



COUNCIL AGENDA: 11-09-10  
ITEM: 3.3

# Memorandum

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** Lee Price, MMC  
City Clerk

**SUBJECT:** SEE BELOW

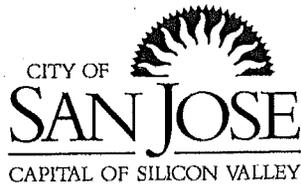
**DATE:** 10-28-10

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**SUBJECT: SERVICE DELIVERY EVALUATION AND OPTIONS FOR  
MAXIMIZING FINANCIAL BENEFITS FROM THE SAN JOSE  
MUNICIPAL WATER SYSTEM TO THE GENERAL FUND**

## RECOMMENDATION

As recommended by the Rules and Open Government Committee on October 13, 2010 and outlined in the attached memo previously submitted to the Rules and Open Government Committee, accept the preliminary Work Plan and proposed Evaluation Criteria to assess service delivery evaluation and options for maximizing financial benefits from the San José Municipal Water System.



# Memorandum

**TO:** RULES AND OPEN  
GOVERNMENT COMMITTEE

**FROM:** Edward K. Shikada

**SUBJECT:** SEE BELOW

**DATE:** October 1, 2010

Approved

Date

10/1/10

**SUBJECT: SERVICE DELIVERY EVALUATION AND OPTIONS FOR MAXIMIZING  
FINANCIAL BENEFITS FROM THE SAN JOSE MUNICIPAL WATER  
SYSTEM TO THE GENERAL FUND**

## RECOMMENDATION

Accept the preliminary Work Plan and proposed Evaluation Criteria to assess service delivery evaluation and options for maximizing financial benefits from the San José Municipal Water System, and recommend Council consideration of the same on October 26, 2010.

## OUTCOME

Council consideration of the preliminary Work Plan and proposed Evaluation Criteria to assess service delivery evaluation and options for maximizing financial benefits from the San Jose Municipal Water System (Muni Water) to the General Fund will allow staff to: (1) evaluate and test out revenue options that do not require a transfer of Muni Water assets, (2) conduct a pre-feasibility study of the financial, technical, legal, and regulatory parameters associated with a potential transfer of Muni Water such as a lease or sale; and (3) report to Council with the revenue options evaluation and pre-feasibility study by February/March 2011.

## BACKGROUND

The Mayor's March 2010 Budget Message directed staff from the City Manager's Office and Environmental Services Department to "re-evaluate the feasibility of leasing Municipal Water to private companies that could generate million of dollars of revenue for the City, as well as current alternatives to generate a rate of return on the system". In April 2010, SJWC issued a letter of interest offering \$25-\$40 million in an upfront payment to lease Muni Water. SJWC also offered an upfront payment of \$54 million to purchase Muni Water, as well as a 2 percent "franchise fee", that SJWC believes would be worth \$4 million a year. SJWC calculated that the present value for the additional \$4 million annual franchise fee to be approximately \$62 million, resulting in a total net present value of \$116 million.

RULES AND OPEN GOVERNMENT COMMITTEE

October 1, 2010

**Subject:** Service Delivery Evaluation and Options for Maximizing Financial Benefits from Muni Water

Page 2

Based on these recent actions, the City Council through the Mayor's June Budget Message directed staff to conduct further analysis of opportunities to generate General Fund revenue from the Muni Water system.

Since 1962, Muni Water has been the subject of several studies and analyses related to the privatization of its operations and assets. The City purchased Muni Water for \$253,000 from Evergreen Water Company in 1961. Shortly thereafter, in October 1962, The San Jose Water Company (SJWC) offered \$348,000 to purchase Muni Water. Subsequently, in October 1968, SJWC offered \$2,043,313 for Muni Water.

In September 1988, the City Council directed staff to prepare a report on the potential sale of Muni Water, with a valuation at that time of approximately \$19.8 million. In the Mayor's Fiscal Year 1994-1995, Budget Modifications Memorandum, staff was directed to evaluate the sale of Muni Water and in September 1996, the City Auditor valued Muni Water at \$40 million. In December 1996, the Council determined that a sale of the system was not feasible because of several significant legal obstacles including, among other things: the agreement with the City of San Francisco under which the City receives Hetch-Hetchy water; Federal tax issues; and provisions of the Public Utilities Code which required that the sale of Muni Water be approved by two-thirds of all voters.

An RFP for the lease and/or operations of the system was issued in July 2001 and in November 2001 the City received responses for three different options, all from San Jose Water Company. In May 2002, staff was directed to negotiate an Operating Rights Agreement with SJWC. The parties could not reach consensus on terms for such an agreement, but in 2003, Council approved a 10-year agreement with SJWC to perform emergency repairs for Muni Water.

Muni Water currently provides water service to 26,272 metered connections with average daily water production of 18.3 million gallons within the City of San Jose. Muni Water services four different areas in the City: North San Jose/Alviso, Evergreen, Edenvale, and Coyote Valley. While these service areas represent approximately 20% of the City's total land area, Envision 2040, the General Plan update, estimates that 19% of the new dwelling units and 38% of the new jobs will be in Muni Water's service area. Population within Muni Water's service areas is projected to increase substantially from 110,000 to 182,000 persons by 2040.

The review as directed in the Mayor's June 2010 Budget Message will require consideration of existing documents, previous legal analyses, and information relative to the system. Other issues to consider include: water rights, the potential impact on water rates, proceeds to the General Fund, a competitive solicitation process, and potential legal issues. The City Manager's Office was directed to coordinate this effort and present a proposed work plan to the City Council by Fall 2010.

October 1, 2010

Subject: Service Delivery Evaluation and Options for Maximizing Financial Benefits from Muni Water

Page 3

## ANALYSIS

### Validating the Primary Objective

Muni Water has no unfunded infrastructure needs and its customers currently enjoy water rates that are below the average rates in the San Francisco Bay Area and Santa Clara County. Over the last ten years, Muni Water has invested more than \$32,500,000 from operating revenues in capital improvements. Assets of Muni Water have come from a combination of Assessment Districts, developer contributions, Redevelopment Agency and ratepayers. On April 28, 2010, after conducting its annual inspection and survey, the California Department of Public Health reported that "San Jose Municipal Water System is commended for maintaining clean and well managed facilities. The wells, reservoirs and pump stations appeared to be in good condition."

Since 1995, Muni Water has not needed any General Fund subsidies. In 2003, the Municipal Code was amended to allow transfers to the General Fund of up to 8% of gross revenues as a Rate of Return, a 2% In-Lieu of Franchise Fee, as well as actual overhead costs which would translate to the City's receipt of approximately \$3.3 million annually, based on the current annual revenue and overhead costs. However, in an abundance of caution, in light of recent cases interpreting Proposition 218, these transfers into the General Fund have since been eliminated. Muni Water now only transfers the cost of overhead to the General Fund, which is about \$800,000 for this fiscal year. In contrast, as of late August 2010, the California Public Utility Commission approved a 10.2% rate of return for San Jose's Class A private utility companies such as San Jose Water Company and Great Oaks Water Company.

Within this context, staff is working with the assumption that the primary objective of this review is to explore alternative service delivery methods as options for **maximizing financial benefits to the General Fund**, rather than to address other operational or technical issues at Muni Water such as expanding or improving the infrastructure or quality of water or service. Should the Rules and Open Government Committee or Council determine that other objectives are of greater priority than the primary objective stated here, staff would need to re-scope the preliminary work plan proposed below and return to the Committee and Council with corresponding modifications.

### Revenue Options without a transfer of Muni Water Assets

Assuming validation of the primary objective, staff believes that due to the complexity, cost, and required timeline for the evaluation and implementation of options that involve transfer of Muni Water assets such as a lease or sale, any scenario that could potentially increase revenue from Muni Water should be evaluated first.

It is important to note, however, that the options outlined below are still conceptual and will need further detailed legal analysis to test out their feasibility. Staff believes that it would be beneficial to test potential voter support through the January 2011 community budget survey.

October 1, 2010

**Subject:** Service Delivery Evaluation and Options for Maximizing Financial Benefits from Muni Water

Page 4

### **Option A**

A citywide voter approved transfer of 10% of Muni Water gross revenues (which includes potable and recycled water), providing a reasonable rate of return to the General Fund, would generate a potential \$2.5 million annually based on projected annual revenue of \$25 million, in addition to the \$800 K that is currently being transferred from Muni Water for overhead costs. As noted above, such a transfer from Muni Water would be consistent with the rates of return already authorized for private water utility companies serving San José.

### **Option B**

A citywide voter approved tax of 10% to be paid by Muni Water customers which would generate a potential \$2.5 million annually to the General Fund, in addition to the \$800 K that is currently being transferred from Muni Water for overhead costs.

### **Option C**

Impact fee to offset City expenditures for the operations, maintenance, and capital costs related to Muni Water's use of the City's rights-of-way. This option will require a study to determine the appropriate rate of reimbursement and could possibly be extended to sanitary and storm utilities, in addition to Muni Water. It would not require voter approval and could be incorporated into FY 2011-2012 budget considerations.

### *Revenue Options requiring a transfer of Muni Water*

The lease or sale of Muni Water assets are other options that could generate revenue for the General Fund. As stated above, any option requiring a transfer of Muni Water assets would involve evaluation of many complex issues such as:

#### **1. *Reliable Water Supply for San José Residents and Businesses***

Ensuring that City residents and businesses served by Muni Water have access to a reliable water supply is of primary importance. The feasibility of making any change to the status quo should carefully assess this evaluation component and compare and contrast it to the current situation. The pre-feasibility analysis will include the following issues:

- i. Potential loss of Hetch-Hetchy water
- ii. Availability of alternate water supply sources in case of loss of Hetch-Hetchy
- iii. The ability and willingness of SCVWD to continue to provide water to another private entity based on potential impacts to their tax exempt bonds due to increased private activity

#### **2. *Required Approvals***

In addition to the City Council, depending on the option pursued, approvals may be required from several entities such as the Santa Clara Valley Water District, the San Francisco Public Utilities Commission, the California Public Utilities Commission, and San Jose voters in order to implement one or more of the transfer options. The pre-feasibility assessment will confirm this approval path through discussions with the potential approval authorities.

**3. *Maximize Muni Water Financial Benefit to the General Fund***

The net financial benefit to the City and the General Fund for each of the proposed transfer options will need to be considered during the feasibility phase. This may involve an upfront payment, an on-going payment over the life of the corresponding transaction agreement as well as associated transaction costs. The pre-feasibility assessment will provide an estimate of transaction costs such as a feasibility assessment, stakeholder approvals, competitive solicitation, and agreement execution.

Alternatively, as stated above, staff could explore the potential of creating a revenue stream from the Muni Water System to the General Fund while retaining City control and operations of the system and within the restrictions of Prop 218.

**4. *Rate Structure***

Under the current model which is set forth in the Code, the City Council sets the rates for Muni Water customers. As mentioned above, these rates are substantially lower than rates paid by San Jose customers who are served by private utilities. Muni Water also offers tiered rates to incentivize water conservation. Prior to doing a feasibility assessment, staff will need to confirm the following key considerations for each of the transfer options:

- a) How will future rates be set and is influencing the rates an important consideration for the City Council?
- b) Potential near and long term changes to the rates

**5. *Alignment with City Policies and Priorities***

During the pre-feasibility analysis, staff will evaluate potential effects and relative priority of the following:

1. Green Vision: sensitivity of technology companies to the quality of any alternate water supply; potential impact on the recycled water system
2. Water supply assessments required for future development
3. Water conservation strategies
4. Fluoridation of drinking water

**6. *Viable Capital Improvement Program***

The long term efficiency of Muni Water depends on a clearly defined and comprehensive on-going capital improvement program. Under the proposed transfer options, an interested operator of Muni Water would need to demonstrate the financial, technical and administrative capacity to adhere to the required capital improvement program in a timely manner. This evaluation parameter is important under either option, but is especially so in a lease/operations agreement arrangement, where ownership of the Muni Water assets remains with the City.

**7. *Transparent and Sustainable Regulatory and Contractual Framework***

Staff is working under the assumption that any solicitation for an alternate service delivery option must be conducted in a competitive and transparent manner. During the

RULES AND OPEN GOVERNMENT COMMITTEE

October 1, 2010

**Subject:** Service Delivery Evaluation and Options for Maximizing Financial Benefits from Muni Water

Page 6

pre-feasibility analysis, staff will develop and confirm with Council any key considerations for the evaluation of proposals. Any future transfer of Muni Water will need to include a comprehensive and clear contractual and oversight framework based on best practices and applicable laws, rules, and regulations. Staffing and costs associated with this ongoing oversight will need to be factored into the final financial analysis.

Finally, and in addition to the above Evaluation Criteria, additional factors such as labor implications will also need to be considered.

Based on previous analysis, the costs associated with the feasibility assessment of a Muni Water transfer such as a lease or sale are estimated at about \$1.5 million. This would be in addition to any costs incurred for regulatory and voter approvals and agreement execution. Although there are many variables related to the financial, legal and regulatory considerations that could impact the timeline, staff is currently estimating December 2013 as the earliest timeframe for execution of a potential lease or sale.

Preliminary Work Plan

Upon Council approval, staff will proceed with the evaluation of revenue options that would not involve a transfer of Muni Water. Options requiring voter approval will be tested through the community budget survey in January 2011. Results from this survey, along with any other policy and cost considerations related to all revenue options not requiring a transfer of Muni Water, will be brought forward to Council in February 2011.

In parallel with the above effort, staff will also proceed with a pre-feasibility study of a transfer of Muni Water, using the various legal, regulatory, technical, and financial Evaluation Criteria presented above. The pre-feasibility study and a detailed work plan with associated costs and timeline related to a lease or sale will also be presented to Council in February/March 2011. The pre-feasibility study will confirm the approval path through discussions with the California Public Utility Commission, the San Francisco Public Utility Commission, and the Santa Clara Valley Water District.

Key Dates	Approval/Input	Action
October 6, 2010	Rules Committee	Consideration of Preliminary Work Plan and Evaluation Criteria
October 26, 2010	City Council	Consideration of Preliminary Work Plan and Evaluation Criteria
January 2011	Community	Community Budget Survey
February/March 2011	City Council	Consideration of: a. Community Budget Survey Results; b. Policy and Cost Considerations of Revenue Options not requiring transfer of Muni Water; c. Pre-feasibility assessment of Revenue Options related to a transfer of Muni Water such as a lease or sale

RULES AND OPEN GOVERNMENT COMMITTEE

October 1, 2010

**Subject:** Service Delivery Evaluation and Options for Maximizing Financial Benefits from Muni Water

Page 7

In February/March 2011, Council will have the option of directing staff to proceed with revenue options that do not involve a transfer of Muni Water assets and/or to proceed with a feasibility assessment and competitive solicitation for a transfer of Muni Water such as a lease or sale.

If Council directs staff to proceed with a revenue option that does not involve a transfer of Muni Water assets but does require voter approval, an estimated timeline for voter consideration is included in the table below. The timeline for implementing any revenue options not requiring voter approval will be included in the staff report presented in February/March 2011.

<b>Key Dates</b>	<b>Approval/Input</b>	<b>Action</b>
Fall 2011	Potential Voters	Polling of potential ballot measure language
November 2011	City Council	Consideration of ballot measure language
Spring 2012	San José voters	Ballot Measure

If Council directs staff to pursue revenue options that require a transfer of Muni Water such as a lease or sale, the detailed work plan outlined in the pre-feasibility assessment will provide the estimated timeline.

**EVALUATION AND FOLLOW UP**

Subject to Council approval of the preliminary Work Plan and proposed Evaluation Criteria, staff will return in February/March 2011 with an evaluation of various revenue options, including results of the community budget survey, policy and cost considerations related to revenue options that would not require a transfer of as well as a pre-feasibility study and an updated and detailed Work Plan, including associated costs and timeline for a transfer of Muni Water.

**POLICY ALTERNATIVES**

Not applicable

**PUBLIC OUTREACH/INTEREST**

- Criterion 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

October 1, 2010

**Subject:** Service Delivery Evaluation and Options for Maximizing Financial Benefits from Muni Water  
Page 8

**COORDINATION**

This memorandum has been coordinated with the Departments of Environmental Services, Finance, and Public Works, and the City Attorney's Office.

**FISCAL/POLICY ALIGNMENT**

The primary objective of this analysis supports the City's goal of increasing revenue to the General Fund.

**COST SUMMARY/IMPLICATIONS**

It is estimated that costs associated with the financial, legal and regulatory analysis for a transfer of Muni Water are about \$1.5 million. If Council wishes to proceed with this option, detailed costs will be brought forward in February 2011.

**BUDGET REFERENCE**

Not applicable

**CEQA**

Not a project, File PP10-069 (a), City administrative and organizational activities.



EDWARD K. SHIKADA  
Assistant City Manager

For questions please contact **Jeff Ruster, Deputy Director**, Office of Economic Development, at (408) 535 -8183.

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San Jose City Clerk



2010 OCT -6 A 11: 38

September 29, 2010

The Honorable Chuck Reed  
Mayor  
City of San Jose  
200 E Santa Clara St  
San Jose, CA 95113

**RE: Proposal to Lease the City of San Jose's Municipal Water System**

Dear Mayor Reed:

Recent media stories have indicated that a private water utility has made an unsolicited proposal to purchase San Jose's municipal water system. While we are not familiar with the details of this particular offer, as the world's largest water company, Veolia Water has significant experience with similar offers made in other parts of the country. From our experience, we recommend that the City consider a long-term lease of the system for it will provide many of the same benefits as a sale, but can be executed more quickly while leaving the City in control of the assets.

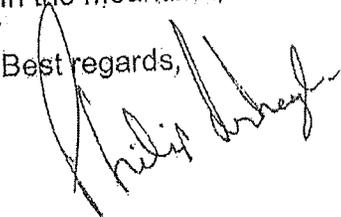
Specifically, the benefits of a long-term lease partnership with Veolia Water would include:

- **Keep Control Local.** A partnership would be structured to ensure that policy decisions, rate setting, and overall management of the water system continues to be controlled by the City of San Jose and not the State of California Public Utility Commission.
- **More than \$40 million to the City.** Our partnership with the City could include a preliminary lease payment of \$40 million or more to the City.
- **Quicker Regulatory Review.** Such a partnership would require less regulatory hurdles than a complete sale of your system and therefore could be undertaken more quickly.
- **Lower Costs.** Veolia Water would utilize our network of 95,000 employees, technical expertise and global purchasing contracts to lower operations and maintenance costs. These savings would be passed onto the City which could use them for rate stabilization, capital improvements or other priorities.
- **No Layoffs.** Veolia Water is prepared to offer job security to all current water system employees as agreed to by the City and employee representatives.

Communities across the United States have successfully turned to Veolia Water to economically meet the water needs of their community and protect public health. We believe we can continue our record of success by partnering with the City of San Jose to develop a proposal that is beneficial to ratepayers and augments City finances.

Our lease proposal is a viable option that does not cut employees, increase rates or transfer local control of your system. Users will see the benefits of our global expertise, technology, and overall maintenance in the quality of their water and rate stability. Please feel free to contact me or Mr. Shilen Patel, Business Development Manager for Veolia Water at (925) 771-7207 with any questions or if you require additional information. In the meantime, Mr. Patel will contact your office to schedule a convenient time to meet.

Best regards,



Phillip Ashcroft  
Executive Vice President and Chief Municipal Operations Officer  
Veolia Water North America

Cc: San Jose City Council  
San Jose City Manager Debra Figone  
San Jose City Attorney Richard Doyle