



Agenda Item No. _____

File Code No. _____

CITY OF SANTA BARBARA

COUNCIL AGENDA REPORT

Item 07

AGENDA DATE: January 13, 2015

TO: Mayor and Councilmembers

FROM: Water Resources Division, Public Works Department

SUBJECT: Proposed Water Rate Increases For Fiscal Year 2016

RECOMMENDATION: That Council:

- A. Provide final direction to staff on the water rates that may be required to address costs associated with the drought, including reactivation of the Desalination Plant;
- B. Set a Public Hearing date for March 10, 2015, at 2:00 PM, in the Council Chambers for Council consideration of increases in the City water rates for Fiscal Year 2016;
- C. Direct staff to release the Notice of Public Hearing to customers, informing them of the hearing date and the proposed changes to the water rates; and
- D. Authorize the Public Works Director to amend and increase a City Professional Services Contract, subject to approval as to form by the City Attorney, with Raftelis Financial Consultants, in an amount not to exceed \$35,000, bringing the total amount of the contract to \$77,397, for support services related to water rates modeling.

DISCUSSION:

On July 29, 2014, Council authorized the Public Works Director to execute a City Professional Services contract with Raftelis Financial Consultants, Inc. (Raftelis), in the total amount of \$42,397, for the Stage Three Water Rate Model Study (Study). The Study has been developed in preparation for continued drought conditions, and the possible need for reactivation of the City's Charles Meyer Desalination Plant (Desalination Plant). The scope of the Study included updating the Water Fund Financial Plan, and developing a rate structure sufficient to generate revenues needed to cover the cost of reactivating the Desalination Plant, along with other expected drought-related costs. The proposed rates are also structured to increase the incentive for reduction in customer water use to ensure the planned 20-percent water demand reduction is achieved. The proposed rates would go into effect on July 1, 2015 at the beginning of Fiscal Year 2016.

The Study assumes that the Desalination Plant will produce 3,125 AFY of water for one year, beginning in summer 2016, and then be put in standby mode, producing a minimal amount of water to keep the Desalination Plant in a ready state. Annual operating costs are estimated at approximately \$5 million per year for full plant production, and

approximately \$2.5 million per year for standby mode. Continuation of the drought would trigger the need for an extended Desalination Plant operation, and possibly for increased production. This scenario would provide additional revenue and require a subsequent rate study.

The capital cost for reactivating the Desalination Plant for a water supply of 3,125 acre-feet per year (AFY) is approximately \$32 million; however, there are significant unknown potential costs. Final project costs will be unknown until a few weeks prior to the award of the contract to design, build, and operate the Desalination Plant, scheduled for May 2015. Staff recommends that the rate notice provide the flexibility to generate sufficient revenues to cover up to \$40 million in capital costs for the Desalination Plant, should proposals to design and build the Desalination Plant come in at that range. In compliance with Proposition 218, the City must notice the maximum rates that could be adopted, but the actual effective rates shall reflect the actual costs to be incurred.

The City will require water rate modeling support associated with adjusting the water rates in spring 2015, to reflect actual Desalination Plant project costs and loan terms, to evaluate water rate scenarios with varying capital funding, and to update the City's buy-in fees for new water connections. These services require support from Raftelis, who are expert financial consultants and who were originally chosen to work on the City's water rates through a competitive Request For Proposals process. The City has an existing Agreement No. 24,936 with Raftelis. The agreement entered into was for a total amount of \$42,397. Staff requests authorization to increase the agreement with Raftelis by \$35,000, for a total not to exceed amount of \$77,397. There are sufficient funds in the Water Fund for this request.

Drought Water Rate Study

Revenues

On a long-term basis, revenue must be sufficient to meet the costs of operating the water system, which includes water purchases, treatment, operations and maintenance expenses, capital improvements, and principle and interest payments on existing debt. Short-term differences between revenues and expenses are balanced by the use of reserves. Increased water rates and some use of reserves will be required for Fiscal Year 2016 to fund the cost of the Desalination Plant and to achieve the 20-percent City-wide water demand reduction target. Rate increases are recommended for all rate tiers in order to cover the full cost of service and maintain the reserve balance at or above Council policy.

With drought-related costs, including costs for reactivating the Desalination Plant, total revenues generated from water rates in Fiscal Year 2016 is expected to increase by 30 to 39 percent over Fiscal Year 2015. The range depends on whether funding for the Water Main Replacement Program is postponed until after the drought is over, or continues during the drought. Planned water main replacements are currently on hold due to funding being diverted to drought-related projects. Emergency water main repair

work has continued as needed. Council policy is to fund annual replacement of one percent of the water system, or approximately three miles of main replacements per year, at an average cost of \$4.2 million. Under Option 1 (Attachment 1), there would need to be another rate increase in Fiscal Year 2018, when the drought ends, to fund a multi-year accelerated Main Replacement Program to catch up to the 1% replacement goal. Under Option 2 (Attachment 2), the Fiscal Year 2016 rates would include continued funding for the Main Replacement Program, with construction to begin when the drought ends. Staff is requesting Council's direction on whether funding for the Water Main Replacement Program should be accelerated after the drought (Option 1) or continue during the drought (Option 2).

Rates Based on Cost of Service

Total revenue requirements, less revenue from other sources such as interest earnings and payments from other agencies that are provided services by City's Water Treatment Plant, are defined as the "cost of service." This cost is the basis for allocating costs to various customer classes by considering both the average and peak quantity of water usage.

Rates are designed to ensure that customers pay their proportionate share of costs, based on the cost of service to supply water to that customer class. The cost associated with each of the City's diverse water sources differs. To provide affordable water for basic health and sanitation, and to sustain residential, parks and agricultural services, Tier 1 is allocated the least expensive water. The remaining, more expensive water is allocated to Tiers 2 and 3, because water use in these tiers is more discretionary, and is generally for outdoor water use, such as irrigating landscapes.

Pursuant to State law established by Prop 218, the Right to Vote on Taxes Act, customers must be notified of any proposed increases to rates at least 45 days prior to the date of the public hearing for Council's consideration of the rate increases. Staff is recommending Council direction to mail the Proposition 218 rate notices to customers during the week of January 19, 2015, in preparation for a March 10, 2015 public hearing. The version to be mailed is pending Council's direction on funding for the Water Main Replacement Program (Option 1 vs. Option 2). Staff is also seeking Council's input on the content of the rate notice; specifically, on how the cost of the Desalination Plant is communicated. Additionally, staff is looking for any input the Council might have on the Drought Frequently Asked Questions (Attachment 3) document that will accompany the Rate Notice.

BUDGET/FINANCIAL INFORMATION:

The proposed drought water rates have been developed to meet the 20 percent demand reduction target, while also meeting the revenue needs of the Water Fund, along with some use of reserves. The projected revenue from water sales has been set to maintain adequate debt service coverage, including sufficient revenue to cover debt service payments, debt service margin, and operating costs. Additional funding will be

needed to cover the cost of necessary drought-related capital projects. It is expected that reserves will be used for Capital Program expenses. As the drought condition changes, staff will re-assess the financial plan and water rates at that time.

ATTACHMENT: Attachment 1 – Draft Rate Notice
(Option 1 - Delayed Funding for Main Replacement)
Attachment 2 - Draft Rate Notice
(Option 2 - Full Funding for Main Replacement)
Attachment 3 – Frequently Asked Questions

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SUBMITTED BY: Rebecca J. Bjork, Public Works Director

APPROVED BY: City Administrator's Office