

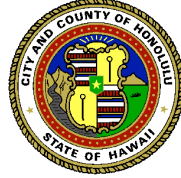
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November 30, 2015

Mr. Edwin S.W. Young, City Auditor
Office of the City Auditor
City and County of Honolulu
1001 Kamokila Boulevard, Suite 216
Kapolei, Hawaii 96707

Re: Audit of the Department of Environmental Services' H-POWER
Contracts and Procurement Practices Dated November 2015:
Management Response

Dear Mr. Young:

The City and County of Honolulu ("City") asserts that the Audit of the Department of Environmental Services' H-POWER Contracts and Procurement Practices Dated November 2015 ("Audit") contains numerous erroneous or misleading conclusions based upon facts that are inaccurate, ignored or simply misunderstood. The City believes that this is due to the fact that the Office of the Auditor ("Auditor") is unfamiliar with waste-to-energy ("WTE") facility operations, so consequently does not understand the negotiations or resulting contract language required for complex WTE facility operations of the magnitude of H-POWER, and does not have expertise in procurement law, especially in contrast to the State Procurement Office. The City asserts that due to these failings, many of the report's findings and conclusions should be re-evaluated or outright dismissed.

The Audit is particularly disappointing because despite the City making all information and supporting documentation relating to H-POWER available to the Auditor during the two year review process and working with the Auditor to pinpoint, emphasize and explain the volumes of information, the Auditor disregarded the majority of the City's explanations, claimed that relevant information was "not within the scope of the audit," and insisted on perpetuating

conclusions that are not applicable to the H-POWER Contract and which, if implemented, would jeopardize the WTE component of the City's solid waste management responsibilities. Even the few corrections that the Auditor did make as a result of the City's efforts revealed the Auditor's failings.¹

I. H-POWER Contract Overview

The original H-POWER construction and operating contract was competitively bid and entered into prior to the enactment of the Procurement Code. For the Third Boiler Expansion (i.e., the primary bases for the extension of the term of the Contract), the Department of Environmental Services ("ENV") consulted with the Department of Corporation Counsel ("COR"), the Department of Budget and Fiscal Services ("BFS"), and the State Procurement Office ("SPO") as to whether competitive bidding was necessary. ENV, with the assistance of the other advising agencies, determined that it was in the best interest of the City to extend the existing agreement with Covanta pursuant to the Original Contract's "right of first refusal" clause. This extension benefited the City because it would mean reduced costs and fewer delays and operational complications over the life of the Contract.

Even the initial cost of the Third Boiler Expansion project (Amendment 11) was reduced from \$370M to \$302M by the City negotiating team, established by the Mayor. Ultimately, the project was completed on budget and four months ahead of schedule. Contracting with another contractor would have required very costly demobilization and remobilization at the City's expense. Also, it would likely have put the Purchase Power Agreement ("PPA") with Hawaiian Electric Company ("HECO") at risk because of the time needed by a new contractor to replace Covanta and take over the operation and maintenance of the H-POWER Facility ("Facility"). Consequently, H-POWER would have had difficulty delivering power to HECO, and the City would have been liable for liquidated damages for nonperformance under the PPA. Also, these delays and difficulties would likely have resulted in more waste going to the landfill rather than to H-POWER.

¹ For example, the Audit originally claimed that the Third Boiler Expansion Project resulted in a cost change of 6,298.32% based upon the Audit's assertion that the original estimated cost for the third boiler construction was \$5,900,000. This is an egregiously inaccurate conclusion. The original estimated cost for the construction of the Third Boiler Expansion Project was never \$5,900,000, and if the Auditor had experience with this type of project, they would have known that the cost for a project of this magnitude would be more than \$300,000,000 and could never be as low as \$5,900,000. It is likely that the Auditor confused the cost for the **Planning and Design** for the expansion (which was approximately \$5,900,000) with the cost of the actual project.

The City has received top awards for the H-POWER project from national associations - the American Society of Mechanical Engineers and the Solid Waste Association of North America - for being one of the more innovative and high performing projects among all U.S. WTE plants. These are not the metrics of a poorly developed project. The Facility today effectively manages the City's waste, provides energy revenue for the City, has stabilized waste management costs, reduced risk, and generated value for the City and its taxpayers.

For such a major long term undertaking, contract amendments and change orders are inevitable. The number and magnitude of these changes for this contract were very much in line with WTE operations and are reasonable. Some of the major changes greatly enhanced the project. For example the innovative approach taken to accelerate construction of the Expansion cooling tower allowed the existing plant to continue to operate throughout the entire construction period while completing the total refurbishment of the existing cooling tower so both would be ready for operation when the Expansion construction was complete. This allowed continued generation and sale of electricity at maximum capacity in an uninterrupted manner greatly increasing City revenue during these time intervals. Addition of the sludge receiving and processing system this year has eliminated potentially more than 20,000 tons of sludge from the landfill each year. Amendments and change orders such as these greatly benefit the City by improving and expanding contract revenues and efficiently managing costs.

II. General Failures Result in Flawed Analysis

This comprehensive response contains the City's numerous objections to the Audit's findings and conclusions. However, there are particularly impactful flaws in the Audit that warrant extra emphasis.

a. Audit Disproportionately Focuses on Costs Resulting in Inaccurate Depiction of H-POWER

The Audit does not provide detailed information on revenues, only costs. This creates a one-sided and therefore inaccurate depiction of the financial status of the facility.

For example, the City provided the Auditor with a spreadsheet to show the overall financial picture of H-POWER. (See H-POWER Spreadsheet attached hereto as Attachment "A.") This spreadsheet reveals that since 1991, H-POWER has generated a total of over **\$201 million** in revenues. H-POWER has not only covered the costs of operating but has generated additional revenues of over \$201M. Conspicuously, this fact was not mentioned a single time in the Audit.

Instead, on page 18, the Audit states that “[i]n 2015, H-POWER reported its first loss of \$543,500. In our opinion, if H-POWER revenues continue to be insufficient to cover operating and construction costs, the city may be obligated to cover the losses.”

Not only does the Auditor fail to mention the millions of dollars of revenue generated over H-POWER’s life, but the Auditor fails to put the loss in the context of 24 years of profit and fails to explain why it implies that H-POWER revenues will continue to be insufficient. Clearly, this focus does not paint an accurate financial picture of H-POWER but instead appears to purposely misrepresent the situation.

This was not the only instance where the Auditor appears to purposely downplay H-POWER successes. On page 55, the Auditor mentions the sale (for \$312.5 million) and repurchase (for \$43.9 million) of the Facility, apparently reluctantly because it is only in the context of analyzing management comments.² In any case, the Auditor states:

The transaction **probably** involved the release of the city’s seller financing (mortgage note). The net gross profit for the city was \$36.1 million (\$80 million [down-payment] less \$43.9 million). While the capital gain was considerable, the capital gains were not as significant as claimed by ENV managers[.]

(Emphasis added). First of all, it is disturbing that the Auditor presumes (i.e., use of the word “probably”) that the City released the mortgage on \$232.5 million when it could have easily confirmed this information by reviewing the documents in its possession (i.e., review above-referenced spreadsheet which was provided to the Auditor) or simply asking the City. If questioned, the City would have clarified that it did release what was remaining on the mortgage for only the last two years of the 20-year mortgage and only after the City received over \$425.6 million in mortgage payments (\$232.5 million balance with interest at 8.04% for 18 years). Second, it is even more disturbing that the Auditor, based upon its erroneous presumption that the City released the mortgage note, claims that the net gross profit was only \$36.1 million. Third, the Auditor insists on criticizing this very advantageous sale by stating that “[w]hile the capital gain was considerable, the capital gains were not as significant as claimed by ENV managers.” The Auditor fails to state what the “significant” capital gain was or how ENV overstated this gain. The facts are that over \$150 million in capital gain was

² In its earlier draft, the Auditor described H-POWER’s project history but conspicuously left out the fact that the City sold the H-POWER facility for \$312,482,532 in 1991.

realized when the City sold the facility in 1991 after constructing it for approximately \$150 million and selling it for \$312.5 million. The City then made a very advantageous repurchase in 2008 for only \$43.9 million. It is not clear from the paragraph on page 55 why the Auditor chose to downplay this sale, downplay the City's proceeds from this sale over 18 years, and downplay the benefits of the repurchase in 2008. In any case, these failings misrepresent H-POWER's financial history and in turn skew the overall analysis.

Further, the Auditor also fails to mention the over \$57.6 million in lease payments that the City received from 1991 through 2008. The land at the site of the Facility was not sold as part of the 1991 sale of the Facility. The City retained ownership of the land and thus entered into the Ground Lease Agreement with the new owner of the H-POWER Facility in 1991 for a basic lease term of 20 years, beginning on May 1, 1990 (H-POWER commercial operation start date) and ending on April 30, 2010. The basic lease value was \$3,222,669 per year, and the City received this value for 18 years (when the City repurchased the Facility in 2008, lease was released).

b. Audit Failed to Recognize the City's Contract Administration Successes

The Audit criticizes the City's contract administration but again fails to paint a complete picture. Specifically, the Auditor fails to recognize that on numerous occasions where Covanta requested cost increases, the City denied the request or negotiated the amount down significantly. For example, in the FY13 true-up, Covanta claimed up to \$5M in damages. After an extensive review of the relevant documentation and negotiation over disputed positions, that amount was reduced to approximately \$1M. This reduction was only accomplished because the City possesses a thorough understanding of the Contract and is involved in the day-to-day operations and management of the facility. This effective management also enabled the City to significantly reduce or eliminate certain operation & management costs and special handling fees for alternate waste receipts, including those for tire and sludge disposal, thus saving the City millions of dollars.

Further, the Auditor fails to recognize corrections made to invoices that were caught during the review process by the City and its consultant HDR because these invoices were superseded and were not included in the final record of invoices. Therefore, the Audit does not consider significant contributions made by H-POWER consultants as well as the City, and in turn, paints an inaccurate picture of H-POWER Contract management.

c. Auditor Failed to Conduct A Complete Review of Invoicing

The Auditor failed to review BFS documentation supporting invoices while accusing the City of paying without justification. The Auditor alleges that the City failed to substantiate \$55 million in payments but did not follow through with BFS to determine if these allegedly insufficient invoices were actually unsupported.

d. The City Did Not Violate the Procurement Code

Auditor claims that the City violated procurement practices but fails to recognize that the Original Contract was entered into prior to the enactment of the procurement code, the Contract included a right of first refusal for future improvement and expansion that allowed the City to continue its relationship with Covanta, and the SPO determined that a similarly structured long-term contract was not violative of the procurement code. The Audit fails to address any of these facts. Instead, being ignorant of the complexities of operating WTE facilities, the Auditor recommends imposing unreasonable and inapplicable requirements on the City in administering the H-POWER Contract. These inapplicable recommendations, if implemented, could lead to unacceptably high tip fees for the public or significant losses to the City, the City breaching the HECO PPA by failing to produce the contractually required energy resulting in lost revenues and monetary penalties, and the breakdown of H-POWER operations which would disrupt waste disposal island-wide.³

e. Audit Failed to Recognize Need for Consultants

Because the City does not have the same level of expertise as Covanta in WTE facility operations and management, the City would be remiss if it did not enlist the services of consultants with the requisite expertise to ensure that the City's interests are protected vis-à-vis the Contractor's. The City and its consultants negotiated with Covanta over one full year to procure an amendment for the construction of the Third Boiler and to extend the operating contract (in light of the expansion) that best protected the interests of the City. The Auditor, again because they are not familiar with the complexities of operating WTE facilities, erroneously contends that the H-POWER Contract, namely Amendments 11 and 12, contained terms that were mostly protective of the Contractor. The Auditor even inaccurately infers that the City's consultants protected the Contractor's as opposed to the City's interests. This is simply not the case.

³ Please see article entitled "The Money Pit: The Real Reason Harrisburg Pennsylvania Went Bankrupt," regarding how a mismanaged WTE facility resulted in dire consequences for the city of Harrisburg. Attachment "B."

Consultants in this industry build their reputation by protecting their clients. The consultants generally only work on the public side or on the operator side of the table, crossing over only for limited reasons. The primary legal contractors and consultants assisting the City have not worked for Covanta.

Counties that take on such contracts choose to hire special consultants because the specialized technical and contract knowledge and skills are difficult to maintain within the governmental organization where these skills would only be used very infrequently. The consultants see these types of contracts repeatedly on a daily basis and have the opportunity to apply knowledge gained from other projects.. These professionals make their living based on their ability to represent the interests of the public sector client. Therefore, it is prudent and cost effective for the City to contract these services when needed.

III. Chapter 2: Contract Administration

In Chapter 2, the Auditor makes numerous contentions regarding contract requirements, payment mechanisms, and the length and reasonableness of the extension of the term of the Contract. The City contends that the Auditor failed to accurately interpret the H-POWER contract language, leading to the Auditor erroneously criticizing the City. The City also contends that the Auditor failed to accurately assess WTE industry conditions, leading again to erroneous conclusions.

a. Failure to Accurately Interpret Contract Results in Erroneous Conclusions Regarding Contract Requirements

i. Contrary to the Audit's Contention, the City Did Use General Terms and Conditions

On pages 11, 13, 14, 17 and at numerous times throughout the Audit, the Auditor accuses the City of failing to use the City's standard General Terms and Conditions ("GTC"). This is simply untrue. The GTC was made part of the H-POWER Contract via Schedule 17 in Amendment 11 in 2009. Further, because these terms and conditions were never repealed, they remain applicable as part of the H-POWER Contract throughout the majority of the Audit's period of evaluation and are still currently in effect.

ii. Contrary to the Audit's Contention, the H-POWER Contract Does Not Limit the City's Access to Records

On pages 11, 13, 14, and 15, the Auditor claims that the H-POWER contract limits the City's access to records because the Contractor has the right to deny such access. This again demonstrates the Auditor's inability to accurately interpret contract language. Section 4.10 of Amendment 11 and section 3.8.1 of Amendment 12 to the H-POWER Contract provide:

The City's Authorized Representative. . . and the City's employees, with the full cooperation of the Contractor, shall, at the City's cost and expense, have, during normal business hours and upon reasonable notice to the Contractor, access to review and copy, in accordance with Applicable Law, all Records, in Native Electronic Format (including metadata) or otherwise, and all other records, books, accounts and invoices to verify costs incurred or payments made by the City pursuant to this Extension Agreement or in connection with the Work, including such costs and payments to any Subcontractor, any purchase order, any Refurbishment Project or other change or modification, including any Repair or Replacement, performed by or through the Contractor and any amendment increasing, decreasing, or providing for payments under this Extension Agreement (collectively, "Cost Records"), in all cases, for the purpose of verifying the Contractor's compliance with the terms of this Extension Agreement. . . . The Contractor shall have the right to deny access to the City . . . to review and copy Records to the extent Records are protected from disclosure by Applicable Law.

The above section essentially enables the City to access all documents relevant to the H-POWER Contract. The Auditor focuses on the Contractor's ability to deny access "to the extent Records are protected from disclosure by Applicable Law" as more restrictive in comparison to the records access clause in the GTC. The Auditor also claims that the Contractor can limit access to records that do not verify the contractor's compliance with the terms of the agreement.

First of all, the fact that the Contractor can deny access *as provided by law* does not limit access to the records any more than provided in the GTC. Contrary to the Auditor's understanding, the GTC does not provide unfettered access to records. In particular, it does not allow illegal access to records. No contract, including ones containing the GTC, can enable illegal conduct. Therefore, unlimited access only allows access in accordance with the law. Thus, both the H-POWER Contract and the GTC enable access to records "in accordance with the law."

Secondly, the H-POWER Contract does not **limit** access to records relevant to the agreement inasmuch as every document relating to the H-POWER Contract can be interpreted as relevant to verifying the Contractor's compliance with the Contract. In other words, this phrase does not give the

Contractor the ability to limit access to any record relating to the H-POWER Contract. Therefore, while the language in the H-POWER Contract is more specific than what is contained in the GTC, it is **not** more restrictive or unreasonable and thus allows the City open access to H-POWER records.

iii. Contrary to the Audit’s Contention, the H-POWER Contract Does Not limit the City’s Right to Audit the Contract

On page 15, the Auditor cites to section 7.1.3 of Amendment 12 of the H-POWER Contract to support its claim that the Contract limits the City’s right to audit Covanta’s conduct. Again, this is a misplaced argument. This section describes “actions by the City’s Authorized Representative relative to application for payments” and claims that a deadline to make payment limits the City’s right to audit the Contract. The H-POWER Contract is certainly not the only City contract to provide for a payment schedule different from the GTC. That is why the GTC are always attached to more specific contract provisions. The fact that the payment schedule is different does not “limit” the City’s right to audit. It just changes the circumstances by which the City would deny payment and request additional justification from the Contractor. This very section outlines in detail the multiple bases upon which the City may do just that, so the City’s ability to challenge a payment request is clearly protected. (The Auditor implies that the ability to challenge a payment request is the same as being able to conduct an audit.) Therefore, unless the Auditor is claiming that the payment schedule and grounds for denying payment are unreasonable, the Auditor cannot state that the City’s right to audit is limited because the City retains the right to audit the records throughout the payment process.

The Audit also erroneously claims that the consultant professional services contracts do not have the right to audit clause. The GTC is attached and incorporated by reference to the HDR contract so HDR is bound by the audit provision touted by the Auditor. Again, the Auditor asserts facts that are inaccurate.

iv. Contrary to the Audit’s Contentions, the H-POWER Contract Does Not Curtail Records Retention

On pages 13, 14, and 16, the Auditor claims that the records retention section of the operating contract enables the Contractor to destroy records before the 20 year contract term expires. This contention is misleading because the Auditor confuses and misuses contract terms.

Amendment 11 or the Expansion Construction Amendment provides the terms for the construction of the third boiler unit. Section 4.10 of Amendment 11 provides the records retention requirement for only the third boiler unit construction:

The Contractor shall retain for such inspection purposes all Records and Cost Records for six (6) years after receipt of final payment pursuant to Section 7.3. This Section 4.10 shall survive the termination or expiration of this Expansion Construction Amendment for such six (6) years period referenced above.

Amendment 12 or the Extension Agreement provides the terms for the continued operation of the H-POWER facility, including operation of the third boiler unit, for an additional 20 year period. Section 3.8.1 of Amendment 12 provides the records retention requirement for this extended operating contract:

The Contractor shall retain for such inspection purposes all Records and Cost Records for six (6) years. This Section shall survive the termination or expiration of this Extension Agreement for such six (6) year period referenced above.

The Auditor mistakenly interprets Section 4.10 of Amendment 11 as the records retention policy for the “operating contract.” In actuality, Section 4.10 dictates the retention requirements for only the expansion construction, not the operating contract. While the Contractor may purportedly destroy the records relating to the expansion construction six years after the final payment for the completed construction (construction has not yet been completed as Covanta is still working on change orders), Covanta cannot destroy records relating to its ongoing operation of the facility until 6 years after termination of the operating contract. In other words, the H-POWER Contract provides for a records retention period for the operation of the facility that is longer than that provided in the City’s General Terms and Conditions and the State Procurement Code.

The Auditor’s erroneous reading of the records retention period for the operating contract is made even more egregious in footnote 4 on page 13 where the Auditor states:

Although the Covanta contract allows the contractor to destroy the records after six years and before the project is completed, ENV and BFS managers stated the Covanta contract was compatible with the city general terms and conditions. We determined the construction and operating contracts were industry templates used by contractors to protect the contractor interests.

First, the H-POWER Contract does not allow Covanta to destroy records before the project is completed. Amendment 11 allows Covanta to destroy records relating to only the expansion construction six years after the construction is completed. Amendment 12 requires the records to be retained six years after the operating contract expires or until 2038. Clearly, the records retention provisions do not allow Covanta to destroy records before completion of the “project,” whether the Auditor defines “project” to mean the expansion construction or the operating contract. In any case, the H-POWER Contract records retention provisions do not inhibit the City’s ability to detect improper payments.

Second, the ENV and BFS managers were correct when they stated that Covanta’s contract was compatible with the City’s GTC because the records retention period for the operating contract goes beyond the contract life and is longer than the GTC records retention period.

Third, it is not clear what the Auditor is referring to when it cites to “industry templates” because the Auditor did not share this resource with the City. Regardless, based upon the fact that the Auditor’s assertions of “industry practice” are shown to be erroneous, the “industry templates” are likewise suspect. In any case, the fact that the records retention requirement for the operating contract is more burdensome to the Contractor than the City and State counterparts refutes the Auditor’s ongoing accusation that the Contractor unilaterally imposed unfavorable contract terms on the City. When interpreted accurately, this contract provision and, as the City points out throughout this response, many other provisions throughout the Contract protect the City as opposed to the Contractor.

b. Failure to Accurately Interpret Contract Results in Erroneous Conclusions Regarding Payment Mechanisms

i. Cost Substantiation

On pages 15 and 16, the Auditor claims that Covanta is not required to substantiate its costs to the extent required by the GTC but instead has the “right to establish and use ‘fair market value price’ for any service or material provided and is not required to provide documents that show the actual costs.” The Auditor is misinterpreting the Contract requirements.

The chart on page 15 compares GTC and H-POWER Contract requirements for invoicing. However, the H-POWER Contract requirements are taken out of context. The reference to the “cost substantiation documentation” appears to imply that all that is required of Covanta to obtain payment

reimbursement from the City is “reasonably acceptable” documentation that does not necessarily include “actual” and “detailed” documentation. In both Amendments 11 and 12, “cost substantiation documentation” does not translate to a simple assertion to request payment but involves providing sufficient documentation that would justify payment, and the City’s right to audit such documentation is reserved. The Auditor also misreads the fair market value component because the fair market value certification serves as a cap on the payment reimbursement, not the sole bases for payment determination. In other words, the Contractor cannot recover a cost in excess of fair market value even if the Contractor actually incurred the expense. This provision is protective of the City and ensures that the City make reasonable and justifiable payments.

ii. **Reimbursement**

The Auditor asserts on page 17 that the “operating contract allows Covanta to receive reimbursements for any costs or expense it incurs. . . . The contract is vague and broad, restrictions are not specific; and the contractor is not required to submit supporting documents that show the actual costs.” This is a careless generalization that the Auditor cannot substantiate.

In actuality, under the operating contract, the Contractor's “reimbursable expenses” are components of the “operating fee” and are limited to those expenses that are specifically identified in the Contract. These reimbursable expenses include but are not limited to environmental costs (stack testing, lab testing, and new permits only), maximum limits for utilities (water, import power) and reagents (lime, ammonia, activated carbon)). Reimbursable expenses are those that are likely to fluctuate and therefore fixing these costs could work to the disadvantage of the City. Thus, reimbursable costs allow payment for actual as opposed to predetermined services. The Auditor states that the H-POWER Contract does not require documentation to justify reimbursable expenses, but because the GTC were incorporated by reference in Amendment 11, the GTC documentation requirements are applicable to reimbursement requests. In any case, the Auditor is mistaken that Covanta can receive reimbursements for “any costs or expense it incurs.” Reimbursable expenses are defined in the Contract and therefore limited and must be justified with the proper documentation to warrant payment.

iii. **General Obligation Bonds**

On page 18, the Auditor claims that the H-POWER Contract contains an “unusual requirement for the city to issue general obligation [(“GO”)] bonds to ensure Covanta and its subcontractors are paid.” The Auditor is mistaken.

Amendment 11 contains a condition precedent to a notice to proceed that the City have funding from GO bond proceeds or other appropriated moneys for payment of costs to be incurred for the expansion construction during the fiscal year. It gives the City flexibility as to funding sources. Nothing in Amendment 11 requires the issuance of GO Bonds. This condition precedent funding option protected the City from starting work without adequate funding for the then current fiscal year.

Section 13.4 of Amendment 11, entitled “Fiscal Authorization Limitation and Termination for Fiscal Non-Funding,” further refutes the Auditor’s claim that the H-POWER Contract did not protect the City by making contracts subject to the availability of funds:

Except as specifically provided for under Hawaii law, the City, acting by and through its Contracting Officer, cannot, by law, expend or contract for the expenditure in any Fiscal Year of more than the amount authorized, appropriated, budgeted and made available for funding the Expansion.

Section 13.4 goes on to provide for termination of the Expansion Agreement for non-appropriation.⁴

Moreover, if the Auditor is claiming that the City is prohibited from issuing GO bonds to finance the Facility, the Auditor is mistaken. Hawaii Revised Statutes section 46-19.1 specifically enables the City to issue GO bonds to finance facilities for solid waste processing and disposal and electrical generation:

§46-19.1 Facilities for solid waste processing and disposal and electric generation; financing; sale. (a) In addition to any other powers provided by law, any county may issue general obligation bonds to finance a facility for the processing and disposal of solid waste, or generation of electric energy, or both, pursuant to section [47-4], and provide for interest on the bonds which will accrue during the construction period. Any such facility shall be and constitute an undertaking as defined in section 49-1, and all revenues derived from the services and commodities furnished by the undertaking, including the disposal of solid waste and the sale

⁴ While it is not a requirement for the H-POWER Contract, the City has employed the use of GO financing to lower the costs of the expansion of its waste disposal system capacity. Moreover, the City routinely employs the use of GO bonds to finance capital projects because GO debt has the lowest cost of capital (i.e., lowest interest rates). To put this in context, the City had \$2.6 billion in GO bond debt at the end of FY 2014.

of steam and electric energy and recovered materials, shall constitute revenues of the undertaking.

.....

(c) A county may lease any facility sold as authorized by this section or enter into an operating agreement or other arrangement with the purchaser or a lessee of the purchaser of the facility upon such terms and conditions as the governing body shall approve by resolution. So long as a facility sold as authorized by this section is available to the county, notwithstanding that availability is conditioned on payment of reasonable fees for the services and commodities furnished thereby, the facility shall be deemed used for a public purpose and payment of the costs of construction shall constitute a purpose for which bonds may be issued as authorized by subsection (a).

Accordingly, there is no requirement in the Contract to issue GO Bonds as claimed by the Auditor. Despite the absence of this as a requirement, the ability to issue GO bonds to finance the Facility is still enabled by the Contract language and is specifically authorized by law.

c. Unfamiliarity with WTE Facility Operations Leads to Erroneous Conclusions

i. Term of Contract Extension Clearly Established in Amendment 12

The Audit contends that Amendment 12 did not provide for a specific expiration date. This is untrue and again attributable to the Auditor's misreading the Contract and lack of familiarity with WTE Contracts in general. Amendment 12 clearly establishes that the extended term of the H-POWER Contract is 20 years after the Acceptance Date, which is defined in the Contract as contingent upon completion of the expansion construction. This contingency is reasonable because the 20-year extension involved operating the new boiler. The date could not be specifically identified in Amendment 12 because the construction completion date could not be predetermined. This is not an uncommon practice for WTE expansion contracts.

ii. Actual Terms of WTE Contracts

The Audit attempts to bolster its criticism of the H-POWER Contract term extension by making misleading comparisons and by inaccurately citing other facilities' information.

The Auditor states that “[o]ur research found the following localities had operating agreements with Covanta that ran 5 to 10 years[,]” citing Fairfax, VA for 5 years with options to renew for two 5 years terms; York county, PA with a 5 year operating agreement; Montgomery County, MD with a 5 year operating agreement; Pinellas County, FL with a 10 year operating agreement; and Indianapolis, IN with a 10 year operating agreement. The Auditor then concludes, contrary to the City’s contention that long term WTE operating contracts are common industry practice, that “industry publications indicated 15 years is normal.” Here are the actual facts regarding these facilities’ operating contracts:

Fairfax County, VA:

The facility began operations in 1990. The term for the initial operating agreement ends in 2016 (25 years). Fairfax County negotiated an extension with a provision for two 5 year terms. The initial contract had provisions with an option for the County to acquire the facility when the 20-year term expired and the initial bonds were paid off. In 2011, Fairfax County had the option to buy the facility or agree to a new long-term lease. After the 5-year extensions are complete, the County will need to find a home for its waste. This could be considered a more risky position for the County because they do not have an ownership position in the facility and could be priced out of its use at the end of the term. The actual terms for the Fairfax County operating contract are **25 years** for the original contract, plus **2+ years** of construction, plus potentially **10 more years for a total of about 37 years**. This is without an expansion of the facility.

York County, PA:

Covanta has had a contract with York County to process its waste at this facility for only 5 years because Covanta acquired the plant in 2009. The plant has been in operation since 1989 or roughly 26 years – 15 years operated by another company (Veolia).⁵ The original operating contract

5 Veolia got out of the WTE operating business, selling their interests largely to Covanta. Green Conversions was the operator for a short time for Pinellas County (acquiring that interest from Veolia) but the arrangement was terminated by the County and re-bid. Covanta won that second bid and now operates the plant. Green Conversions still exists but does not operate any plants. Energy Answers also has operated some plants but does not operate any facilities today. NAES (North American

was for **20 years**. An **extension of 5 years** was added to the contract. Covanta and the County may be in contract negotiations for an expansion and operating contract extension for at least another 20 years.

Montgomery County, MA:

This facility began operations in 1995 and the original contract was set to expire in 2016 for roughly a **20-year term**. The Northeast Maryland Waste Disposal Authority negotiated a **5-year contract extension** (without expansion) with Covanta until 2021. This results in a **25-year term**.

Pinellas County, FL:

Pinellas County re-bid the operating contract and accepted the lowest bid from Veolia in 2007. Veolia had a **17-year contract**. However, Veolia got out of the business of operating WTE plants and sold their interest in Pinellas to Green Conversions Systems (GCS). The plant was in dire need of repair. When conditions continued to deteriorate and the production rate continued to drop - threatening the County's contract to sell 475,000 megawatts of electricity each year with Duke Energy - the County agreed in December to cover GCS' operating costs to help boost production and reduce the plant's emissions. In return, GCS agreed that its contract, which was set to run through 2024, would end Dec. 31, 2014, and the County would put the operation contract out to bid. For one reason or another, the County determined the contract GCS was operating under was no longer viable and re-bid the contract a second time. Covanta was the successful bidder for a **ten-year term**. There is no expansion with this extension.

Indianapolis, IN:

This facility began operations in 1988. An agreement provided for an **extension of 10 years** through 2028 for a total of **40 years of operation**. This contract does not include an expansion.

As is apparent from the actual terms of the above facilities' operating contracts, these WTE plants do not have operating contracts with durations of 5 to 10 years but instead have **extensions and options** for 5 or 10 year periods. Moreover, none of these operating contracts include **facility expansions**. All of the cited facilities, but for one that had operator difficulties, have operating contracts for 20 to 25 years **once**

operation of the plant began. This length of time was required to account for the large investment needed to construct WTE facilities.

The following list of additional plants, the majority of which are operated by Covanta, further substantiates the fact of 20-year or longer operating contracts:

- Hillsborough County, FL. Covanta announced the execution of contracts with Hillsborough County to construct, operate and maintain an estimated \$106 million expansion to the Hillsborough County Solid Waste Energy Recovery Facility. Covanta's subsidiary constructed the Facility and has been operating it since 1987. Construction of the expansion should begin in mid to late 2006 once necessary Federal, State and local permits are obtained by the County, with completion expected within 28 months. Covanta's **original 20-year contract** with the County to operate and maintain the Facility has also been amended to include the expansion and to **extend the contract for another 20 years** during which Covanta will continue to meet operating and environmental performance standards. The Facility's three boiler units annually process over 372,000 tons of residential and commercial solid waste generated in the County. Waste is converted first to steam and then to electricity which is sold to Tampa Electric Company. With the expansion, a fourth boiler unit will be added to increase annual processing capability by approximately 190,000 tons of solid waste per year.
- Hempstead, NY. Hempstead reached the end of its long term waste disposal agreement in 2007. In 2005, it issued an RFP for long term disposal services. Hempstead entered into a new **25-year contract** with Covanta.
- Bristol, CN. Bristol Resource Recovery Facility Operating Committee, a consortium of fourteen Connecticut municipalities, reached the end of their long term disposal contract with Covanta in 2014. In 2008, they began a process to replace the existing agreement, which culminated with their entering into a **20-year long term agreement** with Covanta, commencing July, 2014, which provides bundled services including recycling, bulky waste disposal, e-waste recycling, and the management of organics/composting with the continued operation of the facility.

- Southeastern Massachusetts (SEMASS). The SEMASS facility, owned and operated by Covanta, has **long term agreements for waste delivery**. These agreements have been renewed by various municipalities for terms ranging from **five years to twenty years in duration**.
- Poughkeepsie, NY. On July 25, 2014, the Dutchess County Resource Recovery Agency (“DCCRA”) reported that Wheelabrator Technologies Inc. has officially begun operations of DCCRA’s waste-to-energy facility located in Poughkeepsie, New York. The new operations contract, which followed a competitive procurement process earlier this year, began on July 1, **2014 and runs through June 30, 2027, with two six-year extension options**. Covanta was the former operator from **1989-2014**.
- Alexandria and Arlington, VA. The City Council of Alexandria and Arlington County Board recently agreed to extend the Covanta WTE lease agreement **through 2038** for the disposal of municipal trash.
- Miami-Dade County, FL. Covanta contracted to operate facility in 2010 for 13 years to 2023 for a project that started operations in 1982 for a total of about **41 years**.
- Lee County, FL. Lee County has a contract through 2024 for a **10 year extension** to a 20 year contract for a total of **30 years**. This facility did have an expansion.
- Long Beach, CA. Covanta acquired an interest in the project which started in 1988 for a **30 year** contract. The contract was extended by 6 years without an expansion to about **36 years**.
- Lancaster, PA. Lancaster opened in 1991 and has a contract through 2017 without an expansion for about **26 years**.
- Pasco County, FL. Pasco started operation in 1991 and Covanta has a contract through 2024 or about **33 years**. The contract extension without an expansion was for **8 years**.
- Harrisburg, Pa. Harrisburg was acquired by Covanta and the term is linked to Lancaster

- Burnaby, BC. Burnaby opened in 1988 and is contracted through 2025 for a term of about **37 years** without an expansion.
- Kent County, MI. Kent County started operation in 1990. Covanta indicates the facility operations are contracted through 2023 without an expansion or **33 years**.
- MacArthur, WV. MacArthur started operations in 1990 and changed operators several time. Covanta acquired operation of the facility and extended the operating contract by **15 years** to 2030. The total term of the operating contract is **40 years** without an expansion.

As exemplified by just about all of the above-referenced WTE facilities, the operating contracts are rarely short term and extend for periods between 20 -40 years, even though most of the facilities do not include expansions. Thus, the Auditor's "industry publication" that indicated 15-years as the normal operations period is extremely suspect. Even if this were the case, it is extremely difficult to define the "norm," as each facility's operations differ and in turn would impact the needs of the contract. For the H-POWER Contract, the magnitude of the facility operations (i.e., processes up to 900,000 tons of waste annually), the large investment in the third boiler expansion (over \$300 million), and the long history of effective and profitable management (over 25 years) all contribute to continuing the Covanta/City relationship.

WTE facilities are technologically and environmentally complicated infrastructure enterprises that bring together waste processing, energy production and pollution control systems. They are capital intensive facilities that require skilled, trained staff to operate and maintain. These facilities typically involve a public-private partnership, drawing upon the skills and experience of a private sector partner experienced in the design, construction, commissioning and long term operation and maintenance of these multimillion dollar facilities. The contract for each facility is unique, reflecting the specific local project needs and risk appetite. Due to the high capital cost and desire to spread the debt repayment over years of operation, the contracts are generally 20-years or longer in duration. There are typically multiple contracts that are intertwined - construction agreements, operating contracts, and power purchase agreements. Long contract terms become even more complicated because the contract needs to incorporate provisions that address potential changes that can occur over a twenty year period.

Operating contracts for WTE facilities would be particularly difficult if the term is limited to no more than five years. Under a short term contract, the operator would

likely not be incentivized to maintain large scale, expensive equipment that have major repair cycles that are longer than five years. For example, a turbine generator (TG) that produces all the plant revenue costs tens of millions of dollars and normally requires a major overhaul cycle every seven years. Under a five year contract, the operator will not be incentivized to maintain the TG and the next operator may have major problems because of this. The boilers, the heart of the facility, have parts with long term repair cycles. Because a WTE facility is complex and expensive, making the operator responsible for the long term condition and having long term engineering oversight helps to manage this problem and minimize risks for the City. Accordingly, the majority of WTE facilities have operating contracts for longer operating periods and H-POWER is no exception.

IV. Chapter 3: Contract Management

In Chapter 3, the Auditor makes numerous contentions regarding the City's management of the H-POWER Contract. The City contends that the Auditor failed to fully investigate certain contentions, again leading to erroneous conclusions.

a. Billing Rates

The Audit claims that the City paid for billing rates that exceeded the HDR Engineering, Inc. consultant hourly rates. The scope of the 2009 original HDR contract (SC-ENV-0900180), as described in the "Special Provisions to the Agreement for Professional Services" in section 2, defines a long list of services to be provided, including Operational tasks, and Refurbishment as part of both the expansion and operations contract language in Amendments 11 and 12. The Audit indicates that the rate for the Senior Project Manager was \$146.15/hour. However, this has never been the rate during the period of this Contract in that it has ranged from \$181.40 in the original contract to \$197.00 in Amendment 4. Similarly, the rate cited in the Audit for a Senior Mechanical Engineer of \$175.50 is inaccurate as the actual contract rates have ranged from \$260.40 to \$268.00. Further, both ENV and BFS check billing rates against the HDR Contract for each invoice, so it is extremely unlikely that an unauthorized rate would be paid.

b. Consultant Work

The Audit claims that the City paid for work that was outside the scope of the H-POWER Contract. Before the Audit can come to this conclusion, it is important to understand that there was a lot of overlap between the Baghouse Project and other projects and operations. Such overlap of operational, technical, planning and financial considerations was necessary because it was important to

ensure that the baghouse would fit seamlessly with the whole facility. Examples of these overlapping considerations are as follows:

- It was necessary to reinforce the existing RDF boilers to be compatible with the new baghouse technology.
- O&M costs of the baghouse, including new CEMS technology, bagbreak detectors, etc., needed to be estimated and budgeted for.
- Similar baghouse technology would be used in the Expansion Third Boiler so it was important to use the experience gained in the Baghouse Project to plan for the Third Boiler air pollution control system to ensure compatibility and consistency.
- The new baghouse made it necessary to modify the facility's Department of Health permits, operating plans, reporting and monitoring requirements.

The Audit contends that it could not find the City's justification for the changes and additional work necessary for the completion of the Third Boiler Expansion project, or for the position that such work was within the scope of the construction contract. This contention is not explained as each Contract Change Order clearly identifies the reason and provides sufficient justification for the change.

c. Travel Costs

The Audit alleges that the City should not have paid for certain unallowable and expensive travel expenses. Because this is not noted in the report, the City points out that since the time period addressed in the report, the City has enforced the City's policy for travel reimbursement. Please see the Covanta travel policy dated March 2015 attached as Attachment "C." All invoices containing travel charges since 2012 were not paid and will be revised in accordance with the policy. The Contractor and the City have been working together and negotiating in good faith since 2013 to agree on a travel policy that is more in line with the City's standard practices with their employees, which may directly conflict with practices/policies in place with the Contractor and its subs.

d. Approved Intern Rates That Were Unreasonable

The Audit alleges that the City paid excessive wages for undergraduate student interns. The work completed by the interns that HDR provided could have been completed by an engineer at a much higher cost. Use of interns benefitted the City by bringing in skilled engineering students to complete tasks under the supervision of an engineer, resulting in a substantial savings to the

City. Some examples of work completed included recording and monitoring scale records. This work could not have been completed by a clerical person because technical training and application of knowledge was needed. Other work included using computer skills to develop sophisticated spreadsheets to analyze performance data utilizing skills gained from their college experience. The work, however, was generally tedious in nature and/or repetitive and provided good opportunities for the engineering students, while freeing up engineering staff to guide the interns and check their work while the engineering staff could complete additional tasks. One intern was exceptionally skilled and was available to return for subsequent years for additional work. Because his skills were known and he already knew the facility and personnel, even less time was required to engage him in the required work. He was able to complete even more sophisticated work, including preliminary review of invoice substantiation provided by Covanta where he researched and queried records, finding documents that saved the City tens of thousands of dollars. He also completed sophisticated Excel spreadsheets that simplified and streamlined review of certain operating data, and assisted with projections of energy production potential. Interns may initially be a gamble to find really skilled ones, but highly skilled interns can save substantial costs.

e. Project Funds to Pay Expenses for Another Project

The Audit alleges that the City approved a duplicate payment. First of all, it is not clear what the report is basing this assertion upon. Nevertheless, assuming that it is referring to invoice numbers HI-04-08-15 and HI-05-08-16, this accusation is simply not true. In our meetings with the Auditor, the City explained that there was no duplicate payment relating to these invoices. The so-called "duplicate payment" was instead an accounting mechanism used so that two separate funds could be used to pay invoices from separate projects (Please see invoice numbers HI-04-08-15 and HI-05-08-16). Assuming that \$8,771.67 from HI-04-08-15 (part 1 of the invoice) was correctly paid from Fund 255 and that \$172,539.42 from HI-04-08-15 (part 2 of the invoice) was inadvertently paid from Fund 255 instead of Fund 680. To correct this, \$172,539.42 from invoice HI-05-08-16 was paid from Fund 680 and the balance of that invoice was paid from Fund 255. (Invoice HI-05-08-16 is a service fee invoice and is usually all paid from Fund 255). This was done to make sure that the correct amounts were being drawn from each fund and the total amount paid was equal to the total amount invoiced. There was no duplicate payment approved and no overpayment to the Contractor.

f. Used Almost \$1M in Project Funds to Pay Expenses for Another Project

The Audit alleges that the City used refurbishment funds to pay \$999,929 in expenses that should have been paid with funds from the Air Pollution Control System Improvements Project. Because the new baghouse replaced the electrostatic precipitator (i.e., the air pollution control system that was replaced by newer technology in the form of the baghouse air pollution control system), it was appropriate to use refurbishment funds to complete this project. Please note that there are no such funds as the “third boiler refurbishment project funds” referenced in the Audit. The City interprets this reference to mean “refurbishment funds.”

g. Costs/Invoices Adequately Supported

The Audit accuses the City of failing to adequately support approximately \$55 million in payments. Ironically this claim is not substantiated because the Auditor failed to review the fully executed invoices at BFS.

Progress reports were generally provided for consultant invoices. Except for the consultant contracts and subcontractors that the City has no contractual relationship with, there are no H-POWER time and material contracts. Operating expenses are established at the beginning of the year and invoiced incrementally each month. Operational costs are based upon tonnage, energy production and many rigorous performance guarantees established in the Contract. For example, the Contractor must maintain certain energy production, energy per ton, percentage of metal recovered per ton, and many other performance guarantees. The Auditor seems to be expecting time sheets and expense reports where this documentation would be irrelevant. This is why the H-Power Contract does not fit into the standard City contract format. Construction or CIP contracts are similarly not time and material contracts and are paid based on the percentage of completion of a pre-established price, given appropriate cost withholdings to protect the City. This is also why there are many change orders.

It appears that when the Auditor could not find a fully executed invoice, they would deem it unsubstantiated. However, fully executed invoices are available at BFS, but BFS confirmed that the Auditor failed to request and review the fully executed invoices. BFS asserts that it would not have made payments without the department approval of fully substantiated invoices for payment.

V. Chapter 4: City Procurement Practices

In Chapter 4,⁶ the Auditor claims that the City's procurement practices do not conform to state rules and city polices. This is an erroneous conclusion again based on the Auditor's ignorance of the operations of WTE facilities and lack of expertise in evaluating the procurement requirements for complex WTE facility contracts.

a. Contract Amendments Did Not Require Competitive Bidding And Were In The Best Interests Of The City

The Auditor repeated claims throughout the Audit that the H-POWER Contract amendments, in particular Amendments 11 and 12, should have been competitively bid. The City contends that the H-POWER Contract enabled all of the amendments and the continued operation of the Facility by Covanta.

A closer look at the specific provisions within the H-POWER Contract evidences that the construction and operation of the Third Boiler did not require the City to seek competitive bids. Moreover, keeping the expansion and continued operation under a single operator was and is in the best interest of the City:

- Article I of the Contract for Design, Construction, Testing of a Solid Waste Disposal and Resource Recovery Facility between the City and County of Honolulu and Honolulu Resource Recovery Venture ("Construction Contract"), "Definitions," page I-4, defines the "Facility" as *"the solid waste processing and disposal and resource recovery and electric generating facilities, together with related and appurtenant structures and equipment to be constructed pursuant to the terms hereof on the Site."* Therefore, by definition, any equipment, including an additional boiler, is considered part of the Facility.
- Article V of the Construction Contract, Section 5.1, "Design of Facility," page V-1 provides in relevant part that *"[t]he design shall take into consideration the anticipation that the Facility may be operated to the extent practicable beyond the initial term of twenty*

⁶ Please note that the second to the last column, entitled "Original Amount," in the charts on pages 43 and 71 of the Audit contains the following errors: (1) in the second row entitled "Waste Processing and Disposal Services Contract," the value is \$247,812,780, not \$163,764,130 (see Exhibit II of the Original Contract (C01591)); (2) in the third row entitled "Air Pollution Control System Improvements," the value is \$47,001,000 not \$38,000,000 (see page 4 of Amendment 10); (3) in the fifth row entitled "H-POWER Refurbishment," the value is \$48,000,000 not \$4,000,000 (see page 155 of Amendment 12); and (4) in the seventh row entitled "Subtotal," the value is \$406,761,000 not \$353,760,000 (based upon accurate values).

(20) year operation period, subject to appropriate maintenance and/or replacement of parts. . .[and] the Contractor shall . . . shall perform all other architectural and engineering design work required for the Facility in its entirety. . . . This language indicates that the design of the Facility must anticipate the likelihood of future expansion that must be factored into the initial design, for the life of the facility or beyond the initial 20 year operating period.

- Section 5.5 of the Construction Contract, “Design and Expansion Capacity,” pages V-9, provides in relevant part that *“the Contractor shall insure that the Facility will be capable of expanding, exclusive of any raw waste storage and refuse derived fuel (RFD) storage areas, to a capacity for processing and disposing of Acceptable Waste of up to seven hundred forty-eight thousand eight hundred (748,000) Tons of Acceptable Waste per Year and up to an average of seventeen thousand two hundred eighty (17,280) Tons of Acceptable Waste per Week.”*
- Article VI of the Construction Contract, Section 6.1, “Construction of Facility,” page VI-1 provides in relevant part that *“[t]he Contractor shall procure and/or furnish all services, labor, equipment and materials necessary to construct the Facility in its entirety, all in accordance with this Contract. Such services, labor, equipment and material shall include but not be limited to the following . . . Organization, planning, management, direction, supervision and responsibility for all construction operations necessary to complete the Facility in its entirety, and the furnishing as necessary, for the performance of construction work, of all construction facilities. . . .”* The word “entirety” as used in this section and in Section 5.5 above, indicates that the Contract contemplated that construction of the Facility would extend beyond the initial term of the twenty (20) year operating period such that any new construction within the Facility would be covered by these sections and would be the responsibility of the Contractor.
- Article VIII of the Contract for Waste Processing and Disposal Services Between the City and County of Honolulu and Honolulu Resource Recovery Venture, Section 3.6, “Changes to Facility.” provides *“[i]n the event there is a change to the Facility, the parties shall assume the following responsibilities: (a) The Contractor shall have sole responsibility for any design and construction*

changes to the Facility which involve or affect process equipment or the guarantees or obligations of the Contractor and which the City and Contractor mutually deem necessary or desirable for any reason during the term of the Contractor. . . .“ This section specified that the design and construction of any future expansion of the Facility would be conducted by the Contractor.

Based upon the above referenced sections in the Expansion Construction Amendment and the Extended Operating Amendment, the scope of work in these amendments encompasses the entire design, construction, and operation/maintenance of the Facility, including any future design and construction changes for which the awarded Contractor is responsible. The scope of work ensures that the selected offeror who designed, constructed, and operated/maintained the facility would be in the best position to ensure compatibility within the single system and able to offer an expedient and cost effective solution for any construction and operation/maintenance issues that may arise.⁷

The contract amendments, change orders, and task orders that accounted for the majority of the increase in the H-POWER Contract were for the construction and operation of the Third Boiler. As evidenced above, these modifications are allowable under the terms of the H-POWER Contract and therefore, would not require procurement through competitive bidding. Further, because the H-POWER Contract provisions embody the contention that the same vendor designing and constructing all of the boilers would be in the best position to ensure a seamless integration and compatibility within the same single system, would be most effective managing risks, and would provide the most cost effective solutions for construction and operational issues, the modifications made pursuant to the H-POWER Contract were indeed in the best interests of the City.

Moreover, for an expansion of this magnitude (valued at over \$300 million), an over 20 year extension of time for construction and successful operation is typical industry practice. The longer time interval is necessary to enable the City to keep both the bond payments and the tipping fee for waste disposal reasonable.

⁷ The analysis in this section is mirrored after the opinion provided by the State Procurement Office (“SPO”) regarding a similar City contract. See SPO letter dated September 14, 2012 to the Honorable Romy M. Cachola. Attached hereto Attachment “D.”

Accordingly, the H-POWER Contract amendments are not violative of procurement and such expansion and extension are in the best interests of the City for the reasons asserted above.⁸

b. Cost-Plus, Time and Materials, and Sole Source Contracts

The Audit claims that the City inappropriately used sole source, cost-plus, time and materials, and multi-term contracts. The City contests these assertions.

The original operating contract was a hybrid contract in that it was primarily a task order/fixed price contract but with time and materials contract elements. Amendments 11 and 12 maintained this format. The Contract also provides for limited reimbursement of costs.

The work associated with these projects is unique and advances differently as each component of the project progresses. Defining the scope of all H-POWER projects to best fit the needs for the City is not possible based upon the overall complexity of the operations. Certain questions arise that cannot be anticipated but must be addressed quickly. To address all of these contingencies, the use of time and materials methods allows the City to employ the services needed when required and to adjust the work products, thereby minimizing work that becomes obsolete or outdated by the time it is provided. Essentially, the hybrid contract allows the City the flexibility to effectively address the many complexities in operating this large scale and long-running WTE facility.

c. Analysis of Management's Comments

The Audit disagrees with the City's explanation of certain issues but misrepresents facts, fails to understand WTE operations, and misapplies procurement requirements.⁹

i. The City Worked With and Relied Upon Covanta for Efficient Management and Operation

⁸ H-POWER's expansion costs are in the mix and compare reasonably with other plants. The typical way to compare waste to energy plant costs is to look at the cost per ton per day (\$/tpd). This provides a rough equalization between large and small plants.

A comparison of large and small plants is attached hereto as Attachment "E." As noted, comparing costs for plants can be very difficult to get on the same basis and this approach is not perfect but provides a helpful overview of the comparison.

⁹ The criticisms relating to (1) the appropriateness of using time and materials contracts; (2) typical industry practices; and (3) capital gains from the sale of the facility are addressed at length earlier in this response.

The Audit contends that Covanta should not have participated in the contract process, specifically provide design and construction guidance for the project scope and costs; obtain bids; review amendments change orders, and task order before they were finalized. This is an unreasonable assertion and does not make rational sense.

Covanta is the entity that is responsible for the daily operations of the complex H-POWER facility. It has the expertise in the field of WTE operations and is the primary WTE facility operator in the country. In fact, WTE operators have essentially been reduced to two companies – Covanta and Wheelabrator. It would be irresponsible for the City not to enlist the services of Covanta regarding H-POWER improvements, refurbishments, and overall operations because Covanta, not the City, has the subject-matter expertise. Further, contrary to the Auditor's assumptions, Covanta's involvement does not mean that it will impose its will on the City.

The City hired engineering and legal support, with specific experience representing the public sector in waste to energy contracting, to help with the negotiations with Covanta. This was a negotiation process, requiring give and take to arrive at an agreement that both parties were willing to sign. The agreement must protect the interests of the City but still entice Covanta to do the job, thus reflecting a balancing of the risks and rewards between the parties.

The City and Covanta negotiated basic terms which were summarized in a term sheet. The City's contract legal team with City input then drafted the contract for H-POWER, incorporating many of the terms and concepts of the original agreement. Most of these terms were significantly updated to include lessons learned in other jurisdictions, and additional requirements were added that the operator had to comply with. It is important to note that it was the City's team that wrote the contract, not Covanta's. From the City's perspective, this helped to protect the City's basic interests by minimizing the opportunity for changes inserted by Covanta.

Most of the contract addresses obligations that Covanta must fulfill. For instance, Section 3, Waste Processing and Disposal Services, addresses activities that Covanta must complete. Sections titled "City Controls Waste Stream and Fees" (Section 3.1.3), "HHV Adjustment" (Section 3.1.5), "Operation and Maintenance of the Project" (Section 3.2), "Housekeeping, Maintenance of Buildings and Grounds and Customer Service" (Section 3.3) are a few examples of areas that Covanta must complete under the contract. This section is 68 pages long whereas Section 4, Obligations of the City, is only two pages long.

The terms go to great lengths to protect the City's interests and were developed taking advantage of the specialized support from the City's consultants.

All amendments, change orders, and task orders are written by the City and reviewed by COR, BFS, and the City's consultants (i.e. HDR, Mele Associates) and, in certain cases, outside legal counsel (Williams Mullen, Carlsmith Ball) for compliance with the terms and conditions of the H-POWER Contract and all applicable laws, and for fair and reasonable pricing and contract terms. All of these parties provided and continue to provide input regarding contract provisions and conditions intended to further the best interest of the City. With this input and because the City does not need to rely on Covanta alone, it is reasonable and expected that the City would seek input from its operator, Covanta, on actions impacting H-POWER operations.

ii. Pre-Planned H-POWER Projects Do Not Dictate Procurement Practices

The Auditor claims that the integrated solid waste management plan identified plans relating to H-POWER and therefore the City was obligated to competitively bid these projects. The Auditor fails to cite any applicable procurement provision that requires competitive bidding based upon prior knowledge of projects. The Auditor also fails to address the contractual obligations in the H-POWER Contract, in particular the contract provision that requires the City to provide Covanta with the right of first refusal for future facility improvements. This is a baseless accusation.

d. City Council Approval Not Required for Certain Projects

The City objects to the Audit's recommendation to obtain City Council approval for any project that obligates the issuance and use of City obligated bonds. The City Council already approves all capital projects related to H-POWER. Further, the City Council already approves issuance of all GO bonds, including those providing funding for H-POWER. This recommendation asks for something that already occurs. If this is intended to have the City Council review individual contracts before they can be entered into, then it would place the City Council inappropriately in an executive branch function. Further, this is a redundancy that will delay efficient management of the Facility. In particular, any delay in the disposal of sewage sludge may jeopardize the City's

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compliance with the federal Global Consent Decree,¹⁰ which would in turn result in significant monetary penalties.

VI. **Chapter 5: Conclusions and Recommendations**

Accordingly, as discussed above, the City objects to a majority of the Audit's findings and conclusions. The City contends that many of the facts in this Audit are inaccurate or misleading so that the resulting conclusions are erroneous or without bases. The City asserts that construction and operation of the Third Boiler was and is in accordance with the H-POWER Contract as well as the Procurement Code, and the H-POWER Contract was and continues to be managed in the best interests of the City.

Warm regards,

Roy K. Amemiya, Jr.
Managing Director

Attachments

¹⁰ The Global Consent Decree is the comprehensive settlement between the U.S. Department of Justice, U.S. Environmental Protection Agency, Hawaii Attorney General's Office, Hawaii Department of Health, three environmental groups, and the City. It will address Clean Water Act compliance at Honolulu's wastewater collection and treatment systems. See U.S.A. v. City and County of Honolulu, Civ. No. 94-00765 DAE-KSC. The consent decree requires completion of construction and full implementation of all remedial and control measures at the Honouliuli WWTP no later than June 1, 2024 and at the Sand Island WWTP by no later than December 31, 2035, with an opportunity to extend the Sand Island WWTP schedule an additional 3 years for financial hardship. The City estimates that the cost of the injunctive relief to install secondary treatment will be over \$1.5 billion.