



PUBLIC WORKS DEPARTMENT

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CITY COUNCIL STAFF REPORT

Meeting: November 2, 2021

Subject

For the future operations of the Municipal Water System, consideration of: 1) Key Lease Terms for a new Long-Term Lease; 2) First Amendment of the Current Lease Agreement with San Jose Water Company to extend the term up to three years; and 3) Request to increase Public Works Administration – Special Projects Budget Allocation.

Recommended Actions

1. Provide input on Key Lease Terms for a new Long-Term Lease;
2. Conduct a Public Hearing to consider a First Amendment to extend the term of the Current Lease Agreement with San Jose Water Company for lease of the Cupertino Municipal Water System up to three years;
3. Adopt Resolution 21-XXX (Attachment A), approving a First Amendment to the Current Lease Agreement for lease of real property (Water System) with San Jose Water Company; and
4. Approve Budget Modification #2122-170 increasing appropriations in Public Works Administration – Special Projects (100-80-800 750-071) by \$31,500 for the Municipal Water System Project.

Background

Cupertino has three water service areas as shown in the Water Service Map (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 purple area is served by Cupertino municipal water system infrastructure. This infrastructure is owned by the City of Cupertino and operated by SJWC pursuant to its Lease Agreement with the City. This area is the subject of this staff report.

The lease with SJWC began in October 1977 and runs for a term of 25 years, expiring on September 30, 2022.

As the lessee of the City's water system infrastructure (system), SJWC is responsible for all operations including repair, maintenance, operation, customer service/billing, emergency service, water quality testing and rate-setting.

On December 17, 2019, City Council approved an amended and restated lease (Current Lease) (Attachment C). The Current Lease caps the amount SJWC can charge customers of the Municipal Water System to an amount less than or equal to the amount SJWC charges its own customers within Cupertino (the orange area on Attachment B), as determined by the California Public Utilities Commission (CPUC) and their Public Advocates Office. The Current Lease also requires 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 have been received and improvements are in process.

The Fiscal Year (FY) 2021-2022 City Work Program includes an item to analyze and recommend options for continued operation of the System during the remaining term of the Current Lease with SJWC and following the termination of the Current Lease with SJWC.

On July 20, 2021, City Council considered how the System could be operated in the future after the Current Lease expires. Options considered by Council for future operations included lease, sale, or City operation. After deliberation, City Council took the following actions:

1. Authorized staff to proceed with a Request for Proposal (RFP) process for a new Long-Term Lease utilizing the Public Utilities Code (PUC) § 10061 process.
2. Directed staff to limit duration of a new Long-Term Lease to twelve years or less, with a renewal option not to exceed twenty years total.
3. Directed staff to complete an analysis of costs and resulting water rates if the System were to be operated by City staff.
4. Directed staff to draft Key Lease Terms to be included in a new Long-Term Lease for further consideration by City Council prior to issuing the RFP.

Discussion

Proposed Key Lease Terms to be included in the new Long-Term Lease have been prepared by staff and are included as Attachment D. Council input on the Key Lease Terms will guide final development of the RFP and the new Long-Term Lease.

A consultant has been retained to complete an analysis of the costs and water rates if the Municipal Water System were to be operated by City staff.

It may not be possible to transition to a new Long-Term Lease, City operation of the System, or sale of the System prior to expiration of the Current Lease on September 30, 2022. Therefore, the proposed First Amendment (Attachment E) includes an extension of the Current Lease up to three years.

New Long-Term Lease of System

Leasing the System has provided customers with comparable water service and rates to those provided to other Cupertino residents served by SJWC or Cal Water's privately owned systems. System customers are charged rates consistent with SJWC's other customers (the orange area on Attachment B). With a new Long-Term Lease, the City continues to own a valuable asset and to receive a return on the public investment in the System. Also, operation of the System by an experienced lessee may provide expertise in operations and an economy of scale that could not be achieved if the City operated the System directly.

The Key Lease Terms included in the new Long-Term Lease are more rigorous and comprehensive than the terms included in the Current Lease. The intent of the new terms is to ensure that the System is operated and maintained to all applicable standards. Examples include: increased access to operation records, benchmarking of current best practices for operation and maintenance, and specific requirements for capital investment in the System. These provisions will ensure that System customers receive high quality, reliable water service. They also reflect Council's recent direction to limit the initial term to 12 years with an option for a renewal that could extend the total lease period to 20 years.

If the RFP and award process proceed as currently projected, a new Long-Term Lease could be executed prior to expiration of the Current Lease. However, unforeseen issues could potentially delay the process beyond the September 30, 2022 (expiration of the Current Lease). If issues arise, they may take up to six months to resolve. This would require the Current Lease to have a six-month term extension to March 2023.

In anticipation of the new Long-Term Lease, staff has contacted several water operators, including the City of Sunnyvale, City of Santa Clara, Valley Water, California Water Service Company, SJWC, and Veolia North America. The RFP will be open to proposals from any qualified water operator.

City Operation of System

City operation would involve the City using its own staff to operate the System. 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. A consultant is preparing an analysis of these costs that will be available at a Public Hearing tentatively scheduled for February 2022. If the System is operated by the City, water rates would be authorized by City Council and could be less, equal to or greater than the rates charged to other water customers within Cupertino, depending on the expenses calculated to operate the System.

This alternative is estimated to take up to 30 months to implement, including time to recruit and hire additional City staff, and obtain necessary equipment and regulatory

approvals. This would require the Current Lease to have a two-year term extension to October 2024.

Sale of the System

Sale of the System is the remaining alternative if the City does not enter into a new Long-Term Lease or transition to City operation of the System. The sale alternative could require three years or more to fully complete (including a required election and CPUC approval) and would require a three-year extension of the Current Lease, to October 2025.

First Amendment of Current Lease to Extend Term

If City Council authorizes a new Long-Term Lease with a water utility operator after evaluation of proposals received in the RFP process, it is possible that an extension of the Current Lease will not be needed. This assumes that the RFP and award process proceed on an expedited basis as outlined below.

If the RFP, award, or transition process is delayed due to unforeseen circumstances, the City could direct a six-month extension of Current Lease. If direction is received to operate the System with City staff, a two-year extension of the Current Lease term would be exercised to allow time for the City to prepare for City staff operation. Alternatively, if the City Council chooses to sell the System, a three-year extension would be requested.

Any extension of the Current Lease term requires SJWC to complete annual System capital improvements. The required expenditures for System capital improvements are \$350,000, \$1,600,000, and \$2,500,000 for, respectively, a six-month, two-year, or three-year extension. The 2019 System Asset Management Plan recommends an annual capital improvement amount of \$1.5 million. Staff attempted to negotiate this amount for each of the extension options, but due to insufficient time for SJWC to amortize the various annual costs, the above amounts are reasonable in relation to the duration of each extension alternative. No other terms of the Current Lease are changed. SJWC has agreed to the terms of the attached First Amendment of the Current Lease.

Next Steps

After receiving City Council input on the Key Lease Terms of the new Long-Term Lease, staff will issue the RFP and new Long-Term Lease documents in November 2021. Proposals from prospective water system operators will be submitted to the City in January 2022. Recommendations will subsequently be brought to City Council for a statutorily mandated Public Hearing in February 2022. At this Public Hearing, staff may make a recommendation to enter the new Long-Term Lease with the water system operator determined to be “best qualified to continue to provide equal or better service to the customers of the system” as specified in PUC § 10061. Alternatively, staff may recommend starting the RFP process over or undertaking City operation of the System, depending on which alternative is determined to be the best overall option. City Council could also direct staff to proceed with sale of the System.

Public Notice

Public notice of the public hearing on the First Amendment of the Current Lease was published in accordance with Government Code § 6066, with the first notice published in the Cupertino Courier on October 22, 2021. No other written notices were sent. A webpage for this item was created and can be viewed [HERE](#). A Frequently Asked Questions (FAQ) page can be found on the webpage. It has been 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 November 2, 2021, Public Hearing date.

Sustainability Impact

No sustainability impact.

Environmental Impact

Providing input on Key Terms to the new Long-Term Lease is not a project under the requirements of the California Environmental Quality Act (CEQA) 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. Further, extending the Current Lease is exempt from CEQA under CEQA Guideline section 15301, which exempts from CEQA review any project that “consists of the operation, repair, maintenance, permitting, leasing, licensing, or minor alteration of existing public or private structures, facilities, mechanical equipment, or topographical features, involving negligible or no expansion of existing or former use.” Further to the extent that providing input on Key Terms to the new Long-Term Lease, extending the Current Lease, and adopting the proposed Resolution (collectively, “Action”) is 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 PUC section 10061 lease process does not commit the City to a definite course of action as all proposals could be rejected. Further, if the Council extends the Current Lease by adopting the proposed Resolution or an award is made to enter a new Long-Term Lease, doing so merely provides for the continued operation of an existing System without an expansion in the physical improvements or increase in the level of service, so this is not an activity subject to CEQA. If necessary, environmental review will be conducted for any changes to the System that may be proposed in the future.

Fiscal Impact

Providing Council input on the proposed Key Lease Terms for a new Long-Term Lease will not have a direct or immediate fiscal impact to the City. Funds needed to complete the RFP process are included the Fiscal Year 2021 -2022 Budget on pages 465/466 in 100-80-800 750-071. There is \$69,438 remaining of the \$100,000 approved budget and \$31,500 of additional funds are needed to continue the drafting of multiple agreements and

researching the options for operating the System with City staff. There will likely be future fiscal impacts if a new Long-Term Lease is authorized. Those impacts may relate to the final terms and conditions of the RFP and negotiations of the final terms of the new Long-Term Lease with the selected proposer. Additional City staffing to administer the new Long-Term Lease may be required.

Approval and execution of the First Amendment to the Current Lease will require SJWC to fund the following amounts for capital improvements as follows:

- \$350,000 for a six-month extension
- \$1,600,000 for a two-year extension
- \$2,500,000 for a three-year extension.

The City Council may decide to select one of the extensions above or may determine to forego an extension.

Prepared by: Roger Lee, Director of Public Works

Reviewed by: Dianne Thompson, Assistant City Manager

Chris Jensen, City Attorney

Approved for Submission by: Greg Larson, Interim City Manager

Attachments:

A – Draft Resolution

B - Water Service Map

C – Current Lease

D – Key Lease Terms to the New Long-Term Lease

E – First Amendment of Current Lease