

Agenda Report

January 11, 2016

TO: Honorable Mayor and City Council
FROM: Water and Power Department
SUBJECT: PUBLIC HEARING TO IMPLEMENT THE WATER SYSTEM CAPITAL IMPROVEMENT CHARGE FORMULA PURSUANT TO PASADENA MUNICIPAL CODE ("PMC") CHAPTER 13.20.035.

RECOMMENDATION:

It is recommended that the City Council:

1. Find that implementation of the recommended Water Capital Improvement Charge ("CIC") formula is statutorily exempt from the California Environmental Quality Act ("CEQA") pursuant to State CEQA Guidelines Section 15273 (Rates, Tolls, Fares, and Charges);
2. Open a public hearing to receive public comment on the proposed implementation of the CIC 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;
 - b. Adopt recommended system average increase of \$0.45 per billing unit ("BU") to the CIC based on the adopted Fiscal Year ("FY") 2016 Water Fund Capital Improvement Program ("CIP") budget and forecast water sales volumes; and,
 - c. Authorize use of the CIC formula for FY 2017 based upon adoption of the CIP budget and updated forecast of water sales volumes;
3. Direct the City Clerk or department representative to report on timely written protests received;
4. Close the Public Hearing;
5. Approve the proposed CIC formula implementation and use, and the associated CIC rate increase effective January 18, 2016 or as soon as practical thereafter; and
6. Direct the City Attorney to prepare an amendment to PMC Chapter 13.20.035 to reflect the proposed CIC formula implementation and use.

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. PMC Chapter 13.20 (“Water Rate Ordinance”) includes a formula-based CIC rate established in 2003 that was intended to be adjusted annually to reflect changes in water sales volumes and costs associated with capital investment in Water System infrastructure. It has been determined that implementing the CIC rate adjustment formula requires a hearing in compliance with Proposition 218. The staff recommendation to conduct a public hearing will 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.

Governor Brown’s April 2015 Executive Order mandating state-wide reductions in water use requires Pasadena to reduce its usage by 28% from calendar year 2013 levels. As a result of reduced water consumption, it is anticipated that the Water System will experience a \$12 million reduction in gross revenues and a \$6 million reduction in net income for FY 2016 as summarized in Table I. Approximately \$2.2 million of the reduction in gross revenues is attributable to the CIC.

**Table I
 Budget Impact of the State Mandated 28% Reduction in Water Usage**

(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)

Approval of the staff recommendations will result in an average CIC rate increase of \$0.45 per billing unit (a system average water rate increase of approximately 10%) in order to generate sufficient revenues on an annual basis to cover existing debt service, the cash-funded portion of the adopted FY 2016 CIP and a portion of the debt service for revenue bonds that may be issued later in the fiscal year. The new system average CIC rate of \$1.09 per billing unit would generate additional CIC revenues of approximately \$1.5 million for the balance of FY 2016 and \$4.3 million over twelve months at forecast water sales volume of approximately 9.6 million billing units per year.

The recommended actions will have the effect of restoring the CIC revenues to the level that would have been collected in the current year had annual adjustments to the formula been implemented as required since it was last adjusted in 2008. However, these actions will not recover revenues that were not collected during the years when the rate was not adjusted.

If the recommended actions are approved, the FY 2017 budget will be prepared based on the expectation that the CIC formula will be applied using projected water sales volumes and capital expenditures in the proposed FY 2107 budget. As a result, further adjustment of the CIC would be implemented as required.

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 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 Chapter 13.20.035 of the Water Rate Ordinance, the CIC formula is to be adjusted annually by the Pasadena Water and Power Department (“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.

The CIC rate formula was established prior to the passage of Proposition 218 and therefore was not subject to the requirements that were later implemented. 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.

The City applies a rate differential for customers residing outside of the City limits. The differential is defined in the Ordinance and is based on the higher cost to serve customers outside the City limits. The current rate differential is 25% for the water rates that recover operating and maintenance costs, namely the Commodity Charge and Distribution and Customer Charge. The differential is 35% for the CIC rate because the most recent rate action taken by the City Council in 2009 to address the outside-City rate differential did not apply to the CIC rate. The Department is currently undertaking a full water cost of service study that will include a review of the current rate structure, including the CIC and the rate differentials charged to outside-City customers. The results of the study and potential restructuring of the water rates will be presented to the City Council in 2016.

Proposition 218 Requirements

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, the Department 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.

Proposition 218 Compliance

On November 16, 2015, the City Council established the date of January 11, 2016 to conduct a public hearing to receive public comment on the proposed implementation of the CIC formula.

Pursuant to the requirements of the Proposition 218, public hearing notices were mailed on November 20, 2015 to all property owners/tenants and ratepayers of record regarding the date and time of the public hearing for the proposed implementation of the CIC formula. The notice included the process by which written protests to the proposed implementation of the CIC formula may be submitted. A copy of the public notice is included as Attachment A. The Department posted the public notice and related information on the City's website and also published the notice in two local newspapers on November 25, 2015 and November 26, 2015.

One written protest per parcel, filed by an owner or tenant of the parcel, shall be counted in calculating a majority protest for purposes of Proposition 218. Receipt of written protests by a majority of property owners or ratepayers would prevent the proposed implementation of the Water CIC formula.

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. 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. During the same period, capital expenditures have exceeded revenues generated by the CIC for each year, thereby creating a cumulative "structural deficit" of about \$6 million of funding for investment in capital infrastructure for the Water System. This revenue deficit has been managed by the use of bond funds and capital reserves.

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, Chapter 13.05.035(c), adjustments to the CIC shall be determined 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 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 volume for the next 12 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 provide relief to customers during the economic down turn and to provide for modifications to other components of the water rate without unacceptable overall bill increases.

Proposed CIC Adjustment

The proposed rate adjustment is based on the following values for variables in the CIC formula:

- **Water Sales:** Forecast sales of 9.6 million billing units per year, which reflects the annual water sales associated with meeting the 28% water conservation target. Water sales for the first six month of FY 2016 were 22% less than in CY 2013. If water conservation continues at this level of savings, water sales for the full FY 2016 will be approximately 10.4 million billing units.
- **Capital Expenditure:** The rate adjustment also considers a five-year average CIC-funded capital expenditure of \$10.9 million. The proposed adjustment does not include funding for construction of the Recycled Water project, for which a separate financing plan is being developed.
- **Funding Target Ratio:** While the Department normally plans on cash Funding Target Ratio of 35% for capital investment, a ratio of 30% is recommended for the proposed initial CIC rate adjustment as a means of mitigating the magnitude of the immediate rate impact. The Department plans to return to the 35% average cash Funding Target Ratio in FY 2017.
- **Debt Service:** The projected debt service of \$7.18 million includes increased debt service from an anticipated bond issuance of up to \$40 million in FY 2017. If the bonds are not issued or some other amount of bonds is issued, the CIC formula will be adjusted as appropriate in the future. A larger CIC increase may result if revenue bonds are not issued and the level of capital investment remains

the same. Approval of the recommended actions does not include automatic approval by the City Council of a future revenue bond issuance. The sale of revenue bonds will be presented to the City Council as a separate action.

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

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

Attachment B provides additional information about the capital expenditure work plan for the water system for FY 2016 through FY 2020. It is important to note that there are several funding sources for capital expenditures, including revenues from the CIC rate, customer-funded improvements, the Reclaimed Water project and projected grants and reimbursements from other agencies. Attachment B also provides information about annual debt service from existing and proposed revenue bonds for each fiscal year during this period. The debt service in Attachment B for the proposed bond issue should be considered an estimate only; actual debt service would be based on the number of bonds issued, market interest rates and other associated costs of issuance.

Upon conclusion of the public hearing and approval by the City Council, the CIC rates would be increased as shown in Table II as a result of applying the CIC rate formula to the FY 2016 capital budget. Table II 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 II
Existing & Proposed CIC Rates (\$ per Billing Unit)

	Existing Rates	Proposed Rates	Increase
Summer			
Area A	\$0.62	\$1.07	\$0.44
Area B	\$0.84	\$1.44	\$0.60
Winter			
Area A	\$0.59	\$1.01	\$0.42
Area B	\$0.80	\$1.36	\$0.56

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 III contains examples of the projected impacts on the monthly bill for customers at various consumption levels assuming no change in water consumption habits. While these comparisons demonstrate the bill impact assuming historical water use, on average the Department's customers are currently using 30% less water than in FY 2014 and about 40% less water than in FY 2007 when the CIC rate was last adjusted.

Table III
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%
3"	300	\$1,251.03	\$125.34	\$1,376.37	10.0%
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%

Alternative Rate Actions

Although the staff recommendation is to implement a system average CIC rate increase of \$0.45 per billing unit based on the adopted FY 2016 Water Fund CIP budget and current water sales forecasts as described above, the City Council may decide to take an alternative action with respect to the CIC rate. The level of billing unit sales is a key component of the CIC formula, and the actual level of sales for the remainder FY 2016 and beyond is not known with certainty at this time. Table IV provides a comparison of the recommended \$0.45 increase with alternative CIC rates that are computed based on higher water sales forecasts.

Table IV
Alternative Sales Volume Forecast Scenarios

Sales Forecast (Billing Units)	9,600,000	10,000,000	10,400,000
Reduction in sales from CY 2013 (%)	28%	25%	22%
Formula CIC Rate Increase (\$/Billing Unit)	\$0.45	\$0.41	\$0.36
Overall System-Average Rate Increase	10%	9%	8%
Full CIC Rate (\$/Billing Unit)	\$1.09	\$1.05	\$1.00
FY2016 CIC Revenue @ Current CIC Rate (\$0.64/Billing Unit)	\$ 6,144,000	\$ 6,400,000	\$ 6,656,000
New Revenue from CIC Increase (February - June 2016)	\$ 1,512,000	\$ 1,435,000	\$ 1,310,400
Projected FY2016 CIC Revenue	\$ 7,654,000	\$ 7,835,000	\$ 7,966,000
Projected Annual Revenue at Full CIC Rate	\$ 10,464,000	\$ 10,500,000	\$ 10,400,000

Although water conservation efforts thus far have not achieved the 28% mandatory conservation goal, sales continue to decline and staff recommends setting the CIC based on the assumption that the goal will be achieved over the next twelve months, resulting in water sales volumes of approximately 9.6 million billing units. Assuming a higher level of water sales for the purpose of the setting the CIC rate is contrary to the City's ongoing efforts to meet the water conservation goal and sends a mixed message to the Department's water consumers. Regardless, the water sales forecast will be revisited when the CIC rate formula is reapplied as recommended herein following adoption of the FY 2017 budget.

COUNCIL POLICY CONSIDERATION:

The revenues generated by the recommended implementation of the CIC rate formula will enable the Department to remain aligned with the City Council goals to:

- Maintain fiscal responsibility and stability
- Improve, maintain and enhance public facilities and infrastructure
- Increase conservation and sustainability

The recommended actions will ensure that the Department continues to meet the projected revenue requirements essential to meet debt service obligations and make the capital investments included in the Water System Master Plan without adversely affecting ongoing operations. Furthermore, maintaining the volumetric CIC rate structure provides the maximum possible incentive for customers to conserve water.

ENVIRONMENTAL ANALYSIS:

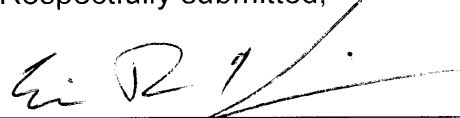
The recommended increase to the CIC is statutorily exempt from CEQA. Section 15273 of the State CEQA Guidelines identifies a statutory exemption for "Rates, Tolls, Fares, and Charges" and states (in part) that:

- 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:

Approval of the proposed CIC rate increase would result in the collection of CIC revenues totaling \$10.4 million per year for investment in water system capital infrastructure, an increase of \$4.3 million per year over the current CIC revenues. Additional revenues for FY 2016 of approximately \$1.5 million are expected based on estimated water sales volumes for a partial year implementation of the revised CIC rate.

Respectfully submitted,



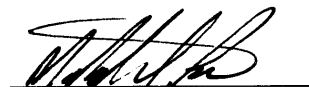
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Attachment

- Attachment A - Public Hearing Notice
- Attachment B - Alternative CIC Rate Scenarios