



Memorandum

TO: SHARON ERICKSON
CITY AUDITOR

FROM: Kerrie Romanow

SUBJECT: RESPONSE TO THE 2016 AUDIT OF
SOUTH BAY WATER RECYCLING

DATE: March 30, 2016

Approved

Date

4/1/16

BACKGROUND

The South Bay Water Recycling Program (SBWR) was established in 1997 as part of the San José-Santa Clara Regional Wastewater Facility¹ treatment process to divert effluent from the San Francisco Bay in compliance with the National Pollutant Discharge Elimination System (NPDES) requirements. While SBWR was established and remains as a wastewater compliance program, it also contributes to our regional water supply. To proactively prepare for future local water needs, the City in conjunction with the Santa Clara Valley Water District (District), completed a two-year Strategic Plan that explored the long term goals for SBWR and wastewater effluent in general. These goals are long-term and require additional analysis and environmental review before they can be implemented.

The Advanced Treatment Facility (AWT), a joint project with the District, became operational in FY15-16 and provides high quality product water that is blended with recycled water to provide a higher quality recycled water to SBWR customers. To minimize the cost of operating SBWR for sewer ratepayers, the Administration has reduced staffing and expenses, prioritized SBWR infrastructure activities, and managed rate increases to achieve operational cost recovery for the first time in FY 2014/15.

As part of the joint effort with the District, the Administration improved financial tracking procedures for SBWR, and revised operational cost management, and rate strategies to appropriately capture costs associated with SBWR. This 2016 audit provides a valuable review of the program status and opportunities for continuous improvement.

¹ The legal, official name of the facility remains San José/Santa Clara Water Pollution Control Plant, but beginning in early 2013, the facility was approved to use a new common name, the San José-Santa Clara Regional Wastewater Facility.

RECOMMENDATIONS AND RESPONSE

Recommendation #1: The Department of Environmental Services should work with the Budget Office and Finance Department to establish operating and capital funds for South Bay separate from other Wastewater Facility operating and capital funds.

Administration Response: The administration generally agrees with this recommendation. Prior to the Audit, the Administration was in the process of implementing new accounting practices that will enable program staff and key stakeholders to review the specific portions of Fund 513 that is attributable to SBWR. However, it is important to retain a clear linkage to the wastewater fund, as SBWR will remain a key asset of the RWF, operated by the City as the administering agency of the RWF, and required by the NPDES permit to treat and discharge wastewater effluent.

Yellow - The Administration will evaluate the feasibility of establishing a separate fund that would allow for the program to remain as part of the RWF for accounting and budget purposes.

Recommendation #2: To improve South Bay's operating and capital accounting, the Department of Environmental Services should:

- a) Establish South Bay staff time allocations for all ESD programs with corresponding charge codes and ensure that they are incorporated in the budgeting process and consistently used by staff.
- b) Establish clearly documented cost methodologies for South Bay that include all costs associated with the program and as detailed in Appendix A of this report.

Administration Response: The Administration agrees that updated methodologies and staff accounting practices are valuable for consistent and accurate cost accounting. The Administration is already implementing revised staff allocation codes and timecard procedures to assure that staff inputs to the South Bay Water Recycling program are accurately tracked. The Administration will revise the existing cost methodology procedures document to include the updated staff codes and procedures.

The Administration agrees with the recommendation to create new charge codes in Appendix A, but would like to clarify that there is a distinction between accurately calculating costs, and automating reports for easy access. The creation of new charge codes will only allow for automation of the reports, while the Administration will also apply management reviewed methodologies to accurately calculate the South Bay Water costs of service.

Green- The program can implement this recommendation within one year.

Recommendation #3: ESD should prepare annual financial statements for South Bay, to be audited by the City's external financial auditor.

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Administration Response: The administration agrees with this recommendation. The revised accounting procedures currently being implemented will facilitate external financial audits of South Bay Water Recycling. All wastewater funds are currently audited annually by an external auditor.

Green- The program can implement this recommendation within one year.

Recommendation #4: To sustain South Bay's operational and capital cost recovery status in the future, ESD should:

- a) Re-negotiate the revenue sharing terms of the Integration Agreement to allow the City to access South Bay revenue to fund South Bay's projected capital costs sooner than is projected to occur under the Agreement as currently written.
- b) Secure a recycled water wholesale cost of service study that can be used to maximize the ability to maintain cost recovery for South Bay.

Administration Response (Part a): The Administration requires more information on this recommendation. The Integration Agreement establishes the Advanced Water Treatment facility as part of SBWR as it treats water that is distributed by SBWR. By showing only the share of net revenue as opposed to gross revenue, the Audit Report does not reflect the true current value of the Integration Agreement to SBWR. SBWR currently retains 100 percent of the revenue necessary to pay SBWR operating costs. The City receives all of the purified water from the Advanced Facility but pays only 60 percent of Net Revenue to offset the operational costs of the Advanced Facility. The City also receives 40 percent of the net revenue from recycled water sales.

The cost share formula between the City and the District for the cost to operate the AWT does limit, in the near term, the City's ability to retain some of the revenue for capital costs. The Administration cannot respond directly to the scenarios presented in this Audit Report because the Administration has not had the opportunity to fully review the District's statement of Advanced Facility operation costs for 2014-2015; project future operating costs; and perform the calculation of investment value of SBWR and AWT for any given year required by the Integration Agreement to apportion the cost share. The above factors and the results of the cost of service study would need to be considered before the Administration could develop a scenario that can accurately project these costs and values into the future. The scenarios also assume stagnant recycled water demand of 11,000 AFY, which conflicts with the demand projections of up to 15,000 AFY estimated by the local water retailers during the Strategic Master Plan.

In addition, with increases in recycled water rates, the cost share formula should enable the City to retain a greater portion of the revenue for capital investment to maintain SBWR. This additional revenue would align with the capital investment in reliability projects which are not anticipated to occur for another five (5) years due to the need for further study and environmental review. The costs associated with potential expansion of SBWR, as identified in the Strategic

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Plan, would be funded from sources other than recycled water wholesale revenue or sewer ratepayer revenues.

The Administration is currently reviewing multiple agreements related to SBWR with the Santa Clara Valley Water District and will consider re-negotiation of the Integration Agreement in conjunction with these other agreements.

Yellow- The recommendation would require integration into a multi-faceted negotiation with the Santa Clara Valley Water District. It is unclear at this time, how this objective will align with the negotiation of existing and agreements with the Water District. The recommendation provides information that the Administration will take into consideration.

Administration Response (Part b): The Administration disagrees with the Audit Report conclusion that SBWR does not currently have a rate model. SBWR currently uses the same "model" used by most other recycled water wholesalers, which sets the recycled water rates below potable water cost (ground water) or costs of service, whichever is less. The wholesale rates for all retailers are the same as stipulated in the wholesale water supply contracts with the retailers. The Administration also notes that the rate model "Questions" cited in the Audit Report, e.g. conservation, are not applicable to recycled water.

The administration agrees with the recommendation to conduct a cost of service study. A cost of service study will provide a useful tool in analyzing program costs and determining the optimum strategy for setting wholesale rates.

Green- The program can implement this recommendation within two years.

CONCLUSION

The Program agrees that clarified and consistent methodologies, as well as review of key agreements, are valuable for South Bay Water Recycling as a wastewater initiative that integrates State regulations, stakeholder interests and agreement requirements. The program looks forward to on-going follow up with the auditor's office in the implementation of these recommendations.

/s/

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Director, Environmental Services

For questions, please contact Jeff Provenzano, Deputy Director, Environmental Services, at (408) 277-3671.