ADMINISTRATIVE REPORT

Date: January 12, 2012
Agenda Item No.: 4
Meeting Date: January 18, 2012

To: **COST OF SERVICE AND RATE DESIGN CITIZEN ADVISORY COMMITTEE**

From: **SHANA EPSTEIN, VENTURA WATER GENERAL MANAGER**

Subject: **RECOMMENDATIONS STEMMING FROM COST OF SERVICE AND RATE DESIGN STUDY**

RECOMMENDATIONS

It is recommended that the Committee:

a. Accept the assumptions in the long-range financial plan as stated in this report.

b. Establish a reserve target for the Water and Wastewater Enterprise Funds.

c. Determine the revenue requirement adjustment most appropriate to meet the fiscal needs and customer expectations of the Water and Wastewater Enterprise Funds for FY13 and FY14.

d. Determine the preferred rate structure to meet the pricing objectives exercise.

e. Provide feedback regarding modifications of the City's current cost pass-through policy to assist in implementing revenue increases based upon other agencies or organizations rate increases or CPI (Consumer Price Index) adjustments.

SUMMARY

In order to complete the Cost of Service and Rate Design Study, staff prepared a ten-year financial projection, which included operations and maintenance costs and capital improvement programs. During the November and December meetings of the Committee, staff and Raftelis Financial Consultants (RFC) presented a number of assumptions that are required to prepare such a projection. The purpose of a long-range planning exercise is to assist in determining how much funds should be collected in reserves to smooth out revenue requirement adjustments over the years, and avoid drastic rate fluctuations. To

complete a long-range financial plan, a number of assumptions must be made to project all costs in the water and wastewater enterprise funds budgets. The projected costs establish the basis of the revenue requirements. That is, rates must be designed to generate enough revenue to cover the projected expenditures for any given year.

It is important to note that the acceptance of the long-range financial plan does not supersede the annual budget adoption process. Annual budget modifications are expected in response to changing conditions and priorities. The significance of the financial plan process is to develop a strategic roadmap which includes debt timing and reserve levels to guide the long-range fiscal health of the organization.

In addition, the rate design is formulated through recognizing the collective pricing objectives resulting from the prioritization exercise completed in October. Modifying a rate structure has impacts to different customer classes and impacts on how those customers will consume water. Most importantly, the rate design is being evaluated through the lens of Proposition 218 to ensure all customers are paying rates equitable to the services that they receive.

DISCUSSION

Long Range Financial Plan Assumptions

The following information details the assumptions used in establishing the 10-year financial plan. While it is expected that changes will occur, they represent the best estimate today of how growth, costs and revenue patterns may shift in the future.

Growth rates

- Single Family Residential (SFR) – no growth in FY 2012 and 0.5% per year thereafter
- Multi-family Residential (MFR) – no growth in FY 2012 and 0.5% per year thereafter
- Commercial/Industrial – no growth in FY12 and 0.5% per year thereafter
- Other – no growth
- Outside City customers – no growth

Inflation Assumptions

- General – 3% per year
- Salaries – no change through FY15, and 0.5% per year thereafter
- Benefits – approximately 0.3% per year
- Utilities – 7.5% in FY13 and 5% per year thereafter
- Chemicals – 5% per year
- Capital – 3.5% per year

Reserves Targets

- Operating reserves – 3 months (or 25%) of operating expenses
- Capital reserves – 50% of average replacement CIP, increasing to 100% in FY17

Interest rates

- Reserves – Earn 1% in FY12 and 13, increasing at 0.5% per year until 2.5% in FY16
- New debt issue – 5.5%, 30-year term

Customer Water Consumption

- Usage projections – 2% reduction for two years, 1% reduction annually starting in FY15
- Historical usage – see June 2011 Urban Water Management Plan consumption and per capita daily use chart (Attachment A)

Wastewater Projections

- Infiltration and inflow – 7%
- Single family density – 2.6 people per household
- Multi-family density – 2.25 people per household
- Per capita daily generation – 53 gallons per person

Capital Improvement Program

While the operating budgets have remained fairly static within the framework of inflation and significant cost pressures from energy and chemical increases over time, funding the infrastructure renewal program represents the lion's share of future higher revenue requirements. The available funding avenues – cash, debt and/or grants – each have their advantages and disadvantages and require careful planning, timing and coordination for optimization. Based on the latest Water and Wastewater Master Plans and today's best estimates, the following projects by category are contained in the 10-year financial plan.

Water = Total $120.4M

- Well Projects – $25.7M
- Pipeline Projects – $42.1M
- Tank Projects – $7.2M
- Pump Station Projects – $3.4M
- Facility Projects – $7.9M
- Treatment Projects – $34.1M

Wastewater = Total $145.M

- Pipeline Projects – $ 29.6M
- Lift Station Projects – $6.6M
- Treatment Projects – $35.8M
- Facility Projects – $6.1M
- Estuary Protection Projects – $67M

While the dollar amounts include an inflationary escalation factor for projects scheduled in later years, the total amount in the financial plan represents only 75% of the overall estimated costs. The total program includes 66 projects but based on historical project completion rates and shifts caused by changing priorities, scope changes, and other unforeseen factors, the plan anticipates that around 50 of these will actually require funding during the 10-year period. This aligns revenue requirements to more realistic timeframes since the capital program is the primary driver of rate increases.

Over the past ten years, the capital program has expended $81.3 and $64.8 million for 44 total projects for the water and wastewater systems, respectively. This included a new membrane filtration plant to treat Ventura River water and significant upgrades to the Ventura Water Reclamation Facility to improve treatment processes to meet strict new environmental regulations and modernize aging facility components. During the next ten years, the plan includes more pipeline replacements, new replacement wells as well as funding for a reuse diversion structure for the water currently discharged by the Reclamation Facility into the Santa Clara River Estuary.

Debt Issuance Ratios
As noted, borrowing money through bonds or other debt programs is one of the funding avenues historically used to support one-time capital projects and is a strong player in the financial portfolios of most utilities. The ratio between how much debt versus cash (or pay-as-you-go) requires the community and future generations to shoulder debt payments. Since debt funding for assets that have a long life expectancy will primarily benefit customers in the future, spreading those costs is often deemed an appropriate funding strategy.

Higher debt loads result in greater revenue needs over the long term, but cost less in the short term. Conversely, choosing to use today's cash to fund projects requires more short-term revenue, but costs less in the long run.

The revenue requirements for the proposed rates reflect a 67% debt ratio for the Water Fund and a 65% debt ratio for the Wastewater Fund.

<u>Debt Service Revenue Requirement</u>
A related issue, the balance between revenue and debt payments is also a factor in the financial planning strategy. Revenue levels must be set sufficiently to cover debt service requirements of at least 125% of net operating income. Currently, projected revenues will not be able to meet debt service coverage requirements in this fiscal year for the Wastewater Fund.

Outside City Rates
Customers outside of the City limits have been charged historically a rate differential of 70% as supported by the *Hansen v. City of Ventura* Supreme Court decision in 1986. Research has shown that the factors that existed at that time, namely financial

contributions to improve assets and water supply for former customers of Saticoy and Mound Water Company, are no longer valid. However, there are financial contributions from City customers that are appropriate to recover from outside City customers which are as follows:

- Property tax on water utility's assets: $0.05/HCF. As the utilities' assets are City property and do not pay property taxes, the City's General Fund and its residents absorb this revenue loss which is not shared by outside City customers.
- Police and fire protection costs on water utility's assets: $0.10/HCF. The assets are protected by Ventura's Police and Fire personnel who are funded by the City's General Fund.
- Differential water supply costs: $0.58/HCF. The water utility's first responsibility is to provide water to City customers. Additional water supply and long-term planning is needed to serve outside City customers and that differential should be recovered.

Since these allocations are cost based and meet Proposition 218 requirements, outside City customers during the next rate adjustments will be imposed a flat surcharge of $0.73 per unit of water (HCF: hundred cubic feet=748 gallons).

Reserve Policy
The City's current Financial Administrative Policy and Procedures regarding financial reserves for Enterprise Funds do not set a specific level for fund balance reserves but allow for:

- Timely replacement of rolling stock and other equipment and infrastructure repairs and/or replacement.
- Adequate cash flow.
- Funds for emergency purchases.
- Maintenance of a ratio of net operating income to debt service requirements of at least 125% (1.25:1).

A more structured policy is a common business practice for modern utilities. The assumptions in the financial plan include an Operating Reserves target of 3 months (or 25%) of operating expenses and a Capital Reserves target of 50% of average replacement of assets, gradually increasing to 100% in FY17. The Operating Reserves will allow for adequate cash flow during disasters or other emergencies and the Capital Reserves will assist in building financial stability to support a healthy replacement program going forward.

Revenue Requirement Adjustment
The long term financial plan, based on the projected operating, debt payments and capital improvement expenses as well as reserve requirements, reflects the need for next fiscal year of $1.6M and $1.4M more revenue for the Water and Wastewater Fund, respectively. For FY14, another $1.7M for Water and $1.0M for Wastewater is projected.

Rate Structure

The rate structure itself has remained essentially unchanged since its inception in the early 1990s. One of the objectives of the Cost of Service Study was to re-evaluate the equity and effectiveness of the rate structure to serve this community's needs in the future. Based on the pricing objectives exercise, the Committee was presented with six different rate structures that identified customer class impacts at the December 14, 2011 meeting. Those options have been narrowed down to three for each utility and customer impacts will be shown with the new revenue requirements as projected in the first year of the financial plan during tonight's presentation by RFC (Attachment B). Depending on the rate structure selected, it is expected that staff will present the final rate modifications required to meet the next two fiscal year's revenue requirements to the Committee for their final review at the January 25, 2012 meeting.

Water Overview

Bi-monthly water charges are currently assessed based on a flat meter charge plus a per unit cost for each HCF used during the period. At this time, the meter service charge is approximately 19% of the total utility's expense. To aid in revenue stability, it is recommended that this charge be increased to recover 25% of expenses. There are three options proposed for the volumetric charges with the second option recommended based on its better alignment with current usage patterns.

WATER (SERVICE CHARGE 25% + HCF VOLUME)					
1	Current	Tier 1 (0-16)	Tier 2 (17-42)	Tier 3 (43+)	
2	Revise 3 Tiers	Tier 1 (0-14)	Tier 2 (15-30)	Tier 3 (31+)	
3	Revise 3-Tiers+Add 4th	Tier 1 (0-14)	Tier 2 (15-24)	Tier 3 (25-36)	Tier 4 (36+)

Wastewater Overview

The current wastewater rate structure sets each residential customer into one of six flat tiers each July for the next year based on the lowest water consumption during the previous November to April, when landscape watering is minimized due to rain and cooler weather. Option two proposes a flat bi-monthly charge for all residential customers and the third option mirrors the current water structure with a fixed service charge plus a volume charge based on actual water usage each bi-monthly billing period. In recognition of irrigation usage, the flow charge would be capped at 20 HCF for single family and 16 HCF for multi-family customers.

While more complicated to implement and explain, option 3 is recommended for its nexus to water usage. Customers who use less water would experience reductions in both their water and their wastewater charges and water efficiency would be encouraged during all 12 months of the year.

WASTEWATER		
Option 1: **Current Annual Tiers**	Option 2: **Residential Flat Charge**	Option 3: **Fixed + Flow Charge**
Tier 1 (0-8)	Single Family	Single Family (capped at 20 HCF)
Tier 2 (9-10)	Multi-Family	Multi-Family (capped at 16 HCF)
Tier 3 (11-12)		
Tier 4 (13-14)		
Tier 5 (15-16+)		
Tier 6 (17+)		

Pass Thru Policy
The City's water ordinance includes a pass thru mechanism for third party charges that has never been implemented. In July 2010, the City Council approved evaluating the feasibility of this mechanism to recover significant, unbudgeted expenses that might occur between rate adjustment cycles. The ordinance language is proposed to be updated to meet Proposition 218 requirements and to clarify what types of costs and under what conditions a pass thru may be activated. While our budget process attempts to anticipate increases in major expense categories such as energy, chemicals, pumping charges, and water costs, unexpected expenses can strain our financial resources. Some agencies have scheduled CPI (Consumer Price Index) inflation increases to avoid costly rate processes for years when the financial plan is essentially on target. We are requesting the Committee's input on this subject so that we can draft a recommendation to Council.

Revenue and Rate History
Revenue history from FY95 through FY10 reflects a net increase of $9,709,164 and $7,593,055 for the Water and Wastewater Funds, respectively (Attachment C). Water residential and non-residential history is detailed for tier ranges, unit costs, and meter service charges (Attachment D). Wastewater rate history is charted for all customer groups (Attachment E).

Next Steps
In summary, in addition to any outstanding items, it is anticipated that the next Committee meeting on January 25 will cover the following topics:

- Year two revenue requirements and customer impacts as reflected in the preferred rate structure.
- Specific pass thru policy language and its potential relationship to projected revenue requirements in later years.
- Alternatives/options to fund the reuse/diversion program as a result of the settlement to protect the Santa Clara River Estuary.

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For

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Attachment A – 2010 Urban Water Management Plan Base Daily Per Capita Water Use Chart
Attachment B – RFC Draft January 18, 2012 Presentation
Attachment C – Water and Wastewater Funds Revenue History
Attachment D – Water Rate History
Attachment E – Wastewater Rate History