Humboldt Community Services District

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August 2, 2007

COPY

Mr. David Tyson, City Manager
City of Eureka
Post Office Box 1018
Eureka, CA 95501

Dear David:

In conjunction with consideration of the proposed Martin Slough project, requests for service from developers, and other issues, the Humboldt Community Services District Board of Directors has been reviewing the District's 1982 regional wastewater treatment contract with the City of Eureka. That review has brought to light several issues that need to be addressed and resolved. The Board has requested that I initiate discussions with you to work together for the mutual benefit of the City and the District.

There are three related issues that arise out of the City of Eureka's use of wastewater treatment plant capacity owned by the Humboldt Community Services District without the District's consent and without compensation to the District.

As you are aware, the proportional capacity share in the wastewater facility was originally City of Eureka, 69.5 percent; Humboldt Community Services District, 23.6 percent; and County Services Area 3, 6.9 percent. Subsequently, the Humboldt Community Services District assumed County Service Area 3, resulting in the current proportional capacity shares of City, 69.5 percent and District, 30.5 percent.

Although the 1982 contract assumed a total design capacity of 6.03 million gallons per day Average Dry Weather Flow, in fact the facility has only been permitted by the California Regional Water Quality Control Board for 5.24 million gallons per day Average Dry Weather Flow. Pursuant to section 3.14 of the contract, if the actual capacity of the sewer treatment facilities should be less than the design capacity, the "deficiency shall be allocated among the parties in proportion to their Reserve Capacity Rights".

As a result, the City of Eureka has capacity rights to 69.5 percent of the current permitted 5.24 million gallons per day Average Dry Weather Flow, or 3.64 million

gallons per day, while the District has capacity rights to 30.5 percent of the permitted capacity, or 1.6 million gallons per day Average Dry Weather Flow.

Pursuant to Section 1.8 of the contract, Average Dry Weather flows for the purposes of determining Proportional Capacity Share is measured by the August average flows (absent abnormal levels of precipitation during that month). According to the City of Eureka's Annual Reports for the Elk River Wastewater Treatment Plant for the past six years (2001-2006), the average (mean) flows for August have been consistently 5 million gallons per day.

In 2001, the District's average flow in August was 1.16 million gallons per day, which means the City contributed the remainder of the 5 million gallons per day flow, or 3.84 million gallons per day. This was 200,000 gallons per day more than the City's Proportional Capacity, and equated to a use of 13 percent of the District's total capacity rights. The City contributed 77 percent of the total Average Dry Weather Flow to the system, while the District's total share of the Average Dry Weather Flow was 23 percent for that year.

In 2002, the District's average flow in August was 1.03 million gallons per day, which means the City contributed the remainder of the 5 million gallons per day flow, or 3.97 million gallons per day. This was 330,000 gallons per day more than the City's Proportional Capacity, and equated to a use of 21 percent of the District's total capacity rights. The City contributed 79 percent of the total Average Dry Weather Flow to the system, while the District's share of the Average Dry Weather Flow was 21 percent for that year.

In 2003, the District's average flow in August was 1.11 million gallons per day, which means the City contributed the remainder of the 5 million gallons per day flow, or 3.89 million gallons per day. This was 250,000 gallons per day more than the City's Proportional Capacity, and equated to a use of 16 percent of the District's total capacity rights. The City contributed 78 percent of the total Average Dry Weather Flow to the system, while the District's share of the Average Dry Weather Flow was 22 percent for that year.

In 2004, the District's average flow in August was 1.17 million gallons per day, which means the City contributed the remainder of the 5 million gallons per day flow, or 3.83 million gallons per day. This was 190,000 gallons per day more than the City's Proportional Capacity, and equated to a use of 12 percent of the District's total capacity rights. The City contributed 77 percent of the total Average Dry Weather Flow to the system, while the District's share of the Average Dry Weather Flow was 23 percent for that year.

In 2005, the District's average flow in August was 1.15 million gallons per day, which means the City contributed the remainder of the 5 million gallons per day flow, or 3.85 million gallons per day. This was 210,000 gallons per day more than the City's Proportional Capacity, and equated to a use of 13 percent of the District's total capacity

rights. The City contributed 77 percent of the total Average Dry Weather Flow to the system, while the District's share of the Average Dry Weather Flow was 23 percent for that year.

And in 2006, the District's average flow in August was 1.04 million gallons per day, which means the City contributed the remainder of the 5 million gallons per day flow, or 3.96 million gallons per day. This was 320,000 gallons per day more than the City's Proportional Capacity, and equated to a use of 20 percent of the District's total capacity rights. The City contributed 79 percent of the total Average Dry Weather Flow to the system, while the District's share of the Average Dry Weather Flow was 21 percent for that year.

Although section 3.2(b) of the contract allows a party to the contract to obtain rights to a portion of another party's unused capacity in the system, the contract requires that the party who is releasing excess capacity determine "that it has unused capacity in excess of its requirements" and the "additional capacity may be assigned by the party to any other public entity by written agreement subject to a right of first refusal by the parties to this Agreement". The District has never made a finding it has excess capacity, nor has it assigned any of its capacity rights to the City of Eureka in writing. The City has not compensated the District for the City's use of the District-owned capacity.

The City's level of utilization of the wastewater treatment facilities, and the unauthorized and uncompensated use of a portion of the District's unused capacity rights, creates three related problems that need to be addressed and resolved: 1.Credit and/or reimbursement to the District for excess operation and maintenance expenses charged by the City to the District; 2. Credit and/or reimbursement for annual capital expenses; and 3. Restoration of the District's contractual Reserved Capacity Rights for future development.

First, as you are probably aware based upon communications between financial staff of the City and the District, the City of Eureka has overcharged the District $773,464 over the years for annual maintenance and operations costs due to the City's calculation errors, primarily by using average monthly flows rather than the "Proportional Volumetric Share", as defined as the "total annual sewage volume of flow" be section 1.9 of the contract. The errors have apparently been corrected for calculations on an on-going basis but the issue of a credit or reimbursement for past overcharges remains unresolved.

Second, pursuant to section 2.4 of the contract, estimated annual capital expenses are allocated under the contract 67.9 percent to the City and 32.1 percent to the District (when the contract's allocation to County Service Area 3 is combined). (Apparently the non-City entity's shares are slightly higher than Reserve Capacity Share percentages due to the City's commitment to incur additional capital-related commitments at the outset of the project.)

While the District agrees that it is fair and equitable for each party to bear its contractual percentage of capital expenses if both sides are using less than their respective Reserved Capacity Rights, the District does not believe it is fair that it pay the annual allocation of capital expense for capacity owned by the District but being used by the City of Eureka.

The District believes that it should receive a reimbursement or credit for its paid allocation of capital expenses for prior years in an amount equal to the percentage of the District's capacity that the City used for each of those years. Beginning with the current year, the on-going capital expense allocations should also be adjusted accordingly.

It appears that the City has exceeded its Reserved Capacity Rights, and has been using a portion of the Reserved Capacity Rights owned and paid for by the District, for approximately 10 years. However, for just the last six years, the District's financial officer has calculated the District's share of treatment capital costs for the portion of the District's capacity used by the City has been over $200,000.

The final issue that must be resolved is how the City will restore to the District the District's remaining contractual Reserved Capacity Rights, so that the District can make that capacity available for development within the District's service area.

Section 3.4 of the contract requires each party to "limit the rate of flow of sewage to or into the Project originating from each party to its Reserved Capacity Right", an obligation which is reiterated in section 3.11. As discussed above, for each of the past six years the City has exceeded its Reserved Capacity Right by 190,000 to 330,000 gallons Average Dry Weather flow, and has used a portion of the District's capacity without consent of the District, or compensation to it. In the past, the District has not had an immediate need for the use of this Reserved Capacity Right, and therefore its residents have not been prejudiced (other than unfairly financially subsidizing the City's wastewater treatment, as discussed above).

However, the District sees the potential need to utilize its currently unused Reserved Capacity Rights in the near future. The City must immediately address how it will reduce its flow to bring it at or below the City's Reserved Capacity Right (3.64 million gallons per day Average Dry Weather Flow) so that there will be actual capacity at the wastewater facility for the District to utilize its Reserved Capacity Right of 1.6 million gallons per day Average Dry Weather Flow. Absent such action by the City, the City will be unable to fulfill its obligation to the District under section 3.2 of the contract, which requires the City to "receive and treat discharges into the City's facilities up to the amount of the reserved capacity".

The District is also concerned that the City appears to continue to approve new developments within the city limits that will increase the City's sewage flow to the treatment facility, thus increasing its infringement of the District's Reserved Capacity Right.

The 1982 contract requires a specific notice and demand for cure of a breach of the agreement. Therefore, pursuant to section 4.9 of the contract, this letter is the District's notice to the City that the District believes the City is in breach of the 1982 contract and the District demands compliance with the terms of that agreement.

Specifically, the District demands that the City comply with the terms of Sections 1.8, 3.2, 3.4, 3.10, 3.14 and related provisions (related to the City's use of the District's Reserved Capacity Rights without consent or compensation); that the City comply with sections 1.9 and 2.5 of the contract by crediting or reimbursing the District for excess operation and maintenance expenses charged by the City and paid by the District; that the City comply with the intent of section 2.4 of the contract by compensating the District for capital expenses for that percentage of the Districts' Reserved Capacity Right the City is using without the consent of, or compensation to, the District; and that the City comply with sections 3.4 and 3.11 by limiting its flow to its Reserved Capacity right, thereby making actual wastewater facility capacity available to District in the amount of the District's Reserved Capacity Rights.

Although section 4.9 of the contract technically requires that breaches of the agreement be cured within 30 days, the District realizes that the some of these issues will reasonably require more than 30 days to address and solve. The District values its longstanding contractual and working relationship with the City, and recognizes that we have additional challenges in the future that will require continued cooperation. The District trusts that these issues can be resolved to the mutual satisfaction of the District and the City, and is committed to working toward an amicable resolution of not only these issues related to the 1982 contract, but to issues related to the additional challenges faced by the District and the City in meeting the current and future needs of the residents of the City and the District. We look forward to the City's response and proposals on how to address these issues as soon as possible and look forward to constructive, concrete discussions on how we will work to resolve these problems.

Very truly yours,

HUMBOLDT COMMUNITY SERVICES DISTRICT

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By Mark Bryant
General Manager