



Agenda Report

November 16, 2015

TO: Honorable Mayor and City Council

THROUGH: Municipal Services Committee (November 10, 2015)

FROM: Water and Power Department

SUBJECT: RECOMMENDATION TO SET THE DATE OF JANUARY 11, 2016 TO CONDUCT A PUBLIC HEARING TO IMPLEMENT THE WATER SYSTEM CAPITAL IMPROVEMENTS CHARGE FORMULA PURSUANT TO PASADENA MUNICIPAL CODE CHAPTER 13.20.035

RECOMMENDATION:

It is recommended that the City Council:

1. Find that the recommended Water Capital Improvement Charge ("CIC") formula is exempt from the California Environmental Quality Act ("CEQA") pursuant to State CEQA Guidelines Section 15273 (Rates, Tolls, Fares, and Charges);
2. Set the date of January 11, 2016 for a public hearing to:
 - a. Approve the implementation of the CIC formula as defined in the Water Rate Ordinance ("Ordinance") to recover the capital improvement costs of the water distribution system. Based on the currently adopted Fiscal Year ("FY") 2016 Water Fund Capital Improvement Program ("CIP") budget, this would result in system average increase of \$0.45 per billing unit ("BU") to the Capital Improvement Charge ("CIC") effective January 18, 2016; and,
 - b. Authorize implementation of the CIC formula for FY 2017 based upon adoption of the CIP budget.

EXECUTIVE SUMMARY:

The CIC is a volumetric component (a charge for each unit sold) of the water rate that provides funds for capital investment in the Water System. The CIC rate formula was established at a time when unit sales were expected to be approximately 14-15 million billing units annually. Over the past five years the CIC has provided approximately \$8 million of annual revenue based on average sales of about 12.7 million billing units. As a result, revenue collection from the CIC has been lower than planned and the Water System Capital Improvement Plan has been funded by cash reserves and additional debt, specifically by the issuance of Build America Bonds ("BABs") in FY 2011.

Governor Brown's Executive Order issued in April 2015, for State-mandated reductions in water usage, requires Pasadena to reduce its usage by 28% during the stated compliance period. As a result of reduced billing units sold, it is anticipated that the Water System will experience a reduction of \$12 million in gross revenues and a net income reduction of \$6 million.

(Numbers shown in \$ millions)	2016 Adopted Budget	2016 Revised Projections	Difference
Gross Operating Revenues	\$59.0	\$46.9	(\$12.1)
Operating Expenses	\$55.1	\$49.0	(\$6.1)
Net Income	\$3.9	(\$2.1)	(\$6.0)

The Ordinance includes a formula-based CIC rate that was meant to be adjusted annually to reflect changes in water sales and planned capital investment in the Water System; however, implementing the CIC rate adjustment formula requires a hearing in compliance with Proposition 218. It is recommended that a public hearing be conducted to clearly establish that an annual CIC rate adjustment (if needed) based on the approved capital budget will meet cost-based rate requirements as defined by Proposition 218.

It is important to note that approval of the recommended actions will have the effect of restoring the CIC rate to the level that would have been in place had annual adjustments to the formula been implemented for each year since it was last adjusted in FY 2008. However, these actions will not recover revenues that were not collected during the years when the rate was not adjusted.

Adoption of the recommended actions would result in an average increase to the CIC rate of \$0.45 per billing unit in order to generate sufficient revenues on an annual basis to cover the debt service and cash-funded portion of the adopted CIP. The new system average CIC rate would be \$1.09 per billing unit.

Two primary factors contribute to the need for the proposed CIC rate adjustment. CIC-funded debt service requirements have increased and are responsible for approximately 25% of the proposed adjustment. The balance of the increase is due to reduced unit sales of water. Capital expenditures over the five-year planning period on which the CIC formula is based are expected to remain at about the same level as compared to the last five years and so will have very limited impact on the rate increase. However, potential expenditures associated with construction of the Non-Potable Water Pipeline Project ("Recycled Water") are not included in these projections nor would they be recovered under the proposed CIC rate increase unless further adjustments were made.

The CIC rate formula will be reviewed as part of the ongoing cost of service update and potential rate restructuring that will be presented to the Municipal Services Committee ("MSC") and City Council during FY 2016. The FY 2017 budget will be prepared based on the expectation that the CIC formula will be applied to projected capital expenditures.

BACKGROUND:

In November 2002, the Water System Master Plan (“Master Plan”) was approved by the City Council to provide a framework for a \$235 million investment in Water System capital improvements over an eighteen-year period through the year 2020. The focus of the master plan includes replacement of aging pipelines, seismic and efficiency upgrades to the City’s reservoirs and other projects to insure system reliability and excellent water quality. The Master Plan also integrated a financing plan comprised of a variety of revenue sources, including pay-go (cash financing) funding from current rates and the issuance of long-term revenue bonds. In February 2003, the Ordinance was amended to establish a formula-based CIC rate to fund the pay-go portion of the Master Plan CIP.

The CIC is an entirely volumetric rate that generates revenues that increase or decrease based on customers’ water consumption. Under Section 13.20.035 of the Ordinance, the CIC formula is to be adjusted annually by the Department to provide revenues to fund capital improvements based on City Council approval of the capital budget. The CIC rate is computed by a formula based on a number of variables, including projected unit sales and planned capital investment in the Water System.

This section of the Ordinance was established prior to the passage of Proposition 218 and so was not subject to the requirements that were later established. Proposition 218 defines water service as a property-related service and requires a 45-day notice to property owners that will be affected by a proposed rate change and to provide the opportunity to comment on and/or oppose the proposed changes.

CIC Rate Revenue Performance

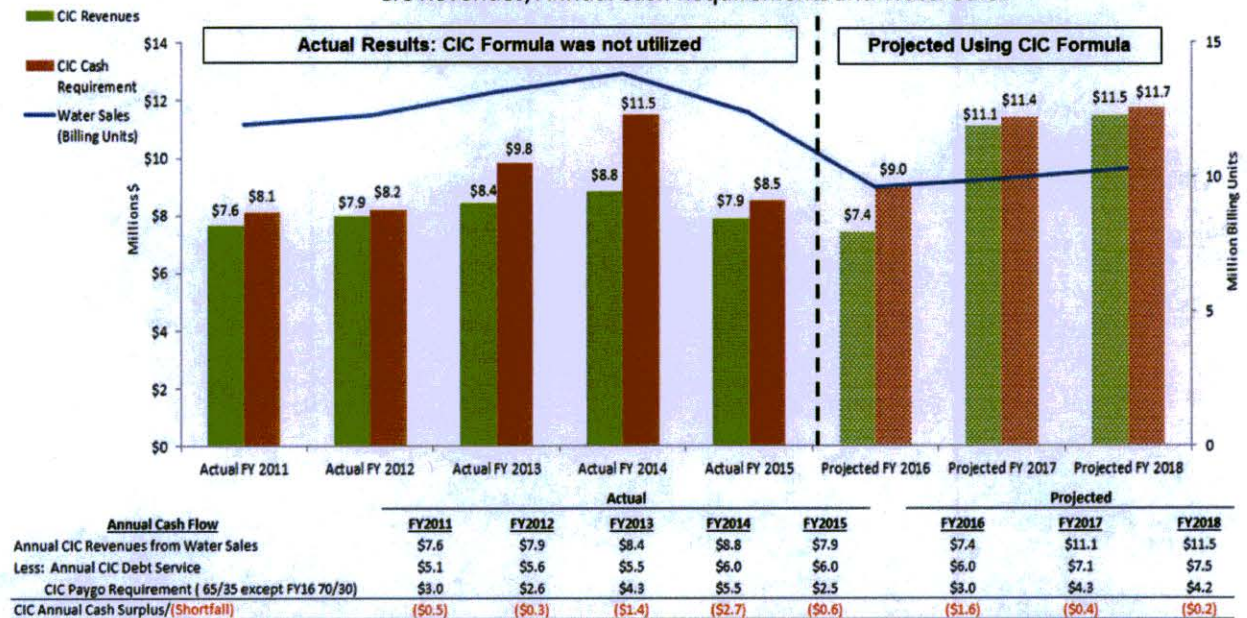
When the CIC formula and the resulting rate was originally implemented in FY 2004, projected annual revenue was expected to reach \$10-12 million to support capital investment as presented in the Master Plan. After it was first implemented, the original rate was adjusted in fiscal years 2005, 2007 and most recently in 2008. The maximum revenue of about \$10 million was collected in FY 2008. Water sales began to decline beginning in FY 2009 due to the success of early conservation programs and the general decline in the economy leading to the “Great Recession.” For several years, capital investment in the Water System was also decreased because less funding was available and staffing levels were reduced.

Over the past five years, the CIC rate has generated average annual revenue of about \$8 million as a result of actual unit sales that were less than projected. As shown in Figure 1, capital expenditures have exceeded revenues generated by the CIC for each year since 2011. This has created a cumulative “structural deficit” of about \$6 million of funding for investment in capital infrastructure for the Water System.

Figure 1 also shows the projected CIC revenues compared to planned cash requirements for each of the next three fiscal years if the proposed adjustment of the CIC formula is implemented. The projected revenues are based on a slight, gradual

increase in sales for each of the next three years, primarily due to new water service connections. Implementation of the proposed rate adjustment would restore the funding needed to match projected capital expenditures, thereby eliminating the annual “structural deficit” in future years.

Figure 1
 CIC Revenues, Annual Cash Requirements and Water Sales



Cash requirements are projected to increase beginning in FY 2017 due to higher estimated debt service costs and expanded investment in reservoir improvements and upgrades to the spreading basins in the Arroyo Seco during FY 2017 and FY 2018. However, total average capital expenditures eligible for CIC funding over the next five years are expected to remain stable compared to the previous five years. The recommended rate adjustment will provide additional funding to more closely match revenues with projected CIC cash requirements.

Attachment A provides additional detailed information about five-year historical and projected capital expenditures and funding sources, including CIC revenues and debt funding.

Proposition 218:

In November 1996, Proposition 218 was approved by California voters with the intent to ensure that all taxes and most charges to property owners are subject to voter approval and to further limit the use of assessments and property-related fees to pay for general governmental services rather than property-related services. In July 2006, the California Supreme Court ruled that water rates are property-related fees for Proposition 218 purposes. This ruling requires that water rate increases are subject to specific notification and public hearing requirements.

Specifically, PWP is required to conduct a public hearing not less than 45 days after mailing the notice of the proposed rate increase to the owners of each identified parcel to which the proposed rate will apply. At the public hearing, all protests against the rate increase are to be considered. If protests against the proposed rate increase are presented by a majority of owners of the identified parcels, the rate increase shall not be imposed.

The CIC Formula:

The CIC rate formula is designed to recover revenues equal to the amount of planned cash-financed capital expenditures in the adopted CIP budget plus ongoing debt service associated with bond-financed capital expenditures related to the Master Plan. Per the Water Rate Ordinance, Section 13.05.035(c), adjustments to the CIC shall be adjusted by the following calculation:

$$\text{Capital Improvement Charge} = \frac{((\text{Funding Target Ratio} \times \text{Capital Expenditure}) + \text{Debt Service})}{\text{Water Sales}}$$

Where:

“Funding Target Ratio” is the ideal debt to equity (cash) funding ratio.

“Capital Expenditure” is equal to the five-year average annual Water Fund capital expenditure.

“Debt Service” is the five-year average annual CIC related debt service payment.

“Water Sales” is the water system projected sales for the next twelve months.

As defined in the Water Rate Ordinance, adjustments to the CIC shall be calculated by the department and shall take effect on the first of the month following City Council's approval of the Water Fund Capital Improvements Program ("CIP"). The CIC was last adjusted on August 1, 2007 and adjustments to the CIC have been deferred to due to the economic down turn and to provide for modifications to other components of the water rate without unacceptable overall bill increases.

Proposed CIC Adjustment:

PWP's water sales are expected to decrease by 28% in FY 2016 due to PWP customers response to the State's mandate, and a reduced level of customer water usage is expected to be standard going forward based on the significant response to the call to conserve. CIC revenues, which are entirely volumetric and based on unit sales, will be inadequate under the existing rate to support debt service obligations and prudent reinvestment in the City's water system infrastructure.

The proposed rate adjustment is based on unit sales for FY2016 of 9.6 million billing units, which reflects the annual water sales associated with meeting the 28% water conservation target. The rate adjustment also considers a five-year average CIC-funded capital expenditure of \$10.9 million. While PWP normally plans on a cash Funding Target Ratio of 35% for capital investment, a ratio of 30% is recommended for FY2016 only. The projected debt service of \$7.18 million includes increased debt service from an anticipated bond issuance of up to \$40 million in FY2017. The proposed adjustment

does not include funding for construction of the Recycled Water project, for which a separate financing plan is being developed.

Applying these values to the CIC rate formula results in the proposed CIC rate of \$1.09/BU as follows:

$$\text{CIC} = ((30\% \times \$10.9 \text{ M}) + \$7.18 \text{ M}) / 9.6 \text{ M BU} = \$1.09/\text{BU}$$

Upon conclusion of a successful public hearing, the CIC rates would be increased as shown in Table 1 as a result of applying the CIC rate formula to the FY2016 capital budget. Table 1 contains the existing and proposed CIC rates for summer and winter periods and for customers inside (Area A) and outside (Area B) the City limits.

**Table 1
 Existing & Proposed CIC Rates per Billing Unit**

	Existing Rates	Proposed Rates	\$ Increase
Summer			
Area A	\$0.62429	\$1.06715	\$0.44286
Area B	\$0.84274	\$1.44056	\$0.59782
Winter			
Area A	\$0.58896	\$1.00676	\$0.41780
Area B	\$0.79504	\$1.35902	\$0.56398

In future fiscal years, the CIC rate may increase if CIP budgets increase or sales continue to decline. Conversely, the CIC rate may decrease if CIP budgets decrease or water sales begin to rise.

Table 2 contains examples of the projected impacts on the monthly bill for customers at various consumption levels.

**Table 2
 Sample Impacts of CIC Increase on Monthly Bills (no change in usage)**

Meter Size	Monthly Usage	Existing Monthly Bill	Impact of Proposed CIC Increase	Revised Monthly Bill	% Change
5/8"	5	\$27.19	\$2.09	\$29.28	7.7%
3/4"	12	\$46.95	\$5.01	\$51.96	10.7%
1"	25	\$101.80	\$10.45	\$112.25	10.3%
1 1/2"	100	\$389.65	\$41.78	\$431.43	10.7%
2"	125	\$518.99	\$52.23	\$571.22	10.1%
4"	600	\$2,334.85	\$250.68	\$2,585.53	10.7%
6"	1,400	\$5,017.95	\$584.92	\$5,602.87	11.7%
8"	2,400	\$9,075.38	\$1,002.72	\$10,078.10	11.0%

While the above comparisons demonstrate the bill impact assuming historical water use, on average customers are currently using 30% less water than in FY2014 and about 40% less water than in FY2007 when the CIC rate was last adjusted. Table 3 illustrates the monthly bill impact of the CIC rate increase for a residential customer with a ¾ inch connection who also reduced usage by 25%.

Table 3

Bill Comparisons Based on Reduced Water Consumption		
	Historical Usage	Reduced Usage
Monthly Usage	12	9
Existing Monthly Bill	\$46.95	\$36.50
Impact of CIC Increase	\$5.01	\$3.76
Revised Monthly Bill	\$51.96	\$40.26
% Change	10.7%	(14.2%)

Timeline and Next Steps:

Following the City Council's action to set a date of January 11, 2016 for the public hearing, a notice will be mailed to all rate payers that will explain the recommended CIC rate adjustments and provide information of the time and place for the public hearing and the process to file a protest or comment. The Table 4 provides the timeline for the CIC proceedings.

Table 4

Date	Action Item
October 27, 2015	MSC Consideration of Recommendation to Set Public Hearing
November 10, 2015	Additional Information presented, Recommendation to Set Public Hearing
November 16, 2015	City Council to Set Public Hearing Date
November 19, 2015	Notice of Public Hearing Mailed per Prop 218 Requirements
January 11, 2016	Public Hearing Date
January, 2016	Implement Updated CIC Rate

In the upcoming months, PWP will present an information item to the MSC regarding the water cost of service study and water rate restructuring proposal. Components of the rate restructuring under consideration are:

- Customer Classifications
- Water Block Allocations
- Rate Stabilization Drought Surcharge
- Redesign of the Capital Investment Charge
- Excessive Water Usage Penalty

COUNCIL POLICY CONSIDERATION:

The proposed CIC proceedings conform to the City Council's Strategic Planning Goals of delivering exemplary municipal services by maintaining the financial stability of the Water System.

ENVIRONMENTAL ANALYSIS:

The recommended increase to the Capital Improvement Charge ("CIC") is statutorily exempt from CEQA. Section 15273 of the State CEQA Guidelines identifies a statutory exemption for "Rates, Tolls, Fares, and Charges" and states (in part) that:

- a. *CEQA does not apply to the establishment, modification, structuring, restructuring, or approval of rates, tolls, fares, or their charges by public agencies which the public agency finds are for the purpose of:*
 1. *Meeting operating expenses, including employee wage rates and fringe benefits,*
 2. *Purchasing or leasing supplies, equipment, or materials,*
 3. *Meeting financial reserve needs and requirements,*
 4. *Obtaining funds for capital projects, necessary to maintain service within existing service areas, or*
 5. *Obtaining funds necessary to maintain such intra-agency transfers as are authorized by city charter.*

FISCAL IMPACT:

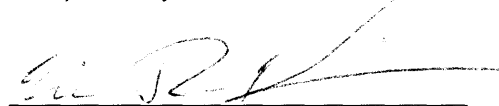
The cost of this action will be approximately \$25,000 for printing and postage expenses to deliver approximately 40,000 public hearing notices to all property owners and water system rate payers.

Funding for this action will be addressed by the utilization of existing FY2016 budget appropriations in accounts 49007920-811000 - Outside Printing and 49007920-814400 - Postage.

The anticipated impact to other operational programs or capital projects as a result of this action will be none.

If the rate action is ultimately approved, over the course of a full year the adjusted CIC rate would result in the collection of \$10.4 million for investment in water system capital infrastructure, an increase of \$4.3 million over the current CIC revenues. Additional revenues for FY 2016 of approximately \$1.5 million are expected based on estimated unit sales for a partial year implementation of the revised rate.

Respectfully submitted,



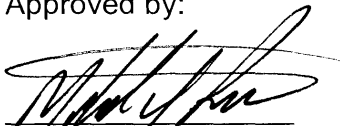
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Attachments

Attachment A – Five-Year Historical and Projected Capital Expenses and Revenues