September 7, 2016

The Treatment Plant Advisory Committee
San José - Santa Clara Regional Wastewater Facility
Attn: Mayor Sam Liccardo, Chair
City of San José
200 East Santa Clara Street, 18th Floor
San José, CA 95113
mayoremail@sanjoseca.gov

Members of the City Council of the City of San José
200 E. Santa Clara Street
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mayoremail@sanjoseca.gov

Members of the City Council of the City of Santa Clara
1500 Warburton Avenue
Santa Clara, CA 95050
MayorAndCouncil@santaclaraca.gov

Re: Master Agreement for Wastewater Treatment
<u>Claims of Breach of Agreement or Inequities</u>

Dear Chair, Members of the Treatment Plant Advisory Committee, and Members of the City Councils of the City of San José and the City of Santa Clara:

West Valley Sanitation District, Burbank Sanitary District, Cupertino Sanitary District, Santa Clara County Sanitation District No. 2-3, and the City of Milpitas (collectively, the "Tributary Agencies"), each individually and jointly file the attached Claims of Breach of Agreement and Inequities ("Claim 2") to the Treatment Plant Advisory Committee ("TPAC"), and the Members of the City Councils of the City of San José and City of Santa Clara, in accordance with the following provisions of the following Master Agreements for Wastewater Treatment:

> Part VII, Section G, of the Master Agreement for Wastewater Treatment Between City of San José, City of Santa Clara and County Sanitation District #4, dated March 1, 1983, as amended.
>
> Part VII, Section G, of the Master Agreement for Wastewater Treatment Between City of San José, City of Santa Clara and Burbank Sanitary, dated May 1, 1985, as amended.

Part V, Section G, of the Master Agreement for Wastewater Treatment Between City of San José, City of Santa Clara and County Sanitation District No. 2-3, dated January 1, 1985, as amended.

Part VII, Section G, of the Master Agreement for Wastewater Treatment Between City of San José, City of Santa Clara and City of Milpitas, dated March 1, 1983, as amended.

Each of the Tributary Agencies is exercising its individual right to file the attached Claim 2 pursuant to its respective Master Agreement. Claim 2 is also jointly filed by all of the Tributary Agencies. Please find attached/enclosed the above-referenced Claim 2, together with all supporting documentation. A list of hyperlinks for each individual Exhibit is also attached to the electronic version of this letter. A hard copy of Claim 2 (with exhibits), will be sent via FedEx.

We look forward to the scheduling of the TPAC public hearing regarding Claim 2.

Sincerely,

City of Milpitas

Nina Hawk, Public Works Director

West Valley Sanitation District

Jon Newby, District Manager and Engineer

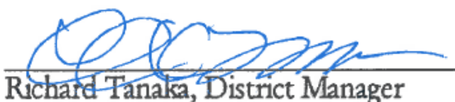
Burbank Sanitary District

Richard Tanaka, District Manager

Cupertino Sanitary District

Richard Tanaka, District Manager

County Sanitation District No. 2-3



Richard Tanaka, District Manager

cc: Board of Directors, West Valley Sanitation District
Board of Directors, Burbank Sanitary District
Board of Directors, Cupertino Sanitary District
Board of Directors, Santa Clara County Sanitation District No. 2-3
City Council, City of Milpitas

CLAIMS OF BREACH OF AGREEMENT AND INEQUITIES

of the Master Agreements for Wastewater Treatment
Between the City of San José, Santa Clara and the Tributary Agencies[1]

I. INTRODUCTION

For decades, the City of San José ("San José") has been mismanaging the San José-Santa Clara Regional Wastewater Facility (the "Plant"), and taking financial advantage of the Plant's silent stakeholders, the Tributary Agencies who contract with San José to discharge wastewater into the Plant. In 1979 the Plant suffered a catastrophic failure, requiring State regulators to issue a cease-and-desist order that put management and staff under scrutiny. Processes were evaluated to ensure there would be no reoccurrence. During the ensuing State-ordered independent assessment of the Plant, it became apparent that San José had been using the Tributary Agencies' capacity rights in the Plant without their knowledge, forcing the Tributary Agencies to file a claim.

Approximately 10 years later, after the parties entered into a settlement agreement, and negotiated new Master Agreements to govern their relationship concerning the Plant, it again violated its state permit by discharging excessive wastewater into San Francisco Bay, impacting endangered species habitat by converting neighboring salt march to fresh water marsh. State regulators ordered San José to take corrective action, this time requiring programs to reduce flow into the South Bay, including building a water recycling system to reduce Plant effluent.

Today, San José continues to mismanage the Plant and take financial advantage of the Tributary Agencies, who have invested heavily in the Plant and have paid for its operation and maintenance for over 50 years in numerous ways:

- Misallocating Plant costs in ways that force the Tributary Agencies to pay more than their fair share;
- Diverting Plant proceeds away from the Plant;
- Using Plant funds to pay for programs that benefit San José alone, such as public art and holiday programs in its parks;
- Failing to manage the Plant in a transparent manner, requiring the Tributary Agencies to resort to California Public Records Act requests to determine how San José misuses the Tributary Agencies' ratepayers' funds;
- Improperly billing the agencies for Plant overhead; and

[1] The "Tributary Agencies" or "Agencies" are Burbank Sanitary District ("Burbank"), the City of Milpitas ("Milpitas"), Cupertino Sanitary District ("Cupertino"), Santa Clara County Sanitation District 2-3 ("County Sanitation District No. 2-3"), and West Valley Sanitation District ("West Valley").

- Operating the Plant as a mere extension of San José despite the existence of other stakeholders.

In perhaps its most brazen move, San José is currently attempting to force the Tributary Agencies to bear the cost of billions of dollars in capital improvement costs for the Plant without their assent, under terms that are unprecedented, unreasonable, and prejudicial. The Agencies' purported obligations to fund these capital improvements, however, are unenforceable because they are not authorized under the Master Agreements. Charging the Agencies for the costs of such capital improvements constitutes a breach of the Master Agreements.

For these reasons, the Tributary Agencies hereby submit this Claim of Breach of Agreement and Inequities ("Claim 2") to the Treatment Plant Advisory Committee ("TPAC").

II. BACKGROUND

A. A Major Plant Failure In 1979 Led To State-Mandated Improvements To The Plant, and New Master Agreements To Provide For The Long-Range Development of the Plant Through The Year 1990.

The Tributary Agencies entered into Master Agreements (the "Master Agreements" or "Agreements") with San José and the City of Santa Clara ("Santa Clara") (together the "First Parties"), as of 1983 and 1985. (Exhibit 1 [Master Agreement].)[2] The Master Agreements govern the Tributary Agencies' use of, and investment in, the Plant, which is jointly owned by the First Parties. Under the Agreements, San José serves as the "Administering Agency" for the Plant.

Before entering into the Master Agreements, the Tributary Agencies discharged wastewater into the Plant pursuant to predecessor agreements with the First Parties dated April 1, 1965 (the "Predecessor Agreements"). In 1979, the Plant suffered a major spill into the South Bay, dumping millions of gallons of untreated sewage due to severe process failures. The incident caused, *inter alia*, the Plant to violate its National Pollutant Discharge Elimination System (NPDES) permit, which in turn led to the California Regional Water Quality Board, San Francisco Bay Region ("Regional Board") to issue a cease-and-desist order to the Plant. (*See generally* Exhibit 2 [California Regional Water Control Board Cease and Desist Order No. 80-20].) Under the order, the First Parties were required to retain an independent consultant to report on the capability of the Plant, identify the causes of the Plant's failure, and recommend corrective measures. (*Id.*)

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[2] Each Tributary Agency has entered into a separate Master Agreement with the First Parties as set forth in Claim 1 (defined infra), some with differing start dates in 1983 and 1985. Because each of the Master Agreements is substantially the same, but may contain minor differences, cites to the "Master Agreements" in this Claim 2 correspond to the Master Agreement between the First Parties and West Valley dated March 1, 1983. References to the Master Agreements, however, are intended to refer to each Master Agreement between the respective Tributary Agencies and the First Parties.

Following the Plant's failure, the Tributary Agencies filed a claim against the First Parties because post-failure assessments of the Plant had revealed that San José was discharging and using the Tributary Agencies' capacity rights without their knowledge. (Exhibit 3 [1981 Settlement Agreement].) The parties entered into a settlement agreement, under which they agreed to redraft the Predecessor Agreements to account for the changes proposed by the independent consultant, and to address the "long-range development of the Plant and the needs of respective parties." (*Id.* at p.5.) The First Parties agreed that such "long-range" developments meant improvements to the Plant "*through the year 1990*." (*Id.*, p.3 (emphasis added).)

The Master Agreements specifically identified the major capital improvements to the Plant as determined by the independent consultant. The Master Agreements refer to these capital improvements as the "Intermediate Improvements" and "First Stage Expansion." The scope of these major capital improvements was outlined in detail in the corresponding CH2M Hill engineering report, which is expressly referenced in the Master Agreements. (*See, e.g.*, Master Agreement, Part 1.J.) The Master Agreements also contained detailed provisions for the "long-range development" of the Plant that provided the same high level of planning and agreement by the Tributary Agencies. For example, the Master Agreements required a comprehensive "Engineering Study" for "long-range" improvements, including "an analysis of capacity needs, the size and nature of proposed facilities to be constructed, a construction timetable and an estimate of total project costs, and an estimate of each participating agency's share of project costs." (Master Agreement, Part 1.F.) The Master Agreements required First Parties to provide the Tributary Agencies with written notice of their intention to expand the Plant. (Master Agreement, Part III.1.) The Tributary Agencies then had 90 days to notify the First Parties if they wished to participate in the proposed expansion. San José had to obtain the Tributary Agencies' express consent to the projects before charging the Agencies for any of the costs. (Master Agreement, Part III.3.)

Never has the Plant undergone major capital improvement without contractually binding provisions that set forth the proposed work in detail – including the schedule and scope. Nothing in the Master Agreements gives San José unfettered discretion to commit the Plant to "long-range" capital improvements beyond those expressly articulated in them. Except where expressly agreed, the Master Agreements were not intended to govern major capital improvements beyond the year 1990.

B. In 2013, San José Proposed The Current Plant Master Plan, Including Billions of Dollars In Major Capital Improvements, Exacerbating The Tributary Agencies' Concerns Over Plant Mismanagement.

In 2013, San José approved a multibillion dollar capital improvement plan (the "CIP") as part of the Plant Master Plan ("PMP") to upgrade and improve numerous aspects of the Plant over the next ten years without seeking or receiving the Tributary Agencies' feedback or assent.[3] In essence, the CIP calls for a rebuilding of the entire Plant. Indeed, the value of the CIP –

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[3] The CIP was approved by the San José City Council on November 19, 2013.

approximately $1.4 billion – is equivalent to the current $1.5 billion value of the Plant. (Exhibit 4 [Plant Capital Cost Allocation For Fiscal Year 2016/17], p.13.)

As fully explained below, the CIP is not authorized under the current Master Agreements. The Master Agreements do not contain an all-purpose provision authorizing major capital improvements. Rather, the only major capital improvements authorized under the Master Agreements are specifically negotiated improvements to address Plant failures, corresponding directives by State regulators, and improvements to *expand* the Plant's capacity. The CIP, on the other hand, is not being carried out at the behest of regulators, or to bring the Plant in compliance with its NPDES permit. Nor does the CIP constitute an expansion of the Plant under the detailed provisions of the Master Agreements governing Plant expansions.

Because major capital improvements like the CIP are not authorized under the Master Agreements, there are no contractual safeguards or provisions to ensure that San José implements them in a fiscally responsible and practicable manner. Thus, implementation of the CIP under the *status quo* would severely prejudice the Agencies. Nothing in the Master Agreements constrains how San José implements the CIP projects. The Agreements do not contain any provisions that specify cost, scope, schedule, or allocation of costs to the Agencies. The Agreements do not provide any safeguards regarding cost predictability for CIP expenses. For example, nothing would prevent San José from issuing the Tributary Agencies a bill for hundreds of millions of dollars – many times more than the bill for any preceding billing period – without any meaningful forewarning or notice, leaving the Agencies scrambling to secure financing to avoid drastically raising wastewater rates.

These are not merely hypothetical concerns. San José has already begun implementing some CIP projects under the presumption they are authorized under the Master Agreements, and, therefore, under the presumption that it has the authority to impose the corresponding costs on the Agencies. Although premature and unenforceable, San José's foray into implementing the CIP only confirms the Agencies' concerns over the lack of appropriate contractual provisions and safeguards. San José has already overbilled the Agencies due to improper cost-allocation methods. Major variances exist between the budgeted cost of CIP projects and the actual expenditures, undermining the Agencies' financial planning.

Although the CIP projects are not authorized under the Master Agreements, many of the projects promise to enhance the Plant's future efficiency and stability, and should ensure the Plant can comply with future regulatory requirements for the next 40 years or more. As a result, the Tributary Agencies are generally receptive to the CIP and prepared to support the projects under appropriate circumstances. But, the Agencies' support of the CIP must be conditioned upon securing appropriate contractual safeguards for their ratepayers – terms that do not exist under the current Master Agreements, but are addressed in amendments the Tributary Agencies have proposed.

San José must also address the Tributary Agencies' additional concerns regarding its management of the Plant, beyond the enforceability and authorization for the CIP, for the Agencies to support the CIP. These include the lack of transparency regarding Plant activities and management, misallocation of Plant costs, improper use of Plant funds for non-wastewater

purposes, and a lack of fiscally-responsible planning for capital projects, including scheduling, financing, budgeting, and record keeping. Although these issues are distinct from the CIP projects, the CIP exacerbates these concerns because it significantly extends the lifespan of the Plant and commits the Plant to billions of dollars in costs.

C. After Numerous Unsuccessful Attempts To Resolve Their Concerns, The Tributary Agencies Filed Their First Administrative Claim.

On January 22, 2016, after several unsuccessful attempts to resolve the Agencies' concerns over the contractual authorization for the CIP through negotiation and staff-level communication, the Tributary Agencies were forced to submit a Claim of Breach of Agreement and Inequities ("Claim 1") to TPAC addressing San José's numerous breaches of the various Master Agreements. San José responded to the Claim on February 26, 2016 ("Response"); the Agencies submitted a reply on March 4, 2016 ("Reply"); and submitted a supplemental response on March 11, 2016 ("Supplemental Response"). TPAC held a hearing on Claim 1 on March 24, 2016, and on June 9, 2016 issued its findings and recommendations, approving a resolution drafted by San José staff, thereby rubber-stamping San José's position and denying the relief sought by the Agencies. A key component of Claim 1 called for the adoption of amendments to the Master Agreements to allow the CIP to be implemented under the same terms that have governed major capital improvements to the Plant in the past, including detailed engineering studies for the proposed work, projections of costs and allocation to the Tributary Agencies, and contractual enforceability.

Because the Tributary Agencies had not yet completed their investigation (due in large part to San José's failure to provide the Agencies with sufficient Plant records), Claim 1 did not fully address all of their concerns regarding the Master Agreements. These concerns included San José misallocating Plant costs in ways that forced the Tributary Agencies to pay more than their fair share, improperly billing the Tributary Agencies for Plant overhead, diverting Plant proceeds away from the Plant for San José's benefit, using Plant funds to pay for programs that directly benefit San José but not the other parties, such as public art and holiday programs in city parks, and failing to operate and manage the Plant in a transparent manner.

In light of San José's response to Claim 1 – and in particular its wholesale rejection of the amendments to the Master Agreements proposed by the Tributary Agencies – the Tributary Agencies hereby respectfully file their second Claim of Breach of Agreement and Inequities ("Claim 2") with TPAC, and the City Councils for San José and Santa Clara, pursuant to the claims resolution procedure provided for under the Master Agreements. (Master Agreement, Part VII, § G.) Although Claim 2 addresses specific transactions and breaches of the Agreements that were not expressly identified in Claim 1, all of the issues in Claims 1 *and* 2 are reflected in the proposed amendments to the Master Agreements, which were included in Claim 1.

Pursuant to the claims resolution procedure in the Master Agreements, the Tributary Agencies request that TPAC schedule a time and place for all parties to be heard within two months of the date of Claim 2. (Master Agreement, Part VII, § G.)

III. DISCUSSION

A. Charging the Tributary Agencies For CIP Projects Is A Breach of the Master Agreements Because Such Costs Are Not Authorized Under The Agreements.

San José has billed the Agencies for the costs of its CIP programs and plans to continue to do so over the next ten years as the CIP is fully implemented. (Exhibit 5 [Plant's 2014-2015 Capital Budget].) The Agencies are under no obligation to make these payments because such costs are not authorized by the Master Agreements.

The Master Agreements, which govern the parties' respective rights and responsibilities concerning the Plant, do not authorize major capital improvement projects beyond those expressly provided in the Master Agreements for "Intermediate Improvements," the "First Stage Expansion," and the provisions concerning Plant *expansions*. The multibillion dollar capital improvements under the CIP – essentially projects to *rebuild* the Plant and not expand it – do not fall within the description of capital improvements authorized under the Master Agreements. (*See* Exhibit 4 [Plant Capital Cost Allocation For Fiscal Year 2016/17], p.13.)

When San José previously undertook major capital improvements to the Plant, the Parties amended the Master Agreements to specifically address and govern such improvements, including scope of work, costs, financing terms, and schedule. (*See, e.g.,* Exhibit 6 [First Amendment To Master Agreement dated December 17, 1985 ("First Master Agreement Amendment")] (in which the parties amended the Master Agreement to provide for significant expansion of the Plant); Exhibit 7 [Second Amendment To Master Agreements dated December 4, 1995 ("Second Master Agreement Amendment")] (in which the parties amended the Master Agreement to allow for, *inter alia*, the development of a water recycling plant).) In fact, it was expressly acknowledged in those amendments that capital improvement programs *require* amendments to the Master Agreements. (*See, e.g.,* First Master Agreement Amendment and Second Master Agreement Amendment ("WHEREAS, changes in treatment plant capacity and Capital Improvement Program costs have been previously approved, *necessitating amendments to the Master Agreement[s]….*") (emphasis added).)

The only time the Master Agreements even mention major capital improvement programs like those under the CIP is to explain what kinds of things are *not included* in the definition of "Replacement Costs":

> 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 or their useful lives;
>
> 2. Structural rehabilitations;

3. *Plant expansions or upgrades* to meet future user demands.

(Master Agreement, Part 1, § N (emphasis added).) Although Replacement Costs are addressed elsewhere in the Master Agreements (*e.g.*, Master Agreement, Ex. B), the Master Agreements do not discuss or contemplate major rehabilitation or Plant upgrades not related to expansion of Plant capacity, which is itself addressed in detail in several different provisions. (*See, e.g.*, Master Agreement, Part 3, § B.)

San José would like to shoehorn the CIP into the Master Agreements in order to unilaterally implement them – and force the Agencies to pay for them – on San José's terms. San José will, therefore, undoubtedly point to a short provision in the Master Agreements that concerns payments by the Agencies for "future improvements" to support its position that multibillion dollar capital improvements like those under CIP are, in fact, enforceable. (*See* Master Agreement, Part 5, § C.) Review of this provision, however, particularly in contrast with other Master Agreement provisions, demonstrates that it simply cannot bear the weight of San José's heavy reliance – to serve as the source of the Agencies' purported obligation to fund multi-billion dollar capital improvements like those under the CIP. *See American Alternative Ins. Corp. v. Superior Court*, 135 Cal.App.4th 1239, 1245, 37 Cal.Rptr.3d 918, 922 (2006) (provisions of a contract are interpreted in context rather than in isolation).

That "future improvements" provision provides:

> C. Payments For Future Improvements.
>
> 1. All payments associated with future improvements at the Plant shall be made on the basis of Agency's existing capacity rights. Final payment shall be determined based upon actual project cost. This payment shall be a proportional share in accordance with a revised Exhibit "A".
>
> 2. First Parties shall, not later than March 1st of any fiscal year, provide Agency with a preliminary estimate of the amount of money required from Agency for future improvements or replacements for the ensuing fiscal year.

(Master Agreement, Part 5, § C.)

First, while the Master Agreements contain definitions for the specific major capital improvements agreed to immediately following the Plant's failure in 1979, the Agreements contain no definition for "future improvements." That fact alone is inconsistent with any interpretation that the "future improvements" provision was intended to address multibillion dollar capital commitments. *See Harris v. Klure*, 205 Cal.App.2d 574, 578 (1962) (a court should avoid an interpretation that will make a contract unusual, extraordinary, harsh, unjust or inequitable).

Second, it is implausible that the only specific provisions of the Master Agreements authorizing major capital improvements are the sparse terms set forth in the "future

improvements" section. Indeed, it defies the fundamental rules of contract interpretation that the parties somehow agreed that major capital improvements of the size of the CIP could be undertaken by San José with no information to the Tributary Agencies beyond a preliminary estimate of costs for the ensuing year – that could be provided merely a few months before billing the Agencies for the costs – which is all that the "future improvements" provision requires. In contrast, the Predecessor Agreements devoted pages simply to define "future capital assets," the term used in the Predecessor Agreements to govern major projects like those under the CIP. (Exhibit 8 [Predecessor Agreement], p.6-7.)

Third, it is entirely unreasonable to interpret the Master Agreements to allow San José to unilaterally commit the Agencies to immensely expensive, long-term capital improvements without needing *any* prior consent from the Agencies as to the specific projects. In contrast, when San José wishes to expand the Plant, the Master Agreements specify in great detail the process by which San José must propose the improvements to the Agencies – including providing them with an engineering report – and the process by which San José must obtain the Agencies' agreement before imposing the costs of the improvements. Under San José's interpretation of the Agreements, it could fully rebuild the Plant every year, if it so chose, and stick the Agencies with the bill. Likewise, it could obligate the Agencies to participate in hundreds of millions – if not billions – of dollars in improvements with little more than a few months' notice. (Master Agreement, Part V.C.2.) These are absurd results, and therefore could not have been what the parties intended. (*See* Cal. Civ. Code § 1638 ("The language of a contract is to govern its interpretation, if the language is clear and explicit, and does not involve an absurdity."))

San José's interpretation of the Master Agreements – under which it enjoys unfettered discretion to obligate the Agencies to pay for *any* improvements it dreams up – would lead to other absurd results. For instance, if San José has no contractual obligation to proceed with a given capital improvement project – which would be the outcome were the CIP deemed "future improvements" – it could include a mega project in the Plant's budget, obligating the Agencies to arrange for and pay for financing it, and then cancel the project without the Agencies having any recourse whatsoever. This could cost the Agencies millions of dollars in unnecessary debt service payments alone.

The more reasonable and sensible interpretation of the Master Agreements is that the provision for "future improvements" addresses only minor modifications to existing facilities to meet new regulatory requirements – such as new monitoring equipment, chemicals for wastewater treatment enhancement, modification for OSHA compliance – for which nothing more than a preliminary estimate of costs for the ensuing fiscal year is necessary. (*See* Civ. Code § 1643 ("A contract must receive such an interpretation as will make it lawful, operative, definite, reasonable, and capable of being carried into effect, if it can be done without violating the intention of the parties.").) If large capital improvement programs unrelated to Plant expansion were authorized by the Master Agreements, the terms of such complex and expensive programs would have been expressly addressed, not just subsumed under a vague "future improvements" provision that provides scant detail about how "future improvements" are to be governed. Had the Master Agreements authorized major capital improvements – projects that would usher in significant process-related changes, and require changes in the Plant's NPDES

permit, like the CIP projects will – they would have included provisions providing the same level of specificity the Master Agreements provide concerning other contemplated changes to the Plant, ones that are arguably of less economic significance than the CIP. (*See, e.g.*, Master Agreement, Part III, § B (Acquisition of Additional Capacity Rights With Plant Expansion, setting forth the procedures by which Agencies may participate in Plant expansions including, *inter alia*, being given written notice by San José of its intention to expand the Plant; the proposed year for the expansion; an engineering study; and a 90-day period in which the Agencies can choose to participate in the planned expansion).)

The circumstances at the time the parties entered into the Master Agreements also bely any interpretation that the Agreements authorize major capital improvements beyond those expressly provided for, namely "Intermediate Improvements," "First Stage Expansion," and Plant expansions that require prior Agency consent. *American Alternative Ins. Corp.*, 135 Cal.App.4th 1239, 1245 (2006) (a court may determine the mutual intention of contracting parties in light of the circumstances under which the contract was made and the matter to which it relates). In the parties' settlement agreements following the Plant's failure in 1979, they agreed to "redraft" the predecessor agreements to address the "long-range development of the Plant and the needs of respective parties," which they specified meant the improvements to the Plant "through the year 1990." (Exhibit 3 [Settlement Agreement].) Hence, the parties could not have also intended the "future improvements" provision of the Master Agreements to serve as the means to address "long-range development of the Plant" 25 years after 1990. *See* Civ. Code § 1647 (A contract may be explained by reference to the circumstances under which it was made, and the matter to which it relates); *see also* Civ. Code § 1642 ("contracts relating to the same matters, between the same parties, and made as parts of substantially one transaction, are to be taken together.").

Interpreting the Master Agreements to include large capital improvement projects unrelated to Plant expansion is also inconsistent with how the parties have performed over the 30-year lifespan of the Agreements. *See* Restatement (Second) of Contracts § 202(5) ("Wherever reasonable, the manifestations of intention of the parties to a promise or agreement are interpreted as consistent with each other and with any relevant course of performance, course of dealing, or usage of trade."). Whenever large improvements have been undertaken in the past, it has been at the behest of regulators to address system-wide failures or serious breaches of the Plant's permit. In fact, despite the Master Agreements being over 30 years old, the parties have *never* undertaken large capital improvement programs to carry out major rehabilitations, improvements, or enhancements – *e.g.* improvements that require a program-based environmental impact report and financing to cover the large capital outlays – except to comply with the orders of Plant regulators. *See Employers Reinsurance Co. v. Superior Court*, 161 Cal.App.4th 906, 922 (2008), *as modified* (Apr. 22, 2008) ("If the parties to a contract have, for years, harmoniously performed the contract in a way that reflects a particular, reasonable, understanding of the terms of the contract, that performance is relevant to determining the meaning of the contract."). In light of the language of the Master Agreements, this course of performance makes perfect sense. Unlike smaller "future improvements" to specific aspects of the Plant, such as those addressed by Part 5.C of the Master Agreement as set forth above, major capital improvements require far greater work, such as obtaining long-term financing, which alone can cost millions of dollars and take many months to set in place, and securing

regulatory approval. Yet, the Master Agreements do not provide any of the necessary procedures or guidance enabling the parties to do these things. Accordingly, the Master Agreements do not authorize the multibillion-dollar CIP costs.

Not only are all charges related to the CIP unenforceable, because they are not authorized under the Agreements, the Agencies cannot be held liable for such costs under equitable principles or quasi-contractual theories. This is true for two independent reasons.

First, each Master Agreement constitutes an express contract governing the Tributary Agencies' relationship to the First Parties concerning the Plant. *Wal-Noon Corporation. v. Norman T. Hill*, 45 Cal.App.3d 605, 613 (1975) (holding that lessee could not recover under an implied contract for repairs it undertook unilaterally where the lease providing lessor had to be notified of the need for repairs first); *Lance Camper Manufacturing. Corp. v. Republic Indemnity Co.*, 44 Cal.App.4th 194, 203 (1996), ("it is well settled that an action based on an implied-in-fact or quasi-contract cannot lie where there exists between the parties a valid express contract covering the same subject matter").

Second, as public entities subject to ordinances limiting their mode of contracting in various ways – including requiring board or council approval for large contracts,[4] the Tributary Agencies cannot be held liable under unjust enrichment or similar equitable theories for work, ostensibly for their benefit, that was undertaken in contravention of the specified modes of contracting. *Pasadena Live, LLC v. City of Pasadena*, 114 Cal.App.4th 1089, 1094 (2004) ("A public entity cannot be held liable on an implied-in-law or quasi-contract theory."); *Henry Zottman v. City & City. of San Francisco*, 20 Cal. 96, 106 (1862) (no recovery from the city of San Francisco by contractor who supplied labor and materials under an implied contract or unjust enrichment theory where the extra work was performed in contravention of the prescribed mode of contracting under the applicable ordinance); *Lundeen Coatings Corp. v. Department of Water & Power*, 232 Cal.App.3d 816, 831 (1991) (municipal water department could not be held liable for work performed by contractor where the work was not performed in accordance with the mode of contracting specified by the city's charter – namely that contracts be in writing in a form approved by the board); *J. Lester Miller v. J.M. McKinnon*, 20 Cal. 2d 83, 87–88 (1942) ("a contract made without compliance with the statute is void and unenforceable as being in excess of the agency's power.").

In sum, if the First Parties choose to proceed with the CIP, without obtaining the Agencies' duly authorized assent, they do so at their own peril.

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[4] *See, e.g.*, West Valley Sanitary District, Cal., Code of Ordinances, ch. 4, § 4.190 (requiring board of director approval for contracts over $30,000); City of Milpitas, Cal., Code of Ordinances, tit. 1, ch. 4, § 2.01 (city council approval required for contracts over $100,000).

B. San José Has Breached The Master Agreements By Refusing to Provide the Tributary Agencies With Sufficient Records To Enable Them To Substantiate Shared Plant Costs and Proceeds.

In light of the Agencies' concerns over the Plant's mismanagement, including high costs, failures to properly allocate Plant costs, and questionable transactions concerning the use of Plant funds or proceeds, the Tributary Agencies have repeatedly sought records from San José to substantiate the costs and proceeds being passed on to them. Not only is such transparency important to the Agencies from the perspective of sound management, the Agencies have a duty to their ratepayers pursuant to Proposition 218 to ensure that wastewater funds are properly being expended for wastewater purposes only. *See* Cal. Const. art. XIIID, § 6.

The Master Agreements provide that San José shall "keep accurate accounts of all receipts and disbursement." The Tributary Agencies have made repeated requests for such records to determine whether the amounts being charged or allocated to the Tributary Agencies are correct. San José initially refused to provide anything but the most simplistic summaries. It took two California Public Records Act ("PRA") requests by the Tributary Agencies to obtain more detailed information, but even then, key information necessary for interpreting and elucidating those records was not provided. In response, the Tributary Agencies had to retain the services of a forensic accounting firm to review the documents produced in response to the PRA requests. That firm has had some measure of success at identifying amounts being charged. However, other information is still needed to fully understand how particular transactions were calculated and to determine whether a particular expenditure was made for the benefit of the wastewater facility – *e.g.*, details for the overhead calculations and supporting invoices for direct expense charges. Without this information the Agencies' forensic accounts are often unable to reach a conclusion that a given transaction is "correct."

San José's failure to operate the Plant with sufficient transparency is an actionable breach of its duties as the Administering Agency under the implied covenant of good faith and fair dealing.

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement. *Carma Developers (Cal.), Inc. v. Marathon Development California, Inc.*, 2 Cal.4th 342, 371 (1992). This implied duty is referred to as the implied covenant of good faith and fair dealing ("implied covenant"). The implied covenant "imposes upon each party the obligation to do everything that the contract presupposes they will do to accomplish its purpose. This rule was developed in the contract arena and is aimed at making effective the agreement's promises." *Careau & Co. v. Security Pacific Business Credit, Inc.*, 222 Cal.App.3d 1371, 1393 (1990), *as modified on denial of reh'g* (2001) (internal cites omitted).

The implied covenant requires San José to allow the Agencies to inspect underlying Plant records in order to substantiate the costs incurred and proceeds received by the Plant. Unless the Agencies have such access, their rights under the Master Agreements are frustrated or illusory because San José would, in effect, have the unfettered ability to incur any costs on behalf of the Agencies without the Agencies having an effective and efficient means of confirming the legitimacy of such costs. *See Kelly McClain v. Octagon Plaza, LLC*, 159 Cal.App.4th 784, 808

(2008) (implied covenant gave tenant in shopping mall the right to access documents to substantiate shared costs where the lease did not expressly provide such right of access). Likewise, San José could fail to report revenue received by the Plant even when such revenue is to be shared with the Agencies.

In response to this issue being raised in Claim 1, TPAC suggested that the Agencies need only study the records, or ask San José staff to explain them, in order to properly understand the accounting for the Plant. Yet San José staff has been unable to explain the accounting methods to the Agencies. Indeed, even the forensic accounting firm hired by the Agencies for this purpose has been unable to decipher important aspects of the Plant's accounting records.

For this reason, the Agencies demand that San José provide access to the Plant's detailed accounting records – *i.e.*, records sufficient to show all charges imposed on the Tributary Agencies, including but not limited to worksheets, cost allocation methodologies, time allocation justifications, and actuarial valuations and findings.[5] Failure to do so constitutes a breach of the implied covenant. *See McClain*, 159 Cal. App. 4th at 808.

C. The Diversion of Plant Proceeds And Use of Plant Funds For Non-Wastewater Purposes In Connection With Plant Lands.

The Agencies have credible reasons to believe that San José has entered into various transactions concerning Plant lands under which proceeds that should have been shared with the Agencies have been diverted, and/or Plant funds have been used for non-wastewater purposes. These constitute breaches of the express terms of the Master Agreements as well as the implied covenant.

1. The Diversion of Plant Proceeds Is A Breach of The Master Agreements.

Under the Master Agreements, the Agencies have the right to a proportional share in proceeds from land surrounding the Plant, referred to as Plant lands. (Master Agreement, Part V, § F.3 ("If First Party should, during the term of this Agreement, receive any income or revenues related to land, products or services at the Plant, then Agency shall be entitled to a share of the income.").) Although San José has discretion in how to make the best use of Plant lands, it must exercise such discretion in good faith under the implied covenant. *Carma*, 2 Cal. 4th at 372 (recognizing that where discretionary power is at issue, the implied covenant requires the party holding such power to exercise it "for any purpose within the reasonable contemplation of the parties at the time of formation—to capture opportunities that were preserved upon entering the contract, interpreted objectively."). Entering into transactions that result in benefits enjoyed solely by San José is a breach of the implied covenant because such

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[5] The Agencies also demand that Plant records begin complying with Office of Budget and Management and Budget's ("OMB") Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, dated December 26, 2013.

transactions would not have been within the parties' reasonable contemplation when entering into the Agreements. *See id.*

2. The Use of Plant Funds For Non-Wastewater Purposes Is A Breach of the Master Agreements.

Under the Master Agreements, the Agencies, along with the First Parties, share the costs of operating the Plant. (Master Agreement, Part V, § D.1.) San José is, in turn, given the authority, as the Administering Agency, to "do any and all things which it shall find to be reasonably necessary" to operate the Plant. (Master Agreement, Ex. E, § B.1.) Specifically, San José has the authority to "provide and supply any and all personnel and services… which it should find to be reasonably necessary" for the operation of the Plant. (Master Agreement, Ex. E, § B.6.) In other words, San José does not have unfettered discretion to incur costs on behalf of the Plant. Rather, such costs must be "reasonably necessary" for Plant purposes. Where it incurs costs that are not reasonably necessary for Plant purposes, it violates the express terms of the Master Agreements. Where San José incurs costs that are not reasonably necessary for Plant purposes *and result in benefits enjoyed solely by San José*, it breaches the implied covenant as well.

3. Specific Transactions In Which San José Has Breached Its Obligations By Diverting Plant Proceeds and/or Using Plant Funds for Non-Wastewater Purposes.

(a) South Bay Water Recycling Program

Due to excessive discharge of treated wastewater into San Francisco Bay in 1991, the Regional Board required the Plant to implement reclamation measures to reduce discharge to acceptable levels, incorporating this requirement into the Plant's NPDES permit. (*See* Master Agreement, Ex. D-2.) To comply, the First Parties and the Tributary Agencies agreed under the Master Agreements to fund the development and operation of the South Bay Water Recycling Program ("SBWR"). (Exhibit 7 [Second Master Agreement Amendment], at D-2.) The SBWR system, which has been in operation since 1997, produces approximately 36,000 acre-feet per year of recycled water. (Exhibit 7 [Second Master Agreement Amendment], Ex. D.)

As acknowledged by San José, "the volume of treated wastewater has significantly decreased, thereby *eliminating the need for recycled water as a wastewater driven permit requirement*." (Exhibit 9 [March 19, 2015 Memo from Kerrie Romanow to Transportation and Environmental Committee], p.1 (emphasis added); Exhibit 9, Ex. A [SBWR Strategic and Master Planning Report ("SBWR Report")], p.ES-5 ("….SBWR has evolved from a wastewater diversion program to a growing component of water retailer's water supply portfolios…"); Exhibit 10 [San José City Auditor's Report dated March 2016 Re: South Bay Water Recycling] ("SBWR Auditor's Report") p.37 ("[The water recycling program] started as a wastewater diversion program but has grown into a part of the region's water supply, providing non-potable water to over 700 large scale water users and has generated net revenue for the first time in his history.").) Given that the Plant's wastewater objectives for developing SBWR have been

satisfied, San José is no longer authorized to incur costs on behalf of the Agencies for expansion or enhancements to the recycled water system.[6] Any further use of wastewater funds to expand SBWR violates not only the Master Agreements, but also the parties' obligations to their respective ratepayers under Proposition 218. *See* Cal. Const. art. XIIID, § 6.

San José continues, however, to charge the Agencies for the costs of *increasing the capacity* of the SBWR system to service more customers. (*See* Exhibit 11 [Excerpts of 2016-2017 Capital Budget], at V-150 ($3.9 million in construction projects to SBWR included in the Plant's 2015-2016 budget); Exhibit 9 [Romanow Memo], p.3 (providing that "near-term" improvements to SBWR will be $5 million for the next five years and will be paid for from the sales of recycled water – *i.e.*, San José will divert Plant proceeds to pay for the improvements).) San José does so because SBWR has gone from serving as a necessary means of satisfying the Plant's NPDES permit, to serving as a source of water for San José to meet General Plan build-out purposes. As explained by Ms. Romanow, the Director of San José's Environmental Services Department, in her March 2015 memo to the Transportation and Environmental Committee, "the use of recycled water has increasingly become an important part of the regional water supply." (Exhibit 9 [Romanow Memo], p.1.) Yet this purported "regional benefit" is not realized by Burbank, Cupertino, West Valley, or County Sanitation District No. 2-3. Using wastewater funds is unauthorized and therefore violates the Master Agreements. Because the marginal benefit of further expansion of the SBWR system inures almost exclusively to San José in the form of increased water to support further development of the city and additional income for recycled water, expenditure of wastewater funds for this purpose is also a breach of the implied covenant.

San José will undoubtedly claim that the "near-term" improvements to SBWR are necessary to ensure the "reliability" of the existing SBWR system, not to expand it. (*See, e.g.*, Exhibit 9 [Romanow Memo], p.3.) This is a red herring. Increasing demand for recycled water – and the strain such increasing demand puts on the existing system – is the driving force behind the short term reliability improvements being pursued. (Exhibit 9, Ex. A [SBWR Report], p.4-9 (stating that, although the system is categorized as an "interruptible supply," "recycled water demands are reaching the maximum capacity for the SBWR system"; also stating that "[t]he current distribution system . . . [is] marginally capable of meeting near-term demands…").)

That the near-term reliability projects are geared toward allowing SBWR to service more customers is evident from the actual projects described in the SBWR Report. (Exhibit 9 [Romanow Memo], Ex. A [SBWR Report], p.4-34.) The very first category of projects discussed in that Report is entitled "Production Capacity." Under that category, the report states: "[t]he near-term peak hour demand is projected to be 53 mgd which exceeds the existing capacity of

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[6] The Agencies agreed to participate in funding the SBWR up to $239,840,000. While actual billings that are shared with the Agencies have not exceeded this amount – due to receipt of grants for the project – SBWR costs to date have nonetheless totaled approximately $250 million. Clearly, this is more than the amount the parties agreed was necessary to generate sufficient recycled water to comply with the NPDES permit.

the recycled water production facilities." (*Id.*) The report then provides that "the proposed 5 year CIP includes implementation of Project P6 and P8." (*Id.*) What is Project P6? A "Capacity Upgrade" that will "[a]dd an additional 14.7 mgd (~1,000 hp) pump to match existing large pump capacity . . . [to] increase total firm capacity of TPS to approximately 56.2 mgd…" (*Id.*) Project 8, likewise, consists of "Filtration and Chlorination Studies" for the purpose of increasing capacity to "57 mgd, which is adequate to meet the near-term peak hour demands." (*Id.*; *see also id.* at p.3-7 (summarizing the additional demand for recycled water anticipated between 2015 and 2020); *id.* ("[t]he near-term recycled water use is defined for this report as the sum of the 2013 recycled water uses identified in Section 3.1.1 and the new uses to be added by 2020.").)

Even if the SBWR near-term so-called "reliability improvements" are intended to address the reliability of the current system, they are still unnecessary to meet wastewater objectives, including those imposed on the Plant through its NPDES permit. The Plant's compliance with the NPDES permit's cap on effluent flow will not be in jeopardy provided the average dry-weather effluent flow does not exceed 120 million gallons per day ("MGD"). (Exhibit 12 [NPDES Permit], pp.12-13.) Compliance with this cap is determined by the average of effluent flow for three consecutive dry weather months. (*See id.*, at p.4.) The effluent flow for any one particular day, or even week, will not implicate the cap. Hence, the SBWR system need only be reliable enough for it to be in operation to comply with this monitoring provision, and only then for just three months of the year. Intermittent interruptions in recycled water service of the sort contemplated in the SBWR Report – *e.g.*, "inability to meet peak flows" – pose absolutely no threat to SBWR's compliance with the NPDES permit.

In fact, new water conservation laws and practices, *inter alia*, have recently made SBWR obsolete to the Plant for purposes of effluent cap compliance. Although the Plant's discharge limit under the permit is 120 MGD, the average dry weather effluent flow has never exceeded 100 MGD in the past 10 years. (Exhibit 11 [5/19/2016 TPAC Amended Agenda] (pg. 252 of 281).) Indeed, for the past two years, the average dry weather effluent flow has been below 80 MGD. (Exhibit 9 [SBWR Auditor's Report], p.3 ("average dry weather flow from the Wastewater Facility to the San Francisco Bay decreased from 130 million gallons per day in 1997 (the year South Bay began operations) to only 70 million gallons per day in 2015").) Simply put, as a practical matter, the Plant does not presently need the SWBR system *at all*. It certainly does not need to expand it, or make it more "reliable" as a water source for retail customers.

In addition to the fact that wastewater funds should not be used for further expansion of the SBWR system, any proceeds from the sale of recycled water should be shared with the Agencies, as is required under the Master Agreements. (Master Agreement, Part V, § F.3 ("If First Party should, during the term of this Agreement, receive any income or revenues related to land, products or services at the Plant, then Agency shall be entitled to a share of the income.").) Yet, as discussed below, San José has entered into an agreement with the Santa Clara Valley Water District ("SCV Water District") under which proceeds from the sale of recycled water will be diverted from the Plant. (Exhibit 13 [March 2, 2010 Recycled Water Facilities and Programs Integration Agreement Between the City of San José and the Santa Clara Valley Water District (the "AWTP Integration Agreement")], Art. 7, § (B)(2) (obligating San José to pay SBWR system revenues to pay operation and maintenance costs for an advanced wastewater treatment plant

operated by SCV Water District on Plant lands); *see also* Exhibit 9 [Romanow Memo], p.3 (providing that SBWR expansion projects will be paid for using SBWR revenue); *Id.*, Ex. A [SBWR Report], p.4-34.); *cf.* Exhibit 9 [SBWR Auditor's Report], p.37 ("[The water recycling program] started as a wastewater diversion program but has grown into a part of the region's water supply…. *San José needs to set up better accounting structures including separate funds for the program in order to ease decision making for managers and provide clarity around revenues and expenses for stakeholders*.") (emphasis added).)

Diversion of Plant proceeds that would otherwise flow back to the Plant through SBWR constitutes a breach of the Master Agreements.

(b) Advanced Wastewater Treatment Plant (AWTP)

Under the AWTP Integration Agreement, San José agreed to contribute $11 million towards the development of an advanced treated recycled water facility and related facilities (AWTF), owned and operated by SCV Water District, but located on Plant lands. (Exhibit 13 [AWTP Integration Agreement], p.9.) San José used Plant funds to make this payment, even though the AWTF is not required for any wastewater purpose. (Exhibit 14 [San José's Response To Previous Action Item dated 9/3/15] ("As such all agencies (San José, Santa Clara and Tributary Agencies) contribute to the treatment of byproducts discharged from the AWTF based on each agency's proportionate share of RWF operations.").) Unlike SBWR – initially developed in order to comply with the Plant's NPDES permit – the AWTF's stated purpose is to "demonstrate the treatment capability of a local AWTF to produce highly purified water that will be blended with existing recycled water to expand irrigation and industrial use." (Exhibit 13 [AWTP Integration Agreement], p.3.) San José never sought, nor obtained, formal approval from the Tributary Agencies to use Plant funds to contribute to the AWTF. Moreover, using wastewater funds for the purpose of "demonstrating the capability of producing highly purified water" clearly doesn't pass Proposition 218 muster.

San José breaches the Master Agreements by diverting proceeds from the Plant in at least three ways related to the AWTP. First, although the AWTP is located on Plant lands and serves no legitimate wastewater purpose, SCV Water District pays the Plant next to nothing – a mere $10 per year in rent – which amounts to a gift of public funds. (Exhibit 15 [San José Invoice Number 233448, dated 9/3/2015].) *See* Cal. Const. art. XVI, § 6 ("nor shall [the Legislature] have power to make any gift or authorize the making of any gift, of any public money or thing of value to any individuals, municipal or other corporation whatever…"). Second, as noted above, the AWTP Integration Agreement purports to require San José to divert Plant proceeds, under certain circumstances, to pay for the AWTP's operation and maintenance costs – proceeds that belong to SBWR, which in turn belong to the Plant. (AWTP Agreement, § 7(B)(2).) Third, the AWTP discharges a huge volume of waste – 2 million gallons per day – to the Plant *completely free of charge*. The Agencies, therefore, pay for wastewater treatment for a facility that has no benefit to the Agencies or the Plant. Indeed, far from providing any benefit, the AWTP materially increases the risk that the Plant will violate the NPDES permit for toxicity violations, subjecting the Agencies to increased liability. (Exhibit 16 [Appendix 6D to SBWR Report], p.6D-6 (concluding that effluent from the AWTP "could have potential impacts on the

[Plant's] chronic toxicity permit requirement" and recommending that "additional toxicity testing should be conducted to better under the impact…".).)

Although San José has discretion to determine how best to manage the Plant and Plant lands, it exceeds the scope of that authority when it takes actions that do not have a sufficient nexus with any legitimate wastewater purpose. Allowing SCV Water District to pay $10 in annual rent, and to commit Plant funds to defray SCV Water District's costs of operating the AWTP – a facility unnecessary for the treatment or discharge of wastewater, and one that does not serve any other legitimate Plant purpose – is a clear abuse of San José's authority under the Master Agreements.[7]

D. San José Has Breached The Master Agreements To The Extent It Has Paid For Other Non-Plant Related Costs Using Wastewater Funds, Or Has Diverted Other Plant Proceeds.

1. Improper and Suspicious Billing Related to Plant Overhead

The Master Agreements require San José to be reimbursed out of Plant funds for expenses incurred as the Administering Agency, including salaries paid by San José to its employees for services rendered for Plant purposes. (Master Agreement, Ex. E, § D.) In addition to reimbursement for such expenses, San José is entitled to be reimbursed 17.313% of all such expenses to pay for certain miscellaneous costs, such as for retirement benefits, medical and hospital insurance coverage for employees, as well as expenses incurred using San José's auditing, purchasing, and engineering departments. (*Id.*)

The Master Agreements, however, expressly proscribe San José from double-charging the Plant for any expenses. (*Id.* (reimbursements are payable to San José "to the extent that such costs and expenses are not included in other items of cost or expense for which San José is otherwise reimbursed from Treatment Plant funds.").) In addition to the express terms of the Master Agreements, double-charging the Plant for overhead expenses would constitute a breach of the implied covenant.

Even though the Master Agreements provide only one way of charging the Tributary Agencies for overhead, the Agencies are currently being charged overheard in multiple ways – for example, in both the operating budget and the capital budget for the Plant. (Exhibit 17 [*Compare* San José 2015-2016 Plant Operating Budget (Fund 513) *with* Overhead Costs Allocated By Project (Fund 512)].) Without knowing more about the attendant circumstances – due to a lack of Plant transparency – these charges appear *on their face* to constitute proscribed double-billing.

[7] The lack of transparency concerning Plant management and transactions prevents the Agencies from fully evaluating the appropriateness of all transactions related to Plant lands, or those that implicate Plant proceeds or costs. To the extent that there are other transactions under which Plant proceeds are diverted from the Plant in exchange for benefits that inure disproportionately to San José, such transactions also violate the Master Agreements and the implied covenant and, are hereby subsumed under this Claim 2.

On a more troubling note, the Agencies have a reasonable basis to believe – based on an interview of a former senior San José finance employee in the treasury department – that interest earnings from Plant funds have been diverted by San José to its general fund or other non-Plant sources, rather than being reimbursed to the Plant as they should be pursuant to San José's Investment Program Reimbursement. Without having sufficient access to Plant records, the Tributary Agencies are presently unable to disconfirm this disturbing report that San José is siphoning off interest earnings from Plant investments. Clearly, such actions would violate the Master Agreements and the implied covenant. Indeed, depending on what other evidence shows, they could constitute outright fraud.

2. Payments For Public Art Programs In San José

The Tributary Agencies have previously requested that San José stop using Plant funds to support public art in San José, purportedly pursuant to a San José public art ordinance. (*See, e.g.*, Exhibit 20 [Cupertino Sanitary District Memorandum Re: "Meeting with San José City Staff," dated January 12, 2011], p.2.) To date, the Plant continues to be charged for such programs. (Exhibit 19 [2/19/2014 Memo to Tributary Agencies from Laura Burke of San José Re: Plant Capital Costs], p.3.) Although supporting public art may be an admirable and legitimate civic goal, it is unrelated to any wastewater purpose. The use of Plant funds to support public art violates the express terms of the Master Agreements that require a reasonable nexus between the use of Plant funds and a legitimate Plant purpose. (Master Agreement, Ex. E, § B.1. (San José has the authority, as the Administering Agency, to "do any and all things which it shall find to be reasonably necessary" to operate the Plant.).)

When the Agencies' concerns over being charged for public art have been raised, San José has contended that the public art payments are *required* under city ordinance. (Exhibit 20 [Cupertino Sanitary District Memorandum Re: "Meeting with San José City Staff," dated January 12, 2011], p.1-2.).) But this is simply not true. Unlike other requirements – such as the payment of minimum wages – support of the public art program by the Plant is not *required* under any generally applicable law. Rather, the applicable ordinance includes an express exception to the requirement that a percentage of redevelopment funds be expended for public art, namely when, under the terms of a contract, the availability of development funds is limited and specified and do not include public art. San José, Cal., Code of Ordinances, tit. 22, ch. 22.08, § 22.08.030(A) (the "Public Art Ordinance").[8]

Under the Master Agreements, the use of Plant funds is always limited and specified for Plant purposes only. (*See generally* Master Agreement, Ex. E, § B.) Hence, expending 1% of all development funds for public art in San José is not required under the Public Art Ordinance, and therefore is not a necessary expenditure for the lawful operation of the Plant. Given this, the use of Plant funds to pay for public art – purportedly under the Public Art Ordinance – constitutes a breach of the Master Agreements and the implied covenant, and a violation of Proposition 218.

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[8] *Available at* http://www.sanjoseca.gov/DocumentCenter/View/28186

3. Plant Funds Used For Holiday Programs In San José City Parks

According to documents produced by San José in response to the Tributary Agencies' public records act requests, it appears that San José has used Plant funds to pay for holiday programs held in San José city parks. (Exhibit 21 [San José Transaction Detail Report for Fund 513].) From the face of such records, the Plant was charged for "sponsorship" payments to an entity identified as "Christmas In The Park, Inc." (*Id.*) A search for "Christmas In The Park, Inc." on Google.com brings up this website as the first search result: christmasinthepark.com. According to this site, "Christmas in the Park is an annual holiday tradition that takes place in the heart of Downtown San José at the Plaza de Cesar Chavez."[9] Support for such a program is not a legitimate use of Plant funds. It constitutes a violation of the Master Agreements and the implied covenant.

4. Improper Charges For The Costs of Unfunded Pension Liability of San José Employees

San José appears to be improperly charging the Plant for the unfunded pension liability of San José employees. Further information from San José is necessary to determine whether this practice results in the Agencies being overcharged.

San José determines the amount in pension liability for "Tier 1" city employees through a citywide actuarial evaluation, which shows, *inter alia*, that San José's pension system is seriously underfunded at just 54% of its funding obligation.[10] (Exhibit 18 [San José citywide actuarial evaluation], p. 10.) As a result, an amount equivalent to 78% of each tier 1 employee's salary must be paid to cover the total unfunded pension liability. (*Id.*, p. 8.) San José allocates the cost of this pension liability through payroll, meaning that the same percentage of each employee's salary is charged to the Plant as a cost. The problem with this approach is that Plant employees may not be, on average, the same age as non-Plant employees of the city. Likewise, they may have not worked for the city for the same length of time, on average, as non-Plant city employees. This means that the actual pension liability for Plant employees could be significantly lower (or higher) than it is for non-Plant employees. Yet, because San José has not conducted a Plant-specific actuarial evaluation, and simply applies the same citywide actuarial analysis to Plant employees, the Plant may be paying a disproportionately larger share of San José's unfunded pension liability. This could mean millions of dollars in additional costs to the Plant.[11]

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[9] *Available at* http://www.christmasinthepark.com/p/about/269.

[10] Tier 1 employees are defined as those hired on or before 9/30/12 (according to the Summary of Plan Provisions at the end of the Actuarial Val report), and Tier 2 are those hired on or after 10/1/12. Tier 1 employees are employees, not including fire, police, and other safety employees, who receive substantially more generous pension benefits compared to Tier 2 employees.

[11] Having to pay 78% in pension liability for Plant tier 1 employees is also clearly much higher than the 17.313% provided for under the Master Agreements. (Master Agreement, Ex. E, § D.)

Due to the lack of Plant transparency discussed above, the Tributary Agencies cannot – without San José's cooperation or the benefit of formal discovery – confirm whether the Plant is paying more than its fair share of pension liability. But even if it turns out that the Plant is paying less, San José's, at best, lax approach to this very significant issue constitutes yet another instance of mismanagement of Plant business, and another example of San José operating the Plant as a mere extension of the city despite the involvement in the Plant of non-city stakeholders. This approach to running the Plant is inherently inappropriate and leads to breaches of the Master Agreements as illustrated by San José's use of Plant funds for non-wastewater purposes, and its diversion of Plant proceeds discussed above. (*See also* Exhibit 10 [San José City Auditor's Report dated March 2016 Re: South Bay Water Recycling] p.37 ("[The water recycling program] started as a wastewater diversion program but has grown into a part of the region's water supply…. *San José needs to set up better accounting structures including separate funds for the program in order to ease decision making for managers and provide clarity around revenues and expenses for stakeholders.*") (emphasis added).)

E. San José's Failure To Provide the Tributary Agencies With the Annual Budget By March 1 Is A Breach of the Master Agreements.

Under the Master Agreements, San José must provide the Agencies with the annual budget for the upcoming fiscal year by March 1 in the current fiscal year. (Master Agreement, Part V.D.2.)

Despite this provision, San José failed to provide the Agencies with an annual budget by this deadline during the prior fiscal year. Not only does this constitute a clear breach of the Master Agreements, it evinces a lack of concern on the part of San José for meeting its contractual obligations. San José's casual approach to performing its duties under the Master Agreements is not well taken by the Agencies.

The Agencies demand that San José respect both the spirit and letter of the Master Agreements and provide the Agencies with the annual budget for the next fiscal year by March 1.

IV. CONCLUSION

For the foregoing reasons, the Tributary Agencies demand that:

1. The First Parties agree to negotiate an amendment to the Master Agreements with the Tributary Agencies – pursuant to the proposed amendments included with Claim 1 – to authorize the CIP projects, and to provide:

- Clear definitions as to prohibited use of funds, in particular limiting the use of funds solely for meeting the permit requirements for wastewater treatment purposes;
- Specific scope, budget, and schedule for capital improvements to be funded by the Tributary Agencies;

- Specific cost allocation/financing and Agency obligations for debt service;

- Justification, explanation, and removal of any overhead that is noncompliant with the Master Agreements;

- Transparent accounting, in conformance with OMB rules, that allows the Agencies to confirm that Plant funds are being expended solely for wastewater treatment purposes;

- A third party audit – and performance audit – to confirm contract provisions are performed to contract provisions and make corrections immediately upon findings of deviation; and

- Fair market value of lease revenue to the Tributary Agencies for all uses of the land unrelated to plant purposes.

2. The First Parties return funds used for non-wastewater related purposes, such as paying for the AWTP, and diversion of revenues used for non-Plant related activities.