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Private Water – Public Concerns:

*Thoughts from a Departing Commissioner – Or,
How I Spent my Six-Year “Summer Vacation”
At the CPUC*

Address to the California Water Association
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Introduction

Good Afternoon. It is a pleasure and an honor to be here with you. The title of your conference: “Back to the Future” is indeed appropriate. However, though the issues confronting the water industry may look similar to those of the past, I would like to suggest today that the context of the solutions going forward may well be quite different, requiring different focus and perhaps different tools.

Since this is the last time I will have the privilege of speaking to this group as a Commissioner of the California Public Utilities Commission, Jack said I had his permission to wander a bit from the stated title of my talk. So with that in mind, I would like to:

- First, offer some brief reflections over the past five and one-half years;
- Second, provide some observations about the present; and
- Finally, looking into an increasingly cloudy crystal ball, offer some comments about the future.

Though my remarks are focused on the investor-owned water utilities in California, you may find in them a reflection of a broader national context. As always, my comments are intended as non-partisan.

My standard caveats, which you all know by heart:

- I am only one commissioner among five.

- I do not speak for the CPUC, which speaks through its decisions.
- I am not stating how I will vote on any matter that is before me at the CPUC; and
- I am leaving office at the end of the year!

Reflections:

With your help, we have accomplished much together over these five and one-half years. I like to think that the PUC has made your lives a bit easier and more predictable, by:

- Helping us move into an era of conservation;
- Developing the Water Action Plan;
- Establishing the Rate Case Plan;
- Authorizing multi-district General Rate Cases;
- Developing and authorizing low income ratepayer programs;

- Beginning to take a serious look at water/energy nexus issues;
- Adding the Distribution System Improvement Charge, D-S-I-C; and
- Most recently, updating the Water Action Plan so that we now have a new version oriented toward the future.
- We also liberalized and clarified the use of balancing and memo accounts, as well as Advice Letters;
- We started the process of decoupling;
- I believe we have the greatest number of pass through accounts in the nation; and
- We have even speeded up the rate case process a little.

I like to think the CPUC system is easier for you to deal with, even if, in your view, we are, on occasion, still quite unreasonable.

Finally, if you look at the new Water Action Plan you will see, among other things, some new initiatives in developing public water policy at the State level, with the idea of balancing conservation, investment, and affordability.

This entire effort has helped to raise the standards of operation in the Division of Water and Audits (DWA), and in the CPUC in general. And I like to think it has also raised the level of professional responsibility, organization, and interaction with the PUC at the water utilities as well. You will know better than I whether my perceptions are accurate.

Overall, I think these years have been good ones for water regulation at the Public Utilities Commission. You are now recognized as full players on the PUC regulatory

stage. Whether that is the good news or the bad news remains to be seen.

Observations about the Present

Given the events of the past few months or so, the election, budget crisis, and the continuing recession, I want to put the world of utility regulation in California into a somewhat broader context, that of the relationship between government and the private sector. Nationally, we are entering into an era of heightened political confrontation, increasingly polarized policy options, and a bitter struggle over increasingly limited resources between ideas of government on the one hand, and business on the other. The stakes are very high. The public is aroused, and much of the policy apparatus is in the hands of social policy activists and government interventionists. Big is bad, small is good; corporations are bad, the “public interest” is good; bankers and their ilk are evil and exploitive, government is protective and good; your special interest is bad, my special interest is good.

In California, we have a dysfunctional state government, public policy largely hostile to business, a crumbling public education system, and a shrinking economy to the point of virtual state insolvency. We have the lowest credit rating in the country. Mississippi thanks you! We are running faster and faster in ever decreasing circles.

Our roads are in poor condition, and jammed to overflow. Many of our cities are on the point of imminent bankruptcy. We have unfunded pension liabilities that cannot be met. We have seen the rise of special pleading groups of all kinds who want “theirs,” and large pockets of unemployment way above the national average. It may be that, as is said so often, California is a precursor of where the United States is headed. And I have not even mentioned our depreciating national currency or decreasing global competitiveness! Suffice it to say, however, the private water industry is facing competition for resources and for even a “place at the table.”

I say this to put my remarks today in context. Just as the national challenges huge, so too do we have less control over the outcomes. Nor has our state has been able to meet its own immediate challenges, let alone solve its ongoing problems. We operate day to day on mythical budgets, unrealistic visions of the future, and surrounded by loose rhetoric.

What Direction for California?

Recently, in various forums, I have argued that Californians may be approaching a tipping point, or a change in mood or attitude, about our state's direction on environmental questions. I have said that we Californians have consistently chosen a green path towards a cleaner and more environmentally benign energy future. Since the 1970s, we have chosen to focus on efficiency in energy as much as or more than expansion of capacity. And we have instituted many other policies in California based on the idea – never specifically articulated, but always understood – that we should be willing to pay a little bit more for our necessities of life for a cleaner, better, future.

In this election we have just tested whether we want to change direction. The answer seems to be a resounding, “NO!” We affirmed our environmental policies, and we stated that we like our environmental direction. Whether we fully understand the ramifications of this attitude is unclear but we “feel good” about it. For example:

- The question of whether we wish to suspend our landmark environmental law, AB-32, the “Global Warming Solutions Act.” was soundly defeated.
- Californians also were asked to choose between two gubernatorial candidates of substantially different views about the environment and the economy. Voters chose the candidate more closely aligned with the green movement, Jerry Brown, by a substantial margin. You will see his views – and the voters’ views – play out in his appointments. It should be interesting! And by the way, the utility sector remains a “preferred risk” in these times of financial uncertainty.

So, if there is going to be a day when Californians change their minds about the direction of the state's green policies, that day has not come. At least on matters related to the green economy, it is reasonable to expect that future regulators will continue down the same path that we have followed in recent years. There will be no "U-Turn," at least not yet. This may be seen as good news for the clean tech industry, for investors, for utilities, and for participants in the so-called "green economy". And for lawyers and government employees.

The Future – OUR Future

With respect to the private water industry, I think we are at an important turning point in the way we look at your business going forward. It is not at all clear that the past years of growth will return soon or at all. Moreover, beyond these trends in environmental policy and law, and trends in our economy, there is one fundamental issue that all of you will face in the years to come, regardless of who is elected or appointed to state offices: California does not have enough water to meet its growth expectations. Each

year we use more water than is replaced by the natural cycle.

An Era of Scarcity:

There may not even be enough to meet present needs. That means there will be heightened conflict over existing supplies, over control of consumption, over sources of new water, and over methods of producing new supplies of water.

We will see an increasingly polarized debate between urban and agricultural use of water and between private and public entities. We will see conflict between water users, between water districts, between the holders of Riparian rights and the holders of Ground Water rights. Resolution of these conflicts will not be easy, at least in part because California has a set of non-associated and non coordinated decision-making authorities, each of which has great powers, but no state-wide vision or authority. I do not pretend to know what form of government agency or court would be best able to make decisions and set state-wide

policies. But I know that we do not have anything in place at this time that will be able to lead us out of this morass.

We have before us at the CPUC the case of the Monterey Coastal Water Project. And I will NOT discuss that case here today, for I must follow protocol in order to be able to vote on the matter. I mention it only to point out the level of complexity involved, and the number of different agencies, entities, and interest groups that have been involved. Surely all of you must realize that water supply augmentation will not become simpler in the near future; it will be more complex. It will not require cooperation of only a few friendly agencies; it will require working with many agencies, public bodies, advocates and interest groups some of whose missions are not compatible with your own. It will not be a matter of hiring a few attorneys to file a few pleadings; it will be many attorneys and many engineers, and many environmental biologists and many urban planners, and representatives of non-government organizations. The list goes on. Anyone who thinks otherwise should study this case carefully.

In addition, we must realize that the problems we have with water are connected to other problems that are not, strictly speaking, just water problems. The environment of the Sacramento River Delta and the Central Valley is a disaster unfolding in slow motion. We have hundred-year-old levees with towns full of people behind them. We have sinking islands. We have a water management policy that is drawing more fresh water from the Delta than is good for the fish and other organisms. We have judges deciding water use priorities, and a series of legislative failures. The bond measures to “fix” the Delta were pulled from the 2010 ballot because it was feared that voters would not support them in this year of austerity. Probably that was a wise decision. But if the people of California do not wish to pay to fix the Delta, do they wish to pay for the consequences of NOT fixing the Delta? Does anyone really think that the bond measures are more likely to pass in 2012?

If it were not already complex, you may have seen that recently, legislators have begun to notice that there may be votes to be gained from making statements about water

issues and writing water legislation. Consider as an example this year's passage of SB-1173, which attempted to legislate that the use of potable water for a non-potable use was a "waste and unreasonable use," and therefore prohibited. Though subsequently vetoed by Governor Schwarzenegger, this bill may be a preview of coming attractions.

Our state constitution prohibits "waste and unreasonable use" of water. Maybe we all think we understand what is reasonable and not reasonable, and maybe we think we know the difference between a benign use and waste. But one way to take control of water, and to move it from one use to another is to legislate what is "Waste" or what is "unreasonable use." Do not be surprised if this strategy becomes an advocacy tool in the years ahead. The State Water Board has clearly indicated that it is ready, willing, and able to use it.

Future Policy Issues for California

Up to now, the cost of water has been pretty close to zero. In the future, we might see a price put on the water itself. Economists argue that the best way to get customers to conserve is to price the water properly. Sending price signals may work. But it may work like gasoline poured on a fire. If the price people are forced to pay for water is substantially greater than the perceived cost of the water, and the only reason is to force people to conserve, it is likely to have severe political consequences. This is especially likely if the only benefit of conservation is seen to be that other people can build more houses, or developers can make more profit.

De-coupling of revenues from water quantity is a necessary and benign policy in my opinion. It makes it possible for you to have rates that appropriately reflect costs. But it does not change the total cost of delivery or infrastructure; or cost of capital. So telling people that they can save money by using less water is not giving them the full story. In fact, if everyone uses less, then future rates

have to be higher. Even without de-coupling, future rates will have to be higher if sales decline, for the costs of the pumping and the people, of the pipes and the trucks, all those costs will not go down. This is a matter of simple arithmetic.

Finally, you will be dealing with new issues that I have only begun to touch. Enter greenhouse gases and the energy-water nexus. I am very proud that we at the CPUC have been able to participate in the Water-Energy Team subgroup of the Climate Action Team (The WET-CAT). Our people assisted in developing numbers for the Air Resources Board's policy document. And I am also proud that we have a set of pilot programs for squeezing some of the energy out of water. But in both cases, our work has once again shown that water touches everything. There are more hands in the stew now than ever before. And the energy companies and the environmental regulators are going to be visiting you more in the future.

When you add to these issues the perception that water service is a “right,” you have the potential for more rather than less conflict. It drives more rather than less government intervention by public bodies that are more and more financially squeezed, have less and less flexibility and often less and less competence, both organizational and human resources. It is reasonable, therefore to ask what happens when growth is no longer a realistic assumption. Your regulator may be your best friend!

So where does all this leave you? In this new and contentious environment, an investor-owned water company in California could do well to consider some aspects of the business that heretofore may have appeared tangential:

- Working to increase public support for what you do. You need to build broader coalitions of the public and various interest groups. You need cover and loyal supporters beyond the usual. That means Public relations campaigns in communities, to

special groups, to the legislature, and to the press, as well as greater efforts to reach out to your customers.

- Initiating broader cooperation with other agencies, such as municipal districts, wholesalers, even energy companies, with regulators, state agencies, and region wide. You have common problems, such as water quality standards and the Pharma issue, that only government can solve. And you need to be inside the tent. An initiative to strengthen CPUC oversight of water regulation might not be a bad first step.
- Financing: “Money, money everywhere and not a drop for drink,” if you will forgive the license. You will need public money to keep up. Ratepayers cannot pay for all of the new infrastructure that will be required to meet future standards. You will need to reach out to the taxpayers. That means educating

voters about your issue as the most pressing need in the arena with all the other pressing public needs.

- I am a believer in Public-Private Partnerships as good business and good politics. There are opportunities there.
- What about new services to your customers? Believe it or not, the recently enacted affiliate transaction rules were established to clarify what can and cannot be done so that you can have greater assurance as you look to do new things. New technologies will open up new opportunities. What about establishing a venture arm in your company?
- Recycled water? There is a whole new and exciting dimension to your business opening up. The mandates are coming; how will you best respond to them?

Conclusion

So, what free advice do I have?

- Understand that you are at war over the hearts and minds of your customers and your communities. Maintaining a positive public perception of your companies must become a part of your normal planning process. You need the public, not just your customers on your side. You may want to double or triple Jack's budget!
- Get engaged in the political process as if your life depended on it; it does!
- Make sure your regulators understand that they are partners in your success in serving the public well, and that you both depend on the capital markets!
- Re-think your growth options "outside the box"!
- Engage vigorously and monitor closely the work of other relevant agencies, and prepare in advance for both the increasing use of the "public trust doctrine" in the service of special interests, and for the insertion by public bodies and the judiciary of new

applications of the “waste and unreasonable use”
concept.

It’s been a pleasure for me to have “grown up” in the
water business in your company. I wish you well!