THE CITY OF SAN DIEGO

**M E M O R A N D U M**

DATE: October 21, 2015

TO: Honorable Council President Lightner and Council Members

FROM: Halla Razak, Director of Public Utilities

SUBJECT: Water Cost of Service Study Memoranda & Information

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This memo serves as the transmittal of five separate attachments listed below. These documents provide various information on the Public Utilities Department – Water Fund cost of service study that will be brought forward for public hearing and City Council deliberation on November 17, 2015.

Halla Razak

SG/slh

Attachments:
1. Answers to Frequent Questions from City Council & Community Members
2. The Real-World Consequences of Not Changing Water Rates
3. Effects on the Water System if Proposed Water Rate Change is Not Approved
4. Rollback of the Capital Improvement Program if No Water Rate Change
5. Overview of Cost of Service Study and Water Rates

cc: Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Mary Lewis, Chief Financial Officer
Paz Gomez, Deputy Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst

Attachment 1

**THE CITY OF SAN DIEGO**

**M E M O R A N D U M**

DATE: October 21, 2015

TO: Honorable Council President Lightner and Council Members

FROM: Halla Razak, Director of Public Utilities

SUBJECT: Answers to Frequent Questions from City Council & Community Members

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The purpose of this memorandum is to provide brief, clear responses to frequent questions that have arisen during our outreach on the Water Cost of Service Study. This information will hopefully assist in answering various questions in an understandable way for our customers.

**QUESTION 1:** We are next to the Pacific Ocean, the biggest body of water in the world. Why are we not constructing more desalination plants?

**ANSWER:** The new water rates are helping to construct and operate the new Carlsbad desalination plant that will open late 2015. It is anticipated to supply up to 7% of the regional water needs for San Diego County.

For a variety of factors including cost, environmental protection and beneficial reuse, the City is moving forward with the Pure Water San Diego program. This program will provide high-quality, safe water supply while being cost-effective for our customers.

The region has supported, and continues to explore the possibility of developing more desalinated water supply, but based on the multiple benefits of Pure Water San Diego, this program is the preferred alternative for our community.

**QUESTION 2:** What efficiencies has the Public Utilities Department undertaken to help control costs?

**ANSWER:** The Public Utilities Department continuously makes changes to manage for greater efficiency. Some of the efforts and efficiencies we have recently undertaken have allowed us to not increase rates due to operating costs since 2012. They include:

- Permanent staff reduction of 329.78 positions since 2007
- Energy cost reduction of $12.1 million annually through green energy generation

- Use of grants and State Revolving Fund loans saving $177.6 million since 2010
- Asset management and facility condition assessments to guide infrastructure investment
- Approximately $50 million in cost avoidance through detailed project management
- In-house identified optimization savings of $1.6 million per year

**QUESTION 3:** If we are conserving more water, why are costs increasing? Doesn't this seem counter-intuitive?

**ANSWER:** This is the most common questions posed to the Public Utilities Department and is a question that we have been active in answering when presenting to communities throughout San Diego. The Water Fund has a significant amount of fixed costs, which include water purchases, debt payments, water treatment costs, energy costs to pump water, etc. These fixed costs represent approximately 80% of all costs in the Department. Based on these fixed costs, when expenditures increase (i.e. due to imported water cost increases) or when revenue decreases (State mandated water restrictions), these fixed costs cannot be changed. As mentioned previously, the Department has worked to minimize both variable and fixed costs through efficiencies to reduce or minimize expenditure increases, and the Water Fund is a zero-profit utility, only charging the cost to serve its customers. When these costs increase and / or revenue declines, water rates need to be adjusted to pay for the costs to properly operate the Water system.

**QUESTION 4:** One of the primary drivers behind this rate increase proposal is the increasing costs of imported water from the Metropolitan Water District (MWD) / San Diego County Water Authority (CWA). What is the City of San Diego Public Utility Department's involvement with CWA / MWD to keep their costs under review and to have our ratepayer's voices heard?

**ANSWER:** The City of San Diego has 10 representatives with a voting entitlement of 39.8%. which must be cast as one vote. They are members of the CWA Board, and are known as the "City-10". The City-10 actively work to ensure that prudent decisions are made to ensure that the City of San Diego pay no more than its fair share of costs for CWA activities in addition to participating in reviewing MWD actions including rate proposals. On the MWD Board of Directors, the Water Authority is allowed four seats and has 17.47% of the vote on a simple majority vote threshold.

**QUESTION 5:** The CWA recently was awarded a judgment against MWD for illegal rates charged between 2011 and 2014 totaling over $220 million. How is this revenue that will partially come to the Public Utilities Department factored into the Water Cost of Service Study?

**ANSWER:** In an August ruling by the Superior Court of California, the MWD was ordered to pay CWA over $220 million for illegal charges over a four year period, which will in turn be repaid to local agencies including the Public Utilities Department. Based on this ruling, the Judge is expected to file the final judgment later this year, and then MWD will have 60 days to file an appeal. It is anticipated that MWD will file this and additional appeals if higher courts issue the same judgment in favor of CWA. Based on this timeline of continuous appeals and unknown timeframe, in addition to any potential of a higher court invalidating this judgment, the Water Rate Case does not include any revenues from this settlement.

However, the Public Utilities Department has built in two reviews of funds into this Rate Case. Each review of funds will entail hiring an independent auditor to look at the assumptions that were made in this Rate Case, including if any settlement revenue was received by the Water Fund, and if any potential adjustment can be made going forward in each year of the rate case based on the difference between actual events and assumptions made.

**QUESTION 6:** The State mandated water restrictions implemented in May 2015 only run through February 2016. What is going to happen then?

**ANSWER:** The Governor's conservation mandate was as follows:

*The State Water Resources Control Board (Water Board) shall impose restrictions to achieve a statewide 25% reduction in potable urban water usage through February 28, 2016. These restrictions will require water suppliers to California's cities and towns to reduce usage as compared to the amount used in 2013.*

The Public Utilities Department has been working extensively with the Water Board to determine what will happen when the mandatory water restrictions are scheduled to end in March. Currently, the Water Board has not let it be known what will occur at this time; however, certain early indications have been given that the mandated drought restrictions will continue. However, this is dependent on a number of factors that may change this outcome, including the anticipation of an El Niño weather event this winter. Additionally, our Public Utilities Department representative working with the Water Board is discussing our City and regional efforts to diversify our water supply (Pure Water, desalination, reservoir expansion, etc.) to potentially reduce our regional conservation mandate.

**QUESTION 7:** What is the Public Utilities Department doing to help assist disadvantaged customers with the increasing cost of water?

**ANSWER:** Proposition 218 is the California constitutional amendment that requires a Water Utility charge customers based on the cost to provide that service to them and one rate payer class cannot subsidize another through higher costs. This also unfortunately applies to providing financial assistance to disadvantaged / low-income customers by charging lower rates. The Public Utilities Department has begun an initiative to institute a program in the upcoming year that would allow low-income assistance while still complying with Proposition 218. This program would entail customers making a tax-deductible contribution in their water & wastewater bill by "rounding up" or making a more specific contribution. This contribution would be placed in a separate account to allow a disadvantage and / or low-income customers to apply for assistance from this account to help offset the cost of their water use.

**QUESTION 8:** With the increasing likelihood of an El Niño event for San Diego this winter, how does this impact the Water Cost of Service Study?

**ANSWER:** The Water Rate Case is based on the forecast for a continuation of drought; however, the likelihood for an El Niño and wet winter continues to grow. The El Niño that is currently projected to occur will likely bring above-average rainfall to Southern California, which will hopefully help to replenish our reservoirs over time to normal levels. However, in even normal conditions, these reservoirs only provide approximately 10-15% of water deliveries to our customers, with the remainder being imported through CWA. Additionally, as in previous El Niño's, the weather events are due to a warming in the Pacific Ocean, which brings warm rains to California. The warmer rains in an El Niño typically prevent the Sierra Mountains from developing a normal to above-average snowpack; which is the largest fresh water reservoir in California. With the snowpack in the Sierra's at a 500 year low (at least), the El Niño may actually not help alleviate this, further exacerbating the State-wide drought situation while providing some local resource in reservoirs.

However, the Public Utilities Department has built in two reviews of funds into this Rate Case. Each review of funds will entail hiring an independent auditor to look at the assumptions that were made in this Rate Case, including if the drought has persisted as projected, and if any potential adjustment can be made going forward in each year of the rate case based on the difference between actual events and assumptions made. This includes the possibility of lowering rate increases if the drought eases due to the El Niño or for any other event (such as in question 5).

**QUESTION 9:** What is the difference between the "unitary" and "zone" rate for recycled water?

**ANSWER:** The City of San Diego has always had a unitary rate for its system and customers of potable, wastewater and recycled water. The City's Public Utilities Department runs and operates its systems as one, serving the City and region. The "unitary" rate for recycled water is being proposed by the Public Utilities Department to update the price for this commodity, which has not changed since 2001. This implies that all customers pay one singular price, regardless of location, just as water and wastewater ratepayers. The "zone" rate will create one rate for customers of the recycled water system that is provided by the North City treatment plant and a separate rate for customers of the system that is provided by the South Bay treatment plant. The zone rate proposal, which is not endorsed by the Public Utilities Department, is based on an alternate proposal from a customer of the recycled water system in the South Bay. Previously, this customer has presented information as to why they believe this rate structure is more equitable; however, the Public Utilities Department does not agree with their reason or justification.

We have noticed our customers in the Proposition 218 hearing and protest form for both options to be considered at the November 17, 2015, hearing. The Council may determine which rate structure they believe to be the most equitable; however, the outcome of this rate proposal will lead to one major difference –the vast majority of City of San Diego recycled water customers will pay a significantly higher cost for this commodity under the zone rate structure as compared to the unitary rate ($2.14 per hundred cubic foot versus $1.73 per hundred cubic foot).

**QUESTION 10:** What is the impact of prevailing wage on the Water Cost of Service Study?

**ANSWER:** The Prevailing wage ordinance was adopted by the City Council in 2013, which requires that the City apply the State's prevailing wage requirements for all City public works projects (including sewer and water projects). The State's prevailing wage requirements make it the responsibility of the contractors for these public works projects to pay wages that are at least equal to prevailing wage rate published by the California Department of Industrial Relations.

Currently, the City of San Diego relies heavily on State Revolving Fund (SRF) loans to finance water and sewer projects because they are financially advantageous to other means of capital borrowing. The interest rate for SRF is less than two percent per year currently, which is significantly less than the comparable interest rates for traditional bond financing. For example, the Public Utilities Department is currently undertaking a capital improvement project for the City-wide implementation of advance meter infrastructure or "smart meters." This project is able to be financed utilizing SRF or bond proceeds. Utilizing SRF financing, ratepayers will realize over $30 million in cost savings as compared to traditional bond financing over the life of the loan. The Public Utilities Department has taken advantage of this financing where possible due to the cost savings to ratepayers. However, to utilize SRF, the State of California stipulates the Davis-Bacon Act be included in any public works contract bid; which requires the payment of local prevailing wage. So to take advantage of savings associated with SRF, prevailing wage (as previously adopted by City Council) is a requirement.

Halla Razak
Director of Public Utilities

SG/slh

Attachment 2
October 21, 2015

## The Real-World Consequences of Not Changing Water Rates

A rate change is proposed as the result of increased imported water costs and State water drought mandates. The impacts are dire if it is not approved as proposed. Immediate measures would be taken that will impact critical operations, jobs and capital projects.

No rate change will result in a drastic reduction to Water Department services to the point of inability to maintain the current level of service, deterioration of infrastructure, potential reduction to City General Fund services to backfill debt service or support legally required coverage of Water Department's existing borrowings, reduced staffing levels, and increased reliance on expensive imported water. No approved rate change would have immediate consequences, whose impacts would be felt by the residents and businesses of San Diego for many years to come.

- **Deterioration of water pipes and infrastructure**
  - Stop or reduction to pipeline replacements and other infrastructure projects
  - More water main breaks and high costs for emergency repair
  - Wasted water due to water main breaks
  - This would return the Water Fund to pre-Fiscal Year 2009 spending levels, when there were 110 water main breaks per year on average

- **Drastic reduction to Water Department services**
  - Stop all investments in smart meters, condition assessments and Enterprise Asset Management
  - Reduce staffing levels with likely impacts to customer service

- **Suspension of the Pure Water local water supply program**
  - Continued dependence on expensive imported water
  - Potential loss of waiver at Point Loma Wastewater Treatment Plant
    - $2 billion in new capital costs could be required

- **Risk of violating federal and state environmental mandates and requirements**
  - Potential for continued State compliance order and fines

- **Financial and credit risks**
  - Risk of credit downgrade, increasing the cost of future water projects
  - Loss of grants and favorable State loans if debt coverage is not met
  - Depletion of entire rate stabilization reserve fund
  - Liquidation of Water Department assets for one-time revenue

- **Potential reduction of General Fund services to make legally required Water Fund payments**
  - Environmental regulations and the City's legal obligation to bondholders may force it to redirect its day-to-day budget toward the Water Fund
  - General Fund may be at risk to pay for the Water Fund's debt service obligations

**THE CITY OF SAN DIEGO**

**M E M O R A N D U M**

DATE: October 21, 2015

TO: Honorable Council President Lightner and Council Members

FROM: Halla Razak, Director of Public Utilities

SUBJECT: Effects on the Water System if the Proposed Water Rate Change is Not Approved

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On September 15, 2015, the City of San Diego Public Utilities Department (Department) presented the Water Fund's Cost of Service Study (rate case) to City Council that outlined proposed rate changes for potable water for FY 2016-2020. During this presentation, the Department gave an overview of the main drivers of these proposed rate changes – the increasing cost of imported water, implementing the Pure Water program, replacement of aging infrastructure and the impacts of the State mandated drought restrictions.

The changes outlined in the rate case and discussed at City Council are required to continue the Water Fund's operations and to replace aging infrastructure at a responsible level on an annual basis, all to ensure the safety, sufficiency and security of San Diego's water supply. The purpose of this memorandum is to supplement the information that was presented to City Council so as to illustrate the impacts to the Water Fund (and consequently, the citizens of San Diego and the region) if the proposed rate changes are not approved.

**Impacts if the Proposed Rate Change is Not Approved**

There would be immediate consequences if the proposed rates are not approved, and these impacts would be felt by the citizens of San Diego for numerous years to come. To attempt to manage the Water Fund on current rates and to comply with mandated bond covenants, it would be necessary to immediately do all of the following:

- Exhaust the entire rate stabilization reserve fund (RSF) of $38.5 million in FY 2016 with no ability to replenish these funds;
- Cut critical jobs and expenses to the point of inability to maintain the current level of service. Reduction in the following amounts would be required: $16 million in FY 2016[1], $67 million in FY 2017, $80 million in FY 2018, and $91 million in FY 2019 and FY 2020 through the following actions:

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[1] In addition to one-time use of $38.5 million RSF, for a required combination of resources of $54.5 million

- Freeze hiring for all vacant positions, including critical operational positions.
- Cease all contractual expenditures for Enterprise Asset Management, condition assessments, asset replacement and upgrades, advanced meter infrastructure, etc.
- Explore liquidation of Water Fund assets for one-time revenue, including watershed land.

➢ Halt the Capital Improvement Program (CIP) for water main replacements above the minimum level of 10 miles of cast iron pipeline per year as mandated by the California Department of Drinking Water, with a shift to emergency break response rather than pro-active replacement:

- Halting water main projects would lead to the deterioration of water infrastructure and a long-term increase in the average age of water transmission and distribution pipelines in the ground, which would then result in an increase in breaks that would continue at a higher rate for decades to come.

➢ Suspend the Pure Water program:

- Cessation of the Pure Water program not only would increase the City's long-term dependence on water from Metropolitan Water District / San Diego County Water Authority (CWA), but would also threaten the continuation of the Environmental Protection Agency (EPA) waiver at the Point Loma wastewater treatment plant.
- Without the EPA waiver, the City, and therefore ratepayers, could be responsible for approximately $2 billion in new costs to move to secondary treatment – which would result in a significant increase in wastewater rates.

➢ Explore potential redirection of General Fund money to make legally required Water Fund payments:

- The City is required to honor its legal obligations to bondholders. As a result, to meet the Water Fund's obligations to pay debt service on time and in full, the General Fund may be required to become the financial backstop to maintain coverage or pay debt service and to maintain regulatory compliance. This could result in serious General Fund service reductions to the public.

The Water Fund would attempt to operate with no rate changes; however, the required enormous cuts to the operations budget would grow to more than 40% of the water budget[2] and it would soon be impossible to meet all mandates and requirements while maintaining current service levels. Based on the consequences of no rate change, the Water Fund would violate its legal bond covenants by not maintaining debt coverage. The Water Fund's inability to meet legal obligations to bond holders would risk covenant compliance, material event filings to bondholders, credit rating reductions, and loss of access to the market. This will jeopardize future attempts to borrow funds for needed capital improvements at reasonable rates, and increase the cost of future water projects.

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[2] Water Budget without debt payments or water purchases

**Impacts if there is a Reduced Rate Change or No Change on January 1, 2016**

At the August 5, 2015, Environment Committee and during the City Council review of the rate case, there was a discussion on the ability to delay the January 1, 2016, rate change to July 1, 2016.

Staff strongly recommends approval of the rate change as proposed effective January 1, 2016. The rate change proposal on January 1, 2016, is the minimum required change in combination with the utilization of a majority of the RSF ($32.0 million) to reduce the initial rate impact and still comply with legal bond requirements. The previous rate case in FY 2013 targeted a 1.25 coverage ratio for debt payments; however, to further minimize the January 1, 2016 rate impact, in this rate case the Department reduced the target to 1.19 in consultation with the Debt Management and Financial Management Departments.

If this January 1, 2016, rate change were not to be approved, the Water Fund would fall below the minimum required threshold for the debt coverage ratio of 1.00 [3]. With the increased cost of water from CWA and no offsetting revenue for this component, there is a direct negative effect on the water system's finances. The targeted debt coverage ratio is still not obtained with a rate change solely for the CWA pass-through costs, which could have an impact on the finances of the General Fund. Alternatively, to forgo the January 1, 2016, rate change and still meet the Water Fund's obligations, the Water Fund would have no choice but to deplete all of the remaining $6.5 million in RSF (completely eliminating the ability to use this reserve for the future) in addition to cutting $16.0 million in operational expenditures in the final six months of FY 2016. These cuts would include operational items identified in detail in the companion memo to this information, titled *"Rollback of the Capital Improvement Program if No Water Rate Change"*.

**Impacts if There is Only a Two Year Rate Change**

The purpose for the Water Fund's proposed rate case being five-years in length is:

- To maintain legal bond obligations and to comply with the City of San Diego's Reserve Policy by rebuilding reserves following the Department's proposed utilization of $32.0 million of the Water Fund's RSF mitigating immediate rate shock to customers; and
- To align the rate case with the five-year CIP plan for the establishment of Pure Water.

The rate changes represent an interrelated strategy; which is to minimize the rate changes in the first two years and rebuild reserves in the following years, thus smoothing the rate changes over the five year period. The Department will utilize the RSF to help mitigate the immediate rate shock to customers that would be required on January 1, 2016, and to provide sufficient revenue to comply with legal obligations to maintain debt service coverage ratios. The current rate case proposed changes in FY 2018-2020 to include an amount necessary to recover a portion of this RSF to comply with the Reserve Policy, which states:

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[3] Dependent on final SRF agreements

*If the RSF goes below the baseline amount of 5%*[4] *of the prior fiscal year water system total operating revenue, it will be replenished to the target level from any surplus net system revenue in the next fiscal year or in conjunction with the City Council authorization of a future Cost of Service Study and rate adjustments.*

This change is not only to comply with the Reserve Policy, but to also avoid any negative credit impacts from the utilization of reserves without a plan to replenish those reserves within the rate case. Fitch Ratings, one of the three major rating agency firms, has stated that key attributes for retaining a strong credit quality (which reduce operating costs to ratepayers through access to debt markets and lower borrowing costs) include the development of a framework for the use and replenishment of reserves and long-range financial planning; while weak credit attributes include low reserves and no plan for replenishment. This rate case complies with this framework of retaining a strong credit quality through replenishment while reducing the rate shock to customers.

Without utilization of $32.0 million from the RSF to reduce the initial rate shock to customers and to meet the Water Fund's obligations, the required change as of January 1, 2016, would be as follows:

| Scenario | January 1, 2016 Rate Increase |
|---|---|
| Use of Rate Stabilization - **Current Rate Case** | 9.8% |
| No Rate Stabilization Use | 25.6% |

This 25.6% rate increase that would be required without utilization of the RSF is too burdensome on rate payers. With the use of the RSF, this rate impact is minimized, but the Department cannot responsibly utilize these funds unless the rate case includes a plan for replenishment.

Additionally, the first phase of the Pure Water program, for a 30 million gallon per day facility, will be designed and initial construction begun during the five-year rate case period. This rate case provides sufficient funding and capital planning for grants and loans to begin this first phase. With a two-year rate case, the Water Fund would be constrained in applying for loans and grants without a sufficient funding plan over this critical phase of planning and initial construction for this locally controlled and drought proof water supply.

## Conclusion

The impacts of no rate change are dire, and will result in a drastic reduction to Department services to the point of inability to maintain the current level of service, deterioration of infrastructure, potential reduction to City General Fund services to backfill debt service or support legally required obligation to bondholders, reduced staffing levels for critical operations, and increased reliance on expensive imported water.

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[4] Reserve Policy level of 5% is achieved in FY 2020 in the current rate case

The Department has worked extensively with our rate consultants, Black & Veatch, Financial Management, Debt Management, and other City personnel to look at a number of rate case scenarios. This included different timing and size of rate changes to meet the Water Fund's obligations and to minimize rate impacts to our customers. The options associated with each alternative scenario carry negative consequences that will impact our customers and the City in both the short term and the long run. As financial stewards for our ratepayers, we believe that this rate case presented to City Council is the most optimal scenario to ensure the continued delivery of clean, reliable and safe water.

Halla Razak
Director of Public Utilities

SG/slh

THE CITY OF SAN DIEGO

**M E M O R A N D U M**

DATE: October 21, 2015

TO: Honorable Council President Lightner and Council Members

FROM: Halla Razak, Director of Public Utilities

SUBJECT: Rollback of the Capital Improvement Program if No Water Rate Change

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As outlined in the memo *"Effects on the Water System if the Proposed Water Rate Change is Not Approved"*, dated October 21, 2015, the effects of no rate changes for the Water Fund would be dire. No rate changes would necessitate a significant reduction in Operations and Maintenance (O&M) and Capital Improvement Program (CIP) spending on an annual basis to attempt to mitigate the reasons for the rate change: San Diego County Water Authority / Metropolitan Water District price increases for imported water, implementation of Pure Water Program, replacement of aging infrastructure and State mandated drought restrictions.

To better illustrate the impacts of no rate changes, the following outlines the steps that would be taken by the Public Utilities Department to manage the Water Fund without a rate change and to comply with legal obligations to bond holders to maintain required debt service coverage, reduce water pipeline replacement to 10 miles (the minimum required on an annual basis per State mandate), and have sufficient funds on hand to operate a significantly scaled down and reactive capital program.

**Infrastructure Reductions**

With no rate change, the Water Fund would be in danger of violating its legal bond covenants by not maintaining required debt coverage effective Fiscal Year 2016. The Water Fund's inability to meet legal obligations to bond holders would lead to significant compliance issues and risk its credit rating, access to the bond market and interest costs. This could jeopardize future attempts to borrow funds for needed capital improvements at reasonable rates. To continue to meet its legal bond and compliance obligations, the General Fund may need to become a financial back stop for the Water Fund, impacting City services.

All advantages to such beneficial resources such as State Revolving Loan funds, grants, and additional bond issuances to continue the capital program would be lost. To assist in managing the Water Fund's diminishing cash-on-hand, all proactive pipeline replacement above the ten-miles of cast-iron pipes required under the State Department of Drinking Water compliance order would end, pump station preventative maintenance would be deferred, and treatment plant upgrades would be cancelled, among other impacts. More specifically, the following impacts would affect Water Fund CIP projects:

- Suspension of the Pure Water Program;
- Cease Enterprise Asset Management (EAM) Program contributions (the Water Fund represents approximately 30% of the entire program's funding);
- Suspend advanced meter infrastructure (i.e. AMI or "smart meters") program implementation;
- Stop approximately 25 additional miles of pipeline replacement per fiscal year above mandated levels. This would return the Water Fund to pre FY 2009 spending levels, when there were 110 water main breaks per year on average; and
- Forgo water safety, storage, and distribution reliability projects. This includes projects such as replacement of the Miramar Clear Wells, which store treated water for distribution to provide supply to meet immediate water demands at any time. Elimination of projects such as this will impact the reliability of the system and ability to serve ratepayers.

**O&M Reductions**

*FY 2016 – Required O&M Cut of $54.5 million*

Should rate changes not be approved at the November 17, 2015 City Council meeting, cuts to O&M and CIP would need to occur immediately to give at least 6-7 months of savings to have the required financial impact. The following are the proposed cuts that would take immediate effect and alternate resources that would be utilized to meet the necessary cuts in FY 2016 totaling $54.5 million:

- Deplete entire Rate Stabilization Reserve Fund (RSF) of $38.5 million;
- Suspend Pure Water program spending on contract and task orders;
- Freeze hiring for all vacancies in the Water Fund;
    - Eliminate all provisional and hourly employees including those in the Customer Service call center and drought response.
    - Evaluate staffing levels for certain Water Fund divisions – such as Water Fund internal engineering and Public Works – Engineering and Capital Projects staff, based on the drastically reduced CIP program.
- End EAM funding for professional services, software, training, and other expenditures;
- Halt all condition assessment contractual spending that is currently not in progress;
- Eliminate AMI spending on contractual items and staffing; and
- Reduce contractual spending across the Water Fund for maintenance of facilities, information technology upgrades, and security enhancements, among others.

*FY 2017 – Required O&M Cut of $66.5 million*
*FY 2018 – Required O&M Cut of $79.5 million*
*FY 2019 – Required O&M Cut of $91.0 million*
*FY 2020 – Required O&M Cut of $91.0 million*

In FY 2016, the Water Fund would utilize all $38.5 million of RSF to attempt to comply with debt covenants, requiring a cut of approximately $16 million in the second half of FY 2016 to reach the estimated $54.5 million in O&M cuts necessary. These cuts implemented in FY 2016 would continue in FY 2017. No additional RSF is available in FY 2017, so enough additional cuts need to be determined to attempt to reach $66.5 million in reduced expenditures. The reductions would grow to $91.0 million per year in FY 2019 and FY 2020.

The following cuts to O&M expenditures through FY 2020 have been identified to address these requirements if no rate changes are approved:

- Continued suspension of Pure Water program, AMI, and EAM;
- Manage increased vacancy levels and potential elimination of positions;
- Continued halt of condition assessments;
- Reduce contractual spending across the Water Fund for maintenance of facilities, information technology upgrades, and security enhancements, among others;
- Reduce fleet levels to save on maintenance, gas, and other associated expenditures – increasing response times to water main breaks;
- Reduce information technology upgrades of water operation and maintenance systems; and
- Cut supplies for water meter replacements, valve maintenance, road repair materials and maintenance items, among others.

The required cuts to O&M over the five-year period total over $380 million. Through the process of identifying what operational expenditures would need to be reduced to attempt to take the Water Fund to reach this level while still keeping the Water Fund viable, approximately $215 million has been identified; leaving a gap of $165 million in resources left to be identified.

## Conclusion

Based on a scenario where no rate changes would be approved for the Water Fund to address the rising costs of imported water, implementation of Pure Water Program, replacement of aging infrastructure and State drought mandate, significant cuts would need to occur to maintain legal bond covenants. However, even significant cuts would not produce sufficient savings to maintain these requirements. Based on this, additional contributions from other sources, such as the General Fund, would need to be identified for the remaining balance required to fulfill these obligations. Operating a utility at such a scaled back financial level will jeopardize the Water Fund's fiscal health and water reliability.

Halla Razak

Halla Razak
Director of Public Utilities

SG/slh

# Cost of Service Study and Water Rates Overview

**Background**: The Public Utilities Department conducted a comprehensive Cost of Service Study to determine revenue requirements to purchase and deliver water to 1.4 million water customers. The study, which is used to determine water rates, has been reviewed and approved by the Independent Rates Oversight Committee. An independent consultant (Black & Veatch) reviewed the financial requirements for the upcoming five years, identifying the needed water rate increases through 2019. (Note: There are no planned wastewater rate increases in the next few years).

## New rate drivers: Higher cost of imported water and state mandates; strategic investments in infrastructure, smart technology and local water supply:

**Key Point**: San Diego is at the "end of the pipe," relying on increasingly costly water sources with prices set by agencies outside our control.

- Fact: San Diego currently imports approximately 85% of its water from Northern California and the Colorado River.
- Fact: The costs of imported water have more than doubled in the past decade and are predicted to do the same again over the next decade.
- Fact: In 2006, San Diego County Water Authority charged the City of San Diego $550 per acre foot for water. In 2016, the rate is almost $1300 per acre foot. That's over a 100% percent increase in the cost of water.

**Key Point**: To reduce dependence on costly imported water, the City of San Diego is developing locally controlled, sustainable and drought proof water supplies, which requires investments.

- Fact: New water rates are helping to construct and operate the new Carlsbad desalination plant. The plant will open in late 2015 and is anticipated to supply up to 7% of the regional water needs for San Diego County.
- Fact: New water rates will help construct the City of San Diego's Pure Water initiative -- a multi-year, phased program that at full build out, will supply the City with 1/3 of our water supply. Plans currently call for up to 30 mgd of Pure Water to be online as early as 2021.
- Fact: Water rates are helping to fund city-wide capital improvements including pipelines, transmission lines and pump stations.

**Key Point**: State mandated water use restrictions and enforcement requirements have required additional, and unplanned, expenditures.

- Fact: Statewide water restrictions have required the City to investigate water waste complaints, issue customer warnings, and as needed, assess penalties.

All of this requires additional personnel and resources to comply with these mandates.

- Fact: New water rates will fund new advanced metering technology. "Smart meters" will allow San Diego water users to monitor their real-time water use and make adjustments as necessary.

- Fact: Declining water sales have reduced revenue that had been counted on to make these necessary investments. Responding to the State mandate, San Diego residents and businesses have reduced their water use by 26% in May and 24% in June. Sales are not expected to rebound as customers are making permanent changes to the way they use water.

**Highest quality service at the lowest possible cost:**

**Key Point**: We are committed to keeping your rates affordable through ongoing streamlining and efficiency efforts. All department costs undergo rigorous analysis and independent verification, with our ultimate responsibility being to you, our customers.

- Fact: The Public Utilities Department has eliminated 329 permanent staff positions since 2007. These rate changes will not cover any department operating costs.

- Fact: Streamlining efforts to date have resulted in $12.1M savings/year in energy costs. In addition, the City has successfully obtained over the past five years $177.6 million in grants and state revolving loans.

- Fact: In an effort to reduce the impact on San Diego water users, the City is planning to use $32 million in reserve funding in the first year of this proposed rate increase.

- Fact: We conduct quarterly reviews of operating and capital expenses to ensure efficiency and prudent use of debt.

**Key Point:** The City of San Diego has significantly improved its water reliability in recent years but there is more to be done.

- Fact: Investments in water infrastructure have resulted in a 43% reduction in water main breaks since 2013.

- Fact: The Carlsbad desalination plant represents another important investment in reliability and local control, producing 7% of regional water supply.

- Fact: ThePure Water San Diego project will ultimately produce 1/3 of local water supply by 2035.

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