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March 11, 2016

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

Re: *Cities of San José and Santa Clara's Supplemental Response to Administrative Claim*

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

First Parties submits this supplemental letter in response to the Agencies' letter dated March 4, 2016 regarding the administrative claim.

1. The Agencies demand greater transparency and accountability in support of their proposed amendment to the Master Agreements but have not been able to transcend the rhetoric of generalities.

The Agencies asked First Parties to secure State Revolving Fund loan ("SRF") financing on their behalf. First Parties could not do so without a promise from the Agencies to repay the debt. The First Parties' proposed amendment to the Master Agreement defines the Capital Improvement Program ("CIP") projects that would be financed, and the framework of the Agencies' repayment obligation. But instead of executing agreements that would facilitate SRF financing, San José is expending significant staff time and resources to respond to the two Public Records Act requests made by the Agencies and this administrative claim. The Agencies assert that none of the information we have produced is responsive, and provides the necessary transparency. This assertion is without basis.

Moreover, the Agencies receive information on a regular basis supporting the amounts billed to them for capital and operating costs. In addition to the documents in support of the annual budget, Agencies receive documentation in support of the

quarterly invoices for both capital and operation and maintenance costs.¹ It would be much easier if the Agencies could simply articulate what additional information they want and have not received, and how this information is relevant to addressing a specific concern.

Good faith and fair dealing principles require that the Agencies also be transparent and accountable. On February 9, 2016, San José requested records from the Agencies to fully respond to their administrative claim, and to make informed decisions regarding the adequacy of current Master Agreement requirements. For example, First Parties currently rely on the Agencies to “self-report” their “actual discharge” of wastewater into the RWF based on estimates. These estimates form the basis for allocating the operating cost share for each outside user of the Regional Wastewater Facility. Evaluation of whether these estimates are still accurate and reliable is significant because ratepayers from San José and Santa Clara pay the balance and majority share of the operating budget. The Agencies finally responded on March 4, 2016, but many of the records were not provided in electronic form when these types of records should have been available in electronic form. When San José staff inspected the records, we learned that important categories of records were either incomplete or not produced. By contrast, when San José responded to the Agencies’ PRA, we uploaded scanned copies of responsive records and continue to review potentially responsive records in order to supplement our prior response.

2. The Agencies’ asserted reasons to not participate in a potential State Revolving Fund loan to finance the Digester and Thickener Upgrade project are not supported by the facts or historical precedent.

The Agencies allege that First Parties ignored their requests to amend the current Master Agreements over several years. As summarized below, First Parties responded to some requests, and did not agree with other requests to amend the Master Agreements because the issues raised were unrelated to implementation of the CIP, premature as to financing, or not in the First Parties’ interest:

- In response to the City of Milpitas’s letters² requesting the Plant Master Plan include guiding principles from Milpitas, City staff conducted a TPAC study session on the Plant Master Plan, and San José City Council recommended consideration of the guiding principles which was instrumental in accelerating the timeline for the biosolids transition in the Plant Master Plan to address Milpitas’ interest in mitigating odor.
- The Cupertino Sanitary District correspondence³ requested amendments to the Master Agreement to show the “financial benefits to the tributary

¹ See Exhibit A for sample of quarterly invoices and related documentation provided to each Agency regarding the use of funds for operating and capital costs.

² City of Milpitas Resolution No. 8025, and letters dated September 24 and October 14, 2010.

³ Cupertino Sanitary District Resolution No. 1221 and letter dated October 7, 2010.

agencies resulting from the sharing of revenues generated by the development and private use of Plant lands such as increased real property taxes and sales taxes generated by leased Plant lands.” The correspondence also alluded to an interest in sharing revenue from the sale of recycled water through South Bay Water Recycling Program, the very same program the Agency would cease to support based on the erroneous assertion that it was unrelated to the treatment of wastewater.

- West Valley Sanitation District⁴ expressed its view that the current Master Agreement was not sufficiently detailed to include the Plant Master Plan, noted the engineering design requirement for allocation of capital cost, and raised the issue of funding development on RWF buffer lands and also requested amendments to the Master Agreement.

In the case of the requests of the Cupertino Sanitary District and West Valley Sanitation District, First Parties fundamentally disagreed with the basis for the requested amendments. To illustrate this point, in the case of West Valley’s requested amendment, the Agencies’ obligation to pay the capital cost of future improvements is enforceable under the current Master Agreement. It is important to distinguish that the CIP is limited to RWF future improvements for the treatment of wastewater while the Plant Master Plan (“PMP”) includes other activities unrelated to the treatment of wastewater. Second, an amendment clarifying that the Agencies were not required to pay for PMP development projects was not necessary because First Parties did not propose that projects outside of the CIP be funded with sewer ratepayer funds. Last, while the Parties could always negotiate new business terms, the Agencies’ current interest is limited to a participation interest in the buffer land revenues. The Agencies do not have rights as owners to determine the best use of the buffer land.

The more recent Agency correspondence between August and December 2015 presumed that an amendment to the Master Agreement was necessary before First Parties could require the Agencies to pay for their contract capacity associated with the CIP. While First Parties were willing to consider a limited amendment to facilitate financing, First Parties did not have an obligation to consider unrelated changes in the First Parties’ interest. To begin negotiation regarding unrelated changes that would have placed an additional burden on San José , as the Administering Agency, whose staff already had considerable responsibility with implementing the CIP. Moreover, during this same period of time, San José staff were meeting with Agency staff and working diligently to develop a financing strategy for the CIP. When the Agencies did submit specific proposals to amend the Master Agreements in October 2015, their proposed revisions encompassed terms that were focused on shifting the liability to operate and rehabilitate the RWF to First Parties.

The Agencies are offering a solution in search of a problem. Specifically, the Agencies insist that the Master Agreement requires new definitions. The current

⁴ West Valley Sanitation District letter dated November 4, 2013.

definitions in the Master Agreement already limit the use of sewer ratepayer funds to wastewater treatment purposes, and are consistent with the California State Revenue Guidelines. With respect to the SRF for the Digester and Thickener Upgrade project, the State would require proof that the expenditures submitted for reimbursement from the SRF loan funds were in fact spent on the project before issuing a reimbursement. The Agencies' suspicions concerning the administration of funds are unsupported in light of the existing Master Agreement terms and the SRF requirements.

If the First Parties accepted Agencies' proposed definition of "Plant Purposes,"⁵ this definition could be interpreted to relieve the Agencies of their current obligation to pay for the cost to operate and maintain the South Bay Water Recycling Program ("SBWR"), a program required to comply with the National Pollutant Discharge Elimination System permit ("NPDES"), and thus a Master Agreement requirement. The SBWR treats wastewater effluent from the Agencies' service areas. The proposed definition also conflicts with the Agencies' existing obligation to repay their portion of the financing to construct the SBWR.

The Agencies do not dispute the CIP's necessity, nor do they contend that the CIP expands the RWF treatment capacity. With the exception of the biosolids transition project that would implement a different method of biosolids treatment, the CIP is limited to projects necessary to rehabilitate the RWF aging infrastructure. Despite the Agencies' agreement on these key points, the Agencies assert that proceeding with the CIP without first amending the Master Agreement is contrary to historical precedent. This is simply not true. The Master Agreements, as summarized below, have only been amended between the Parties to (1) memorialize the repayment terms for financing of RWF future improvements, (2) document each Parties interest in an expansion of RWF, or (3) provide for sale of contract capacity between Agencies.

- First Amendments to Master Agreements to reflect participation in treatment plant capacity expansion;⁶
- Second Amendments to Master Agreements to reflect cost share between Agencies for development of a reclamation program (SBWR) as required by the Regional Water Quality Control Board before issuance of bonds to finance the program;⁷
- Third Amendment to West Valley Master Agreement to sell one million gallons per day (1mgd) contract capacity to the City of Milpitas;⁸

⁵ Agencies October 2015 proposed amendment to the Master Agreement included the definition of "Plant Purposes" to mean "the treatment and disposal of wastewater from the Plant's service area, including the distribution of Recycled Water through the South Bay Water Recycling, for the sole purpose of complying with the NPDES Permit and other applicable state and federal law. Plant Purposes do not include the operation and maintenance of, or capital improvements to the AWPC [advanced water purification center]."

⁶ With Agencies in December 1985.

⁷ With Agencies in December 1995.

⁸ With West Valley Sanitation District in August 2006.

- Third Amendment to City of Milpitas Master Agreement to purchase one million gallons per day (1 mgd) contract capacity from West Valley Sanitation District;⁹
- Third Amendment to Cupertino Sanitary District Master Agreement to sell seven hundred and fifty thousand gallons per day (.75 mgd) of contract capacity to the City of Milpitas;¹⁰
- Fourth Amendment to City of Milpitas Master Agreement to purchase seven hundred and fifty thousand gallons per day (.75 mgd) of contract capacity from Cupertino Sanitary District.¹¹

Since the CIP does not expand RWF capacity, amendments to the Master Agreements are not necessary to enforce the Agencies' existing obligation to pay for the capital cost of future improvements. The current Master Agreement term ends in 2031 but as long as the Agencies continue to discharge to the RWF, they must pay for their proportional share of the cost to operate and rehabilitate the RWF.

3. The Agencies' position that capital cost for projects should be allocated to parameters with the first expenditure is impractical, and contrary to the requirements of the Master Agreements.

The Agencies' statements that they were overcharged for capital cost associated with planning the Digester and Thickener Upgrade project is simply untrue, and misleads the public regarding the capital project development process and the requirements of the Master Agreements. The First Parties agreed that the Master Agreements require that the capital cost for process related projects over \$2 million be allocated to treatment parameters based on engineering design. First Parties' mid-year correction of the capital budget¹² and the corresponding adjustment to the upcoming Fourth Quarter Invoice is in compliance with the Master Agreement because the Digester and Thickener Upgrade project engineering design was not completed until December 2015.

At the March 10, 2016 Treatment Plant Advising Committee meeting, the Agencies urged First Parties to wait until the third quarter of 2016-2017 or January 2017 to adjust the bill to the Agencies for their share of the Digester and Thickener Upgrade project. The Agencies' proposal would be a windfall to the Agencies because if the Fourth Quarter Invoice is based on a budget that assumed Agency financing the balance of its share through short term financing, the Agencies' invoice would be for a lower payment. The Agencies' proposal also contradicts their prior position in the claim that the invoice based on the rolling weighted average and not the specific project

⁹ With City of Milpitas in July 2006.

¹⁰ With Cupertino Sanitary District in August 2009.

¹¹ With City of Milpitas in August 2009.

¹² A mid-year budget adjustment is required because the adopted budget assumed that the Agencies would fund their share through a short term financing, commercial paper program. The Administering Agency initially proposed a budget to include this assumption pursuant to request from the Agencies' staff. Since the Agencies will not be funding their share through a commercial paper program, the budget must be amended so that they can be correctly invoiced for the fourth quarter.

treatment parameters would be a violation of the Master Agreement. More importantly, San Jose and Santa Clara ratepayers would be responsible for the advancing the balance of the Agencies' share for the project until after January 2017.

A project may go through various stages before completion of engineering design including feasibility analysis, project level cost estimates, and design. Each phase necessarily requires incurring capital costs for administration, project management, design, engineering, and other associated costs for project development. It would be impossible to delay charging the Agencies until completion of engineering design. The costs incurred at the planning stage of a capital project must initially be attributed to the rolling weighted average because engineering design is not complete. This methodology is appropriate for a variety of reasons. There may not be sufficient information regarding the project to allocate to specific parameters, or the feasibility analysis may result in a decision to not proceed with the project.

The Master Agreement does not require allocation to parameters before engineering design. The Agencies have asserted this timing is not in their interest for the Digester and Thickener Upgrade project. Whether an agency benefits from an earlier determination largely depends on the parameters treated by the project and their contract capacity in the parameter(s). First Parties would consider allocating the capital cost to parameters at an earlier point in time. The proposed process would allow for allocation based on parameters once project specific engineering information is available and for reasonable periodic confirmation of the appropriate parameter allocations as the engineering design is completed and the project is accepted. The technical memorandum describing this process was provided to staff of the Agencies on March 9, 2016. The Administering Agency could implement this process administratively¹³.

Conclusion

The reality is that the RWF is the only regional wastewater treatment facility that can serve our communities. As public agencies, First Parties are charged with responsibly administering our limited public resources. The appropriate forum for constructive conversation should be through a mediated face-to-face process, and not through asserting unfounded accusations in press releases.

To that end, we look forward to a more constructive process to addressing all of our respective interests. For the reasons stated in the First Parties Response to the Administrative Claim dated February 26, 2016, and this letter, we urge the Treatment Plant Advisory Committee to find that there has not been a breach of contract or inequities, and to encourage the Parties to begin collaborating on a resolution.

¹³ The Master Agreement does not require allocation by parameters before completion of engineering design. When the Master Agreement is amended, the Parties can revise the requirement to conform to the modified process.

Very truly yours,

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RLT/rlt

Attachments: Exhibits A

Cc:

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