CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

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February 26, 2016

Mayor Sam Liccardo, Vice Chair
Treatment Plant Advisory Committee
200 E. Santa Clara Street, 10th Floor
San Jose, CA 95113

Re: Cities of San Jose and Santa Clara's Response to Administrative Claim

Dear Vice Chair Liccardo and Members of the Treatment Plant Advisory Committee:

The City of San José ("San José"), as the Administering Agency and Co-Owner of the Regional Wastewater Facility ("RWF"), submits this response for consideration by the Treatment Plant Advisory Committee ("TPAC") on behalf of the cities of San José and Santa Clara ("Co-Owners" or "First Parties"). On January 25, 2016, the City of Milpitas, West Valley Sanitation District, Cupertino Sanitary District, Burbank Sanitary District, and CSD 2-3 ("Outside Users," or individually "Agency" and collectively "Agencies") filed a claim alleging a breach of contract and inequities under the respective Master Agreements for Wastewater Treatment between First Parties and each Agency. San José submitted a request for public records on February 9, 2016 to each Agency but has not received any records in response as of February 26, 2016. The First Parties reserve the right to supplement this response following receipt of the requested records.

For the reasons set forth below, the Co-Owners submit that the Agencies' claims of breach of the contract and inequities under the Master Agreement are without merit.

BACKGROUND

The Cities of San José and Santa Clara own the RWF. San José operates the RWF as Administering Agency under an agreement with the Santa Clara that dates back to 1959. The RWF treats wastewater from San José, Santa Clara and all of the Agencies. Each of these Agencies has an agreement with San José and Santa Clara ("Master Agreements") governing the relationship between the parties, including the

agencies' responsibilities to pay for a share of the costs to operate and maintain the RWF.

The allocation of RWF costs to the Agencies is also subject to the Revenue Program Guidelines of the State Water Resources Control Board ("State Revenue Guidelines").[1] The State Revenue Guidelines apply to all recipients of State Revolving Fund (SRF) loans. Co-Owners and the Agencies are subject to these Guidelines because they have borrowed money from the SRF in the past, and may wish to do so again in the future.

The current allegations dispute the allocation of RWF costs to the Agencies for a series of capital projects that were identified in the November 2013 Plant Master Plan ("PMP"). The capital projects identified in the Plant Master Plan address the need to address aging infrastructure, new regulations, implementation of a new biosolids dewatering and drying process, and odor control. The Agencies' specific allegation, as raised in the January 25, 2015 Claim, relate to PMP costs identified in the Wastewater Facility Five –Year 2016-2020 Capital Improvement Program ("CIP").

A. Agencies that receive wastewater treatment services must pay for their share of the costs in accordance with the Master Agreements and the State Revenue Guidelines.

Agencies allege that there is a breach of contract because they are going to be overcharged by Co-Owners for the cost of CIP costs. The claim is premature because it is based on alleged action that has not yet occurred. Nevertheless, Co-Owners will respond to the Agencies' arguments in order to clarify any misunderstandings regarding how the Administering Agency intends to allocate CIP cost under each Master Agreement.

1. CIP capital costs that are process related and in excess of $2 million are future improvements which should and will be allocated to Agencies proportionally based on project specific treatment parameters.

First Parties agree with Agencies that under the Master Agreements most CIP costs should be "future improvement" costs and not "replacement" costs. The Master Agreements define "replacement cost" as "all capital expenditures for obtaining and installing equipment, accessories or appurtenances which are necessary during the service life of the Plant to maintain the capacity and performance for which the Plant was designed and constructed" except:

1. Major rehabilitation which will be needed as individual unit processes or other facilities near the end of their useful lives;

[1] State Water Resource Control Board Revenue Program Guidelines (Appendix G) March 1998 Edition.

2. Structural rehabilitation; and
3. Plant expansions or upgrades to meet future user demands.

The State Revenue Guidelines define "replacement costs" in the same manner as the Master Agreements and have identical exceptions for major and structural rehabilitations, plant expansions, and upgrades.

Under the State Revenue Guidelines, replacement is charged as an operation and maintenance cost. Both the Master Agreements and the State Revenue Guidelines' definition of operation and maintenance[2], and replacement cost cover the same type of expenditures[3].

The Master Agreements govern the amounts payable by Agencies to Co-Owners. In addition to paying for operation and maintenance costs, Agencies are required to pay costs associated with acquiring additional capacity and for "future improvements."[4] First Parties agree that future improvements include projects that are not considered a "replacement cost" such as:

1. Major rehabilitation which will be needed as individual unit processes or other facilities near the end of their useful lives;
2. Structural rehabilitation; and
3. Plant expansions or upgrades to meet future user demands.

As specified in each Master Agreement, these capital costs for future improvements should be allocated to treatment parameters if the project is process related[5], and over $2 million based on engineer design. The treatment parameters are flow, biochemical oxygen demand ("BOD"), total suspended solids ("TSS"), and ammonia ("NH3"). These projects costs are allocated to treatment parameters because the specific purpose of the project may be limited to treating the flow or a specific constituent in the wastewater.

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[2] The Master Agreement defines "operation and maintenance" as "[A]ny and all costs and expenses incurred by the Administering Agency, for the administration, operation, maintenance and repair of the Plant, including but not limited to supplies and materials, labor, services, power, chemicals, laboratory control and monitoring, insurance, general administration and incidental items incurred during normal operations. Also included are those expenditures for ordinary repairs necessary to keep the facilities in proper operating conditions."

[3] The Agencies' position that the Master Agreement must be amended to reflect their proposed definitions is not supported by the State Revenue Guidelines because by definition, the amounts collected by First Parties from Agencies can only be used for wastewater treatment services.

[4] Cost allocation provisions are in Part V of all Master Agreements except County Sanitation District 2-3, where they are in Part III. The Master Agreements also refer to payments for "existing capacity rights" which have now been fully paid by all Agencies.

[5] Master Agreements Exhibit B Note B: "Process related facilities and equipment that cost in excess of $2 million shall be allocated to parameters (flow, BOD, SS, ammonia) based on engineering design. Capital costs that are less than $2 million and/or are not process related shall be allocated to parameters using the percentages contained in the most current Revenue Program (Form 8, "Summary of Distribution of Capital Costs").

Per each Master Agreement, future improvements, however, that are not process related must be allocated based on the current capital cost allocation for the existing wastewater facility ("Revenue Program" or "rolling weighted average"). The "rolling weighted average" is the more appropriate methodology for allocating the capital costs of projects that benefit the entire facility because it reflects the current facility investment as allocated by the parameters to date.

1. It is not feasible to delay charging for capital cost until completion of engineer design for process related projects.

The Agencies contend that they cannot be charged for capital costs until the project has been allocated to specific parameters. This position fails to recognize that there are capital costs associated with delivering a project to award of construction, including planning and design. It may not be feasible to have the exact and final parameter allocations at the time the annual capital budget is developed or when the quarterly invoice is issued if the capital cost is to pay for work leading up to and including the engineer design work. In this case, the engineer design work for the Digester and Thickener Rehabilitation Project was not completed until December 2015. Consequently, the allocation of capital project cost in the adopted FY 2015-2016 CIP budget for the Digester and Thickener Rehabilitation Project was both reasonable and in compliance with the Master Agreement when the budget was developed in Spring 2015.[6]

The Agencies' claim alleging a breach of contract arising from an improper allocation of capital cost to the Agencies for the Digester and Thickener Rehabilitation Project should be rejected because the capital cost for this project has not been billed to the Agencies. The Fourth Quarter Invoice for FY 2015-2016 has not been issued. When the Fourth Quarter Invoice is issued, it will be consistent with the capital cost allocation methodology required by the Master Agreement, as described above.

2. The Agencies' argument that their ratepayers are subsidizing San José and Santa Clara ratepayers is not supported by the facts.

The Agencies' claim that their ratepayers are subsidizing San José and Santa Clara ratepayers is not supported by facts. Regardless of whether viewed from the perspective of contract capacity or actual use of the capital facility, the Agencies are not being overcharged for the CIP. San José and Santa Clara ratepayers currently use only 56% of its capacity, but will pay more than 80% of the $1.4 billion dollar capital program. In FY 15-16, the total CIP cost allocation from San José and Santa Clara for unused capacity in the RWF will be nearly double the Agencies' collective payment for their contract capacity. Moreover, since the Agencies' are using a greater percentage of

[6] First Parties fully support and intend to confirm parameter allocations for process related projects at reasonable intervals.

their contract capacity, the Agencies' ratepayers will actually receive the full benefit of their investment in the CIP now in comparison to San José and Santa Clara.

Agency	Flow	BOD	TSS	NH3
San José – for unused capacity	$26M	$7.2M	$3.8M	$1.5M
Santa Clara – for unused capacity	$5.5M	$1.5M	$800K	$300K
Agencies – for contract capacity	$19.2M	$2.4M	$1.5M	$1M

The collective payment of San José and Santa Clara for CIP for FY 15-16 for underutilized flow capacity of 58 mgd is more than the Agencies' collective contract flow capacity of 35 mgd.

Agency	2015 Contract Flow Capacity	2015 Peak Week Flow	Under Utilized Contract Flow Capacity
San José	109	61	48
Santa Clara	23	13	10
Agencies	35	22	13

Agency	2015 Contract BOD Capacity	2015 Peak Week BOD	Under Utilized Contract BOD Capacity
San José	385	155	230
Santa Clara	81	33	48
Agencies	75	51	24

Agency	2015 Contract TSS Capacity	2015 Peak Week TSS	Under Utilized Contract TSS Capacity
San José	342	163	179
Santa Clara	72	34	38
Agencies	72	41	31

Agency	2015 Contract NH3 Capacity	2015 Peak Week NH3	Under Utilized Contract NH3 Capacity
San José	34	21	13
Santa Clara	7	4	3
Agencies	8.5	5.2	3.3

B. Agency payment for capital cost of future improvements based on contract capacity is enforceable under the Master Agreements.

The Agencies insist that the Master Agreements must be amended to include each CIP project, the parameter allocation for each project, project schedule, cost, and financing repayment schedule before the First Parties can require the Agencies to pay for the project. The Agencies' position is not supported by the terms of the Master Agreement. More importantly, the Agencies' position is not practicable since capital costs could be incurred years in advance of engineer design, construction award, or the need for financing.

The type of information the Agencies are seeking to include in an amendment is required under each Master Agreement only if the facility has reached 85% or 142 mgd of the 167 mgd design capacity thereby triggering an "engineering study". An engineering study would specify construction timetable, estimate of total project cost, and an estimate of each participating agency's share of project cost.[7] Since the CIP projects do not expand the capacity of the facility, the current Master Agreements do not need to be amended to include this information to be enforceable. In fact, even after the end of the existing term, January 1, 2031, the Agencies have a contractual obligation to pay for all costs associated with its use of wastewater services as long as it continues to discharge to the RWF.

The Parties do not dispute that the contract capacities in the RWF for each of the Agencies are the same as set forth in Exhibit A to each Master Agreement. The Master Agreements specifically distinguish between the methodology for calculating the payments for future improvements from the calculation of payments for facility expansion or for transfer of capacity rights.[8] The Master Agreements were drafted to allow for updates to the exhibits with current information without the necessity of revising the entire Agreement.[9] Consequently, the Master Agreements have only been amended in limited circumstances when the RWF expanded to reflect whether an Agency participated in the expansion, to document repayment for financing capital projects, and to reflect the sale of contract capacity between Agencies. Since the CIP does not involve a facility expansion or transfer of capacity rights, an amendment to the Master Agreement is not necessary to enforce the Agencies' obligation to pay for future improvements.

C. Seeking amendments to the Master Agreements to confirm repayment by the Agencies before the First Parties assume repayment obligations for the

[7] This same information, and much more detail on the CIP, however, are contained in the volumes of technical memorandums, periodic CIP reports, capital budget documents, and 2014 Validation Report, all of which have been provided to staff for the Agencies.

[8] See Master Agreement Part V "Amounts Payable by Agency to First Parties," Sections A, B, and C.

[9] See Exhibit A for memorandums from TPAC dated February 2, 1983 and to San Jose City Council dated March 18, 1983.

Agencies' portion of the SRF loan is not economic duress but sound financial planning.

The Agencies allege that requiring them to execute an amendment to the Master Agreement before the First Parties would commit to borrowing for the Agencies' share of the Digester and Thickener Rehabilitation Project cost from the State Revolving Fund loan ("SRF") is economic duress. First Parties disagree with the Agencies' characterization.

1. A simple amendment to the Master Agreement would enable Agencies in need of financing to participate in the financial program.

The Master Agreements authorize San José as the Administering Agency, to "maintain, repair, expand, replace, improve and operate the treatment Plant, and to do any and all things which it shall find to be reasonably necessary, with respect to its maintenance, repair, expansion, replacement, improvement and operation." The Master Agreements do not require First Parties to provide financing for the Agencies' share of the capital cost. However, if an Agency wants to be credited for the State Revolving Fund loan, it must agree to participate in the financial program.[10]

In November 2015, a limited amendment to the Master Agreement was provided to the Agencies to extend the term to cover the term for repayment of the SRF. The amendment was rejected for various reasons, some of which are alleged through the claim. At that time, the Agencies asked San José to not pursue short or long-term financing[11]. If SRF financing is not feasible due to the timing required for negotiation of additional changes, the Agencies have the prerogative to pursue other financing options. First Parties also have the option to seek the most advantageous financing of their majority share of the Project.

2. Conditioning the amendment to the Master Agreement pending discussion of issues unrelated to financing would harm the Agencies' ability to participate in SRF.

First Parties anticipates approval of its SRF loan application in Spring 2016. The Agencies' push for additional changes to the Master Agreement, under the guise that it is more than thirty (30) years old and has outlived its purpose, is a negotiation strategy to introduce a package of other proposals that would ultimately shift wastewater treatment costs and liabilities to San José and Santa Clara ratepayers.

[10] Master Agreement Part V "Amounts Payable by Agencies to First Parties," Section F.

[11] Letters from Agencies to City of San Jose dated February 1, 2016 rejecting San Jose's proposed Amended and Restated Master Agreement, and requesting that the parties resolve the claim before "moving forward with any short or long-term financing options."

Due to the scope of the Agencies' proposal, negotiation regarding the additional changes is unlikely to be completed in Spring 2016. Embedded in the proposed package of amendments was a proposal to cap the capital budget. These proposals are not acceptable because an arbitrary capital budget cap bears no relationship to the timing of CIP projects or other factors that may influence the cost to deliver a project. First Parties share the Agencies' desire to maintain predictable rates but rate stability can be achieved through financing. A cap would also mean that if the capital cost for a project is greater than the cap, San Jose and Santa Clara ratepayers would pay the balance, and effectively subsidize the service to ratepayers from other service areas. Subsidizing use by other users is not consistent with the principles governing the setting of the sewer service fees for wastewater treatment required by the State Constitution (Proposition 218) and the California State Revenue Guidelines.

The Agencies have proposed that First Parties should have all liability for operating the RWF as co-owners except for acts of God. First Parties and Agencies currently share liability for the treatment of wastewater at the RWF in proportion to their actual discharge for operation and maintenance costs, and contract capacity for capital costs. Their proposal is inconsistent with the Agencies' obligation to pay their fair share of the cost to operate the RWF. The proposal also fails to recognize that the RWF operations and facilities are impacted by the discharge from users in Agencies' service areas, and is being operated for the benefit of their ratepayers. Such a proposal would shift the risk of treating the wastewater from the Agencies' service areas to the San José and Santa Clara ratepayers.

The Agencies have proposed that they should have the discretion to decide which CIP projects to fund. CIP projects are connected in a system and are multi-year from design to completion of construction. A delay in one component would have a trickle down impact. Such a provision would make it impossible to operate and maintain the RWF, as lack of funding for critical projects could cause a catastrophic failure that would adversely affect all parties.

Finally, the Agencies have argued that they cannot agree to San Jose's limited amendment of the Master Agreement to extend the term because the Administering Agency has not been transparent regarding the need for the CIP or the basis for charging the Agencies. This rationale is without support based on the history of events leading up to the Agencies' claim. The CIP resulted from discussions over the course of many years on the need to rehabilitate and replace critical infrastructure. Volumes of information have been provided to the Agencies regarding the extent of the deferred capital investment including, but not limited to, memos and reports discussing infrastructure condition assessments, recommending action on specific projects, and validation reports to further refine the CIP scope and timetable.[12] San José staff has invested considerable time and resources responding to questions from Agency staff. Specific to the 10-Year Funding Strategy alone, San José has conducted numerous

[12] See Exhibit B for summary of events and documents relating to the PMP and CIP.

presentations, brought various interim actions to TPAC, and attempted to facilitate Agency participation in a financial program.[13] Each year, the Agencies receive extensive communications concerning the budget.[14]

D. The First Parties agree that the Agencies should not be required to pay for the cost of outside legal counsel to advise the First Parties in negotiating amendments to the Master Agreements.

In response to a request from the Agencies to begin negotiations on the Master Agreement amendment, San José brought a proposed budget to TPAC for consideration in January 2016. Under the terms of the Master Agreements, budget proposals related to the RWF are brought before TPAC for TPAC's recommendation before being submitted to the San José City Council. The proposed budget included anticipated costs for analysis and potential negotiations regarding additional substantive changes to the Master Agreement. The Agencies' representatives at TPAC rejected the proposed budget without explanation and the basis for the rejection was not expressed until the claim was submitted.

The First Parties concur that it would not have been appropriate to charge the Agencies for services not rendered on their behalf. The First Parties did not, and would not have charged the Agencies for the cost of outside legal counsel to assist the First Parties in negotiating with the Agencies. While the Agency staff requested clarification regarding the cost share for the proposed financial consultant services[15], Agency staff did not inquire about the outside legal counsel cost.

CONCLUSION

Each Agency that desires to continue to discharge into the RWF and receive wastewater treatment services must pay for the service. This is consistent with the Master Agreement, the California State Revenue Guidelines, Proposition 218, and basic fairness. The First Parties cannot cede their rights as owners, or compromise San José's ability, as the Administering Agency, to implement the CIP to ensure that the RWF continues to effectively treat wastewater for the South Bay Area.

For all the reasons set forth above, First Parties request that TPAC issue an advisory report finding that the Agencies' claim is without merit. First Parties further request that TPAC recommend that the Agencies interested in having First Parties secure financing from the SRF for their share of CIP project costs, pursue a simple amendment to their Master Agreement that address only the issue of their participation in the financing. There may be an appropriate time and place to discuss business terms

[13] See Exhibit C for summary of events and documents relating to the 10-Year Funding Strategy.
[14] See Exhibit D for sample of supporting documentation to budget.
[15] The cost for financial consultant services would have only been shared between Agencies that were seeking to negotiate the specific amendment requiring the analysis.

of the Master Agreements that are unrelated to financing, however, critical projects cannot be delayed because Agencies want to use this opportunity to leverage amendments that would fundamentally shift RWF cost and liabilities to First Parties.

Very truly yours,

RICHARD DOYLE, City Attorney

By: _____
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RLT/rlt
Attachments: Exhibits A - D

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