

EXECUTIVE SUMMARY¹

FIRST AMENDMENT TO THE SECOND SUPPLEMENT TO WATER SUPPLY CONTRACT BETWEEN THE CITY OF HOUSTON, TEXAS AND THE NORTH HARRIS COUNTY REGIONAL WATER AUTHORITY

This Executive Summary outlines the most significant terms of the *First Amendment to the Second Supplement to Water Supply Contract between the City of Houston, Texas and the North Harris County Regional Water Authority* (the "First Amendment"). Like many of the Authority's other contracts with the City of Houston, Texas (the "City"), the First Amendment is a two-party contract between the North Harris County Regional Water Authority (the "Authority") and the City, and the City will execute other substantially similar two-party contracts with the West Harris County Regional Water Authority, the Central Harris County Regional Water Authority and the North Fort Bend Water Authority (collectively, the "Other Authorities"), respectively. Because the First Amendment alters the Second Supplement to Water Supply Contract (the "Second Supplement"), pursuant to which the City, the Authority and the Other Authorities, (collectively, the "Project Parties") are constructing a 320 million gallons per day ("MGD") expansion (the "Expansion Project") of the City's Northeast Water Purification Plant (the "NEWPP"), representatives of all Project Parties participated in the negotiation. This First Amendment builds on collaborative structure created in the Second Supplement for the construction of the Expansion Project and extends similar concepts into the operation and maintenance thereof.

Background

The City and the Authority have a long history of cooperation in order to meet their collective water supply needs, and the First Amendment is another step in that cooperation. However, before providing a summary of the First Amendment, a review of several past City/Authority contracts is instructive.

Original Water Supply Contract. The *Water Supply Contract between the City of Houston, Texas and the North Harris County Regional Water Authority* (the "Original Contract"), effective December 16, 2002, laid the foundation for the Authority to comply with the Harris-Galveston Subsidence District's (the "HGSD") initial groundwater reduction mandate. By the Original Contract, the Authority acquired a contractual right to receive 31 MGD of treated surface water from the NEWPP. In addition to providing for the initial 31 MGD of treated surface water, the Original Contract set forth a procedure by which the Authority could purchase additional water to meet its future needs.

Nothing in the Original Contract allows the Authority input into the procurement, design, construction processes or operations of any facilities. In addition to the Authority, the Other

¹ This Executive Summary is not an exhaustive review of all terms of the First Amendment. The First Amendment contains additional provisions related to the topics discussed herein that are not fully described in this Executive Summary, as well as provisions regarding other issues.

Authorities each executed contracts substantially similar to the Original Contract with the City, but their contracts included different water capacity amounts and, in the case of the West Harris County Regional Water Authority and the North Fort Bend Water Authority, contemplated receiving water from a different water plant owned by the City.

First Supplement. The First Supplement to the Original Contract provides for the funding and construction of the Luce Bayou Interbasin Transfer Project ("Luce Bayou"), which will move raw water from the Trinity River into Lake Houston for treatment at the NEWPP/Expansion Project. The First Supplement outlines the parties' rights and duties related to the construction of Luce Bayou. Upon completion of Luce Bayou, the Authority will acquire an additional 128 MGD of raw water capacity, bringing its raw water capacity to 159 MGD and leaving its treated water capacity at 31 MGD.

Much like the Original Contract, nothing in the First Supplement allows the Authority input into the procurement, design, construction processes or operations of Luce Bayou. Also, as with the Original Contract, the Other Authorities each executed contracts with the City that are substantially similar to the First Supplement, but for varying quantities of raw water.

Second Supplement. After increasing its raw water capacity in the First Supplement, the Authority needed to increase its treated water capacity, which is precisely the purpose of the Second Supplement. The Second Supplement facilitates the design and construction of the Expansion Project so the Authority can use the raw water capacity it acquired in the First Supplement. Upon completion of the Expansion Project, the Authority will increase its treated water capacity by 113 MGD to a total of 144 MGD. In addition to acquiring additional treated water capacity, the Second Supplement gives the Authority a contractual right to participate in procurement, design and construction decisions related to the Expansion Project.

Considering the enormous investment in the Expansion Project by each of the Project Parties, once construction began, the Project Parties began to negotiate a contract to govern the maintenance and operation of the Expansion Project, which is the purpose of the First Amendment. The remaining paragraphs of this Executive Summary outline the most important aspects of the First Amendment. The theme of the Authority having a contractual right to participate in decisions by the City that impact the Authority that begin in the Second Supplement continues in new and significant ways in the First Amendment.

First Amendment

As mentioned above, the First Amendment addresses the operation and maintenance of the Expansion Project and protects each of the Project Parties' investments therein. The First Amendment accomplishes four (4) primary objectives: (i) creation of a Facilities Management Committee to oversee Expansion Project operation and maintenance; (ii) accountability for the amount of water taken by each Project Party; (iii) the impact of the phased construction of the Expansion Project on the Authority's ability to receive water during construction; and (iv) accommodating leases of treated water capacity between Project Parties. The following paragraphs will briefly describe how the First Amendment addresses each of these areas.

Facilities Management Committee ("FMC"). The Authority currently has no formal mechanism for input into the management of the existing NEWPP. This situation will not exist for the Expansion Project because the First Amendment creates the FMC and gives it broad powers related to the Expansion Project. Through the FMC, the Authority will have unprecedented input into operations and maintenance decisions affecting the Expansion Project and will enable the Authority to better protect its investment.

The FMC will be comprised of five (5) people, one appointed by each of the Project Parties. The FMC will meet at least once per calendar quarter, but Houston or any two (2) of the water authorities can call a meeting by providing seven (7) days' written notice to the other Project Parties. At the initial meeting, the FMC will adopt written rules and procedures for its administration. The FMC acts by the same written Consensus Vote process currently utilized under the Second Supplement (more than 63% of Expansion Project capacity required to pass a vote).

The First Amendment provides that the FMC will oversee "matters related to operations, staffing, use of third party operators, budget, maintenance, and rehabilitation of the Expansion Project" and "facilitate the smooth operation of the Expansion Project in accordance with" an operations and maintenance manual to be adopted by the FMC. The FMC can make decisions related to any of these subjects and those decisions must be implemented by the City unless doing so would violate: (i) applicable law; (ii) Houston's employment standards/policies or contract procurement procedures adopted by the Mayor or City Council; or (iii) regulatory requirements related to workplace safety, public safety, operations or regulatory compliance.

However, the ability of the FMC to make decisions carries little weight if the City cannot fund the cost of those decisions. As a result, the FMC will oversee deposits into and expenditures from the newly established Capital Renewal Fund and O&M Reserve Fund, both of which the City will maintain as separate, segregated accounts held in trust for the Project Parties.

The Capital Renewal Fund will be used only for Major Rehabilitations (capital projects estimated to cost more than \$500,000). The Project Parties deposit money into the Capital Renewal Fund in two (2) ways. First, any Project Party that takes more than its share of water from the Expansion Project must pay an Excess Usage Fee on the overage (further discussed under Accountability below) and all such payments are deposited into the Capital Renewal Fund. Second, the FMC may, by written Consensus Vote, establish the need for money, in which case the City will issue cash calls to each Project Party to fund their respective pro rata shares of the total amount required. Therefore, the FMC by written consensus vote can: (i) decide a Major Rehabilitation needs to occur at the Expansion Project; (ii) cause the Project Parties to deposit into Capital Renewal Fund the money necessary to fund the Major Rehabilitation; and (iii) cause the City to utilize the Capital Renewal Fund to complete the Major Rehabilitation.

The O&M Reserve Fund will be used for maintenance items identified by the FMC that cost less than a Major Rehabilitation. The Project Parties deposit money into the O&M Reserve Fund only when required to do so after a written Consensus Vote by the FMC. Much like with the Capital Renewal Fund for Major Rehabilitations, the FMC by written Consensus Vote can: (i) decide a specific maintenance item needs to occur at the Expansion project; (ii) cause the

Project Parties to deposit into O&M Reserve Fund the money necessary to fund the work; and (iii) cause the City to utilize the O&M Reserve Fund to complete the work.

For both Major Rehabilitations and smaller maintenance items, if the work has already been included in the Annual O&M Budget, on which the Estimated O&M Rate the Authority pays each month for water is based, the work will already have a funding mechanism and neither the Capital Renewal Fund nor O&M Reserve Fund should be utilized. As a result, these funding mechanisms exist to facilitate work for which the City has not budgeted, but the FMC determines by a written Consensus Vote should occur.

In short, the creation of the FMC in the First Amendment represents a significant improvement for the Authority's ability to have input into the operations and maintenance of the Expansion Project. The City's agreement to allow the Authority (and the Other Authorities) this level of input into previously City-only decisions recognizes the many-year partnership among the Project Parties, as well as the magnitude of their respective investments.

Accountability. The Project Parties have all been concerned about ensuring no party utilizes water of another party, thereby causing the Expansion Project to run harder than required and/or depriving a party of its treated surface water. In order to address this concern, the First Amendment creates an Excess Usage Fee payable by any Project Party exceeding its capacity in the Expansion Project (for the Authority, 113 MGD). The Excess Usage Fee Rate will equal the then-current rate the City charges to customers for contract treated water without an airgap, currently \$3.84 per 1,000 gallons. The Excess Usage Fee will apply only to the volume of water taken in a given month in excess of a Project Party's capacity in the Expansion Project and will be charged in addition to the Estimated O&M Rate. As noted above, the City will deposit all Excess Usage Fee Payments into the Capital Renewal Fund in order to pay costs for future Major Rehabilitations identified by the FMC.

Phased Construction. The First Amendment clarifies issues caused by the anticipated phased completion of the Expansion Project. The Second Supplement assumes a Phase 1 of 80 MGD and a Phase 2 of 240 MGD. However, the contractor intends to bring Phase 2 online in multiple sub-phases of 80 MGD each. As a result, the First Amendment clarifies that as sub-phases in Phase 2 are substantially complete the Project Parties will share the capacity in the sub-phase pro rata. For example, if Phase 2 is subdivided into two sub-phases (the first being 80 MGD and the second being 160 MGD), then one-third of the Authority's Phase 2 capacity will be available to the Authority upon substantial completion of the first sub-phase and the remaining two-thirds will be available upon substantial completion of the second sub-phase.

Leases. The Original Contract and the Second Supplement will remain in effect until January 1, 2080, another 60 years. However, the Project Parties have a limited ability to accurately project surface water supply demands over such a long period of time. As a result, the Project Parties agreed to allow leasing of Expansion Project capacity among them without requiring the approval of any other Project Party. The First Amendment is largely silent on the terms and conditions of any such lease, thereby allowing the lessor and lessee to determine the terms favorable to them at the time of the lease. However, the First Amendment does require: (i) the weighted vote of any Project Party for Consensus Vote purposes will not change as a

result of a lease; and (ii) determinations of excess water usage by a lessor or lessee will account for the amount of water subject to the lease.

Conclusion

The First Amendment is another step in the many-year partnership among the Project Parties to meet the water supply needs of the Houston region. The Original Contract set the stage for the Authority to acquire the 31 MGD of treated surface water it needs to comply with the HGSD's initial 2010 groundwater reduction mandate. The First Supplement and Second Supplement allow the Authority to receive an additional 113 MGD of treated water capacity to enable the Authority to comply with the HGSD's 2025 groundwater reduction mandate. The First Amendment gives the Authority input into the operation and maintenance of the Expansion Project, so the Authority can confidently expect the Expansion Project to supply the Authority with the anticipated volume of surface water for decades to come.