BOARD AGENDA MEMO

SUBJECT: Expedited Purified Water Program

RECOMMENDATION:

A. Receive and discuss the Expedited Purified Water Program updates and provide direction to staff as needed.

B. Authorize the Chief Executive Officer (CEO) to negotiate and execute a consultant agreement with HDR Engineering, Inc. (HDR) of Walnut Creek, California, for project management services for the Expedited Purified Water Program, for a fee up to $2,400,000.

C. Receive and discuss information regarding environmental review and permitting services

D. Approve a budget reallocation/adjustment of $1,300,000 from the Indirect Potable Reuse Projects — Planning (IPR) to the Silicon Valley Advanced Water Purification Center (SVAWPC) Expansion Project, a Program element, to allow staff to proceed with planning and design of the Expansion Project.

SUMMARY:

The Expedited Purified Water Program (Program), part of the District’s strategy to respond to the four-year drought and is consistent with Board direction to expand water supply, could provide up to 45,000 Acre-Feet per Year (AFY) of purified water for indirect potable reuse to supplement groundwater recharge from other existing sources such as imported and locally stored water supply. The Program consists of several key components: (1) SVAWPC Expansion; (2) Ford Recharge Ponds Indirect Potable Reuse Facility; (3) Mid-Basin Injection Wells; (4) Los Gatos Recharge Ponds; (5) Westside Injection Wells (or central pipeline direct potable reuse as a future alternative); and (6) Sunnyvale Indirect Potable Reuse. The current planning level capital cost estimate for the Program is $800 million and annual operations and maintenance cost estimate is $23.5 million. Additional details of the program background and prior Board actions are provided in Attachment 1.

Due to the ongoing drought, there is increasing urgency for the District to expedite the Program at an acceptable risk and cost to the District. The successful implementation of the Program will mitigate the risk of land subsidence which could significantly impact the infrastructure and economy of the Santa Clara County (County). To this end, on July 28, 2015, the Board approved the following dual track strategy for the Program:

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1 Source: South Bay Water Recycling Master Plan, IPR Treatment Study, and Carollo Engineers. Costs are at a planning level of development and should be considered within a range of -20% to +100%.
• Continue the Public-Private Partnership (P3) track; research P3 financial and legal issues; develop Request For Qualification (RFQ)/Request For Proposals (RFP); and
• Continue with planning and design of the SVAWPC expansion.

The District’s approach to implementing the overall recycled and purified water program is currently organized into 12 strategies as shown in Table 1 below. The primary focus of this agenda item pertains to strategies 6 - Expedite Purified Water Expansion Program (Public Track) and 7 – Develop P3 for the Program (P3 Track).

Table 1—Recycled and Purified Water Program Implementation

<table>
<thead>
<tr>
<th>Strategic Planning</th>
<th>Operations &amp; Capital Program</th>
<th>Board Support &amp; Outreach</th>
<th>Administrative and Financial Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Promote &amp; conduct research to support potable reuse</td>
<td>6. Expedite purified water expansion program (Public Track)</td>
<td>9. Build community &amp; stakeholder support for potable reuse</td>
<td>12. Develop District workforce to support expanded program</td>
</tr>
<tr>
<td>3. Integrate with groundwater management</td>
<td>7. Develop public-private-partnership for the Program (P3 Track)</td>
<td>10. Promote legislation and regulations to advance potable reuse</td>
<td></td>
</tr>
<tr>
<td>4. Develop partnership strategy for countywide system</td>
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</tbody>
</table>

A. Program Updates

In the July 28, 2015 presentation to the Board on project delivery method evaluation, staff identified an initial set of issues to be resolved for successful implementation of the Program by the P3 delivery method (listed as items 2 – 6 below). This section of the report provides an update on the issues identified on July 28, 2015 and additional information for the Board to consider.

1. P3 Project Finance Framework

The use of a P3 delivery method may involve non-District sponsored project financing of the Program. Project Finance is the long-term financing of infrastructure projects based upon the projected cash flows of the project rather than the balance sheet of its sponsors (i.e., P3 syndicates/companies). To familiarize the Board with this form of financing, Attachment 2 provides a general overview of Project Finance.
and of the private activity issues associated with private-sector involvement. The key elements of Project Finance include:

(a) A corporate sponsor selected by the District;

(b) A single-purpose entity formed by the corporate sponsor to act as direct counterparty to the District, and issue debt and equity to finance the project;

(c) A P3 agreement between the single-purpose entity and the District that provides the single-purpose entity with its source of revenues and defines the performance standards, risk allocation, and operations of the Program. The revenue source is funded by payments made by the District to the entity pursuant to the terms of the P3 agreement;

(d) An engineering, procurement, construction (EPC) contract between the single-purpose entity and the builder; and

(e) Non-recourse debt issued by the single-purpose entity secured by the revenues generated from the P3 agreement and the EPC contract between the single-purpose entity and the District.

A P3 delivery method may also involve a degree of private activity in the Program. The definition and general implications of private activity are described in Attachment 2. Attachment 2 also provides an overview of the determinants of program cost and introduces the key metrics of relative cost and groundwater rate impact.

2. IRS regulations regarding private activity related to tax-exempt financing

Private activity relates to the restrictions on tax-exempt debt to finance public agency projects that involve private use under the U.S. Internal Revenue Service (IRS) laws and regulations. This is a key issue which impacts both the financing of the Program and for bonds issued to finance the wastewater facilities supplying wastewater for the Program. Failure to resolve private activity restrictions could result in the District and the wastewater providers’ inability to participate in the Program under a P3 arrangement. To resolve this key issue, staff is working with outside counsel, financial advisor, and the District’s Office of Government Relations to implement a four pronged strategy to ensure that, if the Board elects to move forward with a P3, the bonds issued to finance the Program will be tax-exempt governmental activity bonds and that the P3 arrangement would not jeopardize the tax exemption of bonds issued to finance the wastewater facilities supplying wastewater to the Program facilities. Each of the four strategies will take a minimum of 9 to 12 months to develop and implement; all work efforts will be conducted concurrently with the P3 RFQ/RFP process.

The four strategies are summarized below and further details are provided in Attachment 3:

(a) Develop a P3 agreement that complies with the IRS requirements under the Safe Harbor Qualified Management Contract rules which limit the term of the contract for a water utility to 20 years with a minimum of 80 percent fixed fee pricing;
(b) Support public agencies and American Bar Association's current efforts to liberalize the terms and conditions of the Qualified Management Contract rules, such as a longer contract term, to allow for better commercial applications;

(c) Seek federal legislative remedies, such as an amendment of S1894 (Feinstein) to provide an exemption for private use; and

(d) Request the IRS for a private letter ruling to confirm the P3 arrangement would not adversely affect the tax-exempt status of wastewater/water utility agencies.

3. Availability of tax-exempt financing

Generally, the tax exempt financing market is highly reliable and there is sufficient market liquidity and investor demand to support the Program's financing needs. To the extent that the P3 delivery method does not satisfy the requirements for tax-exempt governmental bond financing, the availability of financing may be limited depending upon meeting the issuance requirements for Private Activity Bonds (PABs), including receiving an allocation of California State Volume Cap for PABs. Additional details on availability of tax-exempt financing and PABs are provided in Attachment 3.

4. Legal issues associated with public contracting, P3s and other legal considerations

Legal threshold issues associated with a P3 delivery method include the issues of private activity and grant funding availability as discussed above, as well as, satisfaction of procurement requirements, and potential imposition of prevailing wage requirements on a private P3 provider. Legal analysis will continue as the P3 delivery method alternatives are further developed. Additional details on these issues are provided in Attachment 3.

5. Grant availability

Staff has initiated work with Carollo Engineers to develop the grants program strategy, which includes evaluation of the availability of federal/state grants, and low cost loan programs for both the P3 track and the public project delivery track. Staff will provide further updates on this effort in future Board updates on the Program.

6. Internal and external stakeholder interests

External stakeholders include environmental groups, elected officials, retailers, and businesses that will want to ensure the expectations for quality are met, and potential contractors and subcontractors who may be interested in the construction of the project. Recommended strategies to address concerns include convening stakeholder meetings and briefings to provide information and solicit input to help ensure stakeholders are comfortable with P3 option. Other recommended strategies include making reports available and easily accessible, and developing supporting informational materials for key stakeholder groups.
Internal stakeholders include District employees, project staff, and other agency staff. Recommended strategies include educating internal stakeholders about the P3 options, including needs, benefits, process and costs by putting together workshops or meetings.

7. P3 RFQ/RFP

The P3 RFQ/RFP process will be managed on a dual track in parallel with the District’s Design-Build (DB) process to deliver the SVAWPC Expansion Project. Staff is targeting to release the P3 RFQ by December 2015 and to evaluate and select at least three firms/syndicates by March 2016. Staff is targeting to issue the P3 RFP for all or parts of the Program by June 2016 and return to the Board for approval of next steps by fall 2016. Firms participating in the P3 RFQ/RFP process may also compete in the DB RFQ/RFP process with certain restrictions to assure a fair process in both tracks.

To encourage participation in the P3 track, the RFQ will state that the District is considering offering a stipend to compensate the participants’ investment of time and resources to prepare and submit a proposal that is responsive to the RFP. Staff will conduct further research to determine the appropriate level of stipend required to attract and retain qualified P3 syndicates to participate in the RFQ/RFP process.

The evaluation criteria for the RFQ will be based on the proposers’ relevant P3 experience in the water/wastewater industry, capital strength, responsiveness, client references, and other relevant criteria. The RFP will be evaluated based on various criteria that are typical to large scale financing and may include, but not be limited to, the following: proposed approach to deliver all or parts of the Program; allocation of risk; pricing; proposed terms and conditions; compliance with District terms and conditions and insurance requirements; and compliance with CA Department of General Services Small Business Enterprise (SBE) Program.

Additional details of the P3 RFQ/RFP process are provided in Attachment 4.

B. Project Management Contract

Project Management Consultant Selection Process

On June 18, 2015, staff published a RFQ for Project/Program Management Services and sent RFQ letters to 12 consulting firms. These firms were identified based on their size, location (most are in the San Francisco Bay area), and program management experience for water/wastewater/recycled water projects. Consulting firms currently involved in Program work were not invited to participate. The RFQ was also posted on the District’s Contract Administration System (CAS) internet portal. District staff conducted a pre-Statement of Qualifications (SOQ) meeting and issued two addenda in the 2-1/2 week SOQ period to clarify the RFQ and respond to questions received from interested consultants. Staff received five (5) consultant proposals by the submittal deadline of July 7, 2015.

A Consultant Review Board (CRB) of three internal staff evaluated the written statements of qualifications and conducted consultant interviews on July 22, 2015. Based on the firms’ qualifications, experience, Program understanding, and project
management approach, the CRB ranked HDR the highest, and recommended that District staff proceed with contract negotiations with HDR.

**Consultant Agreement Scope of Services**

The proposed Consultant Agreement includes tasks for HDR to prepare a Project Management Plan, a Master Schedule, and a Risk Management Plan to assist District staff with oversight of and coordination between current consultant contracts; to plan and coordinate early value engineering workshops; to manage the environmental assessment and documentation to comply with the California Environmental Quality Act (CEQA) and, if necessary, the National Environmental Policy Act (NEPA); and to assist the District in developing the P3 track.

This Agreement contains the provision that if the Consultant performs the project management tasks satisfactorily and the current preliminary engineering efforts and related studies validate the Program, staff may amend the Agreement to include program management services to oversee implementation of the Program.

A summary of the tasks and schedule per the Project Management Services Agreement is presented in Table 2. The cost of these services, including Supplemental Services, for the initial term will not exceed $2.4 million. Prior to performing any Supplemental Services, the Consultant is required to obtain written authorization from the Water Utility Capital Division District Deputy Operating Officer.

**Table 2 – Summary of Tasks and Schedule for Proposed Project Management Services Agreement with HDR**

<table>
<thead>
<tr>
<th>Task</th>
<th>Description</th>
<th>Target Schedule</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Fast-Start Activities</td>
<td>Dec. 2015</td>
</tr>
<tr>
<td>2</td>
<td>Core Project Management Activities</td>
<td>Mar. 2017</td>
</tr>
<tr>
<td>4</td>
<td>Environmental/Permit Planning</td>
<td>Mar. 2017</td>
</tr>
<tr>
<td>5</td>
<td>Assistance with Public-Private Partnership</td>
<td>Mar. 2017</td>
</tr>
<tr>
<td>6</td>
<td>Support Workforce Development</td>
<td>Mar. 2017</td>
</tr>
<tr>
<td>7</td>
<td>Supplemental Services</td>
<td>Mar. 2017</td>
</tr>
</tbody>
</table>

**C. Environmental Review and Permitting Services**

Newly enacted Section 21080.08 of the Public Resources Code provides a narrowly tailored CEQA exemption for recycled water projects that involve the “construction or expansion of recycled water pipeline and directly related infrastructure within existing rights of way. . . and directly related groundwater replenishment[.]” This statutory CEQA exemption is effective only for those projects mitigating drought conditions for which the Governor proclaimed a state of emergency in California, approved by public agencies before the proclamation expires (unless extended) on January 1, 2017.
After extensive analysis of the CEQA exemption, staff has determined that given the current statutory language and the lack of a similar NEPA exemption, the most prudent next step is to prepare to commence an environmental review of the Expedited Purified Water Program components pursuant to CEQA (and possibly NEPA, a requirement for obtaining federal grants). Staff has initiated the selection process for a consultant to provide CEQA assessment and documentation, as well as permitting support services for the Program.

Staff will continue to work with the Governor’s Office and the legislature to seek amendments to the new CEQA exemption statute in order to clarify that the Program contemplated by the District fits within the language of the exemption. In parallel, staff is pursuing a NEPA exemption that will similarly exempt the Program components. Specifically, staff is working to have a NEPA exemption be included in the California Emergency Drought Relief Act, a bill recently introduced by Senators Dianne Feinstein and Barbara Boxer.

D. Budget Reallocation/Adjustment

On April 28, 2015, the Board received information on a proposed $16.5 million inclusion in the capital budget for Fiscal Year (FY) 2015-16, which would fund a number of items, including expediting design for additional treatment facilities adjacent to the SVAWPC (SVAWPC Expansion Project). On April 29, 2015, the Board held a Work Study Session to consider the proposed FY 2015-16 Operating and Capital Budget. The presentation included the Indirect Potable Reuse Projects – Planning (IPR) as one of the key capital projects, with a budget of $16.5 million. On May 12, 2015, the Board approved the District Operating and Capital Budget for FY 2015-16 (Resolution 15-34). Included in that budget was $16.5 million for the Program.

Staff has now identified the FY2015-16 budget requirement of $1.3 million for the SVAWPC Expansion Project. The major milestones in this project for FY 2015-16 include: executing design-build legal counsel services contract, executing a design-build advisory services contract, completing the design-build RFQ process, and issuing the design-build RFP by June 2016.

Staff recommends a budget reallocation/adjustment be approved by the Board to transfer $1.3 million from the IPR project to the SVAWPC Expansion project. Board approval of this request would not increase the FY 2015-16 Budget for the Program; it simply allows for better tracking of Program expenses in the appropriate project account codes. Board approval of this budget adjustment is required per Board adopted Resolution No. 15-34, which requires that all subsequent changes to the approved FY 2015-16 Budget, including adjustments between Capital Projects within a fund that exceed $100,000 per project, be approved by the Board.

FINANCIAL IMPACT:

All work activities to implement the staff recommendations are funded by the FY 2015-16 Board adopted Budget for the Indirect Potable Reuse—Planning Project.

CEQA:
The recommended action does not constitute a project under CEQA because it does not have a potential for resulting in direct or reasonably foreseeable indirect change in the physical environment.

ATTACHMENTS:

1. Program Background
2. Project Finance Overview
3. Legal and Financial Threshold Issues
4. P3 RFQ/RFP Framework
ATTACHMENT 1—PROGRAM BACKGROUND

The State of California is in a fourth year of exceptional drought conditions. Locally, the District’s comprehensive drought response efforts include implementation of 15 strategies, including a call for 30 percent reduction in water use and securing additional water supplies. Despite these efforts, there have been large declines in groundwater storage due to significantly reduced recharge and increased pumping in some areas. As the drought conditions continue, there is an increased risk of subsidence, which could significantly impact the infrastructure and economy of the County.

Seeking to expand the water supply portfolio for the County, the District and the City of San Jose jointly developed the South Bay Water Recycling Master Plan (SBWR Master Plan) for expansion of both recycled and purified water over the next 20 years. The SBWR Master Plan was completed in December 2014 and presented to the Board at a work study session on March 12, 2015. The SBWR Master Plan evaluated four potential opportunities to maximize the use of recycled water produced from the City of San Jose’s Regional Wastewater Facility. These four projects, listed as items (a) through (d) below, were identified for implementation in a phased delivery approach. A potential fifth project, the extension of the Wolfe Road recycled water pipeline in Sunnyvale, while not evaluated extensively in the SBWR Master Plan, is also potentially viable. The location of these projects is shown in Figure 1 below.

a. Ford Recharge Ponds IPR (near-term)
b. Mid-Basin Injection Wells IPR (mid-term)
c. Los Gatos Recharge Ponds IPR (long-term)
d. Westside Injection Wells IPR or Central Pipeline DPR (long-term)
e. Sunnyvale IPR (long-term)

![Figure 1: Proposed Purified Water Projects](attachment1.png)
Table 1 summarizes the capacity, estimated capital costs, and estimated annual Operations and Maintenance (O&M) costs for the five proposed projects.

<table>
<thead>
<tr>
<th>Description</th>
<th>Capacity (AFY)</th>
<th>Est. Capital Costs ($M)</th>
<th>Est. Total O&amp;M Costs ($M/year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ford Recharge Ponds IPR¹</td>
<td>4,200</td>
<td>$70</td>
<td>$4.0</td>
</tr>
<tr>
<td>Mid-Basin Injection Wells IPR²</td>
<td>5,600</td>
<td>$140</td>
<td>$3.5</td>
</tr>
<tr>
<td>Los Gatos Recharge Ponds IPR³</td>
<td>20,200</td>
<td>$260</td>
<td>$10.0</td>
</tr>
<tr>
<td>Westside Injection Wells IPR⁴ (or Central Pipeline DPR)</td>
<td>5,000 (5,000)</td>
<td>$120 ($65)</td>
<td>$4.0 ($4.5)</td>
</tr>
<tr>
<td>Sunnyvale IPR⁵</td>
<td>10,000</td>
<td>$210</td>
<td>$2.0</td>
</tr>
<tr>
<td>Total</td>
<td>45,000</td>
<td>$800</td>
<td>$23.5</td>
</tr>
</tbody>
</table>

¹²³ South Bay Water Recycling Master Plan; ⁴IPR Treatment Study, Carollo Engineers; ⁵As presented in the March 12, 2015, agenda memo, these costs are at a planning level of development and should be considered within a range of -20 percent to +100 percent.

At the March 12, 2015, Board work study session, staff also presented a plan for accelerating the implementation of the proposed SBWR Master Plan elements with a Program that would deliver up to 45,000 Acre-Feet per Year (AFY) within five to ten years for Indirect Potable Reuse (IPR) and, eventually, Direct Potable Reuse (DPR). Completing this Program would allow the District to use purified water for groundwater recharge to increase water supply reliability and help minimize the risk of subsidence when local and imported water supplies are scarce.

On April 28, 2015, the Board authorized single source contracts with RMC Water and Environment for preliminary engineering work, TODD Groundwater, Inc., for groundwater studies, Maine Technology Modeling Group for operations studies, and Carollo Engineers, Inc., for pursuit of grant funding opportunities. The Board also authorized contract amendments with Katz & Associates, Inc., for public outreach, and with MWH Americas, Inc., to update the 2014 South County Regional Wastewater Authority’s (SCRWA) Master Plan.

Key to the successful implementation of an Expedited Purified Water Program is streamlining the project delivery methods. On June 22, 2015, a Board Work Study Session was held to provide the Board and the public with information on the following project delivery methods:

<table>
<thead>
<tr>
<th>Public Project Delivery Methods</th>
<th>Public-Private Project Delivery Methods (P3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Design-Bid-Build (the District’s standard delivery method)</td>
<td>• Design-Build-Finance-Operate-Maintain (DBFOM)</td>
</tr>
<tr>
<td>• Design-Build</td>
<td>• Water Purchase Agreement (WPA)</td>
</tr>
</tbody>
</table>
On July 28, 2015, the Board approved the following dual track strategy for the Program:

- Continue the P3 track; research P3 financial and legal issues; develop RFQ/RFP; and
- Continue with planning and design of the SVAWPC expansion.

**Board Policy**

The Board’s Governance Policies and CEO Interpretations guide development of the recycled water program. The Board’s water supply goal related to recycled water is contained in E-2.1-current and future water supply for municipalities, industries, agriculture and the environment is reliable. The Board’s water supply objectives are contained in the following Ends policies:

E-2.1.4: Protect, maintain and develop recycled water

E-2.1.1: Aggressively protect groundwater from the threat of contamination and maintain and develop groundwater to optimize reliability and to minimize land subsidence and salt water intrusion.

CEO Interpretation of these ends policies calls for the District to develop recycled water to meet at least ten percent of County demands by 2025. In 2015, staff will develop an update to the CEO Interpretation of these Ends policies as they affect recycled and purified water development.
ATTACHMENT 2—PROJECT FINANCE OVERVIEW

The P3 delivery methods under consideration by the District for the Program may require the District’s private partner to provide financing. Such financing would likely be in the form of Project Finance. To familiarize the Board with this form of financing, this attachment provides a general overview of Project Finance and of the private activity issues associated with private-sector involvement in the Program. This attachment also provides an overview of some of the key issues the Board may consider with regards to Program cost.

Project Finance

Project Finance is the long-term financing of infrastructure projects based upon the projected cash flows of the project rather than the balance sheet of its sponsors. The key elements of project finance include the following:

- **Corporate Sponsor.** The Corporate Sponsor would be the entity that the District selects to serve as the private partner. The RFQ/RFP process for selection of the Corporate Sponsor is discussed in Attachment 4. The key roles of the Corporate Sponsor include negotiating a P3 Agreement with the District; negotiating an Engineering, Procurement and Construction Contract (EPC Contract) with one or more qualified builders; arranging for financing of the Program; and providing for Program operations.

- **Single-Purpose Entity.** The Corporate Sponsor will typically establish a single-purpose entity that will serve the following purposes: (1) be the direct counterparty to the District in negotiating the P3 Agreement; (2) enter into the EPC Contract; and (3) borrow monies to finance the Program. The only business of the single-purpose entity will be undertaking the Program. The single-purpose entity will limit the Corporate Sponsor’s financial risk of undertaking the Program, as monies borrowed by the single-purpose entity will be secured by the P3 Agreement and EPC Contract; the Corporate Sponsor will not be liable beyond the pledged security (i.e. non-recourse debt to the Corporate Sponsor). The single-purpose entity will also protect the District from credit risk associated with the Corporate Sponsor.

- **P3 Agreement.** The P3 Agreement is a general term for the revenue-producing contract between the Single-Purpose Entity and the District. The P3 Agreement could take the form of a water purchase agreement, or a services agreement, or some hybrid structure, depending on the specific contract structured by the District to comply with state and federal laws and regulations. The P3 Agreement will be long term, typically covering the construction period plus 20 or more years of operations. The P3 Agreement will specify the circumstances in which the District is required to make payments to the Single-Purpose Entity, and will be used by the District to control the risk allocation between the District and the single-purpose entity. The P3 Agreement will also specify the obligations of the single-purpose entity in constructing, operating and maintaining the Program including the performance standards and any other terms and conditions agreed to by the parties.

- **EPC Contract.** The EPC Contract is an agreement between the single-purpose entity and the builder(s) selected to construct the Program facilities. In a Project Financing, the District will not be a party to the EPC Contract. The EPC Contract will generally provide for the fixed-price, date-certain completion of construction and commencement
of commercial operations, with specified financial penalties if these requirements are not satisfied.

- **Non-Recourse Debt.** The single-purpose entity will raise funds by issuing equity to the Corporate Sponsor and other equity investors, and by issuing non-recourse debt. The primary security for the debt will be the P3 Agreement and the EPC Contract. Lenders and rating agencies will carefully review these key agreements to understand the risks in the project and how these risks could affect the single-purpose entity’s ability to make timely payment of principal and interest. Depending on the specific structure of the P3 delivery method, the debt could take the form of a borrowing from a syndicate of banks and institutional lenders; issuance of Private Activity Bonds (PABs); issuance of governmental purpose bonds, or a combination thereof. The rating on the non-recourse debt, and the resulting financing cost, will be dependent in large part on the District’s willingness to accept greater or lesser risks with respect to the Project.

**Private Activity**

A P3 delivery method may involve some degree of private activity, meaning the involvement of a private party in the Program as opposed to governmental entities. Generally, if the nature and extent of private activity is limited to guidelines specified in the Federal Tax Code, the private activity will be ignored for federal tax purposes and tax-exempt governmental bonds can be issued to finance construction of the Program’s physical assets. On the other hand, if private activity is not consistent with applicable guidelines, then governmental purpose bonds are not available as a source of funding, and instead PABs or a taxable borrowing would be used to finance the Program. Because the borrowing cost is different for tax-exempt governmental purpose bonds, PABs, and taxable borrowing, the nature and extent of private activity is relevant to the cost of raising capital and hence to the overall cost of the project. Private activity considerations may also impact the tax exemption of bonds issued to finance the Wastewater Facilities supplying wastewater to the Program, as well as the District’s future flexibility to implement direct potable reuse. These Program-specific issues, and the District’s four-pronged strategy to address them, are discussed further in Attachment 3.

Generally, tax-exempt governmental bonds are only allowed to be issued by or on behalf of states and local governmental entities, such as the District, for facilities owned and operated by a state or local governmental entity. Facilities which are owned or operated by private parties are generally not allowed to be financed with tax-exempt governmental bonds unless they are qualified as discussed below. In many cases, contractual arrangements which give private parties legal entitlements to a facility or its output that are not generally available to members of the public will jeopardize tax exemption, even if the facility is owned and operated by a state or local governmental entity.

Under certain circumstances set forth in the Internal Revenue Code, rules and regulations issued with respect thereto and other authorities, including case law (collectively, “Private Use Rules”), certain arrangements with private parties will not jeopardize the ability of a state or local governmental entity to finance a facility with tax-exempt governmental bonds. These arrangements include operating or management contracts with private parties which meet certain “safe harbor” requirements having to do with the term of the contract and the way the private entity is compensated (i.e., Qualified Management Contracts). If a state or local entity wishes to finance a facility using a P3 approach with tax-exempt governmental bonds, the P3 transaction needs to be structured in accordance with the Private Use Rules for Qualified Management Contracts.
If a P3 arrangement results in impermissible private use of a facility, the facility generally cannot be financed with tax-exempt governmental bonds. However, for certain categories of assets defined in the Federal Tax Code (including water facilities), tax-exempt financing is still available through issuance of PABs, provided that the issuer obtains an allocation of state volume cap and meets other requirements for issuance. PABs are a form of tax exempt bonds that, unlike governmental purpose bonds, are subject to the alternative minimum tax. All else equal, PABs generally have higher interest rates than tax-exempt governmental bonds, but lower interest rates than taxable bonds. The cost difference between PABs and tax-exempt governmental bonds fluctuates, but generally ranges between 0.25 percent and 0.50 percent which translates into $250,000 to $500,000 in additional annual borrowing costs per $100 million of bonds issued.

The Private Activity Rules apply not only to tax-exempt bonds financing a water facility, but could also affect the tax-exempt status of bonds issued by other local governmental entities that supply wastewater to a water treatment facility. These would include tax-exempt bonds which are already outstanding or which may be issued in the future. Because the Program will receive and treat wastewater from facilities owned by other local governmental entities, the impact of a P3 structure on the tax-exempt status of bonds issued to finance such Wastewater Facilities is an important Program consideration.

The rules under the Internal Revenue Code with respect to private use of facilities such as the Program facilities which are financed by either tax-exempt governmental bonds or private activity bonds are well developed. The rules with respect to how private use of the Program facilities might affect tax-exempt bonds issued by other local government entities supplying wastewater, however, is not as well developed. The strategy to address these potential private use issues in a P3 structure is discussed in Attachment 3.

Cost of the Program

The cost of the Program to the District and its ratepayers will reflect several key elements, irrespective of whether the Program is delivered using a P3 delivery method or a public delivery method. These elements are the capital budget, cost of funds, and operating/maintenance costs. Taken together, these elements will determine the annual cost of the Program.

- **Capital Budget.** The Capital Budget refers to the sum of development costs; engineering, procurement and construction costs; capitalized interest; reserves; and other fees and expenses. District staff, using information developed in the South Bay Water Recycling Master Plan, estimated the Capital Budget for the Program as ranging from $600 million to $1.6 billion, with the wide variance being of the early stage of Program development. The estimated Capital Budget will be refined as the Program is further developed.

- **Cost of Funds.** The Cost of Funds refers to the cost (in terms of interest rate or yield) of obtaining long-term financing of the Capital Budget. The cost of borrowing will be determined by factors including the type of debt instrument (i.e., governmental purpose bonds, PABs, or taxable debt); the applicable credit rating; and market conditions at the time of issuance. In a Project Financing, the Corporate Sponsor’s required rate of return (profit margin) is an additional cost consideration. Additionally the plan of finance typically calls for the issuance of equity as well as debt. In such case, the cost of funds will be a weighted average between the expected equity internal rate of return and the borrowing cost.
- **Operating/Maintenance Cost.** The third component of Program cost is the annual cost of Operating and Maintaining the Program facilities.

In evaluating the cost of the Program at a policy level, the District may focus on two key metrics: the cost of the Program relative to alternative water supply alternatives, and the impact of the Program on groundwater rates.

- **Relative Cost.** Relative Cost refers to the cost of the Program relative to other groundwater recharge alternatives. For comparative purposes, the cost of the Program is typically converted into dollars per acre-foot by dividing annual Program costs by projected acre-foot production. The resulting cost per acre-foot can be compared against historic and projected costs of alternative sources of water supply in order to measure the Program’s relative affordability. The cost per acre-foot analysis will also support cost/benefit analysis of the Program.

- **Rate Impact.** Rate Impact refers to the incremental impact of Program costs on the District’s water rates, and specifically on its Groundwater Production Charge. Multiple factors influence the impact of the Program on rates. For example, the District typically sets rates so as to maintain a coverage margin on District debt as part of its strategy of maintaining strong investment-grade credit ratings which would minimize the financing cost for the District’s current and future Capital Improvement Program. This approach results in the District generating cashflow in excess of its debt service expenditures. However, the excess cash so generated can be used to offset and reduce future costs. A key element of rate design involves anticipating these direct and indirect factors so that rate increases remain affordable.

As the Program is developed, the Program’s annual costs, relative costs, and rate impact will be refined for the specific Program design as well as each of the delivery methods under consideration.
ATTACHMENT 3—LEGAL AND FINANCIAL THRESHOLD ISSUES

This Attachment provides preliminary analysis of certain threshold legal and financial considerations relevant to the implementation of a P3 delivery method by the District.

Private Activity Considerations

Section 141 of the U.S. Internal Revenue Code is the primary Federal Tax Law Provision relating to the private use of facilities financed with tax-exempt bonds proceeds. In addition, regulations issued in 1997 and 2002 and referred to as the private use regulations provide significant guidance on the application of Section 141 to “output” facilities (which the Program is likely to be). Finally, a Revenue Procedure originally issued in 1997 (which has been amended and amplified several times), and generally referred to as the Qualified Management Contract rules give guidance to applying Section 141 to long term contracts for operation or management of facilities financed with tax-exempt governmental bond proceeds.

There is limited guidance with respect to the applicability of the Private Use Rules to wastewater facilities which would supply wastewater to the Program. The guidance that exists is found almost entirely in a single tax court case commonly referred to as the “Santa Rosa” case in which the Internal Revenue Service’s expansive view of private use of wastewater discharged from a wastewater facility was rejected by the tax court, based on the specific facts of the Santa Rosa case.

The application of the Private Use Rules to the Program will be highly fact dependent. For example, the ability to finance the Program with tax-exempt governmental bonds will depend on whether the District or the P3 owns the facilities; whether the District operates the facilities or whether the P3 operates the facilities (and whether the P3’s operating agreement meets the Qualified Management Contracts rules). In addition, the application of Private Activity Rules will vary on whether the output of the Program facilities is injected into the groundwater basin for indirect potable reuse or is sold by the District directly to public and privately owned water retailers for direct potable reuse in the future.

Staff is working with outside counsel, financial advisor, and the District’s Office of Government Relations to pursue a four pronged strategy to ensure that, if the Board elects to move forward with a P3, the bonds issued to finance the Program will be tax-exempt governmental activity bonds or receive a state volume cap for PABs and that the P3 arrangement not jeopardize the tax exemption of bonds issued to finance the wastewater facilities supplying wastewater to the Program facilities. Each of the four strategies will take a minimum of 9 to 12 months to develop and implement; all work efforts will be conducted concurrently with the P3 RFQ/RFP process. The four strategies are described below:

1. Develop a P3 Qualified Management Contract—The District would develop a P3 structure that complies with the requirements for tax-exempt governmental bonds, including rules related to ownership of the Program facilities and the management contract rules. Such an approach would allow tax-exempt governmental bonds or PABs to be issued to finance the Program, but the significant restrictions that would be imposed on private participation may not result in the lowest cost proposal from potential P3 providers. Generally speaking, the current rules for a water utility provider allow contract term of up to 20 years with a minimum of 80 percent fixed fee pricing.
2. Amend the Qualified Management Contract Rules—The District would support public agencies and other stakeholders who are currently working with the American Bar Association and the U.S. Treasury Department to liberalize the Private Activity Rules as they relate to P3’s. The revision being considered with the greatest applicability to the Program is a modification of the qualified management contract rules to allow longer term arrangements with P3’s.

3. Federal Legislative Remedy—On August 25, 2015, the Board authorized staff to seek an amendment to S1894 (Feinstein) which would allow the Program to be developed as a P3 and still be financed with tax-exempt governmental bonds.

4. Private Letter Ruling—The outside counsel will work on a request to the Internal Revenue Service for a ruling (a “private letter ruling”) that the issuance of tax-exempt governmental bonds for Program facilities undertaken under a P3 arrangement would be permitted under the Santa Rosa case and Private Use Rules generally, to confirm that such a P3 arrangement would not adversely affect the tax exemption of bonds issued by local governmental entities to finance wastewater facilities supplying wastewater to the Program and to approve the direct sale by the District of output from the Program facilities to the District’s existing public and private retailers. The outside counsel would develop the private letter ruling in conjunction with representatives of the local governmental entities which own the wastewater facilities expected to supply wastewater to Program facilities.

Availability of Tax Exempt Financing

To the extent that the P3 delivery method meets any of the alternatives described above to be eligible for governmental bond financing, the availability of tax exempt financing is considered highly reliable with low financing cost. Generally, the tax exempt financing market is very active and there is sufficient market liquidity and investor demand to support the Program’s financing needs. In its 2012 report on the municipal securities market, the U.S. Securities and Exchange Commission estimated that $3.7 trillion of municipal bonds are currently outstanding. In terms of new issuance, The Bond Buyer reported $223 billion of bond sales in the first half of 2015. Even at the higher end of capital cost estimate for the Program, the amount of bonds to be issued to Finance Program facilities would be modest relative to both annual new issue volumes and outstanding municipal indebtedness.

To the extent that the P3 delivery method does not satisfy the requirements for tax-exempt governmental bond financing, the availability of tax exempt financing would be dependent upon meeting the issuance requirements for PABs. Section 146 of the Internal Revenue Code limits the amount of PABs that may be issued in a state during a calendar year. In 2015, California’s annual PABs volume cap is approximately $3.9 billion; approximately 62% of this cap has been allocated through July 2015. Estimated capital costs for the Program are significant relative to this volume cap, constituting 15 percent to 41 percent. The California Debt Limit Allocation Committee (CDLAC) is responsible for allocating California’s annual volume cap to specific municipal issuers. The availability of tax-exempt financing for a PABs financing strategy would be dependent upon receipt of adequate allocation of state volume cap.

1 Source: http://www.treasurer.ca.gov/cdlac/
Legal and Permitting Considerations

Legal considerations relevant to the consideration of a P3 delivery method include the issues of private activity and grant funding availability that are discussed above. There are additional legal and permitting considerations relative to the Program regardless of the delivery method that is selected, such as CEQA permitting and brine disposal arrangements. Additional legal considerations that are specific to consideration of a P3 delivery method include compliance with the District’s procurement authority and the need to impose prevailing wage requirements on the P3 provider.

- **Procurement Requirements.** Although the Board has approved the P3 RFQ/RFP competitive process, a single source contract may be considered for a transaction comprised solely of the purchase of water. However, single source is restricted by procurement laws applicable to professional engineering and construction services, and P3s. Government Code 4529.12 requires certain professional services to be procured through a fair competitive process. Government Code 5956.5 requires P3 private party be selected through a competitive negotiation process. Public Contract Code 21161 requires any improvement or unit of work not performed by the District estimated to cost more than $25,000 be awarded to the lowest responsible bidder.

The Infrastructure Financing Act (Government Code 5956 et al.) authorizes local government agencies, including special districts, to use public-private partnerships to finance the development of infrastructure projects. The main limitations are that the infrastructure project must be fee-producing; the infrastructure project must not include any state funds (other than funds from the State Water Pollution Control Revolving Fund and Safe Drinking Water State Revolving Fund), and that the length of the public-private partnership contract must not exceed 35 years.

- **Prevailing Wage Requirements.** Special counsel to the District has advised that prevailing wage requirements will apply to the design-build-finance-operate-maintain P3 delivery method if the Program is paid for in whole or in part with public funds (Labor Code 1770 and 1720(a)(b)). Additional information regarding the financing structure of the Program will be required to provide a final opinion on this issue. In contrast, under a water purchase agreement P3 delivery method, prevailing wage requirements would not apply because public funds would not be used for construction, alteration, demolition, installation or repair work as required under Labor Code Section 1720(a). The use of public funds to purchase water alone would not trigger prevailing wage requirements.

- **Brine Permitting Issues.** The discharge of waste into waters of the United States is regulated by the Clean Water Act (CWA). Currently, brine resulting from the operation of the SVAWPC is discharged into the City of San Jose outfall, which is subject to the terms and condition of the City’s National Pollutant Discharge Elimination System (NPDES) permit issued per the CWA. The District has not received assurances from the City whether additional brine resulting from projects constructed under the Program may be discharged through the City’s NPDES permitted outfall. If the additional brine is not discharged through the City’s outfall, the District will likely have to obtain an NPDES permit for an outfall, which would potentially take many years, or the District would identify and develop an alternative method to manage brine by product from the treatment process.
The above discussion of legal and permitting considerations is not intended as exhaustive or definitive. Legal analysis will continue as the P3 delivery method alternatives are further developed.
ATTACHMENT 4—P3 RFQ/RFP FRAMEWORK

This attachment provides an overview of the RFQ and RFP process for selection of a potential P3 provider.

Dual Track Structure

The P3 RFQ/RFP process will be managed on a dual track in parallel with the District’s Design-Build (DB) process to deliver the SVAWPC Expansion Project. Staff has carefully considered the interaction between the dual tracks, and how to maintain a fair and competitive structure that will meet the District’s requirements and support active participation in both tracks by potential respondents.

Staff is targeting to release the P3 RFQ by December 2015; to evaluate and select at least three firms/syndicates by March 2016; and to hold at least monthly pre-submittal meetings with the shortlisted firms/syndicates to provide technical studies updates between March and June 2016. Staff is targeting to issue the P3 RFP for all or parts of the Program by June 2016 and return to the Board for approval of next steps by fall 2016.

Firms that participate in the P3 RFQ/RFP process may also compete in the DB RFQ/RFP process. However, if a firm participates and is selected by the District in the P3 RFP process, then it cannot continue to compete in the DB RFQ/RFP process to the extent it receives non-public information that could give it an unfair advantage or to the extent it participates in influencing the scope or criteria for the DB RFQ/RFP process. Similarly, a firm selected for DB can no longer compete for P3 if it receives non-public information or influences the selection scope or criteria.

RFQ/RFP Framework

Staff plans to send P3 RFQ letters to engineering/contracting firms active in the water sector, selected financial institutions, and other potential respondents. The RFQ will also be posted on the District’s Contract Administration System (CAS) internet portal. Staff will evaluate responses based on relevant P3 experience in the water/wastewater industry, capital strength, responsiveness, client references and other relevant evaluation criteria.

The Project Management consultant will host/organize regularly scheduled meetings (attendance is not mandatory; the meetings will be recorded and be made available to all participants) to provide the qualified P3 firms with updates on the technical studies and answer questions on the studies. The updates may be once a month or some other interval that may make better sense, depending on the progress of the studies and feedback on how best to organize the meetings to disseminate relevant information. The information will be the same as what is disseminated to the DB teams so that there is no “unfair” advantage in terms of information sharing.

To encourage participation in the P3 track, the RFQ will state that the District is considering offering a stipend to compensate the participants’ investment of time and resources to prepare and submit a proposal that is responsive to the RFP. Staff will conduct further research to determine the appropriate level of stipend required to attract and retain qualified P3 syndicates to participate in the RFQ/RFP process. The RFP will be evaluated based on various criteria that are typical to a large scale financing and may include, but not be limited to the following: proposed approach to deliver all or parts of the Program; allocation of risk; pricing; proposed terms and conditions; compliance with District terms and conditions and insurance.
requirements; and compliance with CA Department of General Services Small Business Enterprise (SBE) program.