



CITY OF MODESTO
AGENDA REPORT

COUNCIL MEETING:
September 14, 2004

September 3, 2004

TO: City Council

FROM: Peter Cowles, Public Works Director

SUBJECT: Proposed Water Rate Increase/Initiation of Proposition 218 Process

Contact: Greg Baird (gbaird@modestogov.com) 577-5458

RECOMMENDED COUNCIL ACTION:

Accept the *Water Utility Cost of Service Rate Study* prepared by Foresight Consulting and the West Yost *Justification and Cost Allocation for Proposed Water System Improvements* report and take the following actions based upon report recommendations:

Adopt a resolution initiating a Proposition 218 Protest process to:

- a. Adjust rates according to the Foresight report's proposed Financial Plan with varying rate adjustments for Fiscal Year 04-05 (dependent upon customer class, lot size, current zone and current rate) and 20%, 15%, 5% and 5% across-the-board rate adjustments in subsequent years (05-06 through 08-09) to support the Financial Plan, and
- b. Adopt Automatic Rate Adjustments beginning July 1, 2009, which would provide for annual rate adjustments linked to changes in the Consumer Price Index, Urban Wage Earners and Clerical Workers Series for the San Francisco CMSA, as prepared by the California Department of Finance. The actual rates levied each year will not exceed the adjusted maximum rates in any given fiscal year without further notification of the property owners, and
- c. Send out protest notices to property owners explaining the new rate structure and proposed rate adjustments and allowing for a protest response, and
- d. Set a public hearing for November 23, 2004 to consider the results of the protest response and to act on the proposed rate adjustments.

BACKGROUND:

The majority of City of Modesto water customers have not received a water rate increase since 1994, ten (10) years ago. Because rates have not increased, current revenues are insufficient to maintain the current system or pay for necessary system improvements.

On March 23, 2004, Council directed staff to undertake the necessary steps to initiate implementation of water rate increases for the water utility. This action was taken after reviewing staff's assessment of water system needs and financial obligations of the water utility. The following sections include an overview of system needs, a synopsis of the rate setting process, a summary of the recommendations provided by the West Yost and Foresight Consulting studies and a description of the Proposition 218 process.

Water System Overview

The City of Modesto Water Utility supplies drinking water to residents in Modesto, Empire, Salida, Waterford, Hickman, Grayson, Del Rio, parts of Ceres and Turlock and county areas adjacent to the city system. About 250,000 residents receive their water from the city system and are billed according to a rate structure utilizing three separate water zones.

For many years, Modesto's water customers received all of their water from 140 wells. These wells pump water (groundwater) trapped in rock layers beneath the ground's surface. To continue to deliver clean, dependable drinking water to the customers, the Water Utility partnered with Modesto Irrigation District (MID) in the early 90's to construct a surface water treatment plant. A third partner, the Del Este Water Company, was purchased by the city in 1995.

The plant, located at Modesto Reservoir, treats surface water from the Tuolumne River. This treated water is distributed to Modesto Water Utility customers at an average rate of 30 million gallons per day (mgd). Since average daily water consumption exceeds 74 million gallons (mgd), peak demand days are at 128 million gallons, and peak hourly demand is at 187 mgd, the primary source of water continues to be from wells, even with the presence of the surface water plant.

The City's current water system (from wells and surface water) is inadequate to provide a dependable supply of quality drinking water to all of its customers. Since 1995, the City has lost production of more than 20% of its active wells, with only 97 the original 140 wells operating today. While some of these wells have failed due to insufficient water and/or mechanical failures, the majority have been taken offline due to contamination. Failure of the system's wells has led to other system concerns, including adequate supply, pressure and drought storage. Because federal and state water standards continue to tighten, it is possible additional wells will have to be removed from service in the future. In some cases, contaminant removal (wellhead treatment) options are available, however these are costly to implement. In other cases, there is no technology available that would remove contaminants sufficiently to meet the federal and state standards.

Because of the number of wells removed from service due to contamination, the water system actually has less capacity today than it did when the surface water treatment plant began operations in 1995. With peak hour demand at 187 mgd, the system is stressed to provide adequate water in all locations at all times. Fortunately, the surface water treatment plant was designed with the concept of expanding capacity in mind and was planned for construction in two phases. Phase One includes the facilities completed in 1995. Phase Two is an addition, which would double the plant's capacity to 60 mgd.

Before Phase Two of the treatment project can deliver Phase Two water to Modesto customers other improvements must be made to the water system. These improvements (referred to as Downstream Improvements) are needed in order to receive the Phase Two water and deliver it to customers. The treatment plant portion of the Phase Two project is estimated to cost \$37.6 million, based on preliminary engineering studies. The Downstream Improvements component of the project is estimated at \$64 million [Cost estimates provided in Attachment 1, *West Yost, Table 1, p 31*].

Total costs for the Phase Two project and Downstream Improvements are estimated at \$101.6 million. Since the Water Utility does not have enough money to pay for these projects, staff proposes a combination of debt financing and cash-funded, pay-as-you-go projects from increased utility rates to pay for these improvements. The money that will be financed will be borrowed in the form of bonds and paid back by the Water Utility rate base. Current rates and reserves are not sufficient to pay for these improvements.

In addition to the Phase Two project and associated Downstream Improvements, there are other system deficiencies that need to be corrected. These include \$51.2 million in projects and programs over the course of the next five years to correct deficiencies within the system [*West Yost, Table 1, p 31*]. Among these projects is the addition of storage tanks, pipeline replacements and upgrades, new wells and

wellhead treatment. Current rates and reserves are not sufficient to maintain the current system or pay for these improvements.

MID Treatment & Delivery Agreement (T&DA)

A Treatment & Delivery Agreement with MID for the Phase Two project is necessary in order to spell out the financing, operational responsibilities, ownership interest and other details of the joint agency project. Staff has worked with MID staff to prepare an agreement that meets the needs of the City as well as of MID. A final agreement should be reached by the end of October and will be brought to Council for review and approval at that time. This agreement details the costs for treatment and delivery of the water from the surface water treatment plant as well as terms and conditions related to future water supply. The T&DA will not be signed until MID receives a permit to divert water for urban purposes from the state Water Resources Board.

Water Rate Task Force

In light of the water system needs and deficiencies and in response to Council's direction, staff assembled a Task Force led by the Finance Committee Chair, Councilmember Brad Hawn, who provided political and technical leadership for the project. Other members of the Task Force included representatives from the City Manager's Office, City Attorney's Office, Finance Department and Public Works Department. The group provided oversight for development of an engineering needs analysis (performed by West Yost Associates) and cost of service rate study (performed by Foresight Consulting) for the water utility. The Task Force also enlisted the services of Harris and Associates to provide assistance with the Proposition 218 Hearing process. Each of these consulting contracts was approved by the City Council.

The Task Force identified the primary commitments of the Water Utility to its customers, namely:

Water Utility Customer Commitments

- Deliver sufficient quantities of clean water at adequate pressures for all water system customers.
- Plan for an adequate supply of water for future customers.
- Provide water system maintenance at a reasonable price.
- Meet the challenges of an unpredictable regulatory environment.

The West Yost Study used the utility's customer commitments as a foundation for identifying system needs and costs.

The Task Force, at Council's direction, also established the following objectives for the Rate Study to be prepared by Foresight Consulting:

Rate Study Objectives

- Develop uniform rates equitable for all customers
- Generate sufficient revenue to meet operating and capital costs
- Collapse the City's three water zones into a single zone
- Utilize accepted cost of service principles and methodology in establishing new rates

The *Water Utility Cost of Service Rate Study* is included as Attachment 2 to this report.

Summary of Rate & Improvement Studies

The West Yost Study examines the City's current water system and identifies facility needs that will improve existing supply reliability (portions of the system have inadequate pressures during peak demand), replace groundwater supplies impacted by water quality issues (City is losing 2.3 wells on average per year due to water quality), keep pace with projected increases in water demand and enable the City to continue to provide high quality service to all of its customers. The West Yost study identifies the following water system capital needs and costs:

Project/Program	Cost
MID Regional Water Treatment Plant (Phase Two)	\$37.6 million
Transmission & Storage Facilities (Tier 1)	\$34 million
Transmission, Distribution & Storage Facilities (Tier 2)	\$30 million
Other Cash-Funded Facilities (<i>storage tanks, pipeline replacements and upgrades, new wells and wellhead treatment</i>)	\$51.2 million
Total	\$152.8 million

The Study determines the Utility will need the Phase Two facility and associated Downstream Improvements between 2006-2009, based upon current demand data and projected growth. The study notes that, even with implementation of all of the system improvements recommended, additional supply will be required in the 2017 to 2020 timeframe [*West Yost, p 12*].

The system needs, timing and costs identified in the West Yost Study provide the foundation for Foresight's projected rate increases and financial plan in the cost of service study. Foresight's cost of service analysis allocates system costs equitably across all customer classes. The methodology establishes a single service area, combining all three water zones into one zone. Rates include a uniform volume-based charge reflecting the volume of water consumed. Residential metered and flat rates are designed so that monthly bills for these customers will be comparable where water consumption is comparable. Residential flat rates are standardized by lot size (previously, the size ranges varied between Zones) based upon number of parcels in each range and patterns of water use. The proposed new flat rate residential parcel size ranges are:

Flat Rate Residential Parcel Size Ranges

1. 0-5,000 square feet
2. 5,001-7,000 square feet
3. 7,001-11,000 square feet
4. 11,001-17,000 square feet
5. Over 17,000 square feet.

Approximately eighty percent (80%) of all flat rate water customers have lot sizes that fall within ranges 2 and 3.

The cost of service methodology also included the following key assumptions:

Key Assumptions for Cost of Service Methodology

- No fire service charges or minimum charge for meters
- Future growth rate of 1.6% / year (based upon Community & Economic Development Department growth forecasts)

- Low to moderate price elasticity impacts
- No changes in water quality standards
- Capital project funding includes a combination of long term debt financing and cash projects

The cost of service rate study concludes that rate adjustments are needed in fiscal year 04-05 to bring metered and flat rate customers to a common rate structure and meet the needs of the report's financial plan [*Foresight, Tables 8-1, 8-2 & 8-3, pp 36 - 40*]. Rate increases and individual customer bills in FY 04-05 will vary by customer class and current zone, with the majority of Zone 1 customers experiencing a 35% increase (range from 14% to 43%). Zone 2 adjustments range from a decrease of 19% to an increase of 15%. Zone 3 adjustments are from 28% to 81%. Adjustments to volume-based charges for metered customers in Zone 1 are an increase of 2.7%. Zone 2 metered is a 16% decrease and Zone 3 metered is a 40% increase. The table below, excerpted from the report, provides a comparison of selected current and proposed new water rates effective January 1, 2005.

Table ES-1 Comparison of Selected Current & Proposed New Water Rates City of Modesto							
Customer Classes	Current Rates			Proposed New Rates & % Change			
	Zone 1	Zone 2	Zone 3	Uniform	Zone 1	Zone 2	Zone 3
Flat Rate Residential							
5,001-7,000 sq. ft. lot	\$20.60	\$24.61	\$15.63	\$27.81	35%	13%	78%
7,001-11,000 sq. ft. lot	\$23.08	\$28.58	\$18.20	\$33.00	43%	15%	81%
Metered Charges							
Uniform Vol. Charge (\$/hcf) (a)	\$0.82	\$1.005	\$0.601	\$0.84	3%	-16%	40%
Fixed Meter Charges							
5/8"-3/4"	\$13.63	\$8.12	\$11.12	\$9.01	-34%	11%	-19%
1"	\$18.14	\$10.17	\$13.94	\$12.78	-30%	26%	-8%
1-1/2"	\$22.54	\$15.53	\$21.09	\$22.13	-2%	42%	5%
2"	\$27.20	\$21.09	\$28.54	\$33.38	23%	58%	17%

From Table 8-1

a. Current Zone 1 metered charges include a minimum of 1,680 cubic feet/mo. Zone 2 and 3 charges are for the first 100 hcf of use.

[*Foresight, p 4*]

On July 1 of the four fiscal years following FY 04-05, all customers are proposed to receive uniform increases of 20%, 15%, 5% and 5% respectively. The average customer (Zone 1, 5001-7000 sq ft, flat rate, residential) will realize an effective 62% increase over today's rate when the July 1, 2005 increase is enacted. This equates to \$12.77 more per month. This increase, coupled with the increases in subsequent years (Year 3 – Year 5), should be adequate to fund the necessary system improvements to correct existing system deficiencies, to construct additional supply capacity related to transmission, distribution and storage facilities within the existing service area (with growth's share of these system improvements to be repaid by new development through increased connection fees) and to continue to provide high quality operations and maintenance of the system.

Of the \$152.8 million in projects identified by West Yost, Foresight provides a funding mechanism for \$140.1 million. The remaining \$12.7 million in projects are assigned to future growth and will be cash-funded through development connection fees. The West Yost report provides a more detailed discussion

of the projects attributed to new development versus those attributed to existing customers [*West Yost, Table 1, p 31*].

Commercial, Industrial and Agricultural Customers

Based on Council's direction to establish uniform rates, commercial and industrial customers (who are already required to be metered) will be charged according to size of service (fixed meter charge) as well as amount of water consumption. The cost per unit consumption is the same as that for residential users [*Foresight, Table 8-1, p 36*]. The bulk of industrial customers are located in Zone 2, which will experience a rate decrease for 04-05 (from \$1.005/hcf to \$0.84/hcf). Commercial customer impacts will vary, based upon the Zone.

The City has few agricultural users. Most agricultural parcels use canal or well water for irrigation. Agricultural properties that are metered will be charged the same rates as residential, commercial and industrial customers. Agricultural properties that are on flat rates will be charged the applicable flat rate based upon lot size.

Existing vs. New Development

Existing customers have generated most of the need for and will receive most of the benefits from the necessary system improvements [*West Yost, Table 1, p 31*]. West Yost attributes 74.2% (\$113.4 million) of total capital project costs to existing customers. The remaining portion (25.8% / \$39.4 million) is allocated to future customers. The table below provides a summary of the financial plan for existing customers and new development:

Project	Cost	Funding Source	Existing Customer Share	Growth Share	Comments
MID Treatment Plant Expansion	\$37.6 M	MID Revenue Bond	\$14.6 M	\$23 M	Rate base will initially fully fund debt payments. Connection fees will be increased to reimburse existing rate base and pay for growth's allocation (61.1%).
Downstream Improvements – Tier 1	\$34 M	City Certificates of Participation (COP) bond	\$30.3 M	\$3.7 M	Rate base will initially fully fund debt payments. Connection fees will be increased to reimburse existing base and pay for growth's allocation (11%).
Downstream Improvements – Tier 2	\$30 M	COP bond financing - \$15M / Cash-funded (existing customers)- \$11.7 M <i>See comments</i>	\$26.7 M	\$3.3 M	Connection fees will be increased to fund growth projects.
Cash-funded, pay-as-you-go Projects & Programs	\$51.2 M	Cash-funded through rate base (existing share only) <i>See comments</i>	\$41.8 M	\$9.4 M	Connection fees will be increased to fund projects allocated to growth.
Prior Year CIP Carryover (pre-audit)	\$1.353 M (estimate)	Cash-funded through rate base	\$1.353 M		These projects were not included in the West Yost report

At present, the City collects roughly \$1.2 million in water connection fees annually. This revenue is insufficient to fund new development's share of system improvements and does not represent the full cost of providing current service for these customers. Staff will return to Council in January to initiate the process of raising connection fees so they reflect new development's full share of system and capital costs.

If development occurs at a faster pace than expected, the water fund will be repaid the advanced capital costs at a quicker pace and the rate-paying revenue base will be larger than anticipated. Faster growth also accelerates the need for future supply projects.

Proposition 218 Process

In November 1996, citizens of the State of California passed a Constitutional Amendment known as Proposition 218. This amendment changed the process for increasing property-related fees within the state. Water rates are considered a property-related fee and, pursuant to Proposition 218, require a Protest Hearing by the property owners prior to instituting a rate increase. Under the Protest Hearing process, property owners within the service area are mailed a rate increase notice and protest form detailing the proposed rate increase. To oppose the rate increase, the property owner must return the protest form to the City. To support the rate increase, there is no action required on the part of the property owner. If a significant number of protests are returned to the City no later than the end of the Protest Hearing date, Council may not approve the proposed rate increase. To meet this test, a majority (50% + 1 ballot) of all the forms mailed out must be returned as Protest Forms. An example is provided below:

Total Number of Protest Notices Mailed to Parcel Owners: 75,000 (estimate)

of Returned Notices Required to "Protest" Rate Increase: 37,501 (50% + 1 ballot)

If fewer than 37,501 (estimate) protests are received, Council may enact the rate increase.

Following Council's approval to initiate the Protest Process, Harris & Associates will mail out protest notices to the City's property owners. Property owners will have until the end of the Public Protest Hearing, set for November 23, 2004, to register a protest. To register a protest, the property owner must deliver the Protest Form to the City by the established deadline. A sample rate increase notice and protest form are provided at Attachment 3.

Supporting Documents

The cost of service study, engineering needs analysis and proposition 218 process relied on other supporting documents, which are not included as attachments to this report but will be made available to the public at the City Clerk's Office and on the City's website. A list of the supporting documents, as well as a brief description (in parentheses) is included below:

- 2003 Urban Growth Policy Review Report (growth assumptions)
- Growth Memorandum issued by the City's Community and Economic Development Department (growth assumptions)
- Report on the Suitability of Using the GIS to determine Parcel Areas (provides rationale for using the Geographic Information System to calculate parcel areas where assessor's data is unavailable)
- Frequently Asked Questions (answers questions regarding the proposed rate increase and the Proposition 218 process) *Note: Available after Sept 4, 2004.*
- Harris and Associates Procedures (outlines the 218 process) *Note: Available after Sept 2004.*

REASON FOR RECOMMENDATION:

A water rate increase is needed in order to:

- Support the costs for system-wide infrastructure needs including storage tanks, pipelines (replacement and upgrade), new wells, wellhead treatment and other water projects and studies;
- Fund preliminary design and construction of downstream improvements;
- Provide coverage for payments to MID for construction and operation of Phase Two of the Surface Water Treatment Plant;
- Maintain water quality under stricter water quality standards;
- Provide for adequate water pressure to meet fire flow standards;
- Fund ongoing operational and maintenance costs associated with the system;
- Provide for equity in and amongst all customer classes;
- Provide for increased water demand within the current service area (Sphere of Influence); and
- Maintain reserve levels adequate to meet bonding requirements.

EXISTING POLICY / RELATIONSHIP TO STRATEGIC PLAN:

This action is related to the following *Strategic Plan* goals:

- Goal I.A.1 Our infrastructure is modern, efficient, effective, attractive and cost competitive
- Goal I.B.1 Water and wastewater system capacity and quality is sufficient for all current needs and future economic growth.

Council set the following policies and direction as part of this process:

1. March 23, 2004 – Approval to begin process for multi-year rate increases.
2. April 6, 2004:
 - a. Endorsement of a one zone water system.
 - b. Endorsement for using a uniform methodology for non-metered residential customers, to be based upon lot size.
 - c. Approved a uniform rate for metered customers.
3. May 11, 2004
 - a. Approved development of a phased metering plan, with full implementation to be reached by 2019.
 - b. Directed staff to take steps necessary to charge schools and churches a metered rate.
 - c. Directed staff to install master meters and backflow devices for churches and schools by January 1, 2005.
 - d. Directed staff to install and read meters on all residential lots larger than 17,501 square feet by January 1, 2005.
 - e. Approved inclusion of an annual inflator for water rates pursuant to an established index for year 6 (2009-2010) and beyond.

POLICY ALTERNATIVES:

1. Council could choose not to accept the cost of service study and engineering report and associated recommendations. Staff does not recommend this alternative, as the water system cannot support infrastructure / operational needs and meet bond coverage requirements without a rate increase. If the rate increase is not approved, more stringent conservation measures will be necessary as

additional well capacity is lost. Even with these measures, as wells go offline the utility will lose its capability to serve additional customers.

Without a rate increase, the City will not be able to fund needed maintenance and repair projects, resulting higher costs in the future. In addition, the city would be in default on its current bond covenants, which fact would make millions of dollars of bonds callable. This would decrease the bond credit rating of the utility and force the City to go through a new intensive public education and rate increase process.

2. Council could choose to modify the recommendations made in the cost of service study and needs analysis.

FISCAL IMPACTS:

The water utility financial plan [*Foresight, pp 30 – 35*] provides a strategy for funding the significant revenue requirements facing the utility over the course of the next five years. The plan attempts to balance two competing objectives: 1) minimizing annual rate increases and 2) building adequate reserves to fund pay-as-you-go capital projects and other long-term funding needs. The proposed rate increases will generate sufficient revenues over the course of the next five years to pay for system operational and infrastructure needs [*Foresight, Table 7-1, p 30*].

The rate ramp up is necessary in advance of the full design costs of the needed capital projects. The financial health of the water fund so that fund balances are adequate to enter the bond market. Absent a rate increase, the water fund is projected to violate bond coverage covenants on the existing outstanding debt during fiscal year 04-05 and a bond issuance would not be possible.

With the revenue realized from the increased rates, the City should be in a good position to enter the bond market and issue certificates of participation in the amount of \$34 million in 2006-2007. This money will fund the Downstream Improvements component of the Phase Two project. Other capital projects will be funded on a cash, pay-as-you-go basis by revenues received under the new rate structure.

COMMITTEE RECOMMENDATION:

The Finance Committee considered this item at its September 2, 2004 meeting and recommended approval to the full Council.

Suggestions made at the Committee level, but not carried forward in the form of a formal recommendation by the Committee include:

- Mandate a Cost of Service Study at periodic intervals (2 – 4 years) to protect against future rate inequities
- Dedicate a portion of Utility Users Tax revenue toward subsidizing Low Income and Senior ratepayers to ease the financial burden associated with the rate increases for these customers

INTERDEPARTMENTAL COORDINATION:

This item has been coordinated with the Public Works Department, Finance Department, City Attorney, Community and Economic Development Department and City Manager's Office.

PUBLIC PARTICIPATION:

The Finance Committee reviewed this item on eight (8) separate occasions during the course of the rate study/needs analysis process. The most recent Finance Committee meeting was televised in order to reach

as broad an audience as possible. In addition, the Economic Development Committee reviewed this item in May and Council presentations were made on three (3) different occasions. The public has had the opportunity to comment at all of these meetings. Staff has made presentations to a number of community groups regarding the proposed rate increases. Further public participation will be afforded during Council's consideration of this item, as well as through the Protest Hearing vote process.

ENVIRONMENTAL REVIEW:

This is a project but is exempt under Public Resources Code §21080(b)(8) and CEQA Guideline 15273.

Of the portion of the rate increase that relates to future capital improvements, the majority is necessary to pay for upgrading or correcting deficiencies in the current system and a smaller portion will be used to purchase supply in the existing service area. While the project, if approved, will provide for in-fill growth within the water utility service area (Sphere of Influence (SOI)) due to increased availability of water, it will not pay for actual transmission capacity within the SOI, which remains to be built (and paid for). The additional supply will be paid for initially by the existing rate-base, subject to reimbursement from development through connection fees to be enacted later.

Public Resources Code §21080(b)(8) and Guideline 15273 provide a statutory exemption from CEQA for rate increases for capital projects in existing service areas. Though this exemption applies to the rate increase action, the capital projects supported by the rate increases (if approved) require independent CEQA review.

STEPS FOLLOWING COUNCIL ACTION:

Following Council approval of this item, staff will:

- 1) Distribute Protest Notices to Water Customers, in accordance with the requirements of state law, as established by Proposition 218 (September 2004);
- 2) Set a Protest Hearing for consideration of returned notices on November 23, 2004;
- 3) Make appropriate Rate Adjustments effective January 2005;
- 4) Initiate the process to Revise Connection Fees/Development impact fees to recoup the new customer component of this project (January 2005); and
- 5) Issue bonds to support the proposed Capital Improvement Program, in accordance with the Financing Plan (2006-2007).

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Reviewed by:

Peter Cowles, Public Works Director

Submitted by:

Jack R. Crist, City Manager

Attachments:

1. *Justification and Cost Allocation for Proposed Water System Improvements* report
2. *Water Utility Cost of Service Rate Study*
3. Notice of Proposed Rate Increase and Protest Form