OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: January 5, 2007 **IBA Report Number:** 07-03

City Council Docket Date: January 8, 2007

Item Number: 201 and 202

Subject: Proposition 218 Noticing of Proposed Water and Sewer Rate Adjustments

OVERVIEW

Items 201 and 202 on the City Council docket for January 8, 2007 request Council authorization to proceed with a public notification process for proposed water and sewer rate increases pursuant to Proposition 218 requirements.

Proposition 218, approved by California voters in 1996, amended the California Constitution to require, among other things, voter approval for all new or increased property-related fees. The language of the Proposition specifically exempts fees or charges for sewer, water, and refuse collection from the voter approval requirement; however, local agencies wishing to implement new or increased fees or charges for these services still must comply with Proposition 218's notification requirement.

If the items currently before the City Council are approved, Water and Sewer staff will mail notices to all property owners of record by no later than January 11. Under the proposed schedule, a formal public hearing will be held on February 26, at which point the City Council will have the opportunity to consider the proposed water and sewer rate increases, provided that a majority protest by noticed property owners is not achieved.

It should be made clear that no action taken by the Council at this time will result in any changes to existing water and sewer rates. This point bears repeating: no action requested by the Council at this time will increase water or sewer rates. All that is being requested at this time is the authorization to proceed with the Proposition 218 notification requirements. That being said, we believe that it is prudent to understand the basis for the proposed rate increases prior to conducting the notification process.

Finally, it should be noted that at the February 26th hearing the City Council may not approve a rate increase greater than what was listed on the public notification without a process of re-notification. Under Proposition 218 the Council does have the legal authority to approve a smaller rate increase or approve a rate increase for a fewer number

of years than what is listed on the notification, or approve no rate increase at all. However, approving rate increases that are lower than those currently proposed may run the risk of not being able to comply with the requirements of the Water Department Compliance Order or the MWWD Final Consent Decree.

FISCAL/POLICY DISCUSSION

One of the requirements of Proposition 218 is that fees or charges imposed for property-related services such as water and sewer must not exceed the proportional cost of the service attributable to each user. In order to determine whether water and sewer charges are in compliance with this requirement, the City must from time to time conduct a Cost of Service Study.

The purpose of the Cost of Service Study is to examine the various cost components of providing water and sewer service, and to determine how those costs are allocated across all utility customers. On this basis, different users may then be charged in relation to their proportionate share of total costs, as required by Proposition 218.

While the current actions request that the Council accept the Water and Wastewater Cost of Service Studies, these Studies are not the focus of this report. Determining the cost of water and sewer service is an extremely elaborate and meticulous process, involving theoretical and philosophical considerations, applying industry standards and methodologies, and performing complex calculations. We defer to the expertise of the consultants regarding the conclusions in the Cost of Service Studies. However, we do support the recommendations made by the Cost of Service Studies regarding modifications to the water and sewer rate structures, as these modifications would result in more precise and equitable water and sewer charges. This support includes the recommendation to increase capacity charges for both water and sewer, since these charges are designed to recover the cost of providing additional system capacity when new users enter the system.

This report focuses on the proposed water and sewer rate increases by first reviewing the capital needs for both the Water and Sewer Departments, and then examining the process by which the rate increase proposals were derived. In addition, we highlight some of the salient factors included in the rate calculations, as well as a few significant issues that are not addressed at this time.

WATER DEPARTMENT CAPITAL NEEDS

The City of San Diego Water Department has developed a multi-year capital improvement program, for which water rate increases are being sought. The driving

force behind the capital improvement plan is a Compliance Order with the State Department of Health Services (DHS). In 1994, the City entered into a Compliance Agreement with DHS, which required the City to correct operational deficiencies and begin a series of needed capital improvements. In 1997, the City was notified that it was not in compliance with this agreement, and a Compliance Order was issued by DHS.

The Compliance Order identified a list of specific capital projects that the City was required to complete. These projects include reservoir rehabilitations and replacements, improvements to the Alvarado Water Treatment Plant, and improvements to various pump plants and transmission pipelines. The Compliance Order also mandated several operational enhancements and quality targets, such as optimizing the water treatment process to achieve certain targets, and requiring certain employees to have minimum level of certification and training.

The Compliance Order has undergone ten amendments since originally issued in 1997, the last coming in 2004. That amendment included new projects that were not in the original Compliance Order. The table below presents a list of projects required by the Compliance Order that are yet to be completed, and which are included in the Water Department's proposed FY08 – FY11 capital improvements plan.

DHS Required Projects

Annual Allocation for Water Main Replacement[1]	$153.9 million
Alvarado Water Treatment Plant Phase 4 (Ozone)	$65.8 million
Miramar Water Treatment Plant - Contract A	$2.6 million
Miramar WTP Contract B - Flocculation/Sedimentatin Basins	$71.1 million
Mirama WTP Contract C - Ozone Equipment/Installation	$28.7 million
Otay 2nd Pipeline - Cast Iron Replacement Phase	$15.0 million
Rancho Bernardo Reservoir Rehabilitation	$6.7 million
Rancho Penasquitos Pump Station	$10.4 million
TOTAL	**$354.1 million**

1. The Compliance Order required 10 miles of water main replacement per year. The figure shown here is the estimated cost of the City's more aggressive plan to replace 15 miles of pipe in FY08 and 20 miles in FY09 and thereafter.

In addition to the DHS-Required Projects listed above, the Department has identified a series of additional capital improvements that are needed, including DHS-Related Projects and Operational Required Projects. DHS-Related Projects refer to projects that are not specifically itemized in the Compliance Order, but that must be done in order to facilitate completion of other DHS-Required Projects. Operational Required Projects are priority projects identified by the Department that are necessary to avoid future deterioration of water system infrastructure. The table below shows the total cost of anticipated capital projects over the forecast period, FY08 – FY11.

Projected Capital Improvement Project Costs, FY08-FY11

DHS Required Projects	$354.1 million
DHS Related Projects	$116.3 million
Operational Required Projects	$49.6 million
Long Range Water Supply Projects	$30.2 million
Grant-Funded Projects	$25.1 million
EPA - 50% Beneficial Reuse	$7.8 million
Caltrans Projects	$2.1 million
TOTAL	**$585.2 million**

The tables above clearly demonstrate the capital needs facing the Water Department. It should be noted that DHS-Required and DHS Related Projects constitute 80% of the identified needs. The remaining 20%, while not related to mandated requirements, will provide needed improvements to the aging water system infrastructure. Without these additional improvements, the City may find itself under the obligations of another Compliance Order in the future.

Water Re-Use

One prominent issue not addressed in either the Water Department's capital improvements plan or rate case is that of enhanced water re-use opportunities. As part of the agreement to gain approval of a renewed modified NPDES permit for the Point Loma Wastewater Treatment Plant, the City was required to conduct a comprehensive study of possible uses of reclaimed water, including indirect potable reuse (IPR).

On January 13, 2004 the City Council approved a resolution directing the City Manager to conduct a year-long study to evaluate options for increasing the beneficial use of recycled water. The Final Draft Report was released in March 2006, and presented to the Natural Resources & Culture Committee on July 26, 2006. The Report included six potential strategies for water reuse, three pertaining to the North City Water Reclamation Plant (NCWRP) and three to the South Bay Water Reclamation Plant (SBWRP).

For both the NCWRP and the SBWRP, these strategies range from only non-potable projects similar to the City's existing recycled water program, to a mixture of non-potable and small-scale IPR opportunities, to large-scale IPR opportunities. While any combination of these potential strategies would reduce dependency on imported water and decrease water purchases, they would also come with significant capital and operating costs. We concur with the Water Department's decision to withhold consideration of expanded water reuse opportunities until further policy direction is provided.

METROPOLITAN WASTEWATER CAPITAL NEEDS

The Metropolitan Wastewater Department (MWWD) has developed a multi-year plan of required capital projects aimed at satisfying the requirements of the Proposed Final Consent Decree. The City of San Diego is currently operating under a Partial Consent Decree, entered into as a result of the consolidated cases of *United States v. City of San Diego* and *Baykeeper v. City of San Diego.* The Partial Consent Decree expires on June 30, 2007, and the Court has firmly indicated that it will not allow further delays in signing the Final Consent Decree. The City will not be allowed to enter into the Final Consent Decree without having the means to fund the required projects.

The Final Consent Decree requires the City to replace or rehabilitate pipelines and trunk sewers, upgrade various pump stations, and maintain operations and maintenance at current levels. The Consent Decree consists of specific capital projects that must be completed, such as rehabilitation and upgrades to specific pump stations; broad requirements for infrastructure improvement, such as replacing, rehabilitating or permanently repairing at least 45 miles of pipeline per year; and operational requirements such as implementing a Residential Grease Outreach and Education Program.

The table below shows the total estimated capital project costs for the proposed capital improvement plan over the forecast period, FY08 – FY11.

Proposed Capital Improvement Project Costs, FY08-FY11

Pipeline Replacement & Rehab.	$277.0 million
Trunk Sewer Rehabilitation	$197.0 million
Treatment Plants Upgrades	$82.0 million
Municipal Pump Stations	$32.0 million
Large Pump Stations	$15.0 million
Other Projects	$45.0 million
TOTAL	**$648.0 million**

Of the $648.0 million in anticipated capital improvement project costs, approximately $473.4 million, or 73%, is attributable to projects and requirements specifically listed in the Consent Decree. It should be noted that the Consent Decree will require capital improvements beyond the four-year timeframe presented in the current rate case. Additional rate increases will likely be necessary after FY11 in order to maintain compliance with the Final Consent Decree.

Point Loma Secondary Treatment

One significant item that is not factored in to the sewer rate case is the issue of secondary treatment at the Point Loma Wastewater Treatment Plant (PLWTP). The PLWTP is currently operating with a modified NPDES permit that does not require full secondary

treatment of wastewater prior to discharge through the deep ocean outfall. However, it is widely anticipated that the City will eventually be required to upgrade the PLWTP to secondary treatment. It is estimated that this upgrade may cost anywhere from $700 million to $1.2 billion.

The current modified permit will expire in June 2008. The cost of upgrading to secondary treatment has not been included in the current rate case because the City has not yet made a decision whether to apply for another modified permit or begin upgrading to secondary treatment immediately. It should be noted, however, that while the full Council has not rendered a decision, the Rules Committee voted unanimously on July 26, 2006 to work toward a Consent Decree that would implement secondary treatment at the PLWTP.

Given the magnitude and the range of the estimated cost associated with upgrading to secondary treatment, we cautiously support the decision to not include PLWTP secondary treatment in the current rate case. However, we wish to strongly point out that this issue is significant and impending, and will likely require significant sewer rate increases to address. We urge that this issue be discussed expeditiously, and brought to the full Council for decision as soon as possible.

RATE INCREASE PROPOSALS

The first step in developing a rate proposal is to determine total revenue requirements, or expenditure needs, over a given period of time. For both the Water and Sewer utilities, revenue requirements generally consist of three components: operation and maintenance (O&M), capital expenditures, and reserve requirements. The second step in the process is to project current operating and capital revenues over the same time period. The difference between total revenue requirements and projected revenues from existing sources is the revenue requirement that must be met through rate increases.

In developing their rate proposals, both the Water and Sewer Departments have thoroughly examined their revenue requirements and anticipated revenues from existing sources. Building on a myriad of assumptions and applying advice from outside experts, the Departments have carefully crafted revenue and expenditure projections in a methodical, step-by-step process, and have concluded that rate increases will be necessary to meet their respective revenue requirements. The following sections describe the various components of the revenue requirements, and highlight some of the salient points about the projections.

Operations & Maintenance

For the Water Department, O&M costs include the cost of operating and maintaining water supply, treatment, storage and distribution facilities, as well as costs associated

with providing technical services and administrative costs such as meter reading and billing. For MWWD, O&M costs are accounted for in both the Municipal Fund and the Metropolitan Fund. In the Muni Fund, for which the City is exclusively responsible, O&M costs include pumping and collection, laboratory and other technical costs, and various administrative costs. In the Metro Fund, O&M costs include Metro pumping, wastewater treatment, technical services, ocean outfalls, sludge disposal, cogeneration and other general administrative costs. The Metro O&M costs are partially offset by the Participating Agencies who are serviced by the Metro system. In general, O&M costs reflect the routine cost of doing business.

The growth assumptions employed by both Water and MWWD in projecting O&M costs are very similar. Some of the most prominent of these assumptions are listed below:

- Salary and Wages – Both Water and Sewer assume a 4% increase in FY08 to accommodate for the final year of the current labor contracts. For all remaining years, no growth is assumed, consistent with the Mayor's 5-Year Financial Outlook.
- Inflation – Both departments assume a 4% inflation factor in each year for most non-personnel expenditures. It is stated that this is a somewhat conservative inflation factor.
- Pension – Additional pension contributions of $2.4 million and $1.9 million per year are factored in for both Water and Sewer, respectively.
- Retiree Health – Both departments are assumed to begin contributing their proportional share to the Retiree Health fund in FY08. Contributions are ramped up over three years until full funding of the ARC is reached. Water is projected to contribute $2.0 million in FY08, increasing to $6.0 million in FY10 and thereafter. Sewer's contributions are projected to increase from $2.7 million in FY08 to $8.3 million in FY10 and thereafter.
- Enterprise Resource Planning (ERP) System – Both departments are assumed to begin funding their proportional share of ERP implementations costs, consistent with the Mayor's response to the Kroll report.

The table below shows the overall annual growth projected in O&M costs for both Water and Sewer.

Projected O&M Costs, FY08-FY11

	FY08	FY09	FY10	FY11
Water	278,997,419	284,853,598	301,285,404	308,253,399
%	*6.07%*	*2.10%*	*5.77%*	*2.31%*
Sewer[1]	208,085,377	216,531,388	225,990,819	231,209,759
%	*1.07%*	*4.06%*	*4.37%*	*2.31%*

1. Includes total O&M cost from the Muni Fund, and the City's share of O&M costs from the Metro Fund.

Over 40 percent of the Water Department's projected O&M expenditures are due to water purchase costs, which are projected to increase at an average of approximately 1.0% per year. This assumes that the unit price of water will remain constant throughout the forecast period. Although the County Water Authority (CWA) will be increasing water purchase rates on January 1, 2007, this increase, known as a pass-through, is already factored into the rate case. However, it should be pointed out that although future pass-throughs are anticipated, none have been assumed in the projected water purchase costs. Should CWA increase rates again during the forecast period, the City will have to either undergo another Proposition 218 notification process in order to pass those rate increases on to retail customers, or absorb the additional costs.

Capital Expenditure Needs

Capital expenditure needs are by far the largest driver of revenue requirement increases. The significant capital needs for both Water and Sewer were discussed in detail in the previous Capital Needs sections. As shown in those sections, the Water Department is anticipating $585.2 million in capital project costs between FY07 and FY11, while MWWD is anticipating $648.0 million. These amounts represent new and additional revenue requirements for the respective departments.

Capital projects are funded primarily through bond proceeds and current revenues, referred to as pay-as-you-go, or pay-go. Both Water and Sewer aim to fund 80 percent of their capital costs through bond financing and 20 percent as pay-go. In order to finance the 80 percent portion, the Water Department anticipates issuing bonds in FY08 and FY10, generating gross proceeds of $334.7 million and $260.2 million respectively. MWWD anticipated issuing bonds in each year during the forecast period, generating total anticipated proceeds of $471.8 million. These debt issuances will require significant increases in annual debt service payments. The increase in debt service payments, as well as the funds required for the 20 percent pay-go, directly drives the increase in revenue requirements.

One of the concerns with the capital improvement plans proposed over the forecast period by both the Water and Sewer is that they do not include various deferred or cancelled projects that had been included in previous rate cases. It seems reasonable to assume that from time to time the relative priority of different capital projects will change, particularly as new studies are done, new information becomes available and more urgent problems are discovered. However, absent further explanation, this discrepancy may give the impression that the deferred or cancelled projects are no longer priorities or that they were never priorities in the first place.

While we believe that there are valid reasons for why certain projects were cancelled or continue to be deferred, we feel that a more comprehensive explanation would be helpful in reconciling current and past priorities. We recommend that both the Water and Wastewater Department report back to the City Council on or before the February 26th hearing with a list of all deferred or cancelled projects that are not included in the current projects list for FY08 – FY11, and provide a basic explanation as to why they are not currently included.

One of the challenges in evaluating the current rate case is in assessing the criticality of certain proposed capital projects. It is easy to understand the urgency of projects required by the Compliance Order and the Final Consent Decree. However, given the limited discussion of the City's overall water and sewer infrastructure needs, it is less clear to what extent all other projects constitute critical needs. While this doesn't mean that we believe these projects are not critical, we feel that more frequent and in-depth dialogue regarding the City's water and sewer infrastructure needs is both welcomed and warranted. The Natural Resources and Culture Committee would be the appropriate venue for further discussion of the City's water and sewer infrastructure needs. Furthermore, the capital programs proposed in the current rate case should come back to Council during the annual budget process each year for review and adoption, including the identification of any changes to the capital programs originally proposed.

Reserve Requirements

Another component that drives total revenue requirements is funding needed to maintain reserve levels. Both Water and Sewer have multiple reserve types that are factored in to their overall revenue requirement projections. Examples of such reserves are listed below:

- Debt Service Reserves – Debt service reserves are restricted reserves that provide protection against defaulting on bond payments in times of financial need. One year of debt service payments is required in the reserve, meaning that each time the City issues new bonds, the debt service reserve goes up.
- Operating Reserve – Operating reserves are used to meet ongoing cash flow requirements, as well as emergency requirements. In the past, both Water and Sewer have maintained a 45-day operating reserve. However, the rate case reflects both departments building to a 70-day reserve over several years.

- Unallocated Reserve – The unallocated reserve is intended to provide for unanticipated needs that arise during each year. For Water, this reserve will be set at 4% of the Department's operating budget in FY08 and thereafter. For MWWD, the unallocated reserve will be funded at $3.3 million.
- Secondary Purchase Reserve (Water) – This reserve is intended to be used as a reserve for water purchases. It is set at 6% of total water purchases to ensure that sufficient revenue is available to purchase additional water if local supplies are deficient.
- Other Reserves – Other reserves such as the Rate Stabilization reserve or CIP reserves add to the overall revenue requirements. In addition, a minimum fund balance is usually required.

Projecting the total revenue requirements for both the Water and Sewer Departments is an arduous process involving many different components, each of which require their own delicate assumptions and projection methodologies. Overall, the revenue and expenditure projections calculated for both Water and Sewer appear to be fundamentally sound and comprehensively presented, and reflect dedication and exemplary effort by Water and Sewer staff.

Shames Settlement

A complicating factor in the proposed sewer rate increase has to do with the settlement reached in the case of *Michael Shames v. City of San Diego*. In 2004, Michael Shames, executive director of the Utility Consumers Action Network, filed a lawsuit against the City alleging that single family resident (SFR) customers had been paying a disproportionately high share of sewer rates to the benefit of commercial and industrial users. On December 6, 2006, the City Council approved a settlement of the lawsuit that would give $35 million in rebates to SFR customers over four years.

In order to generate the additional revenue necessary to pay this rebate, an additional rate increase must be levied on non-SFR customers. However, the State Water Resources Control Board has informed the City that these rebates constitute a cost to the Wastewater Enterprise Fund, and therefore must be allocated across all ratepayer classes, including SFR customers. In order to exact the required revenue from non-SFR customers yet maintain compliance with Proposition 218 cost allocation requirements, MWWD proposes to levy an additional rate increase on all customers, and then provide an equivalent rate offset for SFR customers. Current SFR customers who are entitled to a rebate will then be provided a rebate in the form of a credit on their monthly sewer bills. Rebates to non-current SFR customers will be paid if such customers submit a Proof of Claim to the City establishing that they are not currently an SFR Customer, but were so during any period from May 23, 1994 through September 20, 2004.

The table below shows the additional rate increase that is to be applied to all sewer customers, above and beyond the proposed rate increase for capital improvements and operations, and the associated rate offset given to SFR customers.

Shames Settlement Rate Increases

	FY08	FY09	FY10	FY11
Proposed Rate Increase	8.75%	8.75%	7.00%	7.00%
Shames Rate Increase - All Customers	3.05%	3.05%	0.60%	0.50%
Shames Rate Offset - SFR Customers	(3.05%)	(3.05%)	(0.60%)	(0.50%)
Total Rate Increase - SFR Customers	8.75%	8.75%	7.00%	7.00%
Total Rate Increase - Non-SFR Cust.	11.80%	11.80%	7.60%	7.50%

It should be noted that the additional rates calculated for payment of the Shames settlement assume that the regular proposed rate increases will be adopted. Should the adopted rate increase be less than what is currently proposed, the Shames rate will increase, up to a possible 6.0% if no other increase is adopted.

CONCLUSION

The actions currently before the City Council request authorization to proceed with the public notification process for proposed water and sewer rate increases, pursuant to Proposition 218 requirements. No action taken by the City Council at this time will make any changes to the current water and sewer rates. However, we felt that it was important to understand the basis for the rate proposals before proceeding with the notification process. Accordingly, the focus of this report was on reviewing the capital needs for both the Water and Sewer Departments, and examining the process by which the rate increase proposals were derived.

Our review indicated that both the water and sewer systems have significant capital needs, driven largely by mandates from the State and Federal government through the DHS Compliance Order and the Partial Final Consent Decree. Furthermore, the revenue and expenditure projections used in both the Water and Sewer rate cases are comprehensive, and appear to be both fundamentally sound and supportive of the proposed rate increases. The IBA is prepared to conduct further analyses between now and the February 26 at the request of the City Council. However, given the magnitude and complexity of the rate proposals, we request specific questions or requests for analyses.

It is important to reiterate that additional water and sewer rate increases may be required in the future in order to meet the requirements of the Compliance Order and stay in compliance with the Final Consent Decree. In addition, significant issues such as Water Reuse enhancement and upgrading the Pt. Loma Wastewater Treatment Facility to secondary treatment are not considered in the current rate proposals, and must be addressed in the near future.

Finally, we recommend that Water and Sewer staff report back to the City Council on or before the February 26th hearing with a list of all deferred or cancelled projects that are not included in the current projects list for FY08 – FY11, and provide a basic explanation as to why they are not currently included. We further recommend that the capital programs proposed in the current rate case should come back to Council during the annual budget process each year for review and adoption, including the identification of any changes to the capital programs originally proposed.

[SIGNED]

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