

RESOLUTION NO. 2017-01

**A RESOLUTION OF THE SAN JOSE/SANTA CLARA TREATMENT PLANT ADVISORY COMMITTEE SETTING FORTH THE COMMITTEE REPORT, INCLUDING FINDINGS AND RECOMMENDATIONS ON THE CLAIMS OF BREACH OF AGREEMENT AND INEQUITIES FILED ON SEPTEMBER 7, 2016 BY WEST VALLEY SANITATION DISTRICT, BURBANK SANITARY DISTRICT, CUPERTINO SANITARY DISTRICT, SANTA CLARA COUNTY SANITATION DISTRICT NO. 2-3, AND THE CITY OF MILPITAS**

**WHEREAS**, the Cities of San José and Santa Clara (collectively, “Co-Owners”) own the San José - Santa Clara Regional Wastewater Facility (“RWF” or “Plant”); and

**WHEREAS**, the City of San José (“San José”) operates the RWF as Administering Agency under an agreement with the City of Santa Clara that dates back to 1959 (“San José/Santa Clara Master Agreement”); and

**WHEREAS**, West Valley Sanitation District, Burbank Sanitary District, Cupertino Sanitary District, Santa Clara County Sanitation District No. 2-3 (“CSD 2-3”), and the City of Milpitas (“Tributary Agencies”), each have agreements with the Cities of San José and Santa Clara (“Master Agreements”) under which the Tributary Agencies discharge wastewater for treatment and disposal by the RWF; and

**WHEREAS**, each of the Master Agreements contains provisions requiring that if any party to the Master Agreement has a claim that the other party has in any way breached or is breaching the Agreement, or that the Agreement is inequitable, the complaining party shall file a written claim of said breach or inequity with the Co-Owners’ legislative bodies and with the San José/Santa Clara Treatment Plant Advisory Committee (“TPAC”) for the RWF; and

**WHEREAS**, the Master Agreements further provide that TPAC shall, within two (2) months of receiving a claim of breach or inequities, give all concerned parties full opportunity to be heard on the matter of the claim of breach or inequities, and shall

upon the conclusion of said hearing give the legislative bodies of the parties a full report of its findings and recommendation; and

**WHEREAS**, on January 25, 2016, the Tributary Agencies, pursuant to the terms of the Master Agreements, individually and jointly filed a “Claims of Breach of Agreement and Inequities” (“Claim No. 1”), which relates to Plant Master Plan capital costs; and

**WHEREAS**, on March 24, 2016, TPAC provided the Tributary Agencies and Co-Owners full opportunity to be heard on Claim No. 1, in accordance with the Master Agreements; and

**WHEREAS**, on March 24, 2016, after considering the written arguments, hearing presentations and the supporting documents submitted by the Tributary Agencies and Co-Owners, and testimony from witnesses, TPAC adopted Resolution No. 2016-01<sup>1</sup> finding that:

1. The Administering Agency's methodology for allocating Plant Master Plan capital costs to each Agency is not a breach of the Master Agreements or inequitable;
2. The Agencies' payment obligation for Plant Master Plan capital projects is enforceable;
3. Co-Owners have not breached the Master Agreements or acted inequitably with respect to the proposed amendments to the Master Agreements;
4. The Agencies' allegations related to the lack of transparency are unsupported; and
5. The Agencies' claims with respect to payment for legal services are moot.

**WHEREAS**, the Tributary Agencies objected to the findings in Resolution No. 2016-01 and the Parties agreed to mediate the Tributary Agencies' objection to the findings; and

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<sup>1</sup> Co-Owner's Response to Claim No. 2 (Response to Claim) and an index of documents submitted by Co-Owners in response to Claim No. 2, are collectively attached hereto and incorporated herein by this reference as “Attachment A”. See Attachment A, Ex. A.

**WHEREAS**, on September 7, 2016, the Tributary Agencies individually and jointly filed a second “Claims of Breach of Agreement and Inequities” (“Claim No. 2”) with Co-Owners and TPAC<sup>2</sup>; and

**WHEREAS**, Claim No.2, alleges San José breached the Master Agreements by mismanaging the RWF and taking financial advantage of the Tributary Agencies. Co-Owners received Claim No.2 seven days before the Tributary Agencies and Co-Owners (collectively “Parties”) were scheduled to start mediation on Claim No. 1<sup>3</sup>; and

**WHEREAS**, the Parties attended mediation sessions held on September 14, October 6, December 9, 2016, and March 29, 2017; and

**WHEREAS**, on March 30, 2017, the Tributary Agencies withdrew from mediation and requested a hearing before TPAC on Claim No.2.<sup>4</sup> The Tributary Agencies also requested a joint meeting of all the legislative bodies of all Parties concerned<sup>5</sup> for the purpose of resolving the differences between the Tributary Agencies and Co-Owners regarding Claim No. 1, as permitted under the Master Agreements; and

**WHEREAS**, at the April 13, 2017 TPAC meeting, Co-Owners offered to waive the hearing requirement for Claim No. 2, but the Tributary Agencies did not accept the offer; and

**WHEREAS**, on May 10, 2017, Co-Owners submitted a written response to TPAC and the Tributary Agencies regarding Claim No. 2 (“Response to Claim No. 2”)<sup>6</sup>; and

**WHEREAS**, on May 18, 2017, TPAC provided the Tributary Agencies and Co-Owners with full opportunity to be heard on Claim No. 2, in accordance with the Master Agreements. David Mehretu, Special Counsel from Meyers Nave appeared on behalf

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<sup>2</sup> The Tributary Agencies’ Claim No. 2 (Claim No. 2) and an index of documents submitted by the Tributary Agencies in support of Claim No. 2 are collectively attached hereto and incorporated herein by this reference as “Attachment B”.

<sup>3</sup> Attachment A, Response to Claim, p. 2.

<sup>4</sup> Id.

<sup>5</sup> All the legislative bodies for purposes of the dispute as to Claim No. 1 and Claim No. 2 are each of the legislative bodies of the Tributary Agencies and Co-Owners.

<sup>6</sup> Attachment A, Response to Claim.

of the Tributary Agencies. Rosa Tsongtaarii, Senior Deputy City Attorney from the San José City Attorney's Office appeared on behalf of Co-Owners; and

**WHEREAS**, TPAC has considered the written arguments, hearing presentations and the supporting documents submitted by the Tributary Agencies and Co-Owners, and testimony from witnesses;<sup>7</sup> and

**WHEREAS**, at the conclusion of the May 18, 2017 hearing, TPAC acted by a 6-3 vote to deny Claim No. 2;

**NOW, THEREFORE**, BE IT RESOLVED THAT THE SAN JOSE/SANTA CLARA TREATMENT PLANT ADVISORY COMMITTEE FINDS AND RECOMMENDS AS FOLLOWS WITH RESPECT TO THE TRIBUTARY AGENCIES' CLAIM NO. 2:

**SECTION 1.        FINDINGS**

**A.        Charging the Tributary Agencies for CIP Projects is Not a Breach of the Master Agreements Because Such Costs are Authorized Under the Agreements.**

**1.        The express terms of the Master Agreements authorize future improvements and the payment of capital cost for the future improvements.**

The Tributary Agencies' allege that the Master Agreements must be amended before Co-Owners can proceed with future improvements to the RWF. In support of this position they argue that "[t]he Agencies are under no obligation to make these payments because such costs are not authorized by the Master Agreements."<sup>8</sup> They contend that the Master Agreements, which govern the parties' respective rights and responsibilities concerning the RWF, do not authorize major capital

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<sup>7</sup> A transcript of the May 18, 2017 hearing prepared by City vendor Vitac from the audio recording of the hearing is attached hereto and incorporated herein by this reference as " Attachment C".

<sup>8</sup> Claim No. 2, p.6.

improvement projects beyond those for “Intermediate Improvements,” the “First Stage Expansion”, and “Plant expansions”.<sup>9</sup>

The Tributary Agencies also contend that their only obligations to pay for major capital improvements are set forth in the “sparse” “future improvements” provisions of the Master Agreements which in their view, are the specific provisions of the Master Agreements authorizing major capital improvements.<sup>10</sup>

The “future improvements” provision states:

“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 1<sup>st</sup> of any fiscal year, provide Agency with a preliminary estimate of the amount of the amount of money required from Agency for future improvements or replacements from the ensuing fiscal year.”<sup>11</sup>

Contrary to the Tributary Agencies’ claims, as set forth by Co-Owners, the obligation to pay for capital projects is comprehensively addressed in the Master Agreements which expressly authorize San José, as the Administering Agency, to implement capital projects for the RWF.<sup>12</sup> Co-Owners further contend that historic practice supports the Tributary Agencies’ obligation.<sup>13</sup>

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<sup>9</sup> Attachment B, Claim No. 2, p. 9.

<sup>10</sup> Attachment B, Claim No.2, p. 7.

<sup>11</sup> Attachment B, Ex. 1, Master Agreement for Wastewater Treatment, Part V, Section C (1)-(2).

<sup>12</sup> Attachment A, Response to Claim, pgs. 4-5.

<sup>13</sup> Attachment A, Claim No. 2, p.4.

Although the Master Agreements do not contain a definition for the term “future improvements”, Exhibit E of the Master Agreements entitled “Administering Agency” states that the “Administering Agency shall have the following powers and duties:<sup>14</sup>

1. “To maintain, repair, expand, replace, improve and operate the Treatment Plant, and to do any and all things which it shall find to be reasonably necessary, with respect to its maintenance, repair, expansion, replacement, improvement and operation (subject to the provision of funds therefor in accordance with the provisions of this Agreement), to treat and dispose of all sewage (and by-products thereof) of San Jose and Santa Clara and of any and all “Outside Users” now or hereafter authorized to discharge or convey sewage into or to said treatment plant or any sewer lines leading thereto, so that said sewage and all effluent from said Plant will not pollute the waters of San Francisco Bay, or any other waters, and so that said sewage will be disposed of in a manner authorize by law.
2. To make, award and enter into contracts with third parties for the construction, improvement, replacement, expansion, or repair of the Treatment Plant or any part or parts thereof.
3. To acquire, by purchase, condemnation or otherwise, any and all real or personal property which it should find to be reasonably necessary for Treatment Plant purposes.
4. To receive, be the depository for, expend and disburse, for the purposes of this Agreement, any and all funds or monies advanced, contributed or paid by the parties hereto to said Administering Agency pursuant to the provisions of this Agreement,

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<sup>14</sup> Attachment B, Exhibit 1, Master Agreement for Wastewater Treatment, Ex. E., Sections 1-9.

together with all income collected from “Outside Users”, all other Treatment Plan income, and all other Treatment Plant funds.

5. To keep accurate accounts of all receipts and disbursements of the above-mentioned funds and monies.
6. To provide and supply any and all personnel and services, including, but not limited to, legal, engineering and accounting services, which it should find to be reasonably necessary for the maintenance, repair, expansion, replacement, improvement and operation of said Treatment Plant, the cost and expense of providing such personnel and services to be charged to and shared by San Jose and Santa Clara as part of operating or other Treatment Plant costs as elsewhere provided in this Agreement.
7. To exercise any and all other powers, common to both San Jose and Santa Clara, with respect to the maintenance, repair, expansion, replacement, improvement and operation of the Treatment Plant.
8. To do any and all things reasonably necessary to treatment and dispose of all sewage entering the Treatment Plant in such manner as will comply with all applicable laws and regulations.
9. To do any and all other things which the Administering Agency is required or authorized to do by other provisions of this Agreement.”

The Master Agreements also expressly require the Tributary Agencies to pay for the capital cost of future improvements as particularly described in Attachment A, Master Agreements for Wastewater Treatment, Part V, Sections C (1)-(2).

The processes to bill and pay for capital costs are also specifically described:

“E. Method of Payment.

1. Capital and Land Acquisition. All payments for capital and land acquisition shall be on a quarterly basis. The first quarter beginning July 1<sup>st</sup>. These invoices shall be presented at the beginning of the quarter in which the obligation is anticipated to occur. The date of financial obligations for capital expenses and land acquisitions shall be the date of the award of the contract. These payments shall be based upon the budget for capital costs for the Plant as recommended by TPAC and approved by the Administering Agency...

10. General Information.

a. All bills shall be paid to the Administering Agency within forty-five (45) days from presentation...

b. Adjustments in any payment described above shall be on the basis of actual payment to actual expenditures and shall be made no later than the third quarter billing of the following fiscal year. A statement outlining the method of adjusting costs and actual adjustments shall be included.”<sup>15</sup>

**2. Amendments to Master Agreements have not been required to authorize future improvements except for an expansion of RWF design capacity, participation in financing, or sale of capacity.**

According to the Tributary Agencies the capital improvements under the CIP are comprised of projects to “rebuild the Plant and not expand it.”<sup>16</sup>

This rebuilding does not fall within the capital improvements authorized

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<sup>15</sup> Attachment B, Claim No. 2, Ex. 1, Master Agreement for Wastewater Treatment, Part V, Sections E.1., and E.2.

<sup>16</sup> Attachment B, Claim No.2, p.6.



under the Master Agreements, which means that amendments to the Master Agreements are necessary in order for this work to proceed.

Co-Owners take the position that the Master Agreements distinguish between the methodology for calculating the payments for future improvements from facility expansion or for transfer of capacity rights.<sup>17</sup> They point out that the Master Agreements have only been amended in limited circumstances: when the RWF has expanded, to reflect whether a Tributary Agency participated in the expansion; to document repayment for financing capital projects; and to reflect the sale of contract capacity between Tributary Agencies.<sup>18</sup> Listed below are all the amendments to the Master Agreements identified by Co-Owners since 1983:

1. First Amendments to Master Agreements to reflect participation in treatment plant capacity expansion;<sup>19</sup>
2. Second Amendments to Master Agreements to reflect cost share between Agencies for development of the South Bay Water Recycling Program (“SBWR”) as required by the Regional Water Quality Control Board before issuance of bonds to finance the program;<sup>20</sup>
3. Third Amendment to West Valley Master Agreement to sell one million gallons per day (1mgd) contract capacity to the City of Milpitas;<sup>21</sup>
4. Third Amendment to City of Milpitas Master Agreement to purchase one million gallons per day (1 mgd) contract capacity from West Valley Sanitation District;<sup>22</sup>

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<sup>17</sup> Attachment A, Response to Claim, p. 5.

<sup>18</sup> Id.

<sup>19</sup> With Tributary Agencies in December 1985.

<sup>20</sup> With Tributary Agencies in December 1995.

<sup>21</sup> With West Valley Sanitation District in August 2006.

<sup>22</sup> With City of Milpitas in July 2006.

5. 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;<sup>23</sup>
  6. 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.<sup>24</sup>
- 3. Co-Owners have previously completed improvements at the RWF comparable to proposed projects in the CIP.**

The Tributary Agencies claim that the "...the parties have *never* undertaken large capital improvement programs to carry out major rehabilitations, or enhancements."<sup>25</sup> (Emphasis in the original.) However, Co-Owners point out that since 1983, the RWF has completed improvements that are major rehabilitations without amendments to the Master Agreements. The projects required design by multi-disciplinary licensed professionals and public contract bidding. According to Co-Owners, none of these projects were due to a new permit requirement, or in response to a regulatory agency order. The improvements include:

- WPCP Reliability Improvement Projects (\$85M) FY 08-09;
- Electrical Reliability Improvements (\$11.8M) FY 13-14, FY 14-15;
- Alternative Disinfection Facility (\$10.9M) FY 12-13;
- Handrail Replacement (\$4M) FY 08-09 to FY 15-16; and
- Fire Main Replacement (\$3.65M) FY 07-08 to FY 14-15.<sup>26</sup>

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<sup>23</sup> With Cupertino Sanitary District in August 2009.

<sup>24</sup> With City of Milpitas in August 2009.

<sup>25</sup> Attachment B, Claim No. 2, p. 9.

<sup>26</sup> Attachment A, Response to Claim, pgs. 6-7.

**4. The Master Agreements do not require an engineering study for future improvements that do not expand RWF design capacity.**

The Tributary Agencies seek to require an engineering study for each project. According to Co-Owners, this interpretation of the requirement is incorrect because under the Master Agreements, an engineering study is only required to plan for an expansion if the RWF has reached 85% or 142 mgd of the 167 mgd design capacity.<sup>27</sup> Neither the Tributary Agencies, nor Co-Owners dispute that the CIP would not expand the RWF design capacity.<sup>28</sup>

**5. The Master Agreements do not require amendments for future improvements, and it is impractical to condition the payment for these projects on an amendment.**

The Tributary Agencies want to condition the payment for each project on an amendment that would include a construction timetable, an estimate of total project cost, and an estimate of each participating agency's share of project cost. Co-Owners object to this requirement on the basis that the phasing of the CIP is driven by facility safety considerations and treatment interactions. Capital costs may need to be incurred over the course of many years for activities that precede award of construction and financing such as planning, feasibility studies, environmental review, and engineering design. The project schedules and costs are also refined at each stage of development from feasibility to the award of the construction contract. It's Co-Owners position that the Tributary Agencies' demand is not only contrary to the express provisions of the Master Agreements but impractical from a project implementation perspective.<sup>29</sup>

Co-Owners also contend that there is no factual basis or precedent for the Tributary Agencies' claim that San José would arbitrarily change course

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<sup>27</sup> Attachment B, Claim No. 2, Ex. 1, Master Agreements for Wastewater Treatment at Part I, Section F.

<sup>28</sup> Attachment A, Response to Claim No. 2, p.7.

on a project that has been financed. According to Co-Owners, San José has a mutual if not greater financial interest in minimizing risk and cost to ratepayers.<sup>30</sup> San José practices best industry standards to manage the scope, schedule and costs of CIP Projects.<sup>31</sup> Detailed project information is provided to the Tributary Agencies at each stage through approvals for contract services, studies and reports, monthly CIP and semi-annual CIP status reports, and annual capital budgets.<sup>32</sup>

### **Summary of Findings**

Based on the express language of the Master Agreements, and the other arguments made by Co-Owners above, we find that the Master Agreements require that the Tributary Agencies pay their proportionate share of the capital cost for future improvements at the RWF. Additionally, since the CIP will not expand the RWF design capacity, we find that an engineering study for the CIP is not required. We further find that Tributary Agencies' obligations to contribute their respective costs for capital improvements at the RWF, was already resolved in favor of Co-Owners in our Resolution No. 2016-01, wherein we determined that the Tributary Agencies' payment obligations for PMP capital projects is enforceable under the Master Agreements.

### **B. San José Has Not Breached the Master Agreements Because San José Has Maintained and Provided Sufficient Records to the Tributary Agencies to Enable Them to Substantiate Shared Plant Costs and Proceeds.**

The Tributary Agencies contend they are not able to confirm RWF costs and

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<sup>29</sup> Attachment A, Response to Claim, p.7.

<sup>30</sup> Attachment A, Response to Claim, p. 7; and Attachment A, Exhibit C, Table of Treatment Capacity Fiscal Year 2015-2016.

<sup>31</sup> Attachment A, Response to Claim, p. 7; and Attachment A, Exhibit. D, Summary of Cost Control Measures, and Exhibit E CIP Cost Controls and Estimates.

<sup>32</sup> Attachment A, Response to Claim, p. 8; and Attachment A, Exhibit. F, sample of the Monthly CIP Status Report, Exhibit G, sample of the Semi-Annual CIP Status Report, Exhibits H for 2015-2016 RWF CIP Capital Budget and 2016-2020 RWF Capital Improvement Program.

revenues from the records that have been provided to them by Co-Owners.<sup>33</sup> We find these contentions to be unsubstantiated. Co-Owners state in their Response to Claim No. 2, that the following records are routinely provided to the Tributary Agencies as part of the annual budget, invoicing, and reconciliation processes:

### **Budget Timeline**

- December - Annual Revenue Program Timeline: San José requests information from the Tributary Agencies for an estimate of their “actual” discharges to RWF, and provides proposed capital projects costs for upcoming fiscal year.<sup>34</sup>
- February – Treatment Plant Capital Cost and State Revolving Fund Loan Repayments Allocation: San José provides the capital cost allocation and State Revolving Fund (SRF) payment obligations for the upcoming fiscal year.<sup>35</sup>
- March – Current Fiscal Year Revenue Program: San José uses the information from the Tributary Agencies for “actual” discharge to allocate Operation and Maintenance costs for the upcoming fiscal year.<sup>36</sup>

### **Invoicing and Reconciliation Timeline**

- July 1, October 1, January 1, and April 1: the Tributary Agencies receive quarterly O&M and Capital billing each quarter for the current fiscal year.<sup>37</sup>
- Bi-Annual Debt Service billing is sent to the Tributary Agencies with participation and repayment schedules for SRF Loans and Sewer Revenue Bonds.<sup>38</sup>

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<sup>33</sup> Attachment B, Claim No. 2, pgs. 11-12.

<sup>34</sup> Attachment A, Response to Claim, Exhibit I, sample Annual Revenue Program Timeline.

<sup>35</sup> Attachment A, Response to Claim, Exhibit J, sample CIP and SRF Repayments Allocation.

<sup>36</sup> Id. at Exhibit K, sample Current Fiscal Year Revenue Program.

<sup>37</sup> Id. at Exhibits L-1 and L-2, sample of quarterly O&M and CIP invoices, respectively.

<sup>38</sup> Id. at Exhibit M, sample of Bi-Annual Debt Service billing.

- November – O&M Actuals Reporting: San José requests information from Tributary Agencies on “actual” discharge based on driest week of the year to reconcile the operation and maintenance cost invoiced with the audited expenditures from Comprehensive Financial Audit Report (“CAFR”) for the Third Quarter Reconciliation.
- November – Annual Plant Capacity Report: San José brings the report to TPAC for approval.<sup>39</sup>
- January – Third Quarter Reconciliation: The Tributary Agencies are provided an Annual Transaction Report and Cost Allocations for O&M and CIP following the CAFR, and information from the Tributary Agencies’ revenues and expenditures for the prior fiscal year are reconciled based on final accounting reports.<sup>40</sup>

In addition, the San José 2016-2020 Adopted Capital Improvement Program Budget<sup>41</sup> discusses the RWF - CIP program in detail including:

1. Program overview;
2. Source of funds and use of funds; and
3. Detailed project sheets for each construction project including estimated cost, schedule, and timing of expenditures by the various project development stages.

The source of funds and use of funds is the basis from which the Tributary Agencies are billed each quarter for their proportional share.

Co-Owners also allege that the Tributary Agencies received the working reports for the above documents following an extensive California Public Records Act

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<sup>39</sup> Id. at Exhibits N-1 and N-2, sample of O&M Actuals, and Annual Plant Capacity Report, respectively.

<sup>40</sup> Attachment A, Response to Claim, Exhibit O, sample of Third Quarter Reconciliation.

<sup>41</sup> Id. at Exhibit H, 2015-2016 RWF CIP Capital Budget and 2016-2020 RWF Capital Improvement Program.

request (PRA)<sup>42</sup> and that many of these reports could have been used to validate figures used in the Third Quarter Reconciliation.<sup>43</sup> Counsel for Co-Owners Ms. Tsongtaatarii stated at the hearing that “around 50,000” pages of documents had been provided in response to the Tributary Agencies’ PRA.<sup>44</sup> Ms. Tsongtaatarii, also indicated that the Tributary Agencies could make follow up inquiries for additional documentation if an agency had questions about expenditures for a particular project.<sup>45</sup>

San José met with Hemming Morse, LLP, the Tributary Agencies’ forensic accountant, on May 18 and June 8, 2016 to discuss the cost allocation plan, cost pools, overall methodology, and overhead. Following these meetings, San José provided additional working records.<sup>46</sup>

Furthermore, San José conducts the following audits on an annual basis:<sup>47</sup>

1. All of the City of San Jose's funds are audited annually by a third-party firm following the year-end close of the City's books/financial documents for a specific fiscal year; and
2. The Clean Water Financing Authority's (“CWFA”) financial documents are audited annually by a third-party firm. The report is posted publicly and discussed at CWFA meetings. The CWFA issued the bonds to finance the SBWR for which San José and all Agencies except the City of Milpitas pay debt service.

### **Summary of Findings**

Given the extensive nature of documents already provided to the Tributary Agencies, coupled with the opportunity to obtain additional documentations, we

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<sup>42</sup> Id. at Exhibit P, excerpt index of records provided in response to Tributary Agencies’ Public Records Act requests dated January 12 and February 18, 2016. Review and bate stamping of Set 9 was not complete until September 14, 2016.

<sup>43</sup> Id. at Exhibit Q, overview of how the records provided to the Tributary Agencies relate to the budget, invoicing and reconciliation processes.

<sup>44</sup> Attachment C, pgs. 23-24.

<sup>45</sup> Id.

<sup>46</sup> Attachment A, Response to Claim, pgs. 13-14.

<sup>47</sup> Id.

find that Co-Owners have given sufficient records to the Tributary Agencies to enable them to substantiate shared RWF costs and proceeds. As a result, we find there is no breach of the Master Agreement by Co-Owners.

**C. San José Has Not Breached the Master Agreements by the Diversion of Plant Proceeds and Use of Plant Funds for Non-Waste Water Purposes in Connection with Plant Lands.**

The Tributary Agencies allege that they 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 Tributary Agencies have been diverted and/or Plant funds have been used for non-waste water purposes.<sup>48</sup> The Tributary Agencies contend that these actions constitute breaches of the express terms of the Master Agreements, as well as the implied covenant of good faith and fair dealing.<sup>49</sup>

**1. The diversion of RWF proceeds from land surrounding the RWF is not a breach of the Master Agreements.**

The Tributary Agencies argue that under the Master Agreements, the Tributary Agencies’ have the right to a proportional share in proceeds from land surrounding the RWF, known as Plant lands.<sup>50</sup> They recognize that San José has discretion in how to make the best use of Plant lands, subject to an obligation to exercise such discretion under the implied covenant of good faith.<sup>51</sup> They contend that entering into transactions that result in benefits enjoyed solely by San José is a breach of the implied covenant of good faith because such transactions would not have been within the Parties’ reasonable contemplation when entering into the Agreements.<sup>52</sup>

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<sup>48</sup> Attachment B, Claim No. 2, p. 12.

<sup>49</sup> Id.

<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> Attachment B, Claim No. 2, pgs. 12-13.



According to the Co-Owners, the Tributary Agencies do not have a fee interest in RWF real property nor the same authority as the Co-Owners to make decisions regarding leases or other disposition of land.<sup>53</sup> The Tributary Agencies have participation interest in revenues from the disposition of land and sale of products under the Master Agreements.<sup>54</sup>

Co-Owners also allege that Milpitas and Burbank have not fully paid San José to date for their participation rights in land acquired on or before 1982, a fact which is undisputed by the Tributary Agencies. The parcels acquired on or after 1983, the Mosley Tract, the McCarthy Tract, and Cargill Pond A-18, were acquired and continue to be used for the waste water treatment program, which is also undisputed by the Tributary Agencies.<sup>55</sup>

### **Summary of Findings**

The Tributary Agencies did not identify any transaction or other facts to support their allegation that San José has in some manner received income or revenue that was not shared with the Tributary Agencies, or that San José has inappropriately disposed of Plant lands or abused its discretion under the Master Agreements to make best use of Plant lands. As such, the facts and arguments submitted by the Tributary Agencies do not demonstrate a breach of the Master Agreements by Co-Owners, and accordingly we find that there was no such breach.

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<sup>53</sup> Attachment A, Response to Claim, p. 10.

<sup>54</sup> Id.

<sup>55</sup> Attachment A, Response to Claim, pgs. 10-11.

**2. The specific transactions identified by the Tributary Agencies as violations of the Master Agreements by San José are not a breach of San José’s obligations under the Master Agreements.**

The Tributary Agencies identified the following specific transactions in which they allege San José has breached its obligations by diverting Plant proceeds and/or using Plants funds for non-wastewater purposes:

**a. South Bay Water Recycling Program**

The Tributary Agencies object to applying their share of the RWF revenues to the SBWR including the Advanced Water Treatment Facility (“AWTF”). The SBWR program is a reclamation facility that was required by the National Pollution Discharge Elimination System (“NPDES”) permit to cap the effluent at 120 mgd in order to protect the San Francisco saltwater habitat. The Tributary Agencies financed the cost of the reclamation facility through long term bonds and SRF, and agreed to pay for the ongoing cost to maintain SBWR.<sup>56</sup> In 2014, the State Water Resources Control Board denied San José’s request to remove SBWR as a requirement in the new NPDES permit. While West Valley, Cupertino, Burbank and CSD 2-3 now object because they do not receive a benefit as retailers, this does not diminish the obligation to comply with NPDES permit requirements and finance covenants through the end of repayment in 2021.<sup>57</sup>

The Tributary Agencies contend the AWTF is not a legitimate wastewater treatment cost, because “the average dry weather effluent flow has never exceeded 100 mgd in the past 10 years” which is less than the 120 mgd cap under the NPDES permit.<sup>58</sup> For the Tributary Agencies, this means, “as a practical matter the RWF

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<sup>56</sup> Attachment B, Claim No. 2, Exhibit 7, Second Amendments to Master Agreements in December 1995.

<sup>57</sup> Attachment A, Response to Claim, p. 11.

does not presently need the SBWR system *at all*.<sup>59</sup> (Emphasis in the original.)

In 2010, San José, as the Administering Agency, entered into an agreement with the Santa Clara Valley Water District (“SCVWD”) to build the AWTF that would further treat the recycled water.<sup>60</sup> The associated costs to maintain the existing reclamation facility and debt service are a cost for wastewater treatment services under Proposition 218, because all of the effluent treated by the AWTF is provided back to the RWF before distribution.

San José has been clear that it does not intend to use SBWR revenue to expand the system. The Tributary Agencies cite to a proposed \$3.9M referenced in the FY 2015-2016 CIP for expansion as evidence of malfeasance. In fact, the source of these funds is the SCVWD. As part of the Integration Agreement with the SCVWD to construct and operate the AWTF, the SCVWD agreed to pay \$1M each year until the AWTF came online but the funds could only be used “to support expanding the usage of water produced by SBWR.”<sup>61</sup>

In 2012, the Tributary Agencies selected West Valley Sanitary District to participate in the peer review working group that developed the goals for the Strategic Master Plan. On April 19, 2015, TPAC unanimously approved the Strategic Master Plan including the near term reliability projects on a motion by the representative from West Valley. The proposed reliability projects with an estimated total cost of \$5M are prioritized based on number of customers that could be impacted by a failure, likelihood of

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<sup>58</sup> Attachment B, Claim No. 2, p. 15.

<sup>59</sup> Id.

<sup>60</sup> Attachment A, Response to Claim, p. 11, FN 32. The AWTF project and agreements were recommended for approval by TPAC on February 25, 2010 with only one objection from Cupertino Sanitary District.

failure, and the current expense to maintain and repair existing equipment.

The Tributary Agencies now contend the proposed reliability projects are not necessary because SBWR does not need to operate except in the summer for three months to meet wastewater objectives.<sup>62</sup> Co-Owners response is that this approach is similar to the Tributary Agencies' previous position that the RWF did not need the Cogeneration Facility because the RWF could simply plan for the sewage to spill over until power is restored in emergency situations. Co-Owners state that "[t]he Tributary Agencies seek to limit cost to only activities necessary to meet minimum requirements. But no reputable program should plan for unpredictability in its production."<sup>63</sup>

Although the Tributary Agencies dispute the necessity of the SBWR program, there is nothing in the Tributary Agencies' submissions in support of Claim No. 2, which indicate that the SBWR program is no longer an NPDES permit requirement or that San José, as the Administering Agency for the RWF, is otherwise entitled to, or has the regulatory authority to, unilaterally discontinue the SBWR program. An attempt was made by San José in 2014 to remove the SBWR program as a requirement in the NPDES permit, however, that request was denied the State Water Resources Control Board. The program is apparently still mandated by the permit since no evidence was submitted by either Party to the contrary.<sup>64</sup>

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<sup>61</sup> Attachment A, Response to Claim, p. 12.

<sup>62</sup> Attachment B, Claim No. 2, p. 15.

<sup>63</sup> Attachment A, Response to Claim, p. 12.

<sup>64</sup> Attachment A, Response to Claim, p. 11.

In light of the NPDES permit requirement and San José's obligations under the Master Agreements to do "any and all things...to treat and dispose of all sewage (and all by-products thereof)..." so that said sewage and all effluent from said Plant will not pollute the waters of San Francisco Bay, or any other waters and so that said sewage will be disposed of in a manner authorized by law", we find San José and Co-Owners have not breached the Master Agreements because San José is taking reasonably necessary actions under the Master Agreements by implementing the SBWR program, including the ATWF and near term reliability projects" to dispose of the RWF sewage and effluent as required by law.

**b. Billing related to RWF overhead**

The Master Agreements require San José to be reimbursed from RWF "funds for all costs and expenses incurred by it as Administering Agency" which includes, but is not limited to, salaries and wages paid by San José to its officers and employees for services rendered by them for Treatment Plant purposes.<sup>65</sup> In addition to reimbursement for such expenses, San José is entitled to be reimbursed 17.313% of all such expenses to pay for overhead expenses incurred by San José in furnishing the services and administering the Master Agreement, including: payments made by San José for retirement benefits, payments made by San José for medical and hospital insurance covering officers and employees, miscellaneous overhead of the auditing, purchasing and engineering departments of San José.

The Master Agreements, however, limit San José from double charging the RWF for overhead and expenses. San José is only entitled to reimbursement "...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.”<sup>66</sup>

The Tributary Agencies argue that that the Agencies are currently being charged overhead in multiple ways. By example, they contend that they are being charged for overhead in both the operating budget and the capital budget for the RWF during FY2015-206. However, the Tributary Agencies admittedly make this argument without offering evidence or facts to support the argument. Instead they conclude that the charges appear on their face to constitute proscribed double billing, because they have been unable to know about the “attendant circumstances” of the charges due to Co-Owners alleged lack of transparency.<sup>67</sup>

As discussed in Section 1.B. above, the Tributary Agencies have been given an extensive number of documents and have had several opportunities to identify facts to support their claim of double billing. We find that the Tributary Agencies’ claim of double billing is speculative or “suspicious” at this point and not supported by facts. As a result, we find that San José has not breached the Master Agreements with respect to double charging for overhead.

**c. Payments for Public Art Programs in San José**

In 2008, TPAC unanimously recommended including the RWF in San José’s 1% capital budget allocation program for public art projects.<sup>68</sup> The funds collected from the Tributary Agencies were intended for public art in the RWF service areas that would communicate messages about wastewater treatment and

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<sup>65</sup> Attachment B, Claim No. 2, Exhibit 1, Master Agreement for Wastewater Treatment, Ex. E, Section D.

<sup>66</sup> Id.

<sup>67</sup> Attachment B, Claim No. 2, p. 17.

<sup>68</sup> Attachment A, Response to Claim, p. 12.

potentially enhance some of the newer facilities at the RWF. Since 2011, the majority of RWF projects were deemed to be rehabilitation projects and exempt from San Jose’s public art allocation ordinance.<sup>69</sup>

In response to the Tributary Agencies’ desire to reduce capital cost, San José’s Administration recommended to the San José City Council that the City Council adopt an ordinance to exempt all projects at the RWF from the public art allocation effective Fiscal Year 2017-2018. Ordinance No. 29950 was approved by the City Council on June 6, 2017 and became effective on July 20, 2017.

<b>Public Art FY 2007/08 to FY 2015/16</b>			
	<b>Collected</b>	<b>Credits</b>	<b>Total Paid</b>
Total	\$ 1,381,000.00	\$ (719,000.00)	\$ 662,000.00
Co-Owners	\$ 1,108,681.00	\$ (576,462.00)	\$ 532,219.00
Agencies	\$ 272,319.00	\$ (142,538.00)	\$ 129,781.00

We find that our unanimous approval of including the RWF in San José’s 1% capital budget allocation program for public art projects, along with the San Jose’s discretion under the Master Agreements to allocate funds for public art at the RWF is not unreasonable and further find that such action does not constitute a breach of the Master Agreements. We also note that the RWF is exempt from the public art allocation for projects at the RWF effective July 20, 2017, which should alleviate the Tributary Agencies concerns regarding use of RWF funds for public art.

**d. Plant Funds Used for Holiday Programs in San José City Park**

The Tributary Agencies object to having contributed collectively \$2,500 from 2011 through 2015 to Christmas in the Park. The

<sup>69</sup> Id.

month-long holiday event at Plaza de Cesar Chavez in downtown San José attracts approximately 500,000 people each year, with roughly 40% of the visitors coming from surrounding cities.<sup>70</sup> This is a regional event that provides an opportunity for outreach related to wastewater treatment.<sup>71</sup> A breakdown of the sources of the wastewater treatment is shown in the table below:

<b>Year</b>	<b>Sponsorship Amount</b>	<b>Owner Share (approx.)</b>	<b>Trib Share (approx.)</b>
2011	\$ 7,500	\$ 6,000	\$ 1,500
2012	\$ -	\$ -	\$ -
2013	\$ 1,890	\$ 1,512	\$ 378
2014	\$ 1,645	\$ 1,316	\$ 329
2015	\$ 1,500	\$ 1,200	\$ 300
<b>Total</b>	<b>\$ 12,535</b>	<b>\$ 10,028</b>	<b>\$ 2,507</b>

We believe that regional public outreach related to wastewater treatment is within the scope of San José's responsibilities under the Master Agreements "to do any and all things which it shall find to be reasonably necessary, with respect to its maintenance, repair, expansion, replacement, improvement and operation" to treat and dispose of sewage, including that of any and all Outside Users". As such we find that San José has not breached the Master Agreements by using Plant funds for outreach conducted during Christmas in the Park.

**e. Improper Charges for the Costs of Unfunded Pension Liability of San José Employees**

The Tributary Agencies allege that San José appears to be improperly charging the RWF for the unfunded pension liability of

<sup>70</sup> Attachment A, Response to Claim, p. 13.

<sup>71</sup> Id.



San José employees. However, the Tributary Agencies admit that further information is necessary to determine whether this practice results in the agency being overcharged.<sup>72</sup>

As the Administering Agency, San José is entitled to recover actual overhead under the express provisions of the Master Agreements, including costs such as payments for retirement benefits.<sup>73</sup> The Master Agreements specifically contemplate funding for these benefits as follows:

“D. Expenses of Administering Agency. It is mutually agreed that the City of San Jose shall be reimbursed from Treatment Plant funds for all costs and expenses incurred by it as Administering Agency of this Agreement, including, but not limited to, salaries and wages paid by San José to its officers and employees for services rendered by them for Treatment Plant Purposes. It is further agreed that San Jose shall be paid, from Treatment Plant funds, an amount equal to seventeen and three hundred thirteenth one thousandths per cent (17.313%) of all the mentioned salaries and wages as and for the following overhead expenses incurred by San Jose in furnishing said services and in administering this Agreement, to wit: payments made by San Jose for retirement benefits, payments made by San José for medical and hospital insurance covering officers and employees, miscellaneous overhead expenses of the auditing, purchasing and engineering departments of San Jose... [t]he percentage or amount of overhead allowance or expense payable to San José shall be increased or decreased from year to year to reflect actual overhead and incidental costs and expenses incurred by San Jose for Treatment Plant purposes to the extent that such costs and expenses are not

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<sup>72</sup> Attachment B, Claim No. 2, p.19.

<sup>73</sup> Attachment B, Claim No. 2, Exhibit 1, Master Agreement at Exhibit E, Section D.

included in other items of cost or expense for which San Jose is otherwise reimbursed from Treatment Plant Funds.”<sup>74</sup>

The language in the Master Agreements is clear. San José is entitled to recover the costs of administering the RWF and the Master Agreements which expressly includes “payments made by San José for retirement benefits...” Therefore, we find no breach of the Master Agreements by Co-Owners for using RWF to pay for the retirement benefits of San José’s officers and employees.

Additionally, when questioned by TPAC Chair Mayor Sam Liccardo regarding the payment of retirement benefits at the hearing, counsel for the Tributary Agencies Mr. Mehretu admitted that the pension liability issue is “more of an example, more than anything to show” that the Tributary Agencies don’t have enough transparency in terms of what’s going on at the RWF. He also stated that it’s “an example of a *potential* misuse of funds.”<sup>75</sup> (Emphasis added.)

We further find that in light of our determination that Co-Owners have not breached the Master Agreements for failing to provide sufficient records relating to the revenues and costs for the RWF, taken in conjunction with the Tributary Agencies’ acknowledgment that they do not have a factual basis to support their allegations regarding retirement benefits, there has been no breach of the Master Agreements in this regard.

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<sup>74</sup> Id.

<sup>75</sup> Ex. C, p.17.

**D. San José Did Not Fail to Provide the Tributary Agencies with the Annual Budget By March 1<sup>st</sup>.**

Finally, the Tributary Agencies claim a breach of contract because they received the draft Fiscal Year 2016-2017 budget on March 25 instead of March 1, 2016. The claim fails to disclose that the delay was due to the bids for the Digester and Thickener Rehabilitation project coming in significantly higher than estimates which required revising the budget to avoid impact on the Tributary Agencies. Moreover, the Tributary Agencies were informed in advance that the draft budget would not be issued on March 1. If a draft budget had been issued on March 1, it would have required revisions a couple of weeks later.

We find that while Co-Owners may have not given the Tributary Agencies the budget on March 1, 2016, as required by the Master Agreements, the Tributary Agencies were on notice that the budget would be delayed and were given the reasons for the delay.<sup>76</sup> Since there no facts or evidence submitted by the Tributary Agencies that such delay resulted in prejudice to the Tributary Agencies, we further find there was no breach of the Master Agreements by the Co-Owners for distributing the budget several weeks beyond the March 1<sup>st</sup> deadline.

**SECTION 2. REPORT OF THE TREATMENT PLANT ADVISORY COMMITTEE**

- A. This Resolution, including its recitals, constitutes the report, findings and recommendations of the Treatment Plant Advisory Committee, as required by Part 7.G of the Master Agreements (Report).
- B. The Secretary to this Committee is hereby directed to distribute the Report to the Tributary Agencies' legislative bodies and to the legislative bodies of Co-Owners.

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<sup>76</sup> Ex. C, p.14.

**SECTION 3.**            **RECOMMENDATIONS**

The Treatment Plant Advisory Committee recommends that discussion continue among Tributary Agencies' and Co-Owners' staff on an informal basis in order to arrive at a mutually agreeable amendment to the Master Agreements that focuses on the parties' common concern regarding financing the projects included in the CIP.

ADOPTED this \_\_\_\_\_ day of \_\_\_\_\_, 2017, by the following vote:

AYES:

NOES:

ABSENT:

\_\_\_\_\_  
SAM LICCARDO  
Chair

ATTEST:

\_\_\_\_\_  
Secretary