



PUBLIC WORKS DEPARTMENT

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CITY COUNCIL STAFF REPORT

Meeting: July 20, 2021

Subject

Consideration of the Lease, Sale or City Operation of the Cupertino Municipal Water System and Provide Direction on These Options.

Recommended Action

1. Conduct a Public Hearing to Consider Options for the Continued Operation of the Cupertino Municipal Water System; and
2. Adopt Resolution 21-XXX, Authorizing Initiation of the Public Utilities Code § 10061 Process to Approve a Future Long-term Lease of Real Property, (Cupertino Municipal Water System) that May be Effective as Early as October 1, 2022 (Attachment A).

Background

Cupertino has three water service areas as shown on Attachment B.

- The orange area is served by a water system owned and operated by San Jose Water Company (SJWC).
- The green area is served by a water system owned and operated by California Water Service Company.
- The orange area is served by the Cupertino Municipal water system. This system is owned by the City of Cupertino and leased for operations by SJWC.

This report is focused on the orange area that is served by the Cupertino Municipal water system and leased to SJWC in October 1997 for a term of 25 years.

As the lessee of the System, SJWC is responsible for all operations of the system including repair, maintenance, operation, customer service/billing, emergency service and water quality testing. According to the terms of the 1997 lease, the City received an initial \$6.8M concession fee and an annual payment of \$1 per year from SJWC. On December 17, 2019, City Council adopted Resolution 19-145 (Attachment C), which approved an amended and restated lease (Lease) (Attachment D). This new Lease agreement required SJWC to deposit \$5 million of funds to the City for the purpose of completing capital improvements to the System before the end of the lease. These funds were received, and improvements are ongoing.

Discussion

There are three options to consider for the continued operation of the System when the current Lease ends in September 2022. These include:

1. A new long-term lease of the system
2. Sale of the system
3. City operation of the system

1. New Long-Term Lease – Recommended Option

Leasing the System has provided customers with comparable service to that provided to other Cupertino residents (who are served by SJWC or Cal Water's privately owned systems). These customers are charged rates that are consistent with SJWC's other customers.¹ Leasing the System has the advantage of allowing the City to continue to own a valuable asset and to receive a return on the investment the public made in creating the System. Further, the process for leasing the water system is simpler and less time consuming than a sale of the system. It provides a level of expertise in operations and economies of scale that could not be achieved if the City operated the System directly.

If the City Council decides to continue leasing the System to a third-party the City must initiate a new Request for Proposal (RFP) process in compliance with section 10061 of the Public Utilities Code (PUC § 10061).

Recommended lease provisions would be updated to current best practices for operation and maintenance. These provisions would ensure System customers receive quality and reliable water service, and that the System is operated and maintained to all applicable standards. Recommended provisions would include, but are not limited to, the following:

- Term of 20 years
- Specified dollar amount of annual System improvements to ensure reliable and efficient long-term operation and maintenance
- Setting of water rates and charges to be capped at the rates established by the California Public Utilities Commission for other water customers within Cupertino. (Requirement of current amended and restated lease)

Upon completion of draft new lease agreement the RFP would be publicly advertised. Lease proposals received would be evaluated on:

- Meeting required qualifications, experience, and history in operation of similar or larger water systems
- Concession amount proposed
- Annual payment amount proposed

¹ The current Lease caps the amount SJWC can charge customers of the leased System to an amount less than or equal to the amount SJWC charges its own customers within Cupertino, as determined by the California Public Utilities Commission and their Public Advocates Office.

Proposals determined to be “best qualified to continue to provide equal or better service to the customers of the system” as specified in PUC § 10061 would be presented for City Council award consideration at a public hearing. This process is expected to take up to 15 months to complete.

If the City Council provides direction to pursue a new lease, it will be necessary to start the process soon in order to ensure completion by the October 2022 expiration date of the current Lease. A proposed timeline is included below.

2. Sale

There are two potential options available to sell the System. One option is pursuant to PUC § 10061. The other option is to pursue a legislative amendment and sell pursuant to Government Code § 37420.5.

Selling the System pursuant to PUC § 10061 requires that the City first engage in an RFP process. Once the City has negotiated sale terms with the purchaser determined by City Council to be the “best qualified to continue to provide equal or better services to the customers” of the Water System, then approval of the proposed sale can move forward with the following additional steps:

- 1) A Council resolution determining that System customers “will be provided with equal or better service by the acquiring entity on terms that are just.”
- 2) A resolution adopted by the purchasing entity, concurring in the terms and conditions of the sale.
- 3) Approval of a majority of voters voting in a City-wide special or general election held for that purpose.

If the sale were approved, the California Public Utilities Commission (CPUC) would review the terms. The CPUC could potentially require the parties to renegotiate if the CPUC determined the terms were improper.² This process, including negotiations and CPUC review, is estimated to take up to 41 months. Therefore, the current Lease would need a short-term extension in order to bridge the time between the October 2022 expiration date and the sale of the system.

Alternatively, the City could pursue a sale pursuant to Government Code §37520.5, which allows the City to use a simplified process to sell the System to a bordering water system³ without voter approval. However, the City would first have to successfully obtain an amendment to GC § 37420.5. A legislative amendment to Government Code (GC) §37420.5 would be necessary in at least two respects:

² See for example, the CPUC’s Public Advocates Office opposition to the proposed purchase of the Bellflower Municipal Water System by California American Water Company despite city council and voters approving the sale. <https://www.publicadvocates.cpuc.ca.gov/general.aspx?id=4172>.

³ SJWC, Cal Water and the City of Sunnyvale have water systems that border the System.

- 1) GC § 37420.5 is currently limited to the cities of El Monte, Montebello, and Willows. Therefore, it would have to be amended to include the City of Cupertino; and
- 2) GC § 37420.5 is currently applicable only if “the potentially subsumed public water system is wholly within the boundaries of the city.” Since a small portion of the System is outside the boundaries of the City, GC § 37420.5 would probably have to be amended to eliminate or modify this restriction.

Currently GC § 37420.5 provides that if 10 percent of “interested persons” protest the proposed sale, an election must be called for voter approval. As defined, this means that an election would **not** be required unless 10 percent of Cupertino residents submit protests. In addition, it provides that if 50 percent of interested persons object, the sale process must be put on hold for a year. If the sale were approved, the CPUC would review the terms and could potentially require the parties to renegotiate if the agency determined the terms were improper. This process, including negotiations and CPUC review, is estimated to take up to 45 months and would require the current Lease to have a short-term extension.

A sale is not recommended because it is a time-consuming process with potentially uncertain results since the sale is contingent upon public and CPUC approval. Ultimately, it is not clear that the customers would receive a substantial benefit from the sale of the System, given the current structure of the Lease that ensures rates do not exceed those of SJWC’s private customers. While the City could receive a substantial one-time payment for the System’s assets, it would lose the ability to control this asset in the future.

3. City Operation

This option would involve the City operating the System using its own forces. Taking over operation of the System would transfer all risk and all costs for operation of the System to the City. This would include the costs of maintenance, and could result in increased costs to ratepayers, subject to constitutional limits. Similarly, when serving the approximately 4,500 customers connected to the System, the City would not be able to take advantage of the economies of scale that private purveyors have when serving over one million customers. Due to potentially complex logistics, including specialized staffing and organizational needs, this option is not recommended.

This option, including time to recruit and hire additional staffing, and obtain necessary equipment and regulatory approvals, will take up to 36 months and would require the current Lease to have a short-term extension.

Next Steps

The estimated timeline for a new long-term lease is as follows:

Activity	Date (Subject to Change)
Draft new lease completed	July 26, 2021 – October 1, 2021

RFP issued with draft new lease	October 5, 2021
RFP evaluated by potential proposers	October 5, 2021 – December 7, 2021
Proposals received by City	November 16, 2021
Proposal evaluated by staff	December 7, 2021 – February 15, 2022
Public hearing by Council	March 1, 2022
Transition of System to selected proposer	April 2022 – October 2022
Begin new long-term lease	November 2022

Public Notice

A legal notice ad was published in the Cupertino Currier on July 9, 2021 (prior to the July 20, 2021, public hearing date) No other written notices were sent. A webpage for this item was created and can be viewed [HERE](#). A Frequently Asked Questions page will also be prepared to help inform the public. Additionally, a “News” article was published on the City’s main webpage to provide information and to advise the community of the July 20, 2021 public hearing date.

Sustainability Impact

No sustainability impact.

Environmental Impact

Adoption of the proposed Resolution is not a project under the requirements of the California Quality Act of 1970, together with related State CEQA Guidelines (collectively, “CEQA”) because it has no potential for resulting in physical change in the environment, either directly or ultimately. In the event that this Resolution is found to be a project under CEQA, it is subject to the CEQA exemption contained in CEQA Guidelines section 15061(b)(3) because it can be seen with certainty to have no possibility of a significant effect on the environment. CEQA applies only to projects which have the potential of causing a significant effect on the environment. Where it can be seen with certainty that there is no possibility that the activity in question may have a significant effect on the environment, the activity is not subject to CEQA. In this circumstance, initiating the Public Utilities Code section 10061 process does not commit the City to a definite course of action as all proposals could be rejected. Further, if an award is made to enter a long-term lease, doing so merely provides for the continued operation of an existing Water System without an expansion in the physical improvements or increase in the level of service, so this is not an activity subject to CEQA. Environmental review will be conducted as necessary for any changes to the Water System that may be agreed upon in the future.

Fiscal Impact

Authorization of the recommendation for a new long-term lease will not have a fiscal impact to the City. Funds needed to complete the RFP process are in the Fiscal Year (FY) 22 Budget and no additional funds are needed. However, there will be future fiscal impacts if a new long-term lease is authorized. The degree of these impacts will be affected

by the terms and conditions of the RFP and negotiations with the selected proposer. Additional staffing to administer a new long-term lease may be required.

Sale of the System would provide the City with significant funds. In 2018, the System was valued at \$55M.

Prepared by: Roger Lee, Director of Public Works

Reviewed and Approved for Submission by: Dianne Thompson, Acting City Manager

Attachments:

A – Draft Resolution

B - Water Service Map

C – Resolution 19-145

D – Amended & Restated Lease