

Staff Paper #12:

Utilities

City Utilities: Water, Wastewater, and Storm Drain

The Utility Funds of Water, Wastewater, and Storm Drain are facing many Capital Improvement Project challenges, which will require the debt financing and pay as you go funding strategies.

Many cities' are faced with decision on whether to pay for capital improvements from current revenues (pay-as-you-go) or issue debt. Debt is appropriate to finance assets with high capital costs and long useful lives. Taxpayers of several generations will both benefit and pay for some projects and no one group of taxpayers will be unfairly burdened. The maturity of the debt should not, however, exceed the useful life of the project being financed.

Repair and replacement projects with short useful lives should be part of a City's pay-as-you-go program, with rates and fees set appropriately to accommodate this ongoing operation costs and allow of the building of a contingency reserve level at 10% to 50% of the operating expenses. Carefully planned use of the revenues and a healthy fund balance are favorable to credit agencies. The City of Modesto should exercise caution, however, when drawing down fund balance revenues for capital purposes. Significant reduction of fund balance restricts a city's flexibility in responding to unanticipated revenues downturns or other emergency situations.

Water Fund:

In FY 2002-2003, the Water Fund debt service coverage of 1.25 was barely met using one-time revenues. It is expected that rate increases are needed to not only meet our current bond requirements but also to improve the health of the fund and to prepare for new bonds. The residential flat rate in Zone 1 has not had any rate increases since 1994.

Water Fund: Flat Rate for Single Family Residential						
				LESS THAN 3500 SF	3501 TO 7000 SF	7001 TO 10500 SF
	2000	5% Decrease		\$17.86	\$20.60	\$23.08
	1994	30% Increase		\$18.80	\$21.68	\$24.30
	1993	30% Increase		\$14.46	\$16.68	\$18.69
	1992	35% Increase		\$11.12	\$12.83	\$14.38
	1991	30% Increase		\$8.24	\$9.50	\$10.65

Rate History

In 1990, reports explained that over the next 15 years approximately \$190,000,000 would be required to provide the City of Modesto with a safe, high quality, and abundant water supply. The best option for a water source was a conjunctive use program with existing

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ground water supplemented with treated surface water. 30% rate increases were put into place (25% for financing water facilities plus 5% for operation and maintenance of existing facilities). The MID (Modesto Irrigation District), City of Modesto, and Del Este Water Company formed a partnership to build a Regional Water Treatment Plant. MID owns, operates and maintains the plant and facilities and acts as a water wholesaler by treating, then delivering water to the City of Modesto's distribution system. The first delivery of the 30 million gallons a day (mgd) surface water plant occurred in January of 1995. The City of Modesto purchased Del Este in mid-1995 and now receives all water treated at the facility. The actual project was \$97 million and included the plant, a terminal reservoir and pump station, 28 miles of transmission/distribution pipeline and reservoir outlet works. It was anticipated that phase 2 of the MID plant would double the capacity from 30 mgd to 60 mgd in 2005-2007 to meet increasing demand.

MID services north of the Tuolumne River. It was also assumed that TID (Turlock Irrigation District) would also need to plan and build a water surface treatment plant to provide for service areas south of the Tuolumne River. It was expected that by 1995 water costs in Modesto would need to escalate to that of Bay Area communities because the treatment of ground and surface water was unavoidable and very expensive. An additional 40% increase did not occur in 1995.

Proposition 218

Since 1993 the Water Fund (Zone One only) and the Sewer Fund had transferred monies to the General Fund, known as Contributed Capital in order to repay the General Fund for the initial funding and support of the new growing utility. Proposition 218 passed in November 1996, as a result by October 1999, the Water and Sewer funds stopped the transfers completely. The elimination of the transfer resulted in Water Fund savings of \$1.3 million, which represented an 8% reduction in rates. Funding for maintenance projects offset the reduction creating a 5% reduction scenario in 2000. This reduction scenario however did not take into account the need for inflationary increases and other water related issues concerning higher costs of new regulations and stricter requirements. Nor did the reduction scenario address the second phase of the MID plant or a TID plant.

The Proposition 218 process requires a notice to property owners, at least 45 days before a public hearing, for any increase in user rates. At the public hearing, all protests are considered, and if the written protests against the proposed fee are presented by a majority of property owners, then the increase will not be imposed.

Capital Project Financing Needs

There are many new standards concerning contaminates levels and treatment methodologies. Many of our wells have been shut down or incurred the additional costs of wellhead treatment. Our wells are drawing in various contaminates such as nitrates, uranium, arsenic, and man-made chemicals. The City of Modesto is also involved expensive environmental litigation in order to protect community assets. The trend of well loss with contaminates and litigation is expected to continue.

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New plans for urban water shortage contingencies (including up to a 50% percent reduction in water supply) are needed to ensure reliability and water quality. Water plans must be proactive and require long-term planning. A new urban-based policy of providing for a safe and reliable water supply looks towards the expansion of conjunctive use strategies and using treated surface water as the primary water source for the City of Modesto with our water well supply used to meet peak demand needs and redundancy requirements.

A continued partnership with MID for a Phase Two expansion of the treated surface water plant project is recommended. MID originally designed and plumbed the water plant so that its capacity could be doubled efficiently and cost-effectively when additional surface water supply was needed. In Phase Two, MID will double the output of the water treatment plant to 60 mgd and increase pumping capacity at the terminal reservoir. [mgd = million gallons per day] MID's part of the Phase Two project is estimated to cost in the \$38 - \$40 million range, based on preliminary engineering studies. The City of Modesto's share of the project to build all of the improvements necessary to receive the Phase Two water and deliver it to the customers while improving water pressure and ensuring quality requires an estimated \$64 million dollars. The Phase Two project as a whole should be financed through \$100 million dollars of revenue bonds being repaid over 30 years with \$112 million of interest.

Water Rate Increases

The City of Modesto is moving towards a fundamental shift in using treated surfaced water as the primary reliable source instead of ground water from wells. Modesto's water utility rate need to reflect the costs of operations and maintenance, construction, acquisition, upgrade, repair, and replacement of water systems facilities, including the associated debt service. In March the proposed rate increases were 35% for fiscal year 04-05, 30% beginning on July 1, 2005, 30% on July 1, 2006, then 5% increases on July 1, 2007 and July 1, 2008. The rate increases ranges are based on the timing of the new revenue needed for many important water related projects. On April 6, Council approved the policy direction to move towards a common rate structure that will comply with Proposition 218. The common rate policy direction will require additional adjustments to the rates and rate structures. This additional rate analysis work will take place in April, May and June. It is anticipated that water connection fees will be updated in order to pay for some new growth related projects over time. Many policy decisions will be needed. Some policy discussions will deal with metering as part of an overall plan for creating equity among customers while keeping water conservation in mind.

Current Status

Currently, a new Water Master Plan is underway. An infrastructure and rate study started in February 2004 and will be finalized this summer. Immediate water fee increases need to be discussed in order to meet our revenue requirements. MID has a preliminary project timeline for phase 2, which starts construction in 2005 and finishes in 2007. The preliminary estimated MID project costs are in the \$38-\$40 million dollar range, but does not include all of the City of Modesto's connections, distribution pipelines, and storage tanks estimated at \$64 million. Other project costs add up to over \$51 million over the

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next 5 years. Talks are also being held with TID concerning South Modesto water needs. Also metering requirements are being developed at the State level.

The Wastewater (Sewer) Fund:

The Wastewater Fund is unable to meet the requirements to issue additional debt for needed capital improvements. Many deferred projects and expensive environmental litigation have depleted the reserves.

Rate History

The 1995 Wastewater Master Plan established a financial strategy to pay for needed sewer improvements over a ten-year period (1995-2005). The strategy included a series of debt issues in the amount of \$45 million. In addition, the strategy required a series of five 7% rate increases beginning in 1996.

The 1997 bond issue listed a series of rate increases of 3% to 4.5% per year for five years, but the increases were delayed. In 1998, staff recommended a 5% increase, then a 4%, however the Sewer Rate Advisory Group recommended only a 2% increase by postponing projects, take calculated risks and reduce lift station rehabilitation projects, remove garden refuse pickups, pass some repair and maintenance charges to the Storm Drain Fund, and reduce reserve dollars down to 10% or less. Also, in 1998 the date of rate increases was changed from July 1 to October 1 to accommodate seasonal industries budget planning, a minimum \$2.0 million capital reserve was established, and recommendations for a rate structure review and multi-year sewer rate plan were made.

Sewer Fund: Flat Rate for Residential			CODE 1	CODE 2	CODE 3
2004	3% Increase		\$14.26	\$11.15	\$11.15
2003	4% Increase		\$13.84	\$10.83	\$10.83
2002	4% Increase		\$13.31	\$10.41	\$10.41
2001 (Oct)	5% Increase		\$12.80	\$10.01	\$10.01
2001 (Jan)	8% Increase		\$12.19	\$9.53	adj \$7.84
1996	3% Increase		\$11.29	\$8.82	\$8.82
1995	4% Increase		\$10.96	\$8.56	\$8.56
1994	5% Increase		\$10.54	\$8.23	\$8.23
1993	3.1% Increase		\$10.04	\$7.84	\$7.84
1992	15% Increase		\$9.74	\$7.60	\$7.60
1991	15% Increase		\$8.45	\$6.59	\$6.59

In late 1998, Council considered a proposal to raise rates over a three-year period in the amounts of 2%, 6%, and 6%. No action was taken at that time. In May 1999, staff projected rate increases of 8% in 2000 and 6% in 2001.

In 1999, a rate equity was addressed concerning three rate groups: residential,, commercial, and industrial. The results of the study concluded that residential rates needed to be increased by 6%, while commercial rates are reduced by 16% creating a zero net revenue increase to the Sewer Fund.

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The Sewer fund was in need of a 14% rate increase based on the continuance of the transfer to the General Fund. The elimination of the transfer resulted in \$1.65 million of savings and reduced the need for a rate increase of 14% to 6% in 2000.

In November 2000, a public hearing was set to adjust Sewer Rates. Two rate adjustments were made. The first adjustment was an equity adjustment +8% for residential, -20% commercial, and 0% for industrial. Second, a 3% across the board rate increase for all classes. (The result being +11%, -17%, +3% respectively.) Also, the reserve policy changed from 25% to 15-20% of operating expenditures.

In August 2001 another successful Sewer Rate Increase Public Hearing was held proposing an Oct 1, 2001 increase of 5%, 2002 4%, 2003 4%, and 2004 3%.

Current Status

Many Sewer Fund changes need to be addressed. A Wastewater (Sewer) Master Plan is 2 years away. Environmental litigation issues and costs are impacting the reserve levels. A rate study effort started in February 2004 will continue to the summer. The deferred maintenance issues for repair and replacement needs to be addressed. The Sewer Fund needs to issue additional bonds estimated at over \$25 million in order to take care of existing and growth related projects. Sewer connection fees also need to be reviewed and updated. The new master plan will document the need for additional projects.

Storm Drain Fund:

The Storm Drain Fund does not have any bonds, but without rate increases the reserves will fall to zero and planned maintenance and capital projects will continue to slide allowing for greater deterioration of the infrastructure and the overall health of the fund.

Unlike Water and Sewer, Storm Drain requires a positive majority vote of the people in order to the increase fees. In 2002, a ballot vote was voided because the notice and the ordinance calculation did not match.

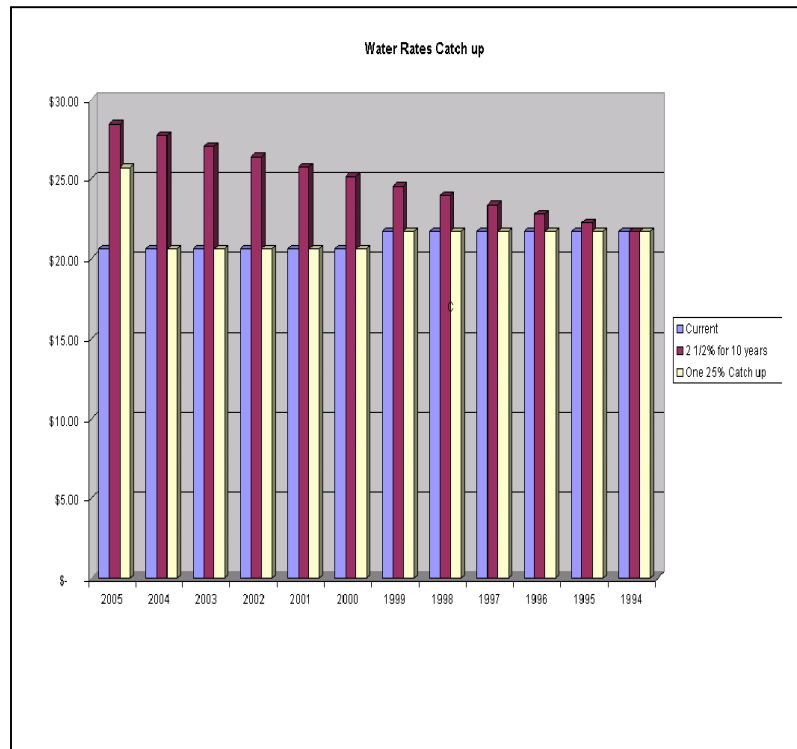
Storm Drain Fund:			LESS THAN 3500	LESS THAN 7000	Over 7000
1995	5% Decrease		\$1.65	\$3.23	\$4.85
1993	Mixed Use Established				
1992 (Oct)	10.2% Increase		\$1.73	\$3.40	\$5.10
1992 (Oct)	Duplex Category Established				
1992 (Apr)	Multi-Dwelling Redefined				
1992 (Mar)	Non-Curb Established (30% of Rate)				
1991	Fund Established		\$1.57	\$3.08	\$4.62

Rate Shock

Rate shock usually occurs when small incremental increases are not made over a period of time. As an example, for the City of Modesto, the last real increase was in 1994 with a rate decrease in 2000. By applying just basic inflationary costs increases at 2.5% for 10 years starting in 1995, the rate base would have had adequate funding for many repair and replacement projects and built a cash reserve sufficient to pay a large percentage of the Phase Two project in cash without incurring long-term interest payments. In order to “catch up” a single rate increase of 25% (2.5% X 10 years) falls short of making up the difference. As a result large consecutive increases are required to build reserves and issue debt in order to finance needed infrastructure improvements. .

Inflation - California CPI			
<i>(All Urban Consumers)</i>			
<u>Year</u>	<u>Index</u>	<u>% Change</u>	
1995	154.0	1.7	
1996	157.1	2.0	
1997	160.5	2.2	
1998	163.7	2.0	
1999	168.5	2.9	
2000	174.8	3.7	
2001	181.7	3.9	
2002	186.1	2.4	
2003	190.4	2.3	
2004	194.2	1.9	<i>forecast</i>
2005	199.4	2.7	<i>forecast</i>
2006	205.3	3.0	<i>forecast</i>
2004-06 Ave.		2.5%	

Source: California Consumer Price Index (CPI), All Urban Consumers, California Department of Finance, 3/04



One important element dealing with rate increases is time. Currently, the water utility needs a rate increase as soon as possible. Annual rates should recover revenues sufficient to operate the water utility on a sound enterprise basis, while paying for O& M expenses, capital expenditure, debt service, and transfers. By combining the issues of no rate increases for 10 years, expenditure cost increases over the last 10 years, environmental litigation impacts, and declining reserve levels the City of Modesto is barely meeting its bond covenants and without a rate increase at the beginning of FY 04-05, the water utility risks having \$84 million of bonds being callable and not being able to issue additional debt in time for Phase Two.

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