

Tributary Agencies Claims of Breach of Agreement and Inequities

March 24, 2016

Treatment Plant Advisory Committee

Public Hearing

The Tributary Agencies

- City of Milpitas
- Cupertino Sanitary District
- West Valley Sanitation District
 - Burbank Sanitary District
- Santa Clara County Sanitation District No. 2-3



The Master Agreements

- Legal agreements between agencies, San Jose and Santa Clara
- Executed in 1983 or 1985 – currently end in 2031
- Obligate agencies to pay an allocated share of operation, maintenance and capital upgrades in exchange for wastewater treatment and disposal
- Contain the outdated and cumbersome dispute resolution process used here

Must be updated to reflect Plant Master Plan

Major Plant Master Plan Projects

- Adopted in November 2013
- Estimated \$2.1 billion in capital costs over 20 years
- Projects include:
 - Rehabilitate digesters
 - New sludge pipeline
 - New biogas flare system = \$92.3 million
- New headworks facility = \$90 million
- New cogeneration plant = \$86.7 million
- Rehabilitate nitrification and secondary clarifiers = \$74.1 million

Why We Filed Claim

- Implementation of Plant Master Plan for next 50 years
- Agencies are accountable to ratepayers
- Agencies lack contractual assurances for financing
- San Jose's lack of transparency on use of ratepayer funds
- San Jose using improper allocation methods
- Agencies overcharged millions for capital upgrades

Overview of Claim Arguments

- Wrong allocation method results in severe overcharges
- Agencies being placed in untenable financial position
- Master Agreements must be updated to enable financing and ensure transparency

Two Allocation Methods Under Master Agreements

\$\$ charged to Tributary Agencies depends on allocation method:

1. **Billable Parameters** – applies to “Future Improvements” and process-related “Replacement Cost” projects that exceed \$2 million
2. **Rolling Weighted Average** – applies to “Replacement Cost” projects that either cost less than \$2 million or are not process-related

**Definition of Replacement Costs specifically EXCLUDES
major and structural rehabilitation projects**

Major and Structural Rehabilitation Projects Are Future Improvements and Subject to Billable Parameters Method

PMP Projects Are Major and Structural Rehabilitation Projects

“[T]he Plant Master Plan [is] a 30-year planning-level document focused on long-term **rehabilitation and modernization** of the Plant.”

San José Rejects Tributary Agencies' Claims Regarding Regional Wastewater Facility

 **News Release**
ENVIRONMENTAL SERVICES DEPARTMENT

For Immediate Release
February 26, 2016

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San José Rejects Tributary Agencies' Claims Regarding Regional Wastewater Facility

SAN JOSE, Calif. - The City of San José today formally rejected claims made by wastewater tributary agencies regarding the planning, implementation, and costs for the long-term Capital Improvement Program (CIP) for the San José-Santa Clara Regional Wastewater Facility that serves 1.4 million people in Silicon Valley and protects the waters and environment of southern San Francisco Bay.

The tributary agencies represent about 20 percent of the population served by the facility located at the northernmost end of San José. The agencies recently filed claim against San José and Santa Clara, owners of the facility, that the City of San José says is inaccurate and misconstrues events.

Under their master agreements with San José and Santa Clara, and as required by state law, the tributary agencies must pay their proportionate share of operating and capital improvement costs, which are clearly defined. The tributaries, however, allege that San José is not allocating costs correctly.

San José rejects this allegation entirely, noting that cost allocations are done in accordance with the master agreements and consistent with State guidelines.

The tributary agencies claim that they do not have adequate information about the CIP which is completely contradicted by the many years of public discussions and participation by tributary agencies in the development of the capital improvement program.

"The tributary agencies' elected representatives and their staffs have been directly engaged in improvement program discussions for the last eight years, and with the financing discussions for the last four years," said Ashwin Kantak, Assistant Director for the San José Environmental Services Department that is responsible for the Regional Wastewater Facility.

"All the tributary agencies explicitly agreed to the funding strategy in June 2015, but now they want to back out of their commitments to replace and modernize essential infrastructure that protects our environment and economy of Silicon Valley as well as the public health of residents of all our communities."

The CIP is a ten-year, \$1.4 billion program that is already rebuilding the sixty-year-old wastewater facility.

The tributary agencies include the City of Milpitas, West Valley Sanitation District, Cupertino Sanitary District, County

Source: San Jose Press Release 2/26/2016

“The Plant Master Plan showed that **every process required major rehabilitation.**”


Source: Plant Master Plan, p. 11

“The CIP is a ten-year, \$1.4 billion program that is already **rebuilding** the sixty-year-old wastewater facility.”

Water Pollution Control Capital Program
2016-2020 Adopted Capital Improvement Program
Overview

PROGRAM PRIORITIES AND OBJECTIVES

The development of this Adopted CIP is guided by the Plant Master Plan (PMP), a 30-year planning-level document focused on long-term rehabilitation and modernization of the Plant. On April 19, 2011, the City Council approved a preferred alternative for the Plant PMP and directed staff to proceed with a program-level environmental review of the preferred alternative. In November 2013, the City Council approved the PMP and certified the final Environmental Impact Report. In December 2013, Santa Clara's City Council took similar actions.



San José-Santa Clara Regional Wastewater Facility

The PMP recommends more than 114 capital improvement projects to be implemented over a 30-year planning period at an estimated investment level of approximately \$2 billion.

A capital program of this size will require significant resources in order to manage and deliver effective projects on time and on budget. On September 24, 2013, the City Council approved a consultant agreement with MWH Americas, Inc. to assist and support ESD in developing and implementing this CIP. On October 15, 2013, MWH program team members mobilized and are now co-located with City staff to form an integrated Program Management Office and program team. In February 2014, the MWH program team completed a detailed project validation process to critically evaluate project needs and priorities. The projects included with this Adopted CIP are based on the outcome of the validation process. Priorities for the near term include securing program funding, evaluating project delivery approaches, developing program staff, and continuing development of project delivery processes.

Program Funding: Over the last year, City staff has worked with program management and financial consultants to develop a long-term funding strategy to provide sustained funding for implementing the CIP program, while minimizing potential impacts on rate payers and ensuring intergenerational equity. As part of this effort, staff met with representatives from the City of Santa Clara and the tributary agencies to discuss guiding principles, funding options, and reserve policies, and to request feedback. Some of the key guiding principles include establishing a predictable base level of cash-funded capital investments, allowing time for all tributary agencies to plan for future revenue needs, and minimizing borrowing costs to the maximum extent practical. A recommended funding strategy was approved by TPAC on May 14, 2015 and by the City Council on June 2, 2015. For the next five years, San José's portion of the funding for the Adopted CIP is programmed into the 2016-2020 sewer rate models with moderate rate increases planned beginning in 2015-2016.

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Source: San Jose Five-Year 2016-2020 CIP

Table 1
 COST ALLOCATION ANALYSIS
 ACCORDING TO CONSTITUENT

Facility	Constituent	Cost ^a
Existing Grit Chamber Modifications	Flow	\$ 32,000
Raw Sewage Pump Station	Flow	1,167,000
Biofilters	BOD	34,928,000
Aeration Basin Modifications	BOD	16,844,000
Secondary Clarifiers	Flow	8,138,000
Biofilter Pump Station	BOD	4,941,000
	Flow	4,209,000
RAS Pumping	Flow	3,501,000
Blower Facility	Flow ^b	10,839,000
Engine/Generator Facility	BOD ^c	10,316,000
	TSS	5,554,000
Flow Equalization Basins	Flow	6,342,000
Nitrification Clarifiers	Ammonia	5,150,000
WNS Pumps	Ammonia	124,000
Tertiary Filter Influent Pumps	Flow	627,000
Tertiary Filter Modifications	Flow	2,158,000
Spent Backwash Treatment System	Flow	2,600,000
Electrical and Computer System Rehabilitation	Flow ^b	4,721,000
SUBTOTAL (Liquid Processes)		\$122,191,000
Sludge Digestion and Pumping		
Upgrade Existing Facilities	BOD	\$ 238,000
	TSS	441,000
New Facilities	BOD	6,601,000
	TSS	12,258,000
Lagoon Reclamation	BOD	1,565,000
	TSS	2,906,000
SUBTOTAL (Solids Processes)		\$ 24,009,000
TOTAL (LIQUID AND SOLIDS)		<u>\$146,200,000</u>

San Jose Applied Correct Methodology in the Past

Source: CH2M Hill Technical Memorandum from
 Glen Daigger to E.H. Braatelian Jr., 3/4/1982, p. TM-7

San Jose Has Conceded This Methodology Applies to PMP

Applies to the new Digester and Thickener project:

“[W]e have determined that the [Digester and Thickener Upgrade project] will treat BOD and TSS at a ratio of 40% BOD and 60% TSS....”

contract. Based on information in the Ten-Year Funding Strategy and updated information from Carollo Engineers we have determined that this project will treat BOD and TSS at a ratio of 40% BOD and 60% TSS. Thus, in order to adjust the cost allocations to the Tributary Agencies in a timely manner, we will be bringing forward an adjustment to the Adopted 2016-2020 budget. Any reconciliation for prior costs on this project will be made in fiscal year 2016-2017 and any final reconciliation will be made at the time of project close out.

Source: San Jose letter to each Tributary Agency 2/26/2016

Applies to most CIP costs:

“First Parties agree with Agencies that under the Master Agreements most CIP costs should be “future improvement” costs and not “replacement costs.”

Re: Response to Administrative Claim
February 26, 2016
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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.

Source: San Jose Answer to Claim 2/26/2016

Wrong Allocation Method is Applied to Other Major and Structural Rehab Projects

3.2.9 Electrical Systems and Power Generation

The CIP includes several projects related to Electrical Systems and Power Generation. These projects include upgrades to the cogeneration facility, digester gas compressors, and digester gas storage.

3.2.9.1 *Capital Cost Allocation*

The electrical systems and power generation facilities generate and distribute electricity and heat that is available for use throughout the entire plant. Consequently, the costs of these facilities are allocated between the four billable parameters relative to the rolling weighted average distribution of all RWF assets.

3.2.10 Fats, Oils, and Grease (FOG) Receiving

The CIP includes a project to build a FOG receiving station to process FOG in the digesters. The FOG will be converted to biogas which will in turn be used to generate electricity in the cogeneration facility.

3.2.10.1 *Capital Cost Allocation*

The electricity generated as a result of FOG processing is available for use throughout the entire plant, therefore, the costs of these facilities are allocated between the four billable parameters relative to the rolling weighted average distribution of all RWF assets.

3.2.11 General Plant Projects

The CIP includes a number of projects that are associated with the rehabilitation and improvement of the general operation of the facility.

3.2.11.1 *Capital Cost Allocation*

As the general facilities serve the entire system, the costs of these facilities are allocated between the four billable parameters relative to the rolling weighted average distribution of all RWF assets.

Applying the Wrong Allocation Method is a Breach of Master Agreements

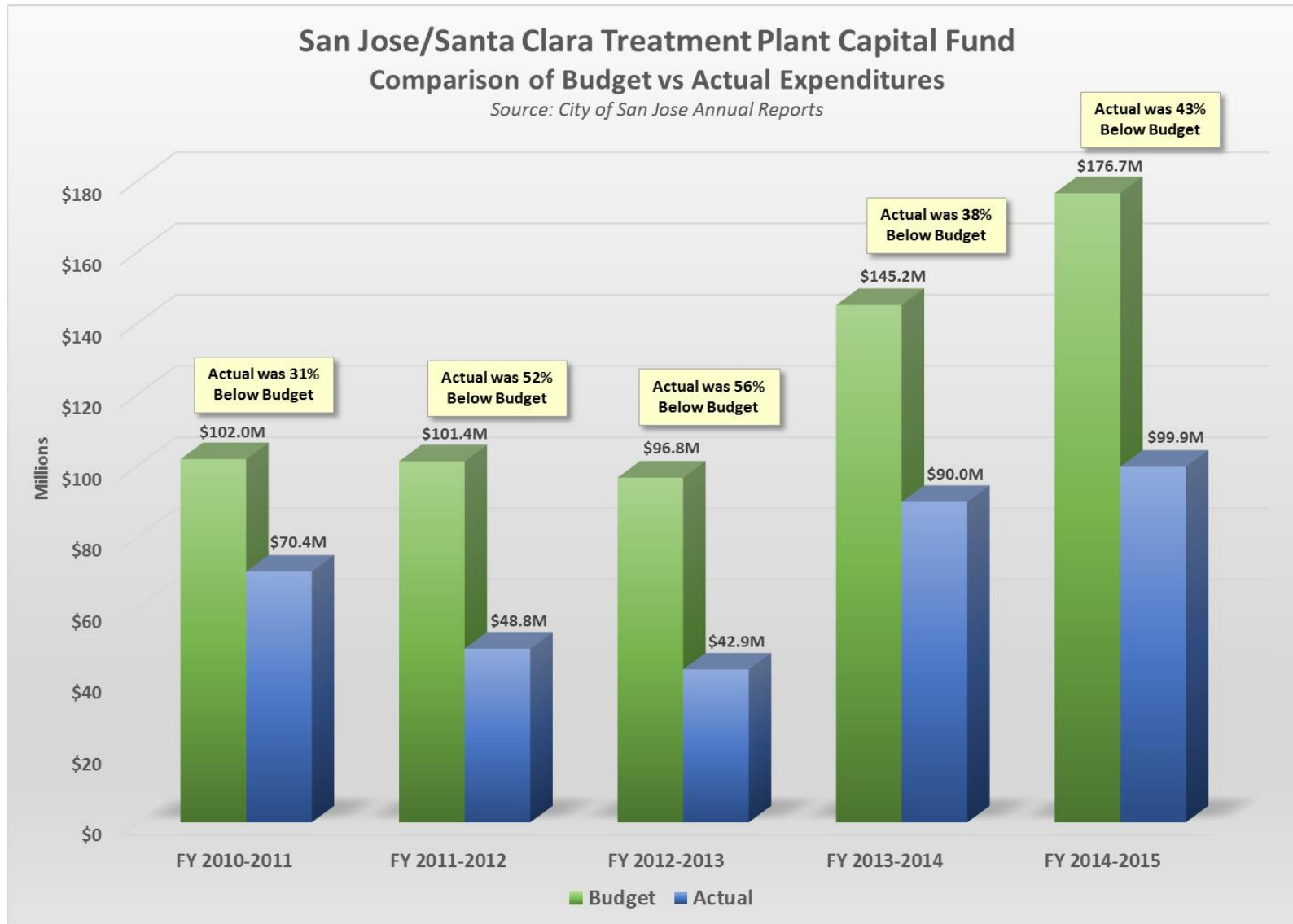
- Cannot use “Rolling Weighted Average” methodology for Major and Structural Rehabilitation Projects
- Results in Severe Overcharges
- Example: Initial Estimated Overcharges for Digesters:
 - West Valley: \$1.37 million
 - Cupertino: \$1.38 million
 - Milpitas: \$2.94 million
 - Burbank: \$90,000

Applying the Wrong Method Places Agencies in an Untenable Financial Position

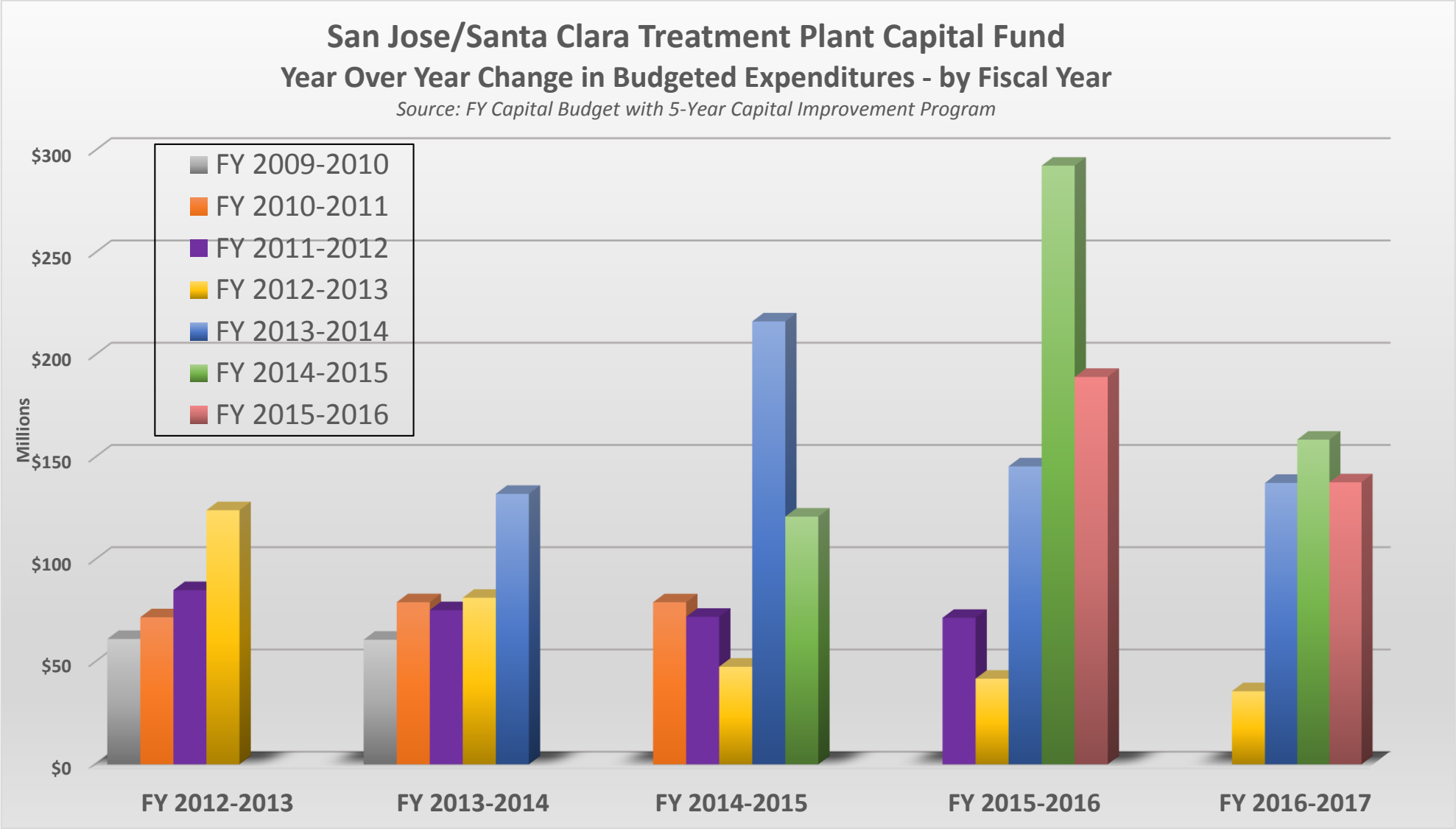
- Overcharges force agencies to take on more debt than necessary
- Third-quarter credits still require long-term financing based on high PMP charges
- Risk of negative arbitrage
- San Jose's offer of low-interest loan for Digesters contingent on economically unacceptable terms
- Agencies face demand for cash payment – total \$30 million up front

**As a Result, Ratepayers Face
Unnecessary Rate Increases**

Impossible for Agencies to Plan for Capital Projects



Impossible for Agencies to Plan for Capital Projects



Master Agreements Must Be Updated

- Amendments for each major PMP project
 - Scope, schedule of implementation, cost, allocation methodology
 - Necessary for Agencies to meet bond covenants
- Amendments must contain provisions for transparency and accountability
 - Clarify San Jose's accounting obligations
 - Guarantee Agencies' right to independent audit
- Amendments must improve budgetary planning and billing procedures

Agencies Need These Terms to Assist
Their Financing of the PMP

San Jose has Demanded Master Agreement Amendments Without Negotiation

- San Jose wants to amend very few provisions and extend term until 2065
- Agencies have requested to negotiate amendments since 2013
- San Jose has ignored Agencies' redlines presented on October 5, 2015
- San Jose cannot unilaterally amend Master Agreements, or compel agreement under economic duress
- Agencies have fiduciary duty to their ratepayers

Agencies Request Relief

- San Jose must properly allocate PMP projects to avoid overcharging
- San Jose must negotiate in good faith proposed amendments to Master Agreements
 - Necessary for Agencies' financing of PMP: Contractually defined project scope, budget and schedule
 - Greater transparency and accountability (e.g. third-party audit)

Questions?