



City of Santa Barbara

Public Works Department

Memorandum

DATE: September 17, 2020

TO: Water Commission

VIA: Joshua Haggmark, Water Resources Manager

FROM: Malcolm Hamilton, Water Resources Financial Officer

SUBJECT: Water Rate Study Update

PURPOSE:

That Water Commission receive a presentation from HDR Engineering, Inc., the City's rate consultant, and provide input on the planned schedule of adoption for water rates and financial planning scenarios to be analyzed.

BACKGROUND:

In October 2019, the City contracted with HDR Engineering, Inc. (HDR) to conduct a comprehensive rate study and perform a cost-of-service analysis for water rates. The cost-of-service study will examine all current assumptions, supporting data, and policy points of the existing rate structure, and ensure that proposed rates are compliant with Article XIII D, Section 6 of the California constitution. This section of California law is commonly referred to as Proposition 218, which was approved by voters in 1996. Proposition 218 includes the requirement that rates may not exceed the estimated cost of providing the service (i.e., cost-based), and must be reasonable, equitable, and proportional.

In February 2020, staff came to the Water Commission and outlined the major policy and planning inputs for the rate study, including the planned adoption period, operating and capital costs, water supply outlook, projected water demands, customer classes, and rate design. At the time, staff intended to recommend a three year rate adoption schedule that would go into effect Fiscal Year 2021 and continue through Fiscal Year 2023. HDR's preliminary analysis of the revenue requirement found that revenue increases of 6% for Fiscal Years 2021, 2022, and 2023 would be necessary to meet the Water Utility's financial obligations. The COVID-19 pandemic, however, introduced significant uncertainty into the rate model, and caused immediate financial hardships for community members and businesses.

In response to the new planning environment under COVID-19, staff came to the Water Commission in April and May 2020 to look at various rate adoption scenarios and the forecasted impacts on future rate increases, capital funding, reserve levels, and debt coverage. The largest immediate impact from COVID-19 to the Water Fund was reduced rate revenue

from the Commercial customer class. Commercial water demand, which is heavily influenced by commuters and tourism, declined in the last quarter of Fiscal Year 2020 – April, May, and June. This drop in commercial demand, coupled with community-wide water conservation that was higher than expected, led to a shortfall of \$3.66 million in rate revenues. However, positive budget variances in salary and benefits, discretionary spending, and water supply fees offset the shortfalls in revenue. Discretionary spending, in particular, saw substantial savings as Water staff deferred or curtailed all non-essential activities in anticipation of these COVID-19 related impacts. More recently, rate revenue from July and August has shown some rebounding to pre-COVID revenues, but staff continues to watch this closely as the long-term effects from COVID-19 have yet to be seen.

Revised Rate Adoption Schedule and Rate Revenue Analysis

In May 2020, the Public Works Budget, including the Water Fund, was presented to Council. In that presentation, staff recommended deferring any water rate increases planned for July 1, 2020, instead opting to target a three percent increase to go into effect in January 2021. Under this scenario, customers would experience a mid-year rate increase in January 2021, but also an increase in July 2021 and annually for two years thereafter. Given the financial stresses placed on the community from COVID-19, staff's interest in having more information available on the COVID-19 financial impacts, and Council's desire to provide relief where possible to the community, staff is recommending a complete deferral of rate increases for Fiscal Year 2021. With that, staff will be returning to Water Commission in early 2021 and going to Council soon after, to recommend a three-year rate adoption schedule for Fiscal Years 2022, 2023, and 2024. In the short term, the Water Fund has reserves in excess of Council Policy that may be used to supplement lost revenue from a pause on rate increases.

As mentioned in the April 2020 Water Commission meeting, it is important to note that rate increases have a compounding effect from one year to the next—small changes in the near term will have large impacts over the course of a 10-year financial plan. Initial analysis showed that foregoing a rate increase in Fiscal Year 2021 would require a combination of reducing capital funding or choosing to debt finance certain projects where applicable, and also looking at opportunities to reduce operating costs – this is still the case. However, the rate model has been updated with the most current capital project needs, timelines, and funding estimates, which has minimized planned capital reductions by smoothing cash outlays and choosing to debt finance certain projects. In the next several years, two State Revolving Fund loans will come to maturity, which will partially offset any new debt financing obligations. The \$10 million desalination grant, estimated water demand, and level of debt financing are the key variables in the rate model that HDR continues to model. HDR will be presenting several scenarios to the Water Commission that consider the optimistic and conservative forecasts for these key variables. Given varying levels of consumption and debt financing, and whether or not the \$10 million desalination grant is able to be executed, HDR is estimating rate revenue increases of 3.5 percent to 5 percent over the three-year rate adoption schedule for the various scenarios.