, this may be an oversimplification. Even Hayward concedes it enjoys special status only as long as SFPUC is able to deliver the water and water supply conditions are normal. (See City of Hayward, 2005 Urban Water Management Plan, page 3-1.)
among 24 of the 27 Wholesale Customers as an ISG expressed in terms of daily deliveries. (See WSA, ¶ 3.02(A).) Three Wholesale Customers – the Cities of Hayward, San Jose and Santa Clara – were not allocated ISGs.4 Both the Supply Assurance and the ISG were continued in the WSA, which establishes a Supply Assurance of 184 mgd (including Hayward) and an ISG for Palo Alto of 17.08 mgd. Both agreements provided that the Supply Assurance and the ISGs are perpetual.

In a separate section, the WSA establishes an “Interim Supply Limitation” (“ISL”) that provides a collective allocation for the Wholesale Customers, plus San Jose and Santa Clara, of 184 mgd. Further, the WSA provides for the establishment of an “Interim Supply Allocation,” or ISA, by SFPUC at a public hearing prior to December 31, 2010. In general, if the total amount of water provided by SFPUC exceeds the ISL under the conditions stated in the WSA, the agencies that exceeded their individual ISAs can be assessed an “Environmental Enhancement Surcharge” (“EES”) in an amount still to be determined. EES will thus constitute monetary penalties similar to a tiered rate structure. A final point central to this discussion is the fact that some Wholesale Customers have kept their water purchases below their ISGs, while others have not. Palo Alto’s own longstanding commitment to water conservation and recycled water has reduced its water purchases well below its ISG.

The determination of ISAs by SFPUC must be completed by the end of this year and has been the subject of impassioned meetings and correspondence in recent months. Palo Alto’s position, as explained below, is that the ISA must be based on the ISG, which is “perpetual” and established by contract, rather than on self-reported “projected purchase” amounts that were never intended by the parties that prepared them to be used for that purpose.

2. **SFPUC May Not Adopt ISAs that Infringe on Palo Alto’s ISG**

The ISG is the sole contractual means of allocating the SA among the Wholesale Customers. It is also the predicate for wholesale payments because water rates are assessed based on proportional annual use. (See WSA, ¶ 5.02(E).) The only limit the WSA places on annual use is the ISG. (See WSA, ¶ 3.02(D).) SFPUC has no legal authority to impose an ISA that adversely impacts the negotiated allocation entitlements or the Wholesale Customers’ agreed upon payment calculation method. An ISA determination based on any factor other than a particular entity’s ISG would not be consistent with the central role of the ISG in the WSA.

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4 Hayward does not have an ISG because of its 1962 agreement with SFPUC. San Jose and Santa Clara do not have ISGs because under both the 1984 Agreement and the WSA they are provided water on a temporary, interruptible basis.
ISGs are the perpetual and exclusive means of water allocation under the WSA. They are contract rights dating back to 1984 and are the sole basis for setting entitlements. The ISG is no historical accident; the SA and individual ISGs were negotiated and agreed to among all the parties based on all available information and extensive input from many sources. ISGs were granted by the 1984 Agreement, survived its termination, and were incorporated and reaffirmed in the WSA. Palo Alto has long relied on its perpetual ISG right in water resources and land use planning, including in evaluating the need for additional supplies, increasing water efficiency, investing in recycled water, and planning economic development.

3. The Water Use Projections Were Never Intended to Be Relied Upon by SFPUC

Palo Alto objects to SFPUC’s reliance on the “Projected FY 2017-18 Purchases” in determining ISAs for the Wholesale Customers. These numbers are taken from BAWSCA’s “Long-Term Reliable Water Supply Strategy Phase I Scoping Report, May 25, 2010.” This was a planning document prepared for BAWSCA. It was the first phase of a three-phase water supply strategy. The numbers used were not approved by Palo Alto for application in the calculation of ISAs under the WSA. Any review of the document would not have been undertaken with knowledge the numbers would be used for an altogether different purpose and would potentially lock Palo Alto and others in to unfavorable ISAs and expose them to substantial EES penalties.

4. As Proposed, the ISAs Would be Contrary to SFPUC’s Stated Policy Goals by Rewarding Waste and Penalizing Past Success in Conservation

SFPUC’s stated policy in imposing the ISL and ISA is to encourage conservation and local supply development. Palo Alto has a long track record of success in this regard. In the mid-1970s, its demand exceeded its current ISG. Today Palo Alto buys much less than its ISG, despite a slight increase in population. (See Attachment 1.) But the draft ISAs penalize Palo Alto’s success. They improperly base the ISA primarily on future demand projections, with no regard for an agency’s past conservation efforts. In effect, this would reward excessive water use where conservation efforts have been less aggressive by reflecting those excessive levels in ISAs. The ISAs essentially grant preferential treatment to those with little or no record of water conservation success. This is a perverse incentive not to conserve and is directly at odds with the ISA’s purported policy goals.
5. Any Action but “Zeroing Out” the ISAs for Temporary Customers Would Elevate Their Status Above That of Permanent Customers

No entities stand to benefit more from ignoring ISGs and basing ISAs on projected purchases than SFPUC’s temporary, interruptible customers San Jose and Santa Clara. They have no ISGs. Unlike every other Wholesale Customer, they have no permanent right to water under the WSA. The WSA bluntly classifies them as “temporary” and “interruptible” customers who are not assured of the right to continue in the system after 2018. (See WSA, ¶ 9.06.)

Palo Alto objects to the fact that these two cities, with purportedly inferior rights, appear to be receiving preferential treatment by SFPUC. Even though San Jose and Santa Clara have no ISG, the 4th Draft continues the practice of the previous drafts by proposing an ISA allowing them to receive their full projection – 4.50 mgd each – without the threat of surcharge or other limitation. This would virtually guarantee that San Jose and Santa Clara would never be subject to EES penalties, when in fairness temporary and interruptible customers should be the first to be assessed EES. If the 265 mgd ISL is ever exceeded, every drop of water purchased by San Jose and Santa Clara under the WSA should be subject to EES penalties. While reserving all rights to assert this position, Palo Alto acknowledges that political expediency requires some compromise at this time, as reflected below in its proposal for establishing ISAs.

6. Palo Alto’s Proposal

Palo Alto is a co-grantee under the Raker Act. (City of Palo Alto v. City and County of San Francisco (1977) 548 F.2d 1374, 1376-1377.) As expressly stated in the WSA, Palo Alto reserves all rights related to the question of what rights, benefits and privileges that status affords. (See WSA, ¶ 8.07.) In particular, Palo Alto does not concede that SFPUC may lawfully impose a water supply limitation of any kind, particularly one that disregards Palo Alto’s ISG rights. However, for the limited purposes of avoiding immediate legal action and facilitating establishment of timely and equitable ISA levels, Palo Alto proposes adoption of the following methodology based on SFPUC’s 4th Draft (see Attachment 3 to this letter):

a. Basis for Establishing ISAs: Each agency’s initial ISA would equal the lesser of (1) its ISG or (2) its projected FY 2017-18 purchases, except for San Jose and Santa Clara, which would each be assigned an ISA of 2.25 mgd. This method would yield the same ISAs shown in the 4th Draft with the exception of San Jose and Santa Clara. This acknowledges San Jose and Santa Clara’s existing relationships with SFPUC and the Wholesale Contractors, while reflecting their status as “temporary” and “interruptible” customers.
b. **ISA Reserves:** The remaining ISL would be placed in reserve and would equal 9.0 mgd.

c. **Distributing the Reserves:** If the 265 mgd threshold is exceeded, the reserve would be distributed in the following order of priority. First, Hayward would receive the balance of its demand. Second, all parties with ISGs would receive up to their ISGs; if reserves prove insufficient, those parties would share the remaining reserve in proportion to their ISGs. Third, all parties with ISGs would receive the balance of their demand without regard to ISGs; if reserves prove insufficient, those parties would share the remaining reserve in proportion to their ISGs. Finally, parties without ISGs other than Hayward (i.e., San Jose and Santa Clara) would share the remaining reserve, if any.\(^5\)

This method of distributing the reserve is optimal because it is fully consistent with existing agreements. First, it would prioritize Hayward in accordance with its 1962 agreement with SFPUC. Next, it would make the second distribution according to each party’s ISG and thereby minimize the risk that any party will be surcharged for purchases falling within its ISG, which would be an unacceptable outcome in light of each Wholesale Customer’s perpetual right to purchase up to its ISG at the price agreed upon in the WSA. With respect to the third and fourth priorities, it would be appropriate to favor permanent customers’ remaining needs over any allocation to San Jose and Santa Clara because if and when an EES is appropriate, it should be imposed on temporary, interruptible parties before permanent customers are affected.

Finally, in addition to the changes Palo Alto proposes for the 4th Draft, it also requests that any adoption of ISA levels be accompanied by a policy statement from SFPUC on the following issues:

- A commitment by SFPUC to end the ISA in 2018.
- A reaffirmation of the principle that the ISG is a perpetual right that shall be the foundation for any water allocation under the WSA.

\(^5\) SFPUC informed Palo Alto this week that staff would ask the Commission (1) to postpone any decision on implementation of the reserve to a date uncertain and (2) to delegate the authority for making this important decision to the SFPUC General Manager. Palo Alto believes a decision on implementation should be made now, in conjunction with adoption of the ISAs, but above all it must be made by the Commission and not delegated to SFPUC staff.
• A commitment to set future EES amounts at a reasonable level.
• A commitment to maintain the ability of Wholesale Customers to permanently transfer portions of their ISG, irrespective of any ISA determination by SFPUC.

Thank you for your consideration of this important matter. The City of Palo Alto and the undersigned welcome your questions and comments.

Very truly yours,

McCORMICK, KIDMAN & BEHRENS, LLP

DANIEL J. PAYNE

DJP:var
Cc:
City of Palo Alto City Council
City of Palo Alto Utilities Advisory Commission
James Keene, City Manager
Valerie Fong, Director of Utilities
Donald Larkin, Interim City Attorney
Art Jensen, General Manager of the Bay Area Water Supply and Conservation Agency

Attachments:
2. Letter to SFPUC Assistant General Manager Steve Ritchie from Palo Alto Mayor Patrick Burt, October 14, 2010.
September 23, 2010

Mr. Steve Ritchie
Assistant General Manager
San Francisco Public Utilities Commission
1155 Market Street, 11th Floor
San Francisco, CA

Subject: City of Palo Alto Comments on Draft Interim Supply Allocation Methodology

Dear Mr. Ritchie:

The City of Palo Alto has reviewed the Draft Interim Supply Allocations (ISA) included with your August 20, 2010 letter.

We have several concerns with the proposed draft ISA, which is based on future forecasts from the Bay Area Water Supply and Conservation Agency’s (BAWSCA) Long Term Reliable Water Supply Strategy Phase I Report (Phase I Report). As an alternative, Palo Alto supports an approach based on the existing, perpetual contractual entitlements of all of San Francisco’s wholesale customers (Wholesale Customers); an approach based on each customer’s Individual Supply Guarantee (ISG). Although Palo Alto does not concede the legality of San Francisco’s unilateral imposition of any water supply limitations, the City is pleased to submit these comments, and we appreciate the opportunity to express our concerns.

1. The Individual Supply Guarantee is a Perpetual Contractual Right and Defines the City’s Water Supply Relationship with San Francisco

Each Wholesale Customer’s ISG is an established, perpetual contractual right that is guaranteed by and survives the expiration of both the 1984 Settlement Agreement and Master Water Sales Contract, and the 2009 Water Supply Agreement (2009 Agreement) between San Francisco and the Wholesale Customers. It is expected that each Wholesale Customer will endeavor to restrict its use of water from the regional water system to its ISG. San Francisco’s draft ISA, which has no relationship at all to the ISG, renders the ISG meaningless.

However, the ISG’s meaning to the City of Palo Alto, a co-grantee under the Raker Act, cannot be overstated. San Francisco cannot impose a limit on the ISG, nor can Palo Alto accept such a limit. The 2009 Agreement specifies that both San Francisco and its Wholesale Customers “share a commitment to the Regional Water System providing a reliable supply of high quality water at a fair price, and achieving these goals in an environmentally sustainable manner” but the draft ISA only serves to erode San Francisco’s commitment to reliability.

1 2009 Agreement, Introductory Statement.
2. **Using the Individual Supply Guarantee to Establish Interim Supply Allocations Promotes Good Water Planning**

Since the creation of the ISG in 1984, the presence of the perpetual right to its ISG has influenced many of Palo Alto’s decisions, including evaluating the need for additional supplies, increased water efficiency commitments, recycled water investments and economic development. Clarity of supply is an essential prerequisite for good water resource planning. Thus, Palo Alto has long relied on its perpetual right to its ISG in all of its water use planning.

Palo Alto strongly supports the mechanism in the 2009 Agreement which allows the transfer of ISGs between BAWSCA agencies, and believes that such transfers will result in additional investment in the most cost-effective conservation or alternative supply resources for the region. However, if the ISA has no relationship to the ISG, these transfers will not occur and investments in water efficiency and new sustainable water supplies will be discouraged or delayed. Therefore, the proposed ISA methodology fails to achieve the stated purpose of the ISA, which is to enforce the interim water supply limitation of 265 million gallons per day (MGD).

3. **Basing the ISA on Long-term Water Use Forecasts is Not Appropriate**

Palo Alto does not support using future demand projections to establish the ISA. Demand projections are mere estimates, require the use of many assumptions and are highly uncertain. The following concerns highlight the problems with using the forecasts that were developed for the Phase I Report and BAWSCA’s Water Conservation Implementation Plan (WCIP):

- **Agencies are not on a level playing field:** Different agencies chose varying degrees of conservation commitments in the forecasts used as the basis for the Phase I Report. Rather than encourage conservation, San Francisco’s proposed ISA allocation method perversely rewards those agencies that made a lesser commitment with an increased ISA.

- **The forecast was not formally approved and is based on incomplete data:** The WCIP report and the projections in the Phase I Report were not approved by the Palo Alto City Council or the BAWSCA Board of Directors. Palo Alto is in the process of evaluating future demand projections and Senate Bill 7x water use reduction requirements, and Palo Alto’s water use projections will likely change during preparation of the City’s 2010 Urban Water Management Plan.

- **The forecast fails to account for prior conservation investments:** The aggressive goals in the WCIP report do not account for substantial water reductions achieved as a result of previous efficiency efforts. Thus, using the WCIP as a basis for San Francisco’s proposed ISA is especially punitive for those agencies that have aggressively pursued, and achieved, conservation for many years.

- **Using forecasts to establish potential penalties will impact future forecast methodologies:** Forecasts are a valuable tool to inform future decisions regarding water supply, conservation and growth. But, if San Francisco adopts an ISA mechanism based on future forecasts, Palo Alto will be forced to re-assess future forecast methodologies to ensure that Palo Alto is not unfairly exposed to risks for use within its contractual ISG entitlement.
4. The Draft Allocation Methodology Does Not Account for Historical Water Reduction Efforts

Palo Alto is unique among BAWSCA agencies in providing gas, electric, water and wastewater services to residents and businesses. Over the past 30 years, Palo Alto has leveraged this unique position to optimize efficiency gains across all services. In the mid-seventies, Palo Alto’s water use exceeded its ISG of 17.07 MGD, but conservation, incentive pricing, increased recycled water use and customer awareness have resulted in dramatic water use reductions. These reductions have been so successful that they permit Palo Alto to use significantly less water than its ISG.

Starting with the 1976 drought, the City invested in substantial capital improvements for more water efficient technology for all customer groups. During this time, Palo Alto implemented an institutional commitment to efficiency for all customers at a time when few utilities were doing the same. This consistent outreach and interaction with customers has resulted in long-lasting water use behavioral changes throughout Palo Alto and accounts for much of the permanent water reductions Palo Alto has achieved.

In 1991, Palo Alto signed the Memorandum of Understanding Regarding Urban Water Conservation developed by the California Urban Water Conservation Council (CUWCC), and committed to meeting targets for conservation best management practices. Since becoming a signatory with CUWCC, Palo Alto has saved over 16,000 acre-feet of water through conservation programs and the use of recycled water, and remains committed to aggressively pursuing all cost effective conservation measures and recycled water options.

Palo Alto’s historical investments in recycled water and conservation have resulted in an approximate 3 MGD water use reduction from Palo Alto’s peak usage. As a result, Palo Alto’s historical savings have benefitted the entire region by reducing overall water demands. Absent this commitment, and similar commitments pursued by some of the other Wholesale Customers, it is likely that the Wholesale Customers in aggregate would exceed their collective supply limitation of 184 MGD. San Francisco’s draft ISA fails to recognize Palo Alto’s historic contribution to conservation, since the methodology is based purely on forward-looking projections.

5. The Proposed ISA Could Cause Financial Harm to Responsible Agencies that Limit Their Water Use to Below Their Individual Supply Guarantees

The perpetual right to its ISG provides certainty for Palo Alto and other Wholesale Customers. Palo Alto expects that usage within an individual agency’s ISG will be charged a fair and reasonable price that is consistently and uniformly applied to all Wholesale Customers. Yet the proposed ISA methodology provides a contradictory and inequitable framework. For example, under San Francisco’s proposed ISA, Palo Alto could pay one price for water up to 13.38 MGD, and a higher price for water beyond that, despite the fact Palo Alto’s ISG is 17.07 MGD. At the same time, several Wholesale Customers would pay the same price for water up to and beyond their contractual ISG entitlement. In theory, Palo Alto could offset any financial risk by

acquiring credits from another Wholesale Customer that is below its ISA. But this situation, in which Palo Alto would be forced to acquire credits from a Wholesale Customer that is above its ISG, is simply unacceptable, particularly because Palo Alto has done so much to remain below its ISG.

Palo Alto strongly advocates that the ISG should be the basis for any interim limitation imposed by San Francisco, to ensure the proper recognition of the ISG as an integral component of the contractual relationship between all parties involved. We look forward to the opportunity to continue to collaborate with San Francisco on this issue.

Please feel free to contact Valerie Fong, the City’s Director of Utilities, at (650) 329-2277 or via email at Valerie.Fong@cityofpaloalto.org to discuss this matter further.

Sincerely,

Patrick Burt
Mayor of Palo Alto

CC: City of Palo Alto City Council
    City of Palo Alto Utilities Advisory Commission
    James Keene, City Manager
    Valerie Fong, Director of Utilities
    Gary M. Baum, City Attorney
    Art Jensen, General Manager of the Bay Area Water Supply and Conservation Agency
October 14, 2010

Mr. Steve Ritchie
Assistant General Manager
San Francisco Public Utilities Commission
1155 Market Street, 11th Floor
San Francisco, CA

Subject: City of Palo Alto’s Comments on Interim Supply Allocations Process

Dear Mr. Ritchie:

The City of Palo Alto has received the 2nd Draft Interim Supply Allocation (ISA) proposal included with your October 1, 2010 letter. As always, the City remains committed to exploring all of its legal options in response to unilateral action taken by any party to the 2009 Water Supply Agreement. But the City is pleased to note that the 2nd Draft ISA methodology at least partially incorporates the Individual Supply Guarantee (ISG). The City of Palo Alto believes this is a step in the right direction and supports the San Francisco Public Utilities Commission’s (SFPUC) movement to a methodology based on the ISG.

As stated in the City’s comment letter on the 1st Draft ISA, Palo Alto cannot emphasize enough the critical role the ISG plays in the contractual relationship between the BAWSCA agencies and the SFPUC. This beneficial relationship provides certainty not only for Palo Alto, but also for San Francisco. If San Francisco acts to weaken or ignore the ISG in any future allocation formula, the contractual relationship between our two entities is weakened as well. As co-grantees under the Raker Act, Palo Alto and San Francisco must work together to preserve our existing contractual relationship and ensure that no action will result in the diminution of our mutual entitlements.

As you know, in December 2010, the SFPUC will consider your ISA recommendation. At that time, the SFPUC has an obligation to clearly reaffirm its perpetual commitment to the ISG as the single most important contractual delivery standard in the 2009 Water Supply Agreement, and acknowledge that the ISA is indeed interim in nature and will cease to exist after 2018. In the meantime, we look forward to the opportunity to continue to collaborate with San Francisco on this issue.
Please feel free to contact Valerie Fong, the City's Director of Utilities, at (650) 329-2277 or via email at Valerie.Fong@CityofPaloAlto.org to discuss this matter further.

Sincerely,

Patrick Burt
Mayor of Palo Alto

CC: City of Palo Alto City Council
    City of Palo Alto Utilities Advisory Commission
    James Keene, City Manager
    Valerie O. Fong, Director of Utilities
    Gary M. Baum, City Attorney
    Art Jensen, General Manager of the Bay Area Water Supply and Conservation Agency
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** All values in Million gallons per day (MGD)**

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