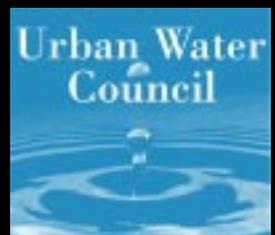


THE U.S. CONFERENCE OF MAYORS URBAN WATER COUNCIL

**Mayor's Guide
to Water and
Wastewater
Partnership
Service
Agreements:
*Terms and Conditions***

April 25, 2005



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SECTION 1 — Introduction

This Guide is intended to provide interested Mayors and local government officials with information about public-private water and wastewater partnership service agreements. The U.S. Conference of Mayor's Urban Water Council (UWC) was established in 1995 to provide a forum for Mayors to share information about water supply and water quality issues, and learn of alternative and innovative approaches that provide “best practices” to solve problems. The UWC has examined the application of public-private partnerships and has determined that water and wastewater partnerships can offer considerable advantages to cities seeking alternatives to traditional public ownership, operation and financing. These alternatives include financing water infrastructure investments using private capital, and implementing upgrades and “Greenfield” projects on a design-build basis coupled with private sector operations and maintenance. The Urban Water Council urges Mayors to consider both traditional and innovative approaches to providing high quality and adequate quantities of water resources to satisfy public needs.

The Urban Water Council recognizes that conventional planning processes, including tools such as the multi-year capital improvement plan, provide a useful framework for cities to assemble information that helps decisionmakers. When water infrastructure is part of the capital improvement plan it is advantageous to add a section to the plan considering alternative service delivery options, and not limit the plan to traditional options such as the design-bid-build model. Alternatives such as short- and long-term contract operations and maintenance approaches, as well as design-build-operate and its many variant forms are worth considering early in the planning process. Waiting until the “last minute” to consider alternative approaches may lead to suboptimal results.

The overwhelming majority of water and wastewater systems in the US are owned and operated by public sector organizations, (e.g., Cities, water boards and authorities, counties and other local government entities). Many cities have developed the required expertise and capabilities to efficiently run their own plants. In cases such as these, cities often will contract with private sector firms to provide specific financial, engineering or construction services as the needs arise. In a number of other cases, the entire water and wastewater system may be owned and managed by a private firm and thereby function as a private regulated utility. In these “privatization” cases a state public utility commission will set the billing tariffs and provide oversight on financing improvements as well as customer service performance.

Under public-private partnerships, municipalities continue to own their water and wastewater systems and establish their own water and sewer tariffs. The responsibilities of the private firm are well defined in a service agreement, and the city and private firm together become accountable to the public to insure that their service needs are being met.

The UWC has, over the last decade, examined the application of public-private partnerships to address both water supply and water quality responsibilities. More than 1,800 of these partnerships exist today. Case studies indicate that water partnerships offer considerable advantages to cities seeking alternative approaches for managing their water and wastewater utility, modernizing their facilities and financing water infrastructure investments. Increasingly, the UWC has reviewed water partnerships that tie contract incentives to improving the water quality conditions including situations involving odor and taste, nutrient loadings from nonpoint sources, and advanced pollutant removal.

While some service agreement issues may be specific to a particular city's needs, there are a number of contractual issues that are commonly dealt with by the public and private parties to a partnership. Much experience has been gained in the development of contractual arrangements of water partnerships. This Guide is meant to identify and discuss how some Cities have successfully incorporated service agreement provisions to fairly treat the City and rate-payers as well as the private parties involved. The UWC continues to focus on water partnerships as a way to ensure both water supply and quality for the future, and some potentially difficult service agreement terms and conditions are discussed in the context of how some cities have avoided partnership problems.

Public-Private Water Partnerships Require Cooperative Efforts

Public-private water partnerships are successful when both parties are willing to cooperate to make the projects work. Water partnerships that unduly favor either the city or the private partner may ultimately doom a project that potentially benefits all parties, including the public.

Accountability is also a critical component of a successful project. The public, media, utility regulators and environmental regulators have a general tendency to view the public and private parties in partnership arrangements as a single entity. While each party is independent in reality, the actions of either party may easily be perceived as “joint” actions. That is why it is important for both parties to communicate routinely, and consult with each other before taking actions that attract public interest.

Cities that are considering water partnerships should seek, through the Request For Proposals (RFP) procurement process, a partner that they can rely on to provide quality services. It is important to note that the trend in water partnerships has advanced from the 3 to 5 year service agreements to more long-term arrangements typically involving 10 to 20 years. The longer-term arrangements are a relatively new phenomenon, and establishing a long-term working relationship with a private sector service provider is a critical success factor. Service agreement issues dealing with risk shifting and risk sharing help define the responsibilities of both the public and private partners.

Although not the subject of this effort, proper focus on the (RFP) process in the water partnership arena is imperative to a successful project. Cities that create an environment of fairness in the procurement process, and try to reduce the considerable uncertainty involved in water partnerships may improve the chances for better competition and a successful long-term project. Some water partnership projects incorporate aggressive competitive strategies in the procurement process, (e.g., the use of “Best and Final Offer” competitions, and simultaneous negotiations with more than one private party). Such strategies should be disclosed in the RFP so that the expectations of the city and the potential private partner with regard to the procurement process are aligned. Such factors could effect a company’s decision to propose on the project. In order for the private partner to accurately price a project, it needs to know that its price will not be compromised if terms of the agreement are changed during the RFP process. While one cannot expect that there will be no negotiation of the contract, or exceptions taken to a draft contract or procurement, the proposal itself, and all of its components, should be afforded respect in the negotiation process.

For convenience, the Guide presents service agreement terms and conditions in a categorical fashion. The next section deals with the Scope of Work as it applies to both the RFP phase of a project as well as the service agreement. The third section of the Guide identifies and discusses water partnership performance criteria and issues. The fourth section deals with contract duration. Section 5 discusses contract termination provisions. Section 6 identifies and discusses bonding and insurance requirements. The seventh section outlines steps that a City should consider when managing the contract over the life of the partnership. Section 8 discusses issues surrounding the method and timing of payment to the private party. The ninth and final section provides some examples of employment issues involved with water partnerships and how some Cities have dealt with them successfully.

Using This Document

This Guide is not intended to represent a comprehensive treatment of water partnership service agreements. It is more limited, and focuses on some old as well as new and emerging contract issues. Field experience has heretofore been limited primarily to the short-term O&M contracts. As the public-sector demand for longer-term partnerships increases, this Guide can be helpful to Cities that are on the “learning curve”. It is emphasized here that water partnerships can only be successful if the public and private parties seek constructive relationships built on trust and a willingness to be flexible to make the partnership work.

The Urban Water Council has developed this Guide in consultation with local elected officials and City administrative staff, consultants representing Cities in water partnership service agreement negotiations, and private water companies, some of which are members of the UWC’s Water Development Advisory Board (WDAB). The Guide is considered to be a “working document” that can be added to and modified as new experience is gained in the field with water partnership arrangements.

It is strongly advised that Mayors and/or their public works, water, sewer or other staff use this document as a guide when considering alternative service or project delivery models. While it provides some useful information in its own right, it is best used in conjunction with municipal attorneys, consulting advisors, public works staff, and even private water companies.

The term City is used in this text (for convenience) to mean local government. It also is intended to represent municipality, community, county or other public sector organization that is the “owner” of the water or wastewater infrastructure. Similarly, the text refers to service agreements and contracts, and they are intended to be one and the same.

The text will sometimes refer to water partnerships. In such cases the reader should note that such reference generally includes water treatment as well as wastewater treatment partnerships. Additionally, the text refers to private partner, private party, proposer, contractor and/or private operator. Each of these terms is intended to signify private sector companies, and the reader should take care to note the context of the particular text wherein they are used. For example, “proposer” in this text means a private company that responds to a Request For Proposals by submitting a proposal to the public party. A private party or private operator becomes a private partner once they enter into contract with a public authority.

The reader is cautioned concerning the use of certain contract language appearing in the text. In some instances, contract language has been added to the as an illustrative example of how certain contract terms and conditions have been successfully dealt with in water partnership Service Agreements. The reader should be aware that the context of the particular language chosen to illustrate a point should not be overly generalized. The language used in any given contract is conditioned by the “context” of the particular project and other provisions in that contract, and may not be appropriate in all situations. Furthermore, some of the illustrative examples contain references to other portions of a project contract, and the full contract text is not provided here in the interest of brevity.

SECTION II — Scope of Work

One of the most important factors contributing toward a successful water or wastewater partnership is the initial statement of work, usually referred to as the “scope of work.” A poorly worded or vague scope can result in confusion and miscues that ultimately impact both the public and private partner.

The “scope of work” is ordinarily contained in both a partnership project request for proposals (RFP) as well as in a partnership service agreement. The discussion here addresses some concerns in both instances.

Flexible versus Prescriptive Scope

Cities considering moving ahead with a partnership arrangement should deal with how prescriptive their expectations are early in the process. There is a spectrum of prescriptiveness ranging from the firm to the flexible, and any point along that spectrum will have consequences for both certainty and overall cost.

For example, a City may choose to be highly prescriptive and conservative regarding the water or wastewater treatment process design for a design-build-operate (DBO) project. If that is the intention, the RFP and/or service agreement should make a clear and unambiguous statement to that effect. Otherwise, a City and their consultants who prefer a conservative approach might find significant aspects of a preliminary technical proposal or service agreement scope to be “objectionable.”

A case can be made that the more prescriptive a scope is, the more costly it may be to the City at the end of the day. An ideal DBO procurement RFP would stipulate performance guarantees and certain minimum design criteria but otherwise would allow liberal creativity and risk taking by the proposers in how they meet the performance guarantees. Stating in the RFP, for example, that proposers should be creative, but still meet all performance parameters, allows the private party to suggest cost-effective alternatives.

Flexibility with Protection for the City

Cities should specify financial damages for noncompliance with the performance guarantees and provide for incentives for performance beyond the performance guarantees if such performance is beneficial for the City if they are taking the flexible approach. Such incentives could result in the private partner maximizing innovation, which could result in additional value for the City. While it is one thing to say the City encourages creativity and an open mind toward the means and methods of the private party, the City must be comfortable with the technology and overall technical approach proposed. The City should make clear in the RFP that such considerations will be an important evaluation factor. The City should clearly state in the RFP technologies that it would not want incorporated into the

project. This is particularly true in a design-build project where the City would have to operate and maintain the plant with its own employees. City employees may not be adequately versed in non-traditional methods. Therefore, it is essential to ensure that the handing over of a plant does not result in a situation where the City employees encounter great difficulty in operating and maintaining physical plant.

City Stakeholder Agreement

An ideal procurement situation would ensure that all of the City's stakeholders support the chosen contract operations of DBO approach. When Cities have multiple groups (City Stakeholders) involved in reviewing and approving a procurement or service agreement it is essential that these groups align their standards of acceptance and expectations before the process matures. Cities should not overlook the fact that unionized labor and the general public who will bear the cost of any rate changes are also stakeholders in this process.

For example, one recent situation occurred where a City Council disagreed with their Water Board's recommendation, and then the Procurement Board refused to sign the contract based on the City Council's recommendation even though the Procurement Board agreed with the Water Board's recommendation. Such outcomes are both inefficient and unfortunate. Taking the necessary time to get City groups aligned on expectations early in the process, and indeed, making this a critical path item can avoid costly delays or failures.

City water and sewer infrastructure often serves multiple jurisdictions. For example, the City of Indianapolis water treatment facility serves 21 separate municipal and County jurisdictions. In the public-private partnership the City felt it was important to reach out to all of the jurisdictions, as well as the Indiana Utility Regulatory Commission (IURC), and the state Departments of Environmental Management and Natural Resources. Residents in all jurisdictions were concerned about rates and charges. Local elected officials were concerned about equity in extending lines and hookups. The City addressed many of these concerns by committing to follow IURC guidelines during the life of the partnership. Early on in the process Indianapolis sought "buy-in" from the communities and state regulatory and oversight Boards.

Clear Expectations on Goals and Preferences

An approach to ensuring that adequate information concerning expectations is availed to proposers is to attach a list of principles in the RFP. The list can inform the proposers of most, if not all, of the important expectations that the City has concerning the facility and service delivery during the contract period. Another approach could be to attach a draft service agreement to the RFP. Either way, or other ways, can lead to reducing uncertainty in the process. It is also important for Cities to make sure the proposers have enough time to provide a thorough proposal to the City.

An efficient DBO procurement process would define the City's expectations and minimum requirements in enough detail to ensure that private parties proposing solutions will compete on a level playing field. This is so, even if the City chooses to take a flexible approach. An RFP should prescribe water quality, physical aesthetic goals (e.g., architecture, landscaping, etc.) and other City preferences. Similarly, a City should clearly identify other parts of an RFP where they are encouraging creativity on the part of the private party. Even in those areas of the RFP a City should at least provide minimum requirements and standards of acceptability.

An example is where a City may want a Visitor's Center with public access for educational purposes to be included in the submitted design in a DBO project. Such a desire should be included in the scope of work in the RFP. The potential private partners should not be expected to "anticipate" such a desire. It is appropriate to ask the potential private partner to employ their ingenuity to provide the City with a facility that will best meet the City's needs and desires.

Other goals and preferences could include providing baseline and enhanced levels of Minority and Women Business Enterprises, or the continued employment of City employees for a designated period after the contract has been awarded. As long as these goals, preferences and minimum requirements are clear to the competing proposers the RFP process is more likely to be successful. To the contrary, a bad example is where a City hints that they prefer a particular technology to be employed (for example—ozone in the filtration plant) but never clearly document that preference in the RFP.

Clear RFP Evaluation Criteria

Whether a water partnership is involved or another facet of public services is outsourced to the private sector, it is not uncommon that contract awards are challenged because the RFP evaluation criteria are vague and/or arbitrary. An RFP should spell out the evaluation criteria, so (i) the competing proposers know what is important to the City and therefore can provide a proposal that focuses on these areas, and (ii) fairness of the evaluation/selection is transparent.

While Cities should strive to be clear on what they desire in a proposal, they should also be flexible as pointed out earlier. When evaluating proposals Cities should consider basing decisions on “Best Value” proposals. Best Value selection is based on price and other factors and criteria, not just low price proposal. Cities often call for proposers to be creative in meeting their needs. Creativity, however, can be used to develop low price proposals or Best Value proposals. The latter should be encouraged especially in design-build and design-build-operate projects that are not limited to operations and maintenance only proposals that tend to favor low price proposals.

The Importance of Pre-Proposal Information to Successful Partnerships

Pre-proposal information can prove critical to a successful project. There are many types of information that are important. One type of information concerns expectations on the part of the City. This was briefly discussed above. The other type of information concerns surface and subsurface infrastructure and its physical condition.

Cities can maximize public benefits by providing adequate information to minimize the risk burden for the proposers. This is especially critical regarding subsurface infrastructure; and, less so for surface infrastructure that can more easily be inspected and assessed by proposers. Information relating to electricity utilization, raw water/inflow characteristics and finished water/effluent quality data, system maintenance, repair and replacement records, regulatory compliance/enforcement actions, and citizen complaints will allow private parties to provide realistic proposals. The absence of such information forces proposers to make assumptions prone to miscalculation and potentially higher cost proposals or significant contractual disputes after a contract is awarded.

Procurements involving capital improvements should consider including a pre-RFP geotechnical investigation that sufficiently defines subsurface conditions, so that the DBO proposers do not have to speculate or conduct expensive and time-delaying separate investigations. When pre-RFP information is sketchy, incomplete or obsolete, private party proposals carry a greater risk burden and build that risk burden into their price.

By providing the potential proposers with accurate geotechnical data the subsequent proposals are more likely to contain project pricing based on realistic assumptions. The City will have the comfort that unless the actual geotechnical conditions encountered during the construction phase are materially different from those reasonably anticipated based on test data change orders in this area will be minimized.

The absence of good information on subsurface conditions may result in a service agreement that contains requirements that are eventually found out to be impossible to meet without additional capital investments. This situation is unfortunate in that it may result in a failure of the partnership. Cities should consider assuming some responsibility for either providing adequate information on the subsurface conditions, or they should share some responsibility if actual conditions significantly vary from the private party’s reasonable assumptions.

It should be recognized, however, that there are inherent problems associated with providing “comprehensive” geotechnical data concerning subsurface infrastructure. While a City may determine critical areas where bore holes should be positioned the City may have little or no knowledge of the design specification from a particular proposer. Hence, where the City positions bore holes and where the proposer would like to see them to fit their design criteria may be significantly different.

Some options for dealing with the situation described above can be considered at the RFP stage. For example, the City can provide a critical level of geotechnical information in the RFP, but also allow proposers to perform borehole analysis that fits their proposed design before submitting the RFP to the City. Alternatively, the City may allow for the proposer to submit a proposal based on the City provided geotechnical information, and allow for some changes after the proposal award, but provide some definition of acceptable change orders related to design and pricing in the contract. Mayors should be aware, however, that significant changes after a proposal award might trigger concern among the losing proposers.

Permit Approvals

DBO procurements and some Operations and Maintenance (O&M) contracts that require installation of new equipment or change in operations often require pre-approval by permitting authorities. Service agreements and RFPs should include City involvement in the pursuit of municipal, county, state and federal permits. Cities can, in some instances, request expedited permit review, especially when the City will be the holder of the permit. It is in the interest of the City as well as the permitting authority to give priority to permit applications that involve public purpose services such as wastewater and drinking water facilities.

While the City often can petition permitting authorities for expedited review, modifications and approvals, it should be clearly determined at the RFP stage (or shortly after a proposal award) what role the City will play in the process. For example, decisions should be made regarding whether the City or the private party will prepare the permit and submit it for approval. The private party may, for example, prepare the permit, but have the City review it before submittal. Alternatively, the City may direct the private party to prepare the permit application, then review it and then take responsibility for submitting it to the permitting authority. There are a number of approaches that can be taken, and, in the end it may not substantially matter who prepared and submitted the permit application. What is important is the City should recognize that they can take an active role in helping to expedite the permit approval process. Such action can help contain costs and keep project development on schedule.

Water Facility Rehabilitation Risks

Some DBOs are for entirely new facilities while other DBOs require major rehabilitation of existing facilities. Proposing to rehabilitate existing facilities presents greater risk to the private party due to unknown conditions and the need to make assumptions about the re-usability and life of existing facilities. Such RFPs should consider promoting greater creativity by the private proposer and avoid overly prescriptive conditions, except for those areas where City protection is absolute. For example, a concrete basin that is definitely not re-usable because of known, documented and irreparable deterioration should not be required to be part of the terms of the contract.

A Protocol of Interaction

Procurement processes should include opportunities for interaction between the City and potential proposers. Such interaction may include, for example, a request for comments on draft procurement documents, workshops with potential proposers to discuss comments to draft procurement documents, written correspondences regarding proposal clarifications, as well as face-to-face meetings to discuss proposals. The private parties that invest in responding to RFPs are incentivised to point out procurement requirements that are unrealistic or unnecessary. It is both fair and important to maintain a level playing field for all proposers by not providing any proposers advantageous information that is unavailable to other proposers. Such discussions can provide significant advantages to the overall process including allowing for clarifications of the intent of the written words.

As water partnerships mature from RFP to contract award to notice to proceed and beyond, communications between all parties is critical to project success. Cities should consider including a provision in the service agreement that would define the expected interaction/relationships with the City and the private partner during design, construction and operation.

Another consideration for Cities is how the private partner deals with the media. Cities may want to consider requiring that the City water and sewer Department have a right to review all media releases by the private partner concerning the partnership before contact with the media is established. There may be some further consideration to delineate various types of media contact into categories that require notification and prior approval by the City, notification with no prior approval by the City, and notification after the fact.

Review Enabling Legislation

A critical step in the Scope of Work is to determine whether or not existing state and/or local law will allow a particular project type to occur. For example, in some states (e.g. Massachusetts, New Jersey and others) existing state law or regulation does not allow for long-term facility contract operations or DBOs without specific enabling legislation or regulatory approval for the specific project. Additionally, some states may have existing procurement laws that might also place restraints on how such a public-private partnership arrangement can be structured. Condi-

tions such as “low-proposal” only; or, total private operator contract costs must be a certain percentage less than existing facility operations costs should ideally be understood before the RFP stage, but certainly no later than before a proposal is awarded to a private party. Indeed, the proposers should provide information pertaining to what steps would be necessary to obtain local and state project approvals. Furthermore, regarding permit approvals, the City and the private party should jointly recognize what legislative requirements must be satisfied in order to proceed with a water partnership (whether short- or long-term operations, DBO or some variant approach); and there should be some clear agreement and assigning of responsibility for achieving the required state legislative approvals.

SECTION III — Managing Risk Allocation and Performance Criteria

Generally speaking, this Section is focused on a subset of risk considerations, and in the interest of brevity it is not intended to provide a comprehensive listing of all risk concerns and how they should be allocated in a water partnership. Cities should consider asking proposers to provide a matrix of risk items that allows companies to point out how they think risks should be allocated, and if they differ from the risk allocation specified by the City in the RFP. Such a matrix can provide the City with critical information to compare proposals. Indeed, the City may want to specify what risks should be in a matrix, and request proposers to identify other risk items that should be included.

Performance Criteria

Private asset management contracts for water systems are generally considered “performance-based contracts.” Standards are set, and the means and methods of reaching those standards (management approach, operating techniques, and so forth) are left to the contractor. Specificity in establishing the expected level of performance thus is essential in a good partnership. Because factors outside anyone’s control may affect the contractor’s performance, such factors also should be carefully identified. Attention to developing a clear work scope and a fair and reasonable listing of uncontrollable events excusing performance will go a long way to creating an enduring partnership in which the expectations of both parties are more likely to be satisfied. Likewise, identification of events that will not excuse performance will avoid future conflict.

There is a spectrum of specificity possible for a City to choose from when establishing a water partnership service agreement. They can be very general, and state broad goals, duties and responsibilities. Or, they can be very specific and detailed. The contract between a community and private partner should state explicitly, and if possible, quantitatively, the criteria for satisfactory performance, because what is measured gets managed and, conversely, what is not measured tends to be forgotten.

Preparing for a Successful Transaction

Municipal Preparation: Extensive preparation by the municipality is important to a successful public-private partnership, both to establish proper contract performance criteria and to provide private proposers with information sufficient to make an informed proposal. Although the municipality is not selling the utility plant or system, proposers should be provided all significant information regarding the assets, as if the proposers were proposing to purchase the assets. Thus, the municipality should make available complete data and information concerning, for example, managed asset plans, drawings and specifications; capital improvements under construction and planned; current employees and union agreements; contracts with suppliers and customers; existing permits, consent decrees, administrative orders and pending litigation; regulatory compliance records; budgets, rates, revenue collection history and outstanding debt; maintenance records; and records of past performance. Whether or not this information can or should be warranted as complete and correct is a matter for negotiation, but it should be assembled and made available.

Undertaking a transaction of this nature often proves to be an important opportunity to take stock of the condition and direction of the entire utility operation. Questions arising during the preparation of a request for proposals often include the following: Is the utility currently being operated in full regulatory compliance? Have the assets been properly maintained? Is it reasonable to ask a contractor to assume management responsibility on a long-term basis without making initial capital improvements suggested by prudent industry practice? Should the private

party be allowed to make initial capital improvements with appropriate relief granted in “full management” until capital improvements are made? Are there aspects of current operations that need to be improved? How should anticipated regulatory change be handled? Adequate staff and consultant time and budget devoted to the preparation phase of the transaction by the municipal sponsor will help considerably to expedite the procurement, and secure attractive proposals.

Contractor Preparation: Considerable time and expense also is involved in proposal preparation by potential contractors. A model must be developed that will accurately predict costs over the long term, and yield a reasonable profit. Opportunities for savings from improved management, operation and maintenance practices need to be identified. Where capital improvements are involved, the need for adequate contractor preparation is even greater, as the contractor must design the improvements to the level necessary to support a guaranteed design/build price proposal. This work involves a substantial resource commitment by experienced contractor personnel, in addition to the effort of preparing the proposal itself.

Every opportunity given to potential proposers to conduct this necessary due diligence will improve the resulting public-private partnership. Sufficient time to conduct site investigations, asset inspections, review of records and management interviews should be allowed. Gathering complete data on the utility system and making it available digitally is advisable. Providing for proposer review and commentary on the request for proposals, or draft request for proposals, is also valuable. Sufficient preparation and an adequate opportunity for participation on the part of the contractors will permit better pricing and increase the likelihood of reasonable and sustained profitability, benefiting both the public and private partners.

Performance Guarantees

Compliance with Environmental Regulations

The primary long-term performance guarantee with respect to a public-private partnership service agreement in the water and wastewater sectors is compliance with current applicable law and regulatory standards. These include standards set under the federal Clean Water Act or Safe Drinking Water Act and their state counterparts. The private partner should bear responsibility for conducting operations in compliance with applicable laws and regulations where the facilities are capable of such compliance. This would entail the payment of fines and damages imposed for non-compliance, provided that the failure to comply was not the result of an Uncontrollable Circumstance, or a limitation of the physical assets that the private party is being asked to operate.

Where the system is not capable of achieving compliance and the public partner is responsible for the funding of capital improvements and/or repairs and replacements, the public partner should bear the risk of non-compliance, provided non-compliance resulted from the failure of the City to fund necessary capital improvements and/or repairs and replacements. Where the private partner bears some or all of the responsibility for capital, it should bear the risk to the extent it has not made necessary improvements, repairs or replacements in accord with the contract’s terms.

Contract Language — Example: (This example may not be relevant when Design-Build improvements are included in the scope of services)

CONTRACTOR shall operate and maintain the Wastewater Treatment Plant in a cost-effective and professional manner. Such operation and maintenance shall be in accordance with generally accepted practices for wastewater treatment. The wastewater effluent discharged from the Wastewater Treatment Plant and other operational characteristics shall at all times meet the requirements of all governmental regulatory agencies in effect on date of execution of this Agreement, and as may at anytime be require by law, subject to Section IV (B) below, including those requirements as specified in California Regional Water Quality Control Board Order No. 01-022 within the limits of the operating capability of the Wastewater Treatment Plant. (Provision from an agreement for contract operation and maintenance of the City of Burbank water treatment plant.)

While the private party is responsible for environmental compliance, the public partner is still involved. Cities usually take an oversight role when it comes to private party compliance. It is normal for private partners to keep the

public partner informed of actions taken to comply with regulatory requirements. Sometimes this involves simple reporting and establishment of a reporting requirement to identify actions and “due-dates.” Sometimes the service agreement calls for the private partner to consult with the public partner before meetings are held with state and local regulatory agencies. The City should consider whether or not they want full disclosure of contacts with regulatory officials; and, whether or not a City representative should be present at such meetings. Sometimes the arrangement will simply allow for information sharing between the partners when actions or contacts with regulators are made.

Quality and Quantity of Effluent

Water quantity guarantees, as well as water quality guarantees, are essential. In general, contracts will require the treatment of water or wastewater in volumes up to specified maximum levels, often with daily, weekly and monthly sub-levels as long as they are within the design capacity and capability of the Facilities. The fixed work scope for which the fixed component of the service fee is payable is generally established on a million-gallons-per-day annual average basis. There should be adjustments for raw water quality or for “flows-and-loadings” levels that exceed those on which the fixed work scope was based.

The quantity and quality of water or wastewater that enters the treatment plant has a significant impact on operating costs and efficiencies. Performance and cost guarantees proposed by prospective private partners assume that the raw water input to the water treatment plant or the sewage that enters the wastewater treatment plant will fall within specified quality and quantity parameters. The contract should address what will happen if the raw water or influent falls outside of that range and leads to increases in operating costs.

If deviations are outside of the design range of the facility, uncontrollable circumstance provisions should govern the obligations of the parties. Where deviations are within the design range, but in excess of the service levels upon which the service fee was proposed, the contract should provide for pre-agreed upon incremental (per unit) pricing. If the nature of the deviation is such that the pre-agreed upon incremental pricing is not applicable, the uncontrollable circumstances, and, if necessary, change orders provision of the contract should apply.

Water partnerships can avoid substantial controversy if the City defines acceptable raw water, influent or other input in the procurement documents so all proposers clearly understand this important aspect of risk allocation. By clearly defining these parameters proposers have an opportunity to comment on them. The definitions then carry through to the Service Agreement along with the concept that as long as acceptable input is delivered the private operator has to perform; and if unacceptable input is received, then necessary relief will be granted to the private operator.

Contract Language — Example: (See example from Compliance with Environmental Regulations section.)

Enhanced Standards

Contracts involving the construction of new facilities may call for compliance with “enhanced standards,” standards that are more stringent than current law and anticipate the adoption in the near or medium term of new regulatory requirements. Such standards also may address matters of concern that are not technically explicit in the current regulatory structure. In water projects, for example, enhanced standards may be established to govern issues of taste, odor, color, or certain elements (metals), or to anticipate possible regulatory change governing new constituents or testing procedures. Enhanced standards for wastewater projects may require the private partner to meet the stringent effluent standards currently being met by municipal management, rather than the less stringent stated permit standards. The approach may be an explicit “requirement” with penalties attached if not achieved; or, it may be intended as a “goal” with certain financial incentives tied to level of achievement. Such flexibility concerning enhanced standards provides an opportunity for the City to offer financial incentives to the private operator to achieve socially desirable environmental and aesthetic benefits.

Enhanced standards have also been established to obligate the contractor to achieve the same level of performance achieved by municipal operators if that level is better than that required by current law. It should be recognized that additional expense may be involved in asking contractors to perform beyond currently established standards, and that the additional expense may skew cost comparisons if such standards are not being attained by municipal management, this subject is also discussed later. As failure to achieve the enhanced standards may not result in a regulatory violation, remedies for failure to meet such standards may provide for greater notice, cure, and mitigation provisions

than would be applicable to failures to meet standards imposed by applicable law. Additionally, if the enhanced standards are agreed to on a goal rather than an explicit requirement basis, there may be no failure issues to deal with but simply the loss of a financial incentive opportunity for the private party.

Other Performance Guarantees for Water Treatment

The type of project will dictate the types of performance guarantees that may be required. For example, performance guarantees related to a water treatment facility or system would include: a water treatment guarantee to ensure that finished water quality meets applicable law limits; a water delivery guarantee to ensure that adequate supplies of the finished water are delivered to rate payers; a production efficiency guarantee to ensure that a facility is operated to produce a specified percentage of finished water from raw water; and a hydraulic transients guarantee to ensure that the facility is operated to avoid the occurrence of hydraulic transients. Any guarantees included in the Service Agreement should be reasonable, equitable and appropriate for the project.

Other Performance Guarantees for Wastewater Treatment

Performance guarantees related to a wastewater treatment facility or system normally include: a system effluent guarantee requiring the system effluent to comply with applicable laws; a residual disposal guarantee to assure the proper disposal of sludges produced by the treatment operations; an environmental guarantee relating to air emissions, noise, vectors, and similar issues and an odor guarantee to ensure that the facility or system is operated in a manner to eliminate or reduce odors emanating from the facility or system.

Cities considering such additional performance guarantees need to be careful about the language used in the Service Agreement. For example, odor guarantees may be fraught with pitfalls, and the methodology for the guarantee should be based on real world practicality and not rely on “classroom” exercises that may be promising but are not demonstrated. The City should recognize that if a new physical asset needs to be built to deal with odor problems it should agree with the private operator about the performance criteria that the odor control is designed to achieve. Odor, after all, is a subjective phenomenon. Since some odors are more or less objectionable to different people it is difficult to structure performance criteria effectively and practically.

Residuals Project Performance Guarantees

Performance guarantees related to residuals processing or management include a sludge throughput guarantee which requires a private partner to process a specified amount of sludge through the system on a periodic basis. Other guarantees are typically included relating to sludge product quality, processing efficiency, product marketing, residuals disposal and air emissions.

When off-site disposal or beneficial reuse of residuals such as biosolids are involved, Cities should be mindful of uncontrollable circumstances. Landfill disposal and beneficial reuse arrangements are seldom arranged under long-term contracts. A private operator may be subject to fluctuating prices as well as capacity limitations when sending residuals to a landfill. Furthermore, some landfill operators may either choose to prohibit or be legally required to prohibit sludge disposal in a solid waste landfill. Similarly, beneficial reuse of biosolids may experience both price and capacity fluctuations. These potential situations or conditions suggest that there be some flexibility in the guarantees, especially if they are for long-term partnerships.

Customer Service Guarantees

Where a private partner’s service obligations directly interface with the utility customers, particularly in the water distribution and billing and collection areas, a contract often requires the private partner to meet certain customer service standards and to maintain a community outreach plan to ensure that the City’s needs are met. A private partner will be required to set up a telephone number and e-mail address to which all complaints and communications may be directed. The private partner may be required to log all complaints and communications, and will be required to respond within a specified time period to all such complaints and communications. In cases of complaints and communications relating to emergencies, such as leakage, spillage, breaks or back-ups, the private partner will be required to respond within a matter of hours. Likewise, the private partner will be required to respond to non-emergency related complaints and communications in a reasonable time period.

Pricing such customer service guarantees poses a challenge. For example, how does a private operator price the number of breaks or back-ups that require responses in any given future year? There are methodologies to handle this situation, but the Service Agreement provision should be well thought out and reasonably negotiated.

“As-is” Risk

There are at least two dimensions of “as-is” risk that are important to mention. One is ensuring that there is an adequate amount of information from the City to describe the expectations that the City has concerning the actual duties and responsibilities of the private party regarding the operations and maintenance (and any capital improvements or process changes). A second dimension concerns the “as-is” condition of surface and subsurface facilities. Generally, Cities may not want to have a private partner take the risks for deferred maintenance or aging infrastructure. Cities and private partners can work cooperatively with reasonable risk allocation to provide for the proper maintenance, repair and replacement of physical assets.

Dealing appropriately with as-is risk for surface and subsurface facilities poses a number of challenges. It is important for Cities to be able to claim that a water partnership project, from the RFP process through the duration of the contract term is fair to all parties. If proposers make different assumptions in their proposals the City still has to make a comparison based on the plan and the cost. If the chosen proposer later seeks a change order(s) and the cost basis for the project changes, there may be legitimate questions as to whether or not the process is ultimately fair. This is not to suggest that change orders are inherently an indication that the process is faulty. One way to address the as-is risk is to consider that all above ground facilities can be treated as an as-is risk; and, all below ground (subsurface) facilities may be treated with some shared risk between the City and the private party.

At the outset of a management contract, Cities want to make sure that once the operator starts, the operator will not be able to claim that the condition of the system or facility is worse than it assumed and that it can not meet its operating and maintenance obligations under the contract for the proposed contract price. On the other hand, private parties, rightfully, are uncomfortable taking the “condition” risk of facilities which it has not previously operated, for which there are only minimal maintenance records and for which it may not be able to adequately inspect, or for certain components including subsurface equipment or pipes that it can not inspect at all.

Private parties should be able to guarantee their service fee based upon reasonable diligence with respect to those components of the system that can reasonably be inspected. What is reasonable to inspect may vary depending on the nature of the project, but should be clearly defined in the RFP and the Service Agreement. In most cases, underground facilities, and facilities that can only be properly inspected by cutting through other structures or equipment, or by draining material or removing materials, would not be considered system components that can be reasonably inspected and, therefore, the private parties should not be asked to take the as-is condition risk of such facility components.

It may be reasonable to shift certain of these risks to the private partner after a specified period of time or “grace period.” The length of a “grace period” should depend upon the size of the system and the condition of the assets at commencement of the contract. A grace period should have a defined end. Since the private partner is charged with the responsibility of operating and maintaining the system it must ultimately undertake the risk of its condition at some point. This principle is limited by situations in which the City refuses to make capital improvements (for which it bears the financial responsibility) that are required for compliance. In such situations, the private partner should not be responsible for non-compliance resulting from the City’s failure to make the improvement. (See the section covering “Non-Performance”, below).

Where the private partner is contractually obligated to make certain initial Capital Improvements, the grace period should be long enough for it to complete the work. (See Example #1, below).

In some situations, where the system is in need of repair, the parties may agree upon a work metric that requires the private partner to complete a pre-determined number of repairs. (See Example #2, below).

One way to avoid some of the uncertainty pertaining to facility condition, and which can aid in the due diligence process, is for the City to commission an engineering study prior to the release of an RFP. This can be helpful in targeting problems with facilities and allow a more educated assessment, by both the public and private parties, about which specific facilities are faulty. However, if neither the engineer nor the City will guarantee the accuracy of this information, the grace period remains an appropriate mechanism to protect the private partner and help the partnership succeed.

Another contractual option would be to exclude the “As-is” risk to be assumed by the private partner.

Contract Language — Example #1: (This example may not be relevant when Design-Build improvements are included in the scope of services)

Limitations on the Company's Assumption of "As-Is" Risk; Uncontrollable Circumstances. It is specifically understood that the Company's assumption of the "as-is" risk of the condition of certain of the System Assets shall not take effect for a period of _____ from the Commencement Date, (the "Grace Period, during which time the Company shall be excused from performance, non-compliance, indemnity obligations (including those arising from third party Legal Proceedings,), liquidated damages, default, termination and governmental fines and penalties ("Performance Relief") except to the extent based on Company Fault or Company failure to comply with its obligations pursuant to this Agreement.

The Assets to which this section shall apply are as follows: _____

Performance Relief pursuant to this provisions shall apply only to the extent that non-performance is caused by the faulty or substandard facilities listed herein, or where said facilities will not inherently allow the Company to meet performance or Applicable Law.

If, in order for the Company to perform its obligations under this Contract it demonstrates that a Capital Modification is required, the City hereby agrees to make such Modification, at its cost, in accord with Section _____), or to extend the Grace Period until such Modification is made.

If the City has agreed to make a Capital Modification that will allow the Company to meet all performance standards or Applicable Law, or if the Company needs to perform Operation Services that will rectify a problem with the facilities such that performance standards and Applicable Law can be met, the Grace Period shall be extended only until such time, given all the circumstances, as the Capital Modification has been completed or the Operation Services should have reasonably been completed.

Contract Language — Example #2: (This example may not be relevant when Design-Build improvements are included in the scope of services)

Condition of Collection System and Dam; Backlog Work. The City has not made any representations as to the condition of the Collection System or the Dam, or any buildings, structures, improvements, Equipment, Vehicles, machinery or tools associated with the Collection System or the Dam. The Contractor shall complete the backlog of Repair Orders as identified in Schedule _____ (the "Backlog Work" no later than _____; provided however, (i) that the amount of new Repair Orders per year shall fall within a range of _____ to _____ and (ii) the Contractor will not be expected to reduce the Backlog Work if the Contractor, pursuant to the City's request, performs work beyond the scope of this Agreement without additional funding for additional labor, equipment and materials costs. The Contractor shall do the Backlog Work utilizing the Minor Corrective Maintenance Fund, the Major Corrective Maintenance Fund, and the Minor Capital Improvements Fund. In the case of pre-effective date of the Original Agreement Repair Orders identified in Schedule _____ attached hereto, the Contractor shall complete such work and shall be paid for such work as Additional Services under Section _____. (Provision from an Agreement for the operation and maintenance of a storm & wastewater collection system.)

Performance Relief for Uncontrollable Circumstances (UCC)

The Service Agreement normally provides relief from performance guarantees when the private partner's failure to meet the performance guarantees results from an uncontrollable circumstance. These typically include acts of God, changes in law, certain labor stoppages, conditions outside the facility design capacity and capability, and the discovery of hazardous substances.

Some risks fall into the category of uncontrollable circumstances in the sense that they are not under the control of either partner. Examples are loss of power, floods, storm damage, earthquakes, and acts of public enemy and

unforeseen subsurface conditions that affect the ability of the private partner to meet the contract terms. Uncontrollable circumstances typically are covered by a force majeure clause that excuses the private partner if its failure to perform could not be avoided by the exercise of reasonable care. In such cases catastrophic damage either impedes the operator of the facility, or a “material cost” is needed to address the issue. Cities may want to consider the concept of “materiality” (material damages) and define it to the extent possible. For example, material costs can be defined as the cost to “fix” a problem brought on by natural causes divided by the overall costs for operating and maintaining the facilities. Thus, the City may want to negotiate a certain percentage that delineates whether the public or private partner should pay for the “fix,” or if one party should pay, or if both parties should share costs.

Changes in law are generally classified as an uncontrollable circumstance, but because of their importance to the utility industry, they are sometimes separately addressed in the contract. Sometimes, the private partner is responsible not only for the laws and regulations in place at the time of commencement, but also for specific laws and regulations that the parties know will be in place during the term of the contract. In fact, anticipated laws and regulations, especially those that concern environmental issues, often play a role in the public partner’s decision to seek a private operator of its system. If the RFP is clear in this regard, all prospective proposers are expected to price the cost of compliance with the new law into their proposals.

The ability of a contractor to manage a water or wastewater asset depends upon the nature of the raw water or influent that requires treatment. Management contracts normally assume that the quality of raw water or influent will fall within a certain specified range, or envelope, determined by the design capabilities of the facility. If the actual parameters fall outside the envelope, the contractor should be given performance relief from its obligations under the agreement.

This design capabilities “envelope” should not be confused with the parameter range that is typically created to determine the contractor’s base service fee compensation. If the influent/raw water quality is outside of this parameter range but within the design capabilities envelope, the contractor should be afforded additional compensation but not performance relief.

Excuse for Non-performance:

The private partner should be excused from performance where it is prevented from performing as a result of any circumstance beyond its reasonable control, whether it be a force majeure event, a change in relevant law, or otherwise. Performance should be excused for only the amount of time reasonable and appropriate under the circumstances, and only if the private partner has acted to mitigate the situation, where possible.

Termination Resulting from Uncontrollable Circumstance:

An Uncontrollable Circumstance may warrant termination of the contract. As the owner of the assets and the system, the financial risk of termination for uncontrollable circumstances usually rests with the City. If the City were to bear the full risk, the private partner would be made whole in the event of such termination, and a termination fee could include a reasonable lost profit component. However, given that neither party is at fault, it may be appropriate, in longer-term contracts, for the parties to share the burden and reduce the amount of lost profit the private partner might otherwise have received.

Fee Increases or Reductions Resulting from Uncontrollable Circumstances:

Where uncontrollable circumstances have a material effect upon the cost of ongoing operation and maintenance, the contract should include a mechanism for an equitable adjustment (increase or decrease) in the base fee. Appropriate contractual provisions that either contain pre-determined compensation formulas or allow for equal bargaining power in negotiating fee adjustments are equitable means by which to determine the amount of the adjustment.

Additional Non-Recurring Compensation:

The City, as owner of the system, should bear the risk of additional expenses incurred by the private partner as a result of an Uncontrollable Circumstance. The contract should include a mechanism that addresses this type of situation and allows the private partner recovery of its reasonable costs. The lost profit component of a termination payment could be negotiable.

Non-performance

The Service Agreement might also include provisions addressing performance that falls below the established regulatory criteria. If the contractor fails to meet the performance guarantees due to its acts or omissions, and is not excused due to the quality of the raw water or influent or due to an uncontrollable circumstance, the contract typically provides for a variety of remedies short of default and termination. In many circumstances, these failures do not result in damages to the client and this should be factored into the development of remedies. This is especially true where the contractor fails to achieve enhanced performance standards but nevertheless meets applicable legal and regulatory standards.

The remedies should be reasonable in light of the actual damages suffered by the public partner and the overall objectives and financial considerations of the contract. If deemed reasonable by the parties, these remedies often include liquidated damages for exceedences, proportioned to the harm suffered and not to constitute a penalty; the payment of any fines or penalties imposed on the public partner by the department of environmental protection or department of health; and the obligation to take the steps necessary to prevent the recurrence of the violation. Notice of breach, and an opportunity to cure, ordinarily must be given before the contractor is deemed to be in default and made subject to termination. Notice and cure periods could be considered for all default events.

Other

Capital Maintenance and Deterioration of Asset Value

Where the private partner is not contractually obligated to make capital improvements and/or repairs and replacements, it should only bear the risk of deterioration of asset value, but only to the extent that such deterioration should have been prevented by appropriate operation and maintenance. Where operation and maintenance is in compliance with the contract and applicable law, normal wear and tear and the responsibility for replacement after useful life has expired (for capital items) should be the responsibility of the public partner. (For draft language, see the section on “System Repairs and Replacements,” below.)

However, where the private partner is contractually obligated to make capital improvements and/or repairs and replacements, it should bear the risk subject to pre-negotiated contract terms addressing the condition of the physical assets at the termination of the contract.

As with allocation of the “As-Is” risk discussed above, an engineering study or a facilities audit may be very useful to determine the state of the assets at commencement of the contract, at intervals during the term, and at expiration. It is very important that the parties enter into the contract with a clear understanding of the system, its capabilities and its condition.

Costs in Excess of Contract/Scope Creep

Where the scope of the operation and maintenance obligations is clear, the private partner should bear the risk that the sum it proposes is sufficient to cover the cost of its services. However, there are often grey areas about the extent of services, especially in larger systems, and the parties may have differing views about the exact scope of services. Therefore, it is important that there be clarity with regard to the specific tasks the private partner is expected to perform. Without clarity the public partner runs the risk of what it believes are gaps in service and the private partner may face an ever-increasing scope of work (“scope creep”). Pre-proposal diligence, by both parties, and clear contract language is generally necessary to ensure that there is complete understanding as to the scope of services. Accuracy of public partner records and proposals that include significant detail are very helpful in this regard.

Where circumstances warrant (as where the scope is very broad and encompassing or where ongoing expenditures are otherwise very difficult to estimate), the parties may come to an alternate arrangement. Monetary caps on maintenance and repair costs may be employed. In these situations, there is an amount beyond which the private partner (that has acted prudently and in accord with industry standard) will not bear financial responsibility. Any expenditure above the cap is generally subject to public partner review and approval. (See Contract Language Example on page 15).

Contract Language — Example: (This example may not be relevant when Design-Build improvements are included in the scope of services)

***Maintenance and Repairs.** The parties have budgeted the base amount of \$ _____ to provide for necessary Predictive, Preventive, Routine and Minor Corrective Maintenance required for the continued operation of the Gary Facilities in the First Agreement Year and have included that amount in the Annual Fee, to be paid to the Contractor in equal monthly installments. Said base amount, after Agreement Year 1, shall be adjusted annually, based upon changes in the CPI and in the same manner as the Annual Fee as hereinafter described (“adjusted amount”).*

The Contractor shall furnish all labor, materials and other services necessary to accomplish Predictive, Preventive, Routine and Minor Corrective maintenance. In connection therewith, the District will allow the Contractor, where appropriate, to make use of their annual contracts for procuring goods and services necessary to complete the work. The Contractor shall provide a quarterly accounting to the District of all amounts spent on such maintenance during each Agreement Year for the purpose of reconciling actual costs against the monthly amounts budgeted. If during any quarter the Contractor spends less than the adjusted amount, as indicated by such reconciliation, the Contractor shall provide a credit against the next monthly payment due the Contractor from the District in the amount of such difference. If during any Quarter the Contractor spends more than the adjusted amount, as indicated by the reconciliation, the District shall pay the Contractor the amount of any underpayment within sixty (60) days from receipt by the District of the reconciliation statement.

Eligible maintenance related costs for which the Contractor shall be entitled to recoup pursuant to this section should include the cost of all materials, supplies, equipment rental and subcontracting costs, plus _____ percent (___%). The Contractor shall be entitled to recoup its labor costs for Predictive, Preventive, Routine and Minor Corrective Maintenance performed by the Contractor’s staff if such work had been regularly contracted by the District prior to the Effective Date, as identified in Schedule _____. The Contractor shall notify the District when expenditures for such maintenance during any Agreement Year reach _____ percent (___%) of the adjusted amount. An expenditure that would exhaust the adjusted amount for any Agreement Year requires the District’s written approval. In the event the District shall approve a proposed expenditure by the Contractor which causes expenditures for Predictive, Preventive, Routine and Minor Corrective Maintenance during an Agreement Year to exceed the adjusted amount, the Contractor shall proceed with the work and the District shall reimburse the Contractor for the cost thereof no later than sixty (60) days from the date of receipt of an invoice from the Contractor therefore. Any maintenance monies which remain unspent as of the end of any Agreement Year shall be returned to the District. (Provision from an Agreement For the operation, maintenance and management of the City of Gary, Indiana, wastewater treatment and collection system.)

Change Orders

In general, the private partner is responsible for submitting its proposal with a fixed price for a fixed scope of work, and absent a material change in circumstances, the public partner should be able to rely on the proposal. This is important not only to provide each party with certainty, but also for ultimate compliance with IRS Revenue Ruling 97-13. This Ruling requires that a minimum of 80% of the private partner’s compensation (for contracts longer than 5 years), in any given contract year, be fixed.

However, since circumstances may change, the City should have the right to issue change orders, provided that 97-13 is considered and provided that there are contractual provisions that protect the private partner’s financial interests. A private partner proposes a price based on the tasks it is to perform, and upon synergies it believed it could expect. Substantial deviation from the original scope of work could cause the private partner undue financial harm.

Where uncontrollable circumstances result in an ongoing increase or decrease in operational expenditures, change orders are also an appropriate mechanism to adjust the contract price. (See the section on uncontrollable circumstances, below). Appropriate contractual provisions that either: contain pre-determined compensation formulas; or allow for equal bargaining power in negotiating price changes resulting from any type of change order, substantially reduce the risk of harm to the private partner and allow both parties to have some certainty with regard to their financial obligations when issuing change orders.

System Repairs and Replacements

Generally:

The obligation for system repairs and replacement is largely situation-specific and governed by the terms of the contract. Where the private partner is not responsible for system repairs and replacements that are capital in nature, it should not bear the risk of having to make them unless the need for them could have been prevented by appropriate operation and maintenance. Where the private partner is responsible for repairs and replacements, it should bear their costs in accord with the specific terms of the contract.

Necessary Capital Improvements, Repairs and Replacements:

Unless planned prior to contract execution (as in contracts with design/build components), the City generally has the right to approve any suggested capital improvement, (an addition to the system) by the private partner (regardless of the Agreement's structure as to the party which bears the cost). While the City will naturally need to maintain control over capital items, its failure to approve a necessary improvement, could result in the inequitable imposition of fines or penalties (to be paid by the private partner), or private partner non-compliance and/or default. Accordingly, the City should be required to approve any capital improvement that is required for the private partner to meet its contractual obligations and to comply with relevant law or, to the extent reasonable and necessary, should excuse the private partner from performance. Additionally, the City should fully indemnify the private partner against any financial loss resulting from the City's failure to approve the capital improvement. An exception to this principle would be where the need for a capital improvement resulted from a private partner's negligence or intentional wrongdoing. Additionally, the private partner should nonetheless be responsible for operating within system capabilities.

In certain contracts, the private partner has the obligation to fund necessary capital repairs or replacements (capital items that pertain to previously existing facilities). Where this is the case, the private partner should generally be able to choose to make the repairs or replacements in its discretion. Its failure to do so should be subject to penalty only where contractual provisions are not otherwise being met. However, where the private partner obligation is subject to a cap, it should seek City approval before committing funds that are the City's ultimate responsibility. However, where the City refuses to approve a capital repair or replacement that is necessary for compliance with the contract or applicable law, it should excuse the private partner from its obligations (to the extent they could not be met because of the City's refusal) and bear the risk of any resulting damage. The private partner should nonetheless continue to be responsible for operating within system capabilities.

Example Contract Language: (This example may not be relevant when Design-Build improvements are included in the scope of services)

“When the Private partner submits a recommendation for a capital improvement pursuant to the terms of this Agreement, the City, in its discretion, shall determine whether to approve the Private partner’s recommendation(s).”

If the City (does not accept) (refuses to fund) a capital improvement which according to commonly accepted engineering, operation and/or maintenance practices, is necessary for compliance with the terms of this Agreement or with relevant law, the Private partner shall not be held responsible for non-compliance to the extent the Private partner is prevented from complying as a result of the City’s failure to approve (fund) the capital improvement.

Additionally, if the City (does not approve) (fails to fund) a capital improvement which according to commonly accepted engineering, operation and/or maintenance practices, is necessary for compliance with the terms of this Agreement or with relevant law, the City shall indemnify and hold the Private partner harmless from any loss, damage, fine, or penalty suffered by the Private partner as a result of the City's (denial) (refusal)."

Indemnification

Neither party should be made to indemnify the other against loss resulting from the other party's acts and omissions. Although administratively more difficult, each party should bear responsibility in proportion to its fault. Aside from general issues of fairness and equity, it is very often not possible to obtain insurance for loss resulting from having indemnified another for its fault. Further in most public-private partnership situations, the private partner will be performing all contractually required tasks and controlling the means and methods by which they are performed. Therefore, the City should be in little danger of bearing responsibility for loss resulting from private partner obligations. Although the private partner need not indemnify the City for the City's actions, the contract should make clear that the private partner must bear responsibility for all of its negligent actions and omissions unless they were directed by the City.

Where there are limitations on the City's ability to indemnify, contract language should make clear that its obligation to do so (for its own actions) would be only to the extent legally allowable.

Example Contract Language:

"Private partner to Indemnify City. The Private partner shall defend, protect, indemnify and hold harmless the City from all liability, damages and other costs, including reasonable attorney fees and consultant fees, caused by or arising out of:

(a) the proportionate extent of the negligent act or negligent omission or other wrongful conduct of the Private partner, its employees, or agents, unless such conduct resulted from the direction of the City; (b) the Private partner's failure to provide the standard of care, skill and diligence required in the performance of its duties; (c) any breach by the Private partner of a representation, covenant or warranty set forth in this Agreement; (d) any violation by the Private partner of any federal, state or local law, ordinance, rule, regulation, order, decree, permit or grant condition prior to the Effective Date, unless such violation was directed by the City; or (e) any process changes proposed and implemented by the Private partner.

City to Indemnify Private partner: To the extent allowable by law, the City shall defend, protect, indemnify and hold harmless the Private partner from all liability damages, or other costs, including reasonable attorney fees and consultant fees, caused by or arising out of: (a) the proportionate extent of the negligent act or negligent omission or other wrongful conduct of the City, its employees, or agent or the City's direction to the Private partner to perform such act; (b) the City's failure to provide the standard of care, skill and diligence required in the performance of its duties under this Agreement; (c) any breach by the City of a representation, covenant or warranty set forth in this Agreement; (d) any violation by the City of any federal, state or local law, ordinance, rule, regulation, order, decree, permit or grant condition prior to the Effective Date; or (e) any process changes proposed and implemented or requested by the City.

Contributory Fault: In the event that both the Private partner and the City are negligent, or otherwise at fault and the negligence or fault of both is the proximate cause of such claim for damage or loss, then each party will be responsible for the portion of the resulting liability or damages equal to such party's comparative share of the total negligence or fault.

Consequential Damages: In no event shall either party, its subcontractors or their officers or employees be liable for the other party's special, indirect or consequential damages, whether such liability arises in breach of contract or warranty, tort including negligence, strict or statutory liability, or any other cause of action (other than third party claims).

SECTION IV— Contract Term and Duration for Contract Operations Partnerships

Public Partner Options

A public partner has a variety of options regarding the term of an operating contract for a water or wastewater facility. Contract length may vary from one to five years, with automatic or negotiated extensions, to twenty years or longer. The public partner needs to evaluate its own needs and analyze the factors described below as they apply to its situation. This evaluation and analysis by a large number of public partners in recent years has led to the conclusion that the benefits of longer term contracts outweigh any concerns there may be about them.

Contract Operations

Trend Toward Longer Contracts

Since the advent of public-private partnerships in the water and wastewater industry over thirty years ago, there has been an increasing trend towards longer term contracts. Before 1997, the typical term for an operations and maintenance contract was three to five years; however, with a change in the federal tax laws in 1997 sponsored by the USCM under IRS Revenue Procedure 97-13 and 97-14, longer term contracts up to 20 years have been permitted. This 20 year term allows the public partners to continue to issue conventional governmental purpose bonds (not subject to the alternative minimum tax) for water and wastewater facilities and to protect the tax-exempt status of existing tax-exempt bonds. For those public partners using private activity bonds rather than conventional governmental purpose bonds for water and wastewater facilities, contract duration of 25 to 30 years with a private operator is permissible, subject to State law.

Benefits of Longer Contracts

Some of the benefits of a longer contract are:

- public partner knowledge of long-term operational savings allows better planning and budgeting about how to spend the savings on necessary public capital improvements.
- attainment of lowest lifecycle cost
- enhances City risk profile, without shifting unreasonable risk to the private party, through single point accountability/responsibility covering design, construction, operation and maintenance, (in the case of DBO projects)
- private partners are willing to invest more of their own capital if the contract is long enough for them earn a return on that capital. The longer contract creates a way for the public partner to have access to capital through the private partner and its balance sheet.
- frequent public procurements and operating disruptions, with their associated costs and risks, are avoided.

Other Considerations

Some public partners may be concerned about committing themselves to a longer contract, either because they believe that a longer contract will remove some motivation for the private partners to perform properly or that it will create inordinate difficulties for the public partner if the private partner does not perform properly. The public partner needs to weigh the benefits of a longer term contract against these concerns, but a well-drafted contract will give the private partner ample incentive to perform and will provide the public partner with options for enforcing performance or terminating the contract. Private partners in the water service industry value long-term relationships, and maintaining performance levels to achieve customer satisfaction is a high priority.

Design-Build-Operate and Build-Own-Transfer

Long Term Contracts with Financing Component

Many of the same considerations for contract operations contracts are applicable to DBO and BOT contracts, including tax-exempt bond considerations and operational cost savings by the public partner. One additional and critical factor in DBO and BOT contracts is that they frequently involve significant investment by the private partner that is building the facility, or there may be a financing that is directly dependent upon the successful implementation of the DBO or BOT contract. In these circumstances, the term of the contract needs to be sufficiently long to permit an adequate return on capital invested in the facility, whether the investment is through a bond financing linked to the operation of the facility or through some other capital investment structure. This term is generally at least 20 years.

The uninterrupted payment of principal and interest in these situations is a critical consideration for Service Agreement negotiations. The City, at a minimum, would accept a “take or pay” (also known as “put or pay”) obligation. In the event of private operator default, and termination due to such default, the contract should provide for certain lender cure rights.

SECTION V — Contract Termination for Contract Operations Partnerships

There are several bases for termination. There are several methods by which the parties to a contract may terminate it. Termination may occur outside of the contract provisions. For example, a contract may be terminated simply by mutual agreement of the parties, or because of fraud or duress. The termination discussed here, however, involves termination in accordance with the provisions of the contract.

The most general categories of termination that are contained in contract provisions for water and wastewater facilities are:

- termination for cause
- termination for convenience
- termination for extraordinary situations

Termination is generally perceived as a last resort. Any termination of a contract, other than a termination for convenience, should generally be viewed as a drastic action, as well as a last resort. A well-drafted contract will have provisions that, except in extraordinary situations, will allow the public partner to achieve its objectives without termination. These include clearly described performance standards and liquidated damages for non-performance in appropriate situations. When typical methods of contract enforcement, however, are inadequate, the usual range of contract termination provisions discussed below provides the public partner with a variety of options for protecting its interests.

Termination for Cause

Some Standard Termination Provisions

In order to expedite termination for cause in those extraordinary situations of non-performance, a contract should explicitly and clearly state the circumstances that could lead to termination for cause. Typical events include:

- Failure of private partner to satisfy system performance standards
- Private partner becomes bankrupt, insolvent, etc
- Private partner fails to maintain project security or insurance
- Private partner fails to comply with legal requirements, including environmental regulations

Enforcement of Performance Standards and Environmental Regulations

Properly treated water or wastewater is the objective of all water and wastewater contracts between public and private partners. Accordingly, the private partner will generally be responsible for violations of environmental permit

standards and other performance standards regarding effluent/finished water characteristics and other matters. Exceptions to this rule and situations where the private partner will not be responsible are: (1) the influent provided for treatment at the facility did not meet specified parameters (for example, for toxicity or “flows and loadings”) when it arrived at the facility, (2) an uncontrollable circumstance prevented proper treatment of the influent, or (3) the public partner was somehow at fault and contributed to the private partner’s non-performance.

In those situations where the private partner is at fault, a decision has to be made when drafting the contract about whether the breach should be the basis for (1) a claim for damages, which may, in appropriate circumstances, include specified liquidated damages payments, (2) termination, but only if the breach is not cured after notice and a reasonable cure period, or (3) immediate termination without notice.

Most non-performance situations can be handled through payments of damages or do not become a basis for termination unless they are repeated and persistent. Some non-performance situations, however, are the proper basis for immediate termination. These include (1) abandonment of the operations of the facility and (2) failure to meet certain minimum annual operating standards established in the contract.

Damages

In the event of termination for cause, the public partner may have the right to seek legal and equitable remedies provided by law, including seeking compensation for:

- The costs of correcting the damages resulting from non-performance by the private partner
- The costs of transitioning back to public operation or to another private partner
- The net present value of the incremental costs of operations by the new provider.

To ensure adequate compensation, the public partner might require a performance bond, a letter of credit, a parent company guarantee, or other types of surety (see insurance and bonding requirements on page 22). Specified limits of liability are typically established and are usually percentages of contract value or percentage of capital installed.

Many existing public-private partnerships that require a form of surety utilize a performance bond. Reasonable upper-bound estimates can be developed for damages that could result from contract termination. Requiring multiple layers of surety such as combinations of performance/payment bonds, large letters of credit, and corporate guarantees can add unnecessary costs to the public partner and can eliminate competition from otherwise capable and qualified firms.

Service Agreements can also contain other project security measures. For example, provisions can be incorporated to require: retainage; payment withholding; payment in arrears; insurance; dispute provisions; and, liquidated damages. A City should carefully consider these security measures when considering the entire security package for the project.

Limitations on Liability

Requiring proposer’s to assume unlimited liability or a liability limit greatly in excess of estimates of the damages that could result from contract termination can increase the cost of the contract without providing any additional benefit to the public partner. Private parties often express concern that it is too great a risk to offer unlimited liability. Cities should recognize that private party guarantees are limited by a Company’s net worth. All liability is effectively limited by a Court’s determination of appropriate damages. The parties should be clear in the agreement as to which types of “liabilities” experienced by the contractor are subject to the stated limitation on liability. For example, cost overruns are typically not assessed against a limitation on liability.

Most Drastic Remedy

Termination for cause is the most serious action a party to a contract can take, and all reasonable efforts to avoid it should be made. Service Agreements often incorporate a notice of default in addition to a cure period. If the default is “incurable” the parties then act accordingly. There can be grave repercussions for the terminating party if the “just cause” relied upon was, in fact, insufficient to justify the act of termination. For example, the party against whom

termination is attempted may have a claim for damages for bad faith or wrongful termination. In addition, courts may require that the terminating party (1) acted timely and did not waive its right to terminate, (2) was not itself in breach of the contract, (3) did not contribute to the events causing the breach, (4) gave adequate notice and time to cure, and (5) did not interfere with the performance of the other party.

Termination for Convenience

When the public partner wishes to include in a contract provision that permits it to end the contract for reasons other than poor performance by the private partner, the contract termination is considered to be for convenience. In this event, it is important that the contract address the payment to the private partner, and the contract should specify the standards that will be applied and the process to be followed to reach a financial settlement. Additionally, the option of transferring existing contracts with contractors and suppliers must be spelled out to the satisfaction of both parties.

In the event of termination for convenience, the public partner could compensate the private partner for:

- Demobilization costs (removal of materials and personnel)
- Subcontractor or supplier cancellation costs
- Transition costs, if requested by the public partner
- Repayment of the private partner's unamortized outstanding debt for capital improvements and start-up costs paid for by the private partner
- Compensation to the private partner for some or all of its lost revenues and profits might be considered.

A water partnership contract may consider providing private companies with the right to terminate for convenience. Allowing private parties to terminate for convenience is not currently an industry standard. In the event that a City might agree to such a contract provision the parties would negotiate appropriate compensation terms.

Termination for Extraordinary Circumstances

This category of termination is intended to cover those situations where neither a convenience termination nor a for-cause termination is appropriate but the public partner wants the ability to end the contract without paying the amount usually required for a convenience termination. For example, if uncontrollable circumstances cause the service fee to increase more than some established amount (for example, 25% in any year), it may be appropriate to permit an extraordinary termination with a smaller payment to the private partner than is required in a convenience termination situation.

Cities should note that there is substantial concern among the water service industry regarding termination in general. Some would argue that the first four forms of compensation listed above should be paid to the private partner. The concept is that the private provider should be made whole. There is a concern that the private party could realize a "windfall" to some extent. In this situation, if a termination occurs a best value approach could be to make the private party whole but eliminate a "windfall" situation.

Special DBO and BOT Considerations

The considerations for a DBO or BOT contract are quite different than those for the typical contract operations contract because a financing of some sort is involved in DBO and BOT contracts, and any termination has to address how the financing will be repaid. It is generally the case that, since the private partner has more invested in a DBO or BOT contract, terminations for cause in those contracts is made more difficult for the public partner. For example, other than a failure to pay amounts due within a reasonable period of time or bankruptcy, frequently the only standard for a default termination in a DBO or BOT contract is repeated and persistent failure to perform material obligations. Liquidated damages and other damage awards are the typical means of enforcement. In addition, lenders often are provided extended cure rights or time to take over the facility and perform the private partner's obligations (or find another operator to do that). Any convenience termination needs to provide for assumption or payment of debt for the facility by the public partner, however, as stated on page 18, there is an opportunity to have the public and private parties negotiate how the principal and interest will be paid.

SECTION VI — Bonding and Insurance

Bonding and insurance requirements are two important aspects of successful public-private partnerships. For this reason, it is important to be fully aware of the bonding and insurance requirements which are specified in your contract. This section will attempt to provide a general background as to the types amounts of insurance and bonds that will normally be included in connection with a partnership contract.

Project Insurance

Almost all procurements require contractors to purchase and maintain certain minimum levels of insurance. The most common forms of insurance are workers compensation insurance policies, comprehensive general liability insurance policies and automobile liability insurance policies. In specific cases, contractors may be required to provide additional insurance that is not included in the base insurance policies described above (e.g., environmental impairment liability insurance where hazardous wastes may be involved, professional liability insurance where design or professional judgment may be involved, etc.). In designing insurance requirements, cities should be mindful that insurance is expensive and will ultimately be passed on to the cities in the service costs. Cities should additionally realize that the insurance marketplace is far from static and the current status of the marketplace should be reflected in insurance requirements (e.g., post-9/11 insurance and bonding costs are significantly higher and such policies are more difficult to obtain). Cities should, therefore strive to make insurance requirements reasonable in light of the scope of work, size of the project, the current insurance climate and the expected proposers for the project.

Sufficient insurance limits should be established to assure adequate but not unreasonable protection. Over 98% of general liability claims are paid or settled under \$1 million, and between 85-90 % of environmental/professional claims against large contractors/consultants are paid or settled for \$1 million or less. Liability limits in these ranges statistically cover the vast majority of claims. The following is a listing of the insurance policies and limits that are generally required on public-private partnership projects, together with a listing of additional policies and limits that may be required to deal with specific risks that may be encountered by the project.

Liability Coverage: This type of insurance relates to bodily injury or property damage to third parties for which the service provider is found legally liable.

General Liability: The request for General Liability limits should have some correlation between the scope and size of the project. The average contract will require General Liability limits between \$1 million to \$10 million per occurrence. Limits of \$1 million to \$2 million are typical, but, again, size and scope of the project directly affect the limit amount.

Automobile Liability: The average contract will require Automobile Liability limits between \$1 million to \$10 million for owned, leased, hired and non-owned vehicles. Limits of \$1 million to \$2 million are typical.

Workers' Compensation: The average contract will require statutory Workers' Compensation limits and Employers' Liability limits between \$1 million to \$5 million.

Umbrella Excess Liability: The average contract will often require the contractor to supplement its base insurance coverage with an umbrella policy that increases the limits of the underlying policies to the required level. For example, a general liability insurance requirement for \$5 million in general liability insurance coverage might be met by a contractor with a base general liability policy of \$1-\$2 million and an umbrella policy of at least an additional \$3-\$4 million.

Property Coverage: This insurance relates to property damage to scheduled locations. This includes coverage for real property, personal property, inventory, computer equipment (EDP), boiler & machinery and business interruption. As a general rule the City would continue their obligation to insure scheduled locations such as treatment plants and pump stations.

Builder's Risk: If construction services are to be performed, a Builders Risk insurance policy written on an "All Risk" basis may be required to cover the full replacement cost of the facility during construction and for a specified period of

time after completion of construction. Builders Risk insurance carriers require very detailed project and financial information prior to the issuance of such policies. As a general rule, once a facility is constructed, started up, operating and accepted by a City (with title and ownership transferred to the City), the obligation to insure the facility against property damages is transferred to the City.

Requests for proposals will very often include additional insurance requirements that require the contractor to purchase additional insurance coverage or amend the contractor's existing insurance policies in certain respects. Once again, a City should guard against adding unnecessary or unreasonable insurance requirements because it will increase the cost of the service fee to the City. Examples of issues that are often addressed in RFP's or during negotiation of the final service contract include the following:

Additional Insured Status: Many contracts provide Additional Insured status to the client on the General Liability, Automobile Liability and Umbrella Excess Liability insurance policies. Workers Compensation and Employers Liability and Professional Liability policies will not add non-employer entities as additional insureds.

Waiver of Subrogation: This is the relinquishment by an insurer of the right to collect from another party for damages paid on behalf of the insured. The waiver of subrogation condition in current liability policies is often referred to as "transfer of rights of recovery." Since both the City and the contractor maintain insurance, a mutual Waiver of Subrogation is a reasonable contract request in this area.

Dedicated Limits: This is a requirement that insurance policies or limits be dedicated solely to the project, thus adding significant insurance cost to the project with limited or no additional benefit since 85% to 98% of losses are under \$1 million as previously outlined.

Bonds

The same comments regarding insurance requirements apply to bonding requirements. In designing bonding requirements, Cities should be mindful that bonds are expensive (even more so in the aftermath of 9/11) and will ultimately be passed on to the City in the form of higher service costs. Cities should strive to make bonding requirements reasonable in light of the scope of work, size of the project, the current insurance climate and the expected private party proposers competing for the project. Cities may also consider accepting Letters of Credit (LOC) instead of performance bonds for some contract conditions.

Proposal Bonds

Generally:

Although not universally requested or required in procurements, proposal bonds are sometimes requested in competitive procurements to demonstrate the contractor's good faith and ability to: (1) enter into a contract within a certain time, and (2) furnish the required performance and payment bonds. The proposal bond concerns the contractor's responsiveness and the contractor's ability and willingness to move forward with a project after the contractor is selected and awarded the contract. The obligation or guarantee of the surety is normally limited to the penalty amount of the bond, as stated on the bond form.

AIA Document A310 is probably the most common proposal bond form used for general construction. Surety companies usually have their own forms, which can be used when a specific one is not required by the contract specifications. Most proposal bond forms contain the same basic language as in AIA Document A310.

Proposal Bond Penalty

The penalty amount of the proposal bond that may be paid (the "penalty amount") is normally included in the proposal specifications. Although the penalty amount of the proposal bond can be set at any amount by the owner/agency, usually the penalty is limited to a percentage of the likely proposal amount as follows:

- Normal construction 10%
- Federal contracts 20%
- Material/supply contracts 5%

Extremely large projects, however, may drastically reduce the above percentages. For example, the proposal bond on a \$100 million long-term water/wastewater project will probably not exceed \$1 million, or 1% of the value of the project. In any event, the penalty amount of the proposal bond should not exceed the amount that would be reasonably necessary to reimburse the City for the additional costs of re-issuing the procurement or selecting the next most responsive proposal in the event that the contractor is selected but chooses in bad faith not to move forward with the project.

It should be noted that the surety issuing a proposal bond is not necessarily obligating itself to write the final performance and payment bonds. It should also be noted that the surety's obligation to pay the penalty amount of the proposal bond would be determined by the terms of the contractor's proposal and the actions that the contractor took after contract award to negotiate and enter into a contract with the City. A contractor and surety would have no liability, for example, in the event that the contractor refuses in good faith to execute a contract that contains unreasonable contract provisions that were outside the scope of the City's procurement or the contractor proposal.

Performance and Payment Bonds

Performance and payment bonds are routinely requested or required where significant capital improvements will be constructed as part of the project, or surety for the operation and maintenance performance. The performance bond states that the contractor will perform a particular contract in accordance with the contract terms, plans, and specifications. The payment bond guarantees that the contractor will make payments to vendors and subcontractors for labor and materials used or reasonably used in the performance of the contract. Performance and payment bonds are irrevocable and non-cancelable by the surety. The obligations under the bonds remain until such time as the contract is completed and the bonds are released by the obligee. Surety bonds for operation and maintenance contracts are typically issued for annual periods. Surety companies normally charge a premium for performance bonds and issue associated payment bonds without charge.

Penal Amount

The penal amount of a performance bond is stated in the contract specifications, and usually it is 100 percent of the annual contract amount. Surety companies do have reduced rates/premiums that are applied when the penalty amount is reduced to 10 to 20 percent of the contract price. As a general rule, surety companies will not issue performance or payment bonds that have penal amounts greater than 100% of the contract amount.

Changes to Performance Bond Premium Necessitated by Change Orders

As previously mentioned, the premium for the performance and payment bonds is based on the annual contract price. At the beginning of the contract, the contractor is charged a premium based on the original contract price. The final premium for the bond is based on the final contract price. When negotiating change orders, it is extremely important that the bond premium for the change order be included in the change order amount.

Performance Bonds for Design-Build Projects

Performance bonds traditionally guarantee the obligation of a contractor to construct a project in accordance with the specifications for such project. Such bonds do not cover the obligation of the contractor to demonstrate that the project meet "acceptance" standards. This type of security is available separately in the form of efficacy insurance. The dramatic increase in design-build and design-build-operate delivery projects has been accompanied by the requirement that certain sureties include a requirement to demonstrate "acceptance" under the coverage. Owners seeking performance bonds in design-build and design-build-operate projects should be clear about what requirements must be covered by the bond as well as what is being offered by the private partner.

SECTION VII — City Responsibilities to Perform Contract Management During the Contract Term

Public sector responsibility to provide its ratepayers and customers with water and wastewater service does not end once a private sector operator enters the partnership and assumes operations and maintenance duties at the water or wastewater plant. It is, after all, in most instances the public sector that continues to own the water or wastewater plant asset and ultimately the public sector that remains accountable for that asset to its ratepayers and customers. For this reason, the City should continue to monitor and oversee, to the extent possible, the operations and performance of the contract operator to make sure the private operator is fulfilling its obligations under the service contract and is complying with applicable law. In practice, the scope of the City's oversight responsibility will be dependent on the size, sophistication and experience of the City's staff and the budget available to the City. Much of the oversight responsibility can be satisfied with requirements for the private contractor to periodically report on the condition and performance of the facilities as described in more detail below.

To facilitate communication and interaction between the private operator and its municipal client, monthly reporting against the contractual performance criteria and an oversight committee or advisory board should be established to provide an environment conducive to open management and the overall success of the partnership. In addition to the advisory board, a contract manager should be assigned, if possible, to oversee the implementation and management of the contract as well as act as the head liaison with the private operator. The contract manager role may be assigned to the City Manager or Director of Public Works depending upon the size of the City and the scope of those positions. It is important for the City to choose the right person to assume this very important responsibility. Since the City has delegated its operating responsibility to the private partner, selecting a person with contract management skills rather than operational experience has generally proved to be the most successful approach. The advisory board can be made up of five to ten individuals representing various disciplines and backgrounds within the community.

A dispute resolution process should be established at the onset of the contract to set ground rules on how to manage areas of uncertainty when unplanned events occur or issues arise that were not previously discussed, contemplated or agreed to in the contract.

Additionally, there are many related activities and obligations that Cities retain that generally will not be transferred to the private contractor. For instance, the City may choose to remain the central point of contact for the residents to contact for many types of customer service requests related to the project activities.

The City will retain its rate setting and enforcement rights even where the related administrative and operating activities are transferred to the private contractor. For instance, the private contractor may agree to provide billing and collection services but the City will retain the right to set the rates and the right and obligation to enforce such rates against the customer.

Although the private contractor may be tasked to perform certain security functions under the service contract, it is generally incumbent on the City to retain the ultimate responsibility for the security of the physical plant and surrounding area by providing appropriate security personnel and/or devices to protect against any losses resulting from the theft, damage, or unauthorized use of the facilities. This is especially true where the private contractor's hours of operation are limited during the workweek and on weekends. As a result of the post-9/11 security planning and response measures taken by all water and wastewater systems it is incumbent on both the public and the private partners to work closely together on security preparedness and emergency response.

Related to the above, the City's ownership of the facilities also generally dictates that the City is the party with the responsibility to procure and maintain property insurance on the facility. The City will also generally retain the planning and permitting functions and activities, including the responsibility to pay and respond to any enforcement actions or fines that are not the result of the private contractor's acts or omissions.

Frequently, a City will use the private contractor to develop and implement the City's capital improvements program. The private contractor will often develop an annual list of proposed capital projects for the client, and the private contractor's continued successful performance under the contract and applicable law may be dependent on the City funding and implementing certain capital improvements in a timely manner. The private contractor will also

likely be dependent on the City to keep in force all project warranties, guarantees, easements and licenses that have been granted to the City and are not transferred to the private contractor under the service contract. In certain instances, the City may allow the private contractor to utilize the City's vehicles, equipment and staff where appropriate as mutually agreed under the service agreement.

In summary, open and frequent communications and coordination between the City and the private contractor are imperative during the contract term to protect and satisfy the respective rights and obligations of the parties with the respect to the facilities and the City's ratepayers and customers.

SECTION VII — Method and Timing of Payment to the Private Partner and Related Issues

Service Fee Structure

Most public-private partnerships for water or wastewater projects involve a fixed price with an annual increase based on one or more economic indices such as the consumer price index. It may be beneficial to use a weighted average of various indices that more accurately reflect the types and proportion of costs associated with the service provided. Indices should reflect local economic conditions when appropriate. The amount of the fixed annual service fee is ordinarily established through the competitive proposal process. The company usually proposes a price based on its assessment of the costs of labor, operations, maintenance, repair and replacement, and similar services, as well as overhead, administrative costs, risk and profit. The private partner receives periodic service payments, usually monthly, over the term of the contract. Certain expenses and costs, however, such as the utility costs, may be passed through directly to the community, subject to guaranteed maximum utilizations. A contract will also allow for limited variable costs that may be incurred but were not included in the base level of service in the fixed fee basis set at the outset of the contract term. Although the service fee is generally a fixed fee, a contract will allow adjustments for uncontrollable circumstances or changes in influent loads or flows of raw water outside a specified range.

Costs to the private partner are generally higher immediately after assuming operational responsibility. The start-up costs may include planning, installation of equipment to improve the efficiency of operations, implementation of more efficient work processes, and training of personnel. A private partner occasionally loses money in the first year or two of the contract. The start-up costs are borne by the private partner, but constitute part of the overall service fee. Such costs, however, are recouped by the private partner over the life of the contract, and should reasonably be accounted for in establishing the fee for any early "convenience" termination.

Incentive Payments

Some contracts include incentive or award payments for performance that exceeds expectations, provided such performance can be defined clearly. Cities should consider benchmarking approaches to define what exceeds expectations. Incentives should be measurable, beneficial to the City and its water users, and generally deemed as attainable. Incentives can be included to complement, or in some cases, replace the performance guarantee damages approach. Incentive payments have been established, for example, for reducing electricity usage, improving customer service, reducing unaccounted-for water and achieving aesthetic goals or environmental protection goals that are clearly in excess of regulatory compliance standards. Incentive payments, however, are subject to the requirements of IRS Revenue Procedure 97-13 and other federal tax laws.

Repair and Replacement Costs

The contract should clearly establish the responsibility for repair and replacement costs. Generally speaking, Cities rely on private parties to pay for repairs based on the assumption that the proposer has figured such costs into their contingency pricing on repair and replacement. However, if proposers do not have adequate information on the condition of the equipment they may overestimate the pricing, and the City will pay more than is necessary. Or, the proposer may underestimate the pricing and may be the proposal winner but still be the loser because they may have to assume the unexpected costs. Thus, the City might pay more than is necessary, or the private party may lose money on the project. Neither outcome is optimal, and the latter may lead to a failure of the project.

Different communities have taken various approaches in such instances. A traditional approach is to establish a threshold amount for the cost of a repair on a per incident basis in the contract that is the responsibility of the private party. If the cost of a required repair exceeds the threshold, then the community pays. Some contracts require the community to pay only the amount in excess of such threshold, while other contracts may require the community to pay the entire amount for such repair if such threshold is exceeded. Experience suggests that many equipment components fall under established thresholds, thus, the private partner has a strong incentive to maintain equipment properly and to perform preventive maintenance. Alternatively, a contract may require that all repair and replacement costs, whether minor or major in scope, are included in the annual service fee, sometimes up to a set annual dollar cap.

The former approach requires a community to continually consult with the private partner as to whether the repair and replacement work is needed and, if so, the cost of such repair. The alternative method eliminates the need for such consultations and the potential for dispute. Additionally, because the private partner is required to perform all repairs and replacement as required, such approach represents a decision on the part of the community not to engage in deferred maintenance since such costs are already built into the annual service fee.

Considering that long-term partnership agreements offer benefits to both the public and private parties there should be some recognition that 10 or 20 year partnership arrangements can experience various levels of uncertainty regarding repair and replacement. It is in the best interest of both parties to maintain the proper care of the physical assets. It is difficult at best to make accurate estimates for repair and replacement. Discussions concerning asset maintenance should take advantage of engineering principles such as “weighted average useful life” for facility components. This may provide one way to better understand repair and replacement uncertainty. Ultimately, when a City decides how to deal with this uncertainty in contract language there should be some consideration given during contract negotiations to the potential need for cost adjustments over time. While there may not be a current contract standard that is inherently fair to all parties, the parties can at the very least identify some alternatives during the negotiation phase of the partnership agreement.

Cost Substantiation

Cost substantiation is the methodology by which the private partner demonstrates to the City that non-fixed costs for a service provided are reasonable and fair. For example, a contract may limit the private partner’s mark-up for labor and materials to limit future disputes with respect to variable fees submitted by the private partner. Such measures protect a community from over paying for services, which are not included in the fixed service fee payable to the private partner.

Dispute Resolution Process

Cities may want to consider a Dispute Resolution provision in the service agreement. Indianapolis, for example, established a Coordinating Committee comprised of senior City officials and senior private party executives that meets monthly to review “potential problems” before they become “disputes”. Face-to-face meetings of the Committee help the partners discuss contract term interpretations. It may be in the best interest of the partners to discuss, negotiate and settle disputes before they are directed to arbitration or Court.

Revenue Procedure 97-13

In order to maintain the existing tax-exempt status of debt previously issued for the system by a City, and the tax-exempt status of the City’s debt to finance any future capital needs of the system, the contract should be structured so as to constitute a management contract that does not result in private business use of property financed by the City within the meaning and intent of applicable regulations and rulings of the Internal Revenue Service including Revenue Procedure 97-13. In particular, in longer-term contracts the contract will provide that the City will be under no obligation to, and will not, pay compensation for services to the private partner for any year of the contract, if such payment, or any portion thereof, would result in less than 80% of the private partner’s compensation for services for such year of the contract being based on a periodic fixed fee or would result in any portion of the private partner’s compensation being based on net profit, as such terms are defined in Revenue Procedure 97-13.

Thus, up to 20% of the private partner’s compensation can be variable. The variable component provides additional compensation for work that is outside the private partner’s basic work scope. Such compensation may be

realized through adjustments for “flow and loadings” or “raw water parameters” that are outside base ranges, and incentive payments for savings in electricity usage against maximum guaranteed levels.

Costs that the company passes through to the City for reimbursement, and costs paid directly to third parties by the City, are disregarded in the fixed fee/variable fee ratio. Further, the private partner cannot have an interest in the net profits of the facility, and the facility cannot be leased to the private partner. Compliance with these rules allows project debt to be considered a governmental obligation, and therefore tax-exempt.

SECTION IX — Employment Issues

A major concern for Cities that are considering water partnerships is the status of City employees currently operating and managing water and wastewater facilities. The motivations for a City considering a partnership include, for example, cost-savings; increased regulatory compliance; capital investments and system rehabilitation; improved customer service; etc. It is often the case that Cities want to realize some or all of these public benefits, but they do not want the work force to suffer.

As the trend in water partnerships continues to favor longer term service agreements there have been some fundamental issues concerning the employees. The major issues here include: continued employment at current staffing levels, compensation and benefits; and, representation by collective bargaining units. A number of partnerships entered into by Cities provide examples of how these issues have been (and can be) handled via the service agreements.

Continued Employment

A number of Cities that have entered into long-term water partnerships have required the private party to retain all existing City employees. This requirement is often stated in the RFP, and the winning proposer must agree to the condition. Private parties often agree to take on the employees or make a conditional offer (subject to employee screening) for them to stay on the job. The private party usually only downsizes staff through attrition or because the City employee does not choose to remain on the job. Private parties, however, retain the right to dismiss employees for cause. Where employees are unionized, the bargaining process (i.e. Impact Bargaining) normally governs employee rights for continued employment as well as for seniority recognition, disposition of accrued benefits, pay and other benefit issues (see below). The requirement to retain all City employees may or may not apply to the current facility manager or general manager. It is standard procedure for the chief manager of the facility to be placed by the private party.

Some Cities offer employees the option of transferring to another position in the City. This allows the current employees a choice.

Water partnership experience indicates that continued employment has been both varied and flexible. A notable example of how the private partner retains current City employees includes water partnerships like Camden, New Jersey. The private party offered the 76 City employees continued employment with comparable or better benefits or severance packages. Thirty-one of the employees chose to take the severance package, transfer to another job in the City or take early retirement with benefits.

Another example is the Gary Sanitation District, Indiana. The private partner offered all 144 employees jobs. They were guaranteed benefits and compensation comparable to or better than what the City offered.

Yet another example is the Town of Stonington, Connecticut. Prior to the proposal being issued, nineteen employees operated the system. By the time the award was made to the private firm, four employees had transferred to the Town’s DPW. Eleven of fifteen remaining employees were offered jobs with aggregate compensation and benefits in accordance with the collective bargaining agreement of AFSCME Local 1302. The remaining four former employees were offered new union positions at a nearby project. All former Town employees received severance compensation from the Town.

Representation by Collective Bargaining Units

Water partnership arrangements have been very flexible with regard to unionization of workers. Partnerships do not exempt employers from labor laws; so, if employees vote to join a collective bargaining unit the employer (in this case the private partner) cannot prevent the employees from doing so.

During the first few years of a water partnership, or sometimes later in a partnership term, employees may choose to continue to remain with the existing union or to elect to be represented by a new union. Where unions are involved, the bargaining process is key and it must be allowed to proceed fairly for all parties. Provisions that address employee pay and benefits in the service agreement may no longer be appropriate. Initially, when the contract between the City and the private partner is negotiated, and a union does not represent the effected employees, the intent of the provisions concerning employee rights in the service agreement is to afford the employees relatively broad protection because, at the time, there was no other mechanism to address employee interests. This broad protection gives the employees an expectation of consistency that serves to initially effect a smooth transition while moving from public sector to private sector employment. Consequently, similar protective provisions that have been the subject of impact bargaining between the City and the Union should represent the same intent so as to pave the path forward for developing the independent bargaining relationship between the employees and those that represent them, and the private employer. This provides a platform for clearer communications between the parties of which ultimately has a direct effect on the level of service provided to the customer and ultimately the consumer.

One example of the flexibility of water partnerships involves Woonsocket, Rhode Island. Woonsocket entered into a 20-year partnership with a private partner. All 24 current employees were offered jobs at equal or better salary. The employees were represented by AFSCME as City employees; and as private employees they continue to be members of and represented by AFSCME.

Another example is Perth Amboy, New Jersey. The 39 current employees are “leased” from the City of Perth Amboy by the private partner. The employees have the same job descriptions and contractual benefits under the service agreement, and they are still represented by the same union, which is affiliated with AFSCME.

Milwaukee Metropolitan Sewerage District is another example. The private partner now employs all 233 employees. Every employee receives pay equal to what the public partner provided, but they receive enhanced benefit packages along with career training opportunities. The employees are represented by one of the following unions: the public employees union Local 366 of AFSCME–Council 48; the Milwaukee Building and Construction Trades Council, District 10 of the International Association of Machinists and Aerospace Workers of the AFL-CIO; and, the International Union of Operating Engineers–Local 317.

Some water partnerships have resulted in public employees shifted to become private employees, but they have voluntarily rejected unionized representation. This is the case in water partnerships in: the City of Glen Cove, New York; the City of Gardner, Massachusetts; Devens, Massachusetts; and, the City of Danville, Virginia.

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Mayors' Guide to Water and Wastewater Partnership Service Agreements

WHEREAS, The U.S. Conference of Mayors' Urban Water Council recognizes that federal government estimates place the need for investment in existing and new water and wastewater infrastructure at more than \$550 billion just to comply with the requirements of the Clean Water Act; and

WHEREAS, The U.S. Conference of Mayors' Urban Water Council has examined the need for water and wastewater infrastructure investment and has determined that local government currently provides 90% of the investment in water and wastewater infrastructure annually; and

WHEREAS, local government normally finances water and wastewater infrastructure investments via municipal/revenue bonds, and that competition for infrastructure bonds for other uses are competitive and effectively limit the amount that can be directed towards water and wastewater infrastructure; and

WHEREAS, The Urban Water Council has urged Congress to eliminate state volume caps for Private Activity Bonds (PABs) used for water and sewer projects; and

WHEREAS, The Urban Water Council encourages Cities to consider the benefits of public-private partnerships in water and wastewater infrastructure (including public-private partnerships in the form of contract operations, design-build-operate arrangements, build-own-operate arrangements, or other appropriate arrangements) as a way to save money, to ensure adequate water supplies, to achieve compliance with environmental rules, enhance water service provision and to maintain and improve water and wastewater infrastructure; and

WHEREAS, Local government experience in arranging long-term water and wastewater partnerships has grown and making informed decisions about partnership contract terms and conditions is important to protect the public partner, ratepayers and infrastructure asset, as well as the private party and infrastructure operator.

NOW, THEREFORE, BE IT RESOLVED that The U.S. Conference of Mayors recommends that Mayors considering water partnerships review and consider use of the *Urban Water Council Report—Mayors' Guide to Water and Wastewater Partnership Service Agreements*.

The Urban Water Council

A Task Force of the U.S. Conference of Mayors

The UWC is open to all Mayors, and functions like a USCM task force. It provides Mayors with a forum for discussion of issues impacting how cities provide and protect water and wastewater services to the community. Some of the issues that the UWC focuses on include: watershed management; water supply planning; water infrastructure financing; rehabilitation of surface and sub-surface water infrastructure; water conservation; wetlands construction and education programs; water system program management and asset management; etc.

The UWC will continue to develop local government positions on Federal legislation, regulations and policy. The UWC acts through the USCM Environment Committee, and other Committees, as appropriate, to propose and adopt resolutions on water related matters that benefits the nation's cities.

THE URBAN WATER COUNCIL

*The Urban Water Council acts as a
task fore for the U.S. Conference of Mayors*

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