



Memorandum

TO: Mayor and City Council

FROM: Councilmember Rose Herrera
Councilmember Kansen Chu
Councilmember Nancy Pyle

SUBJECT: SEE BELOW

DATE: November 5, 2010

Approved

Rose Herrera
JM

Kansen Chu

Date

11/5/10

Nancy Pyle (KS)

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

RECOMMENDATION:

1. Modify the preliminary Work Plan and proposed Evaluation Criteria to exclude the options related to the sale or lease of Muni Water.
2. Any costs associated with the Work Plan and procurement options are not borne by the Muni Water ratepayers.

BACKGROUND

The long-term solutions to the City's current budget problems need to be common sense solutions that trim excess spending and position San Jose for economic growth. The consideration of a sale or lease of San Jose Muni Water is none of those.

As we explore creative revenue generating options for closing the structural deficit, we must consider what is best for the City as a whole. It is imperative we see the bigger picture. The bigger picture considers that water is a precious resource. That controlling our water utility is important to our future. And San Jose's future is bright. With over one million residents calling San Jose home and start-ups and big companies like Cisco, eBay and Adobe choosing to locate here, we will recover, we will see job growth, and one day we will be a stronger economy than we are today. Short-sighted decisions could jeopardize it all.

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WATER IS A PRECIOUS RESOURCE

High cost of history repeating itself

Usually when a city considers selling a utility, the operating or maintenance losses are so great, it is better to just let it go. This is not the case with Muni Water. It is one of the best run and well-maintained water systems around. Unlike other systems maintained by the city such as roads. Muni Water has no unfunded maintenance liability. San Jose has wisely invested and maintained our water infrastructure and would lose this investment if we sell or lease it.

This would be the eighth time the City has pursued this strategy. The most recent attempt was in 2002 when the City spent one and a half years and over a million dollars borne by the Muni Water rate payers. In the end, the decision was made not to move forward. Back then, the City Council authorized the City Manager to negotiate an operating agreement with San Jose Water Company. Eventually, the negotiations failed and no action was taken. We should not spend millions of dollars again to pursue an option that has insurmountable issues and is unwise planning for San Jose's future.

It is still urgent that we examine and pursue all options that make sense as San Jose faces a \$41 million deficit which could grow larger for FY 11-12. Taking another look at using Muni Water revenues for the General Fund is a reasonable alternative.

is a reasonable alternative. To be clear, up until three years ago, Muni Water was transferring up to 10% of its gross revenues to the City's General Fund, as allowed under Muni Code 4.80.630. The City received a total of 10% in two parts. For the first part, eight percent of Muni Water's gross revenues were transferred to provide the City with a "reasonable rate of return to the City." The second part included two percent as an in-lieu fee. The in lieu fee is in-lieu of a franchise fee applied to private companies. For example, Great Oaks pays the City a two percent franchise fee but San Jose Water doesn't pay due to a legal decision. During FY2007-2008, the City began phasing out the transfer of gross revenues out of concern that this opened the City up to litigation. Those transferred revenues violated Proposition 218 because it was above and beyond the cost of service.

Prop. 218

The ability for the City to receive the eight percent transfer of Muni Water's gross revenues and the two percent in-lieu fee was cut off as a result of California voters passing Proposition 218 in 1996, called the "Right to Vote on Taxes Act." Prop. 218 requires property related fees be used only for the purposes for which the fee was collected. It is easy to see why a sale would be appealing to those who believe that the funds from the sale or lease of this utility would be able to be deposited in the General Fund to restore much needed services. However, Prop. 218 is still on the books and all the same legal challenges exist. In the case of a lease, Prop. 218 requires a nexus between the rates charged to customers and the cost of service. Specifically, the San Jose

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Water Company proposal includes a lease scenario where the lease is contingent upon raising rates of Muni Water customers. As we all now know, under Prop. 218, raising rates beyond the cost of service is not permissible and the option to lease is moot. We are right back where we started: unable to use Muni Water revenues to benefit the General Fund.

The amount of staff time and resources needed to explore the sale or lease options are so great, and it is clear that those options are not truly viable. We should learn from history and respect the intent of Prop. 218. If maximizing revenue is the goal, then wasting current resources is not the path to achieving that goal.

Protecting Access to Hetch Hetchy

Our bright future is in jeopardy because of the wide ranging impacts of selling or leasing Muni Water. Already, California is one of three states that uses a quarter of the entire nation's water supply, according to the U.S. Geological Survey, Government Accountability Office. Water is a precious resource and we must ensure the future of San Jose's economy and quality of life by having a secure high-quality water supply. Most large cities own their water utility and would never consider selling it to the highest bidder.

If the City transfers Muni Water assets by selling or leasing to a private entity, we jeopardize our access to Hetch Hetchy water, widely regarded by residents and businesses as high-quality, pure water. One reason why the water quality is among the best in the nation is that the Hetch Hetchy watershed has been maintained in pristine condition for nearly 100 years. If we lose access to water from the Hetch Hetchy reservoir, we will never regain it. There is a long line of municipalities waiting to take our place if we are foolish enough to give it up.

Financing Hurdles

Another issue that stands in the way of maximizing revenue potential of Muni Water is its' tax-exempt bond financing. It has been explained that the Internal Revenue Code regulations governing tax-exempt bonds that finance Muni Water and South Bay Water Recycling improvements significantly impact the City's ability to lease or sale Muni Water to a private entity. Furthermore, the City Attorney's Office issued a Memorandum to the City Council on August 15, 1995 identifying several costly issues that must be addressed prior to any sale of SJMWS. It goes on to explain the issues include "potential limitations on distribution of sale proceeds, the tax-exempt status of the outstanding assessment district bonds, and procedures set forth in the Government Code that apply to the sale of assessment district bond financed improvements." At a minimum, all those issues, including citywide voter approval that must pass by a 2/3 vote, must be finalized before the City could even consider any benefit from the proceeds of a sale. In a scenario where we sell or lease the system and we overcome all the obstacles in place, the benefit to the General Fund is still years away. We would not see a dime any time soon.

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In the same memorandum, the City Attorney explained that if the system is sold, sale proceeds may need to go to property owners in the assessment district. Another issue to overcome. If the system is sold to a privately owned utility, it would be considered a private purpose under IRS rules for tax-exempt bonds. Therefore, the interest on the outstanding bonds is taxable

The Muni Water system is maintained through the sale of tax-exempt bonds. If there is private activity on those bonds, the bonds need to be refunded. Therefore, if Muni Water is leased or

sold to a private company, the proceeds would be used to pay back those bonds. So again, more issues need to be addressed meaning more wasted time. To avoid these issues, we would have to pay back almost \$8 million in bonds. And lastly, the Government Code referenced in the aforementioned memorandum states that any sale requires a citywide vote and needs 2/3 to pass.

There are so many costly issues that expend money and staff time. Unfortunately, we do not have enough of either to risk.

PURSUE OPTIONS THAT DO NOT JEOPARDIZE SAN JOSE'S FUTURE

Securing our future

Already, we have invested millions of dollars into the economic vitality and success of North San Jose, also known as the Innovation Triangle. The North San Jose Development Policy is one of the most exciting and proactive efforts underway in San Jose to attract new businesses and plays a vital role in the City's economic strategy. It is in our best interest to do everything possible to ensure its success. Because if the North San Jose Development Policy is successful, San Jose is successful. With more than 26.7 million square feet of new R & D and commercial space, the jobs generated and the innovations created will have a profound impact on our economy.

As San Jose focuses on stimulating economic growth, it is in San Jose's best interest to support the businesses we have and facilitate the location of new ones. One way of doing that is by continuing to supply the high-quality water of Muni Water. By controlling our own water system, the City Council can anticipate and control growth. The City Council can vote to proactively invest in the system's infrastructure. As the Bay Area Economic Forum learned in their examination of the Hetch Hetchy system in 2002, businesses need reliability. Businesses seek out low-risk locations to focus their capital investment on their products and innovating in their industry. We should not do anything that could be perceived as a disadvantage to locating in San Jose.

Transparent options make the most sense

The City Manager is proposing three revenue options that do not require a transfer of Muni Water assets. These options make the most sense because they are the most transparent. San Jose

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voters get a say in increasing the revenue from Muni Water without risking San Jose's future. These are worthy options to explore as we try to close the budget gap and provide vital services. There is a reasonable approach to maximizing revenue from the Municipal Water System without jeopardizing the Water Utility Fund (Fund 515).

CONCLUSION

We strongly recommend the Mayor and City Council support the options to maximize financial benefits of the San Jose Municipal Water System that do not include the sale or lease options.

The City's on-going budget problems require innovative solutions that do not expose the City to so much short-term and long-term risk.

Water is a precious resource. We are fortunate to have a water utility under our jurisdiction. We should not do anything that jeopardizes our control of it. It also makes little sense to release control of a well managed and well maintained utility. Furthermore, releasing control of a water utility is not a "best practice." Most big cities nationwide control this utility and are glad to do so.

Going forward, we believe there are options that maximize the benefit to the General Fund that have a chance of success in the near future. These are options that will have an impact much sooner. Success means our ability to restore services like library hours, reopening community centers, and strengthening public safety. And the viable options do not include the sale or lease of the water system. In either of those two scenarios, there are just too many obstacles that are insurmountable. If there were just one or two issues, it would be worth including them in the work plan. But there are more than five complicated issues with significant legal implications and limitations. It is not in San Jose's best interest to include the transfer of assets in the current work plan. We should focus on maximizing revenue generation options that will benefit the General Fund as soon as possible. In terms of the sale or lease of the system, there are major legal obstacles that we feel will ultimately result in no action and a lost of over a million dollars. With the limited resources we already have, it is unwise to squander those resources on losing battles.

With all that in mind, we strongly support the proposed work plan and evaluation criteria that do not include the sale or lease options. It is in the best interest of the City to move forward on options that are feasible. With revenue generation possibilities within reach, let us move forward on those that restore needed services San Jose residents deserve.