

BROOKTRAILS TOWNSHIP

COMMUNITY SERVICES DISTRICT

24860 BIRCH STREET

WILLITS, CA 95490

(707) 459-2494

FAX (707) 459-0358

e-mail: btcSD@pacific.net

September 15, 2004

Ross Walker, City Manager
City of Willits
111 East Commercial Street
Willits, CA 95490

Re: City of Willits - Brooktrails Township CSD
Sewer Agreement

Dear Ross:

The Board of Directors has authorized me to forward this letter to you to propose an adjustment to the Agreement For Disposal of Sewage by and between the District and the City.

There are two topics requiring attention: (1) flow measurement, and (2) accounting verification.

As to flow measurement, the primary goal is achieve verifiable allocation for the future. The Second Amendment, at Paragraph 15, provides that the City will maintain a weir and metering recording facility on the District outfall line at the City boundary from which the District flow may be ascertained and recorded. We have mutually experienced frustration in maintaining and calibrating two separate meters. We believe that Dale Fraser, a calibration engineer, represents a resource to settle upon one calibration schedule for one jointly maintained and operated meter to record the Brooktrails flow. Technological advances will permit us to each have real-time information as to the meter readings. Therefore, we propose that we mutually retain Dale Fraser to calibrate the most accurate of the two existing meters and to develop a calibration schedule to maintain the accuracy of the measuring meter.

The denominator meter has also experienced limitations in accurately recording total flow because it is an inverted siphon rather than a true flume meter. I understand that it is not possible to bring the denominator meter into compliance with the Agreement and it is not possible to accurately measure wet weather flows. It is apparent that until the new disposal system comes online, we will have to live with the existing denominator meter, so it would make sense to agree to a formula to estimate total flow during times it cannot be properly measured. However, we propose that we take any reasonable steps to increase the accuracy of the denominator meter for the interim period, and consult with each other as to the measuring protocols for the new disposal system.

"A California General Law Local Government"

As to accounting issues, we have had a fundamental difference of opinion as to the City's financial reporting requirements under the Agreement. Succinctly stated, it has been the District's opinion that the City is required to have its sewer expenses stated separately in accord with accepted municipal accounting practices, and audited. The Audit Report received by the District since 1996 has been out of compliance with the District's interpretation of the Agreement to the extent that it relies entirely upon data supplied by City staff to the auditor, rather than upon an independent examination and verification. The City's position has been that the documentation supplied to the District is encompassed within an audit report and that the submissions constitute compliance with the Agreement.

To evaluate this issue, the District retained Terry Krieg and Associates (CPA) to audit the FY 01-02 and FY 02-03 years at a cost to the District of over \$25,000. The audit has been prepared, reviewed and finalized. While the audit is complimentary of the City's accounting staff for its maintenance of City financial records, particularly as those records tie between the charges to the District and identifiable City expenses, it exposes systemic overstatement of allocated expenses to the Sewer Operations account for the years in question.

These systemic overstatements of expenses have accumulated over the years, but were identifiable only through an audit such as was commissioned by the District, it not being otherwise ascertainable from the level of detail provided by the City to the District in its Annual Report. While many of the systemic accounting errors were unintentional, and not always necessarily in favor of the City over the District, the absence of allocation verification over the past six years has accumulated in a level of arbitrary estimation and error which should be unacceptable to both entities.

The District has shelved potential arbitration of accounting issues in favor of developing a forward-looking tightening of accounting accuracy. Therefore, the District is more interested in correcting these matters for the future than seeking credits for past overpayments. It is not then necessary to outline the identified accounting issues at length, because the District does not propose herein to resolve those prior year differences, or to seek credits for past errors. In an appendix to this letter, I provide a summary of findings illustrating the types of accounting issues we propose to resolve prospectively, rather than retrospectively.

We have several proposals as to various methods by which we could address accounting issues in the future to resolve the accumulation of error into statements of expenses, and would be willing to entertain any other proposals or comments the City may have in showing up the accuracy of the statement of expenses. The District's proposals for resolving these are:

(a) Utilize the District's interpretation of the existing Agreement as requiring an audit of the allocated expenses to the District in the level of detail as that performed by Krieg and Associates, at the expense of the City. This expense is approximately \$12,000 per year. We understand that the City has in the past resisted this interpretation. Therefore, we propose the following alternate means to achieve the same end:

(b) On an annual basis, settle upon allocated operational charges to the District by agreement in January, providing for an expedited, amicable arbitration procedure to resolve any differences that the staffs cannot work out within a specified time frame of sixty days. We would propose that the time frame work back from the time necessary for the parties to establish rates for the forthcoming fiscal year. We see the advantage to this approach as being that any disagreements would be prospective rather than retrospective, and could foster consensus rather than potential confrontation. For example, allocation of indirect costs unsupported by documentation would be negotiable given all relevant facts. As it stands now, the City makes an arbitrary allocation which the District must either accept or arbitrate.

(c) Proceed with the current contractual language, but with the District retaining an auditor each year to audit the allocated expenses and the parties negotiating the expense of such an audit.

(d) Lastly, the District is willing to pursue the concept of a Joint Powers Agency approach to management and funding of the new disposal system so as to synchronize operations and funding between the two entities. This is a radical approach ranging far beyond flow measurement and accounting verification issues into the topic of operating efficiency. Surely, there are advantages and disadvantages to such an approach, but at this juncture it does serve us both well to consider whether there are better ways to mutually provide service to our respective citizens. This proposal is offered merely for the sake for putting it on the table for discussion, with the caveat that it is not advocated by the District at present as a solution, but merely as a possible approach to adjusting the relationship and improving the overall delivery of service.

These approaches are not intended to be exclusive of any suggestions by the City, which suggestions are welcome.

With the issues framed as above, I believe that it would now be appropriate for you and our respective counsels to meet at your convenience to develop a solution to the issues identified herein.

Yours very truly,

BROOKTRAILS TOWNSHIP COMMUNITY
SERVICES DISTRICT

MICHAEL CHAPMAN
General Manager

cc: Board of Directors
Christopher J. Neary
Terry Krieg

APPENDIX - SAMPLING OF ACCOUNTING ISSUES

1. Allocation of Administrative Overhead. The allocation of administrative overhead to the sewer department included a number of allocated items which would typically be excluded in allocated operating costs, such as City Council compensation and benefits, election costs and postage. Technically, the allocation to Sewer Operations for 2002-03 was \$139,844 and for 2001-02 was \$145,245. The respective allocation of administrative overhead was \$41,971 and \$45,245. Intuitively, the assigned allocation of administration costs of this magnitude seem quite high for the administration of a small sewer department.

2. Insurance. The City received insurance rebates which were credited back to the General Fund rather than to the Sewer Department. Mr. Krieg determined that the City had received refunds of \$81,171 in 2001-02 and \$72,568 in 2002-03, the net result being an overstatement of expenses to the District because the District was functionally excluded from enjoying the benefit of the credit.

3. Electricity. Similarly, the City received rebates from PG&E totaling \$12,934 in 2001 and \$9,289 in 2002. While the District shared in the allocation of the original expenses, the credits were made back to the sewer maintenance fund, rather than the sewer operations, the which functionally excluded the District from enjoying the benefit of the credit.

4. Allocations.

(A) There is insubstantial documentation of City staff time which is accounted for in each of the departments in payroll registers without documentation of activities which leads to estimation of time without sufficient backup. It has been identified that the Utility Supervisor was assessed an 85% allocation to the sewer operations budget, but was responsible not only for sewer plant operations, but also sewer maintenance crews and water plant personnel, as well as many federal and state regulations relating to drinking water safety issues. Perceptionally, the District has reservations about this allocation, particularly in that it is not documented within governmentally accepted accounting tolerances.

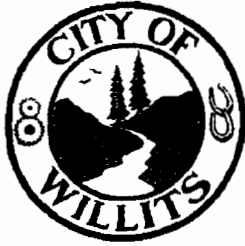
(B) It also appears that in addition to the City's general overhead allocations to the sewer operations budget, which includes all salaries, the City Manager and the City Finance Director's salaries are also directly allocated, resulting in a double allocation of these expenses. This of course results in overstatement of sewer operation expenses, a portion of which is passed on to the District.

(C) Power Costs. There is no explanation as to why most power costs are charged to treatment (which cost is shared by the District) and so little charged to collection, which is not shared. Attempts to investigate this allocation were frustrated by the unavailability of the PG&E invoices or documentation as to the allocation.

(D) Similarly, arbitrary allocations are assigned to sewer operations for engineer retainer and the City attorney.

In short, the allocation and apportionment system currently utilized is not qualitative and as such, leads to potential distortions and overstatement of the District's share of expenses.

5. **Capital Costs.** Furthermore, capital costs are not accounted for and tracked in a way that assures that the costs are incurred solely for sewer operations, or in a way which classifies capital costs in accord with the Second Amendment, or in allocation between capacity costs, quality improvements or replacement costs.



CITY OF WILLITS

CITY HALL - 111 East Commercial Street, (707) 459-4601 • Fax (707) 459-1562
POLICE DEPARTMENT - 125 E. Commercial St., (707) 459-6122 • Fax (707) 459-0405
Willits, CA 95490

November 2, 2004

Mike Chapman
Brooktrails General Manager
24860 Birch Dr.
Willits, CA 95490

Dear Mike:

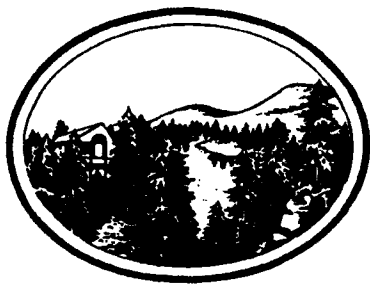
In regard to your September 15, 2004 letter, I would like to obtain a copy of the Audit which was prepared by Terry Krieg. I believe this document would be useful in our analysis of the points you raise in your letter.

Thank you for your consideration of this request.

Very truly yours,

Ross Walker
City Manager

cc: Pat Frost, Finance Director



BROOKTRAILS TOWNSHIP

COMMUNITY SERVICES DISTRICT
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November 10, 2004

Ross Walker
City of Willits
111 East Commercial Street
Willits, CA 95490

Re: City of Willits - Brooktrails Sewer Agreement
Your Letter of November 2, 2004

Dear Ross:

In your letter of November 2, 2004, you requested a copy of the Audit which was prepared by Terry Krieg to be utilized by you in analyzing the points raised in our September 15 letter. On November 8, 2004 you indicated by telephone that the Audit would also be useful to consider the City's approach to its own audit.

The Board of Directors had previously instructed me to maintain all applicable privileges with respect to the Audit. To accommodate your request, the Board of Directors on Tuesday, November 9, 2004 approved release of the February 10, 2004 transmittal by Terry Krieg consisting of 41 pages without waiving any applicable privileges, except as to the released data. This transmittal is made subject to the following conditions:

1. It is to be used only for the City's internal purposes in testing your accounting procedures. As you can see from the Audit, our arrangement with Mr. Krieg was that the Audit would be used only by Brooktrails and should not be relied upon by those that did not participate in determining the procedures. We are happy to release the Audit with the expectation that you receive it only for your internal use, and not for reliance upon any of its conclusions, or for any other use.
2. The second condition is that the release of this Audit shall not be construed to be a waiver of any applicable privileges for subsequent Audits prepared Mr. Krieg interpreting these audit results and/or documents considered by the Brooktrails Board in Closed Session.

Ross Walker, Esq.
November 10, 2004
Page 2

Although the draft Audit dated February 10, 2004 is marked "Draft," the significant changes from the draft Audit and the final Audit related to PG&E invoices which could not be located at the time the February Audit was prepared, but were subsequently supplied by City Staff to Mr. Krieg.

Hopefully, the release of this Audit will facilitate your internal accounting review.

In light of your request for a copy of this information, I will point out that our letter of September 15, 2004, indicated that the District was prepared to shelve potential arbitration of accounting issues in favor of developing a forward-looking tightening of accounting accuracy. In our letter of September 15, we outlined that the District is more interested in correcting accounting matters for the future than in seeking credits. It was for that reason we did not outline accounting issues at length and included an Appendix merely to illustrate the types of accounting issues we proposed to resolve prospectively, rather than retrospectively.

Again, with respect to our letter of September 15, 2004 we are looking forward to the City's responses to our suggested approaches, or other suggestions the City might have, and also in establishing the meeting suggested in our letter of September 15 to develop any appropriate contract adjustments, both with respect to these issues and with respect to the proposed sewer facility.

Sincerely Yours,

BROOKTRAILS TOWNSHIP COMMUNITY
SERVICES DISTRICT



MICHAEL CHAPMAN
General Manager

cc: Board of Directors
Christopher J. Neary, Esq.
Terry Krieg, CPA



BROOKTRAILS TOWNSHIP

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December 7, 2004

Ross Walker — City Manager
City of Willits
111 E. Commercial St.
Willits, CA 95490

Re: Proposed Fourth Amendment Disposal of Sewer

Dear Ross,

I understood by your November 17th telephone call that you felt it best to withdraw the proposed agreement that the City submitted to the District last month.

We are mindful that the ability of Brooktrails to pay its fair share has been raised, and we are proposing an alternative agreement that more closely tracks with a typical revenue bond arrangement*, whereby a revenue stream is identified and dedicated to payment of the loan obligation. We have also proposed a late charge payment arrangement; and a security interest in the District's dedicated Revenue Fund (ie. sewer fund). We further dropped the prohibition of a prepayment penalty as USDA does not impose such a remedy.

Lastly, we need clarification about the amount of additional plant capacity the project will produce. Originally, the Second Amendment was based upon two simple concepts: dry weather flow and wet weather flows. In response to that question, SHN referred the District to Table 18 on page 40 of the May 2004 Preliminary Engineering Report. Unfortunately, we found that the nine parameters listed in this table tended to more obscure, rather than clarify the question. We need to narrow the parameters to easier contractual concepts.

We also look forward to also resolving the issues raised in my September 15, 2004 letter.

Yours truly,

Mike Chapman
General Manager

Encl: Proposed Fourth Amendment

* We are also still agreeable to returning to the original concept of the District and the City each obtaining their own loans from USDA if that were feasible (possible) and more desirable than the present approach.

DRAFT

FOURTH AMENDMENT
TO
AGREEMENT BY CITY OF WILLITS FOR DISPOSAL OF SEWAGE
FROM BROOKTRAILS TOWNSHIP COMMUNITY SERVICES DISTRICT

This Agreement, is made this _____ day of _____, 200_, by and between the CITY OF WILLITS, a California general law city (the "City") and BROOKTRAILS TOWNSHIP COMMUNITY SERVICES DISTRICT, successor in interest both to BROOKTRAILS COMMUNITY SERVICES DISTRICT and to BROOKTRAILS RESORT IMPROVEMENT DISTRICT (the "District").

WHEREAS, the parties make this Agreement with reference to the following facts and understandings:

R E C I T A L S

- A. On September 11, 1967 City and District entered into a written agreement entitled Agreement by City of Willits for Disposal of Sewage from Brooktrails Resort Improvement District (the "Original Agreement").
- B. City and District have now amended the Original Agreement on three separate occasions, by written agreements entered into on April 17, 1970 ("First Amendment"); November 21, 1975 ("Second Amendment"); and September 8, 1982 ("Third Amendment"). By the terms of the Second Amendment, the First Amendment was repealed and rescinded and no longer has any force or effect. The Second Amendment also made substantial revisions to the Original Agreement, and those revisions remain in effect and continue to bind the City and District, except to the extent modified by the Third Amendment.
- C. After City and District entered into the Second Amendment, a new waste water treatment plant was constructed which now serves the City and District. The plant has design flows of 1.3 million gallons per day ("mgd") average dry weather and 3.0 mgd peak weather flows for the plant results in discharge in violation of the Water Quality Control Plan for the North Coast Basin as adopted by the North Coast Regional Water Quality Control Board ("NCRWQCB") under Order No. R1-2001-71. Consequently, NCRWQCB has issued Cease and Desist Order No. R1-2001-77 requiring City to cease and desist from discharge and threatening to discharge in violation of WDR Order No. R1-2001-71.
- D. In response to the Cease and Desist Order, City has prepared an engineering design report entitled "Preliminary Engineering Report Waste Water Treatment Facilities Upgrade (May 2004)" and therein has recommended certain improvements which will bring the system substantially into compliance with the Basin Plan standards and increase waste water treatment capacity by replacing a major portion of the existing waste water treatment plant equipment, machinery and facilities with a "new plant" which will utilize oxidation ponds and a wetlands area.
- E. City has obtained a commitment from Rural Utilities Service, U.S. Department of Agriculture (the "USDA") for a grant in the sum of One Million Dollars (\$1,000,000.00) and a loan amount of Ten Million, Two Hundred Eight-Five Thousand Dollars (\$10,285,000.00) payable over forty years to construct the new plant (the "USDA Loan").
- F. City and District wish to share in the cost of the new plan and apportion between them the loan payment responsibility and incremental plant capacity resulting from these improvements.

NOW, THEREFORE, City and District agree as follows:

1. **Effective Agreement.** Except as modified by the express terms of this Agreement, the Original Agreement, as amended by the Second Amendment and the Third Amendment shall remain in full force and effect.
2. **Apportionment of Costs.** The District shall pay 37.69% of the ~~USDA Loan~~ being the sum of Three Million, Eight Hundred Seventy-Six Thousand, Four Hundred Sixteen and 50/100ths Dollars. In the event that the apportioned cost increases, City shall notify District in writing before invoicing such cost.

DRAFT

3. **Time and Manner of Payments.** The District's contribution toward the repayment obligation to the USDA shall be paid semi-annually in equal installments on the fifteenth (15th) day of _____ and the fifteenth (15th) day of _____ each year, commencing on _____, 20____. The District will have in effect at all times that the loan obligation to the USDA is outstanding an ordinance of the District establishing fees, tolls, rates and other charges for and rules and regulations relating to sewer service, which shall raise gross income and revenues deriving from fees, tolls, rates and other charges, together with interest earned thereon, excepting all refundable deposits made to establish credit, which shall hereinafter be referred to as "Revenues" to a level that, beyond all reasonable doubt, will yield a sufficient amount equal to the amounts necessary to make the semi-annual payments required of the District herein.

4. **Separate Sewer Revenue Account.** The Treasurer of the District shall establish a Revenue Fund as a separate fund, into which the Treasurer shall deposit all Revenues as they are collected and received by the District for the purpose of depositing all Revenues designated by District for payment of the semi-annual payments as they are collected and received by the District (the "Fund").

5. **Right to Audit.** The City shall have the right to audit, at its expense, District's books, records and accounts in order to insure that the District is raising sufficient funds and segregating such funds for payment to the City sufficient to pay the District's cost share of the USDA Loan repayment as provided herein.

6. **Security Interest.** The District shall grant a security interest in the Fund to the City to secure the obligations set forth in this Agreement.

7. **Default.** In the event the District is delinquent in any payment to the City as required hereunder, District shall pay a late charge of five percent (5%) of the amount of the delinquent payment.

8. **No Warranties.** City has made no representations or warranties regarding the amount of additional plant capacity that may result from the completion of the improvements contemplated hereunder. However, City shall certify to District in writing within thirty (30) days after improvements are complete the total amount of incremental capacity available and the portion of incremental capacity to which the District shall be entitled, consistent with the District's financial contribution hereunder.

9. **Accounting for Operational Costs.** [insert any agreement entered into between City and District concerning tightening of accounting allocations as suggested in Mike Chapman's September 15, 2004 letter to Ross Walker].

CITY OF WILLITS

BROOKTRAILS TOWNSHIP COMMUNITY
SERVICES DISTRICT

By: _____
KAREN OSLUND, Mayor

By: _____
CHARLES A. ORTH, President
Board of Directors

Attest:

Attest:

City Clerk

MICHAEL CHAPMAN
Secretary to the Board of Directors

Approved as to form:

Approved as to form: