

MEMORANDUM

TO: UTILITIES ADVISORY COMMISSION

FROM: UTILITIES DEPARTMENT

DATE: APRIL 4, 2007

SUBJECT: RECOMMENDED FY 2007-08 WATER RATE INCREASE

RECOMMENDATION

This report requests that the Utilities Advisory Commission (UAC) recommend that the City Council:

- a) Approve a 10 percent retail water rate, or \$2.2 million revenue, increase effective July 1, 2007;
- b) Approve, in concept, another 10 percent retail water rate or \$2.5 million revenue increase, for FY 2008-09;
- c) Approve the discontinuance of the current discounted rate for commercial, industrial and institutional irrigation customers; and
- d) Initiate a monthly "Customer Charge" for all customer classes designed to collect a reasonable portion of the utility's non-variable operating costs. This customer charge will be fixed and will not be related to volume of water used.

Imposing both the rate increase and customer charge will trigger Proposition 218's notice and protest hearing procedures.

BACKGROUND

The Water Fund's revenue requirement consists of a number of components including: wholesale water cost, distribution system operations, Capital Improvement Program (CIP) projects, funding of the Water Rate Stabilization Reserve (W-RSR) and the Emergency Plant Replacement Reserve (EPRR), and debt service. Any change in one or more of these components, or a change in retail sales levels, can trigger the need for a rate adjustment. During the budget process, staff forecasts customer revenues and utility expenses in order to quantify the annual revenue requirement. Changes to forecasted revenues or expenses are reflected in adjustments during the midyear budget process.

In FY 2005-06, as part of the mid-year budget adjustments, staff reduced the water budget revenue by \$2.6 million, based on water sales-to-date, which were 12.9 percent below the original budget projections. The lower sales level for FY 2005-06 stemmed from a reduction in water usage, especially irrigation water, as a result of above average rainfall and ongoing water

efficiency impacts. Since water rates have been volumetrically-based for the last few years, changes in rainfall patterns have had significant impacts on Water Fund revenue.

After the adoption of the City of Palo Alto Budget for FY 2006-07, the San Francisco Public Utilities Commission (SFPUC) increased its wholesale water rates. A budget adjustment increasing the wholesale supply costs by approximately \$800,000 to account for the increase in wholesale water rates was made as part of the midyear budget process. Since retail rates had already been set and implemented, this additional expense was funded from the W-RSR.

During the FY 2006-07 budget process, a 7 percent revenue increase was proposed by the Utilities Department and approved by the City Council. That revenue increase was not sufficient to bring the W-RSR balance above the Minimum Guideline approved by the City Council. However, to avoid a larger rate increase, the decision was made to slowly fund the reserve until it reached the Minimum Guideline Level in FY 2010-11, unless there was a need to accelerate that schedule. The Minimum Guideline will be \$4.9 million for FY 2007-08.

DISCUSSION

Revenues, Expenses and Reserves

The Water Utility continues to experience declining sales levels due to efficiency improvements and certain large customers leaving the system. At the same time, there have been increased wholesale supply, operating and CIP costs. There have also been unanticipated costs related to retiree medical liabilities and Workers' Compensation. These impacts have resulted in withdrawal of funds from the W-RSR during FY 2006-07, leaving the W-RSR balance below the Minimum Guideline Level.

The SFPUC has indicated that wholesale water costs may increase in FY 2007-08, but, since the SFPUC's budget process runs later in the year than Palo Alto's, the SFPUC's final adopted rates are not currently known and may substantially differ from early projections. Due to the continuing trend of declining water sales, revenue forecasts for FY 2007-08 and beyond have been adjusted down to match this pattern. CIP expenses are projected to be \$1.1 million greater in FY 2007-08 than FY 2006-07.

After the proposed 10% rate increase, the W-RSR balance is forecast to be \$12.4 million at the end of FY 2007-08. This includes an \$8.5 million return from the FY 2006-07 CIP budget to the W-RSR. The \$8.5 million represents the close out of various individual CIP projects which are elements of the City's Emergency Water Supply and Storage Project. The Emergency Water Supply and Storage Project is estimated to cost roughly \$40 million with expenditures beginning in FY 2007-08. Utilities staff is working with the Administrative Services Department to explore utility revenue bond financing necessary to fund the Emergency Water Supply and Storage Project.

The projected W-RSR balance at the end of FY 2007-08, will be above both the target level established by the "Annual Risk Assessment for Reserves", and the Maximum Guideline Level approved by Council due to the temporary infusion of \$8.5 million from closed CIP projects.

Assuming retail rates are increased 10% for FY 2008-09, the W-RSR balance at the end of FY 2008-09 is forecast to be \$3.4 million or \$200,000 below the Minimum Guideline Level for that

year. Staff will reassess the Water Utility risks, revenues and reserve levels for FY 2008-09 during the budget process for that fiscal year.

Customer Charge

Until the end of FY 2002-03, all water rate schedules included a monthly meter charge based on meter size. The meter charge was designed to recover a portion of the fixed costs of serving the customers including meter reading, accounting costs and administrative costs. In June 2003, staff recommended, and the City Council approved, the discontinuance of the monthly meter charge and a change in the Water Utility pricing policy to collect revenues from all customer classes through pure volumetric pricing. (CMR:267:03). The objective at that time was to encourage customer water efficiency and avoid potential conflicts with California’s Proposition 218. In FY 2002-03, the revenue collected from the meter charge was approximately \$1 million, or five percent of the Water Utility revenue.

The “Customer Charge”, recommended for FY 2007-08; collects revenue for services rendered to the customer regardless of usage, and mitigates the revenue uncertainty associated with predicting water usage. Staff recommends the fixed charge be termed a “Customer Charge” to more accurately describe the nature of the charge. The proposal calls for the customer charge to vary based upon the meter size as applied to all water rate schedules.

Staff reviewed a survey by the California Municipal Utilities Association and found that the majority of California’s water utilities have both a fixed customer charge and a volumetric charge. The recommended residential customer charge of five dollars for a 5/8 inch meter appears to be in line with that of other water utilities. Table 1 below shows the fixed monthly charges for surrounding cities:

TABLE 1: Water Rate Comparisons

Meter Size	Palo Alto (Proposed)	Mountain View	Los Altos	Menlo Park	Redwood City
5/8 “	\$ 5.00	\$ 4.10	\$ 10.47	\$ 12.95	\$ 14.25
3/4 ”	5.00	4.10	15.71	19.43	21.38
1 ”	6.50	8.20	22.07	25.17	35.63
1 1/2 “	12.27	13.30	35.31	37.18	71.25
2 ”	19.37	24.80	55.16	56.30	114.00
3 “	77.65	43.05	95.99	121.09	213.75
4 “	130.60	67.70	132.40	212.44	356.25
6 “	260.43	135.55	215.14	366.46	712.50
8 ”	383.67	215.85	344.23	1,036.00	712.50
10 “	383.67	315.00	441.32	1,489.25	712.50

A recently completed water cost-of-service study determined the pro-rata share of fixed costs for each customer class. To avoid a sudden large negative impact on the smaller water users (with meters up to two inches in size), staff recommends that the customer charge initially be set at a level that does not fully collect all fixed costs, but rather a portion of those costs. The portion of fixed costs left uncollected by the customer charge would continue to be collected volumetrically. For example a five dollar monthly charge is proposed for most of the residential customers (5/8 inch meter), which represents 48% of the fully allocated cost-of-service result of

\$10.40. Incremental changes will be made over time in order to match revenue from the customer charge with the fully allocated cost of service. For larger customers, with meter sizes of three inches or more, the proposed monthly charge, varying with meter size, will immediately collect the fully allocated customer costs.

The expected revenue from implementing a fixed charge is approximately \$1.6 million. The impact of all revenue requirement changes and the new monthly customer charge, will result in an average residential customer's water bill increasing by \$6.04/month (or 10.4%, from \$58.17 to \$64.21). Small users will have a monthly bill increase of \$4.74 (for 4 monthly usage of CCF, the monthly bill will increase from \$16.16 to \$20.80, a 28.7% increase).

Proposition 218 Water Rate Increase Procedure:

Proposition 218 amended the California Constitution and set forth procedural requirements public agencies must follow in order to enact or increase a property-related fee. Since Proposition 218 applies to the water service rate increases and customer charges described here, the City must provide written notice by mail to water customers subject to the proposed fees, followed by a public hearing held not less than 45 days after notice is mailed. The notice must include the amount of the fee, the basis upon which the fee was calculated, the reason for the fee, and the date, time and location of the public hearing. If written protests against the proposed fees are not presented by a majority of customers, the City may impose the fee.

Allocation of the Rate Increase

A cost-of-service study conducted during FY 2005-06 for the Water Utility determined the allocation of costs between customer classes. The results indicated inequities among customer classes that needed correction. This imbalance is exacerbated by the changing customer mix in the City.

Table 2 below shows the impact of the proposed rates increase on customer bills based on different consumption levels for the residential and non-residential classes.

TABLE 2: Impact of Rate Increase on Customer Bills

Customer	Usage (CCF)	Proposed Monthly Bill	Amount of Proposed Increase	Percent Increase
Small Residential 5/8" Meter	7	\$ 32.64	\$ 4.36	15.4%
Average Residential 5/8" Meter	14	64.21	6.04	10.4%
Residential 5/8" Meter	20	91.27	7.48	8.9%
Large Residential 5/8" Meter	35	158.92	11.08	7.5%
Medium Commercial 3" Meter	300	1,379.95	104.95	8.2%
Large Commercial or Industrial 6" Meter	1200	5,469.63	369.63	7.2%
Large Commercial or Industrial (irrigation only) (W-7) 6" Meter	3000	13,283.43	1,163.43	9.6%

In addition to implementation of the customer charge, staff recommends discontinuing the discount for all the commercial, industrial and institutional irrigation rate schedule (W-7) which has been in effect since July 2003. Water Rate Schedule W-7 currently gives a discount to large

customers who install a separate landscape irrigation meter. The City still supports the installation of separate irrigation meters, but feels that the customer savings on wastewater bills provide sufficient incentive to do so. This change will provide a new price signal to improve landscape efficiency.

Comparison of Palo Alto Water Rates and Surrounding Cities:

For several years, Palo Alto's retail water rates have generally been higher than surrounding areas, due to wholesale water rate increases from SFPUC, the funding of an aggressive Capital Improvement Program (CIP) to rehabilitate or replace aging water distribution infrastructure, and increases in allocated costs from other City departments for services provided to the Water Fund. A 2007 bill comparison of municipal water rates in Redwood City, Mountain View, Los Altos and Menlo Park indicates that the average Palo Alto residential customer pays approximately 32 percent more than comparable customers in surrounding cities. There are indications that nearby cities that purchase their water supplies from the SFPUC may be raising rates this year. At this time, the certainty or magnitude of their rate increases is not known.

Risk Assessment

An annualized risk assessment has been performed by staff which compares projected reserve levels to applicable risk factors. This assessment has determined that reserve balances are adequate for FY 2007-08. An updated risk assessment will be performed as part of the budget process for FY 2008-09.

A rate increase of 10 percent, or a revenue increase of \$2.5 million, in FY 2008-09 is also recommended by staff. The projected ending W-RSR balance of \$3.4 million for FY 2008-09 would be below the Minimum Guideline Level of \$5.4 million, but only slightly below the projected risk assessed reserve level of \$3.6 million. Staff will evaluate the revenues, expenses and risks during the FY 2008-09 budget process to ensure that the Water Utility remains financially sound.

Table 3 below summarizes the end of year balances for the W-RSR, the risk assessment level and the Reserve Guidelines. Note that the risk assessment level is determined by assessing the short-term risks to the water fund. The Reserve Guidelines were established to manage risks over the longer term.

TABLE 3: Water Reserve Balance, Guideline Levels and Risk Assessment Level

Reserve Balance and Guideline Levels	FY 2007-08	FY 2008-09
End of Year Balance (Forecast with No Rate Adjustments)	\$10.2 million	- \$1.3 million
End of Year Balance (Forecast with Proposed Rate Adjustments)	\$12.4 million	\$3.4 million
Risk Assessment Level	\$3.3 million	\$3.6 million
Reserve Minimum Level	\$4.9 million	\$5.4 million
Reserve Maximum Level	\$12.4 million	\$13.6 million

ALTERNATIVES

Staff evaluated the impact of alternative rate proposals to the proposed \$2.2 million revenue increase. Any smaller rate increase would require reducing some combination of the operating

budget, Capital Improvement Program, or the W-RSR. Reducing the CIP would hinder water main replacement projects, where the infrastructure has exceeded its system design life. Reducing the water operating budget will hinder the reliability and safety of the water system. Withdrawing more funds from the W-RSR would drive the reserve balance further below the Minimum Guideline, and could necessitate an emergency rate increase request to accommodate infrastructure failure, or an increase in water supply costs.

RESOURCE IMPACT

Approval of this rate proposal will increase the Water Fund metered retail sales revenues by approximately \$2.2 million for FY 2007-08. Due to the return of \$8.5 million from encumbered CIP projects, the W-RSR balance is projected to be temporarily above the Maximum Reserve Guideline Level at the end of FY 2007-08. However, the returned monies will be earmarked to partially fund the City's Emergency Water Supply Storage project starting in FY 2007-08.

Staff also recommends that Council approve in concept an additional 10 percent rate increase, or \$2.5 million, in FY 2008-09 to bring the W-RSR closer to the Minimum Guideline Level.

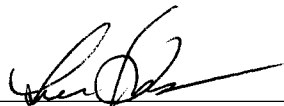
POLICY IMPLICATIONS

This rate proposal meets the following Utilities Strategic Plan objectives: to invest in utility infrastructure to deliver reliable service and to provide superior financial service to the City and competitive rates to customers. Approval of the proposed water rate increase does not represent a change to existing policies.

ATTACHMENTS:

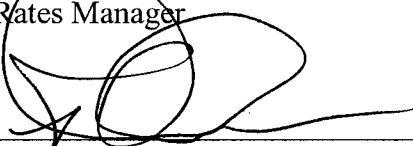
- A. Water Rate Schedules W-1, W-2, W-4, and W-7

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GENERAL RESIDENTIAL WATER SERVICE

UTILITY RATE SCHEDULE W-1

A. APPLICABILITY:

This schedule applies to all residential single family water service.

B. TERRITORY:

Inside and outside the incorporated limits of the City of Palo Alto and land owned or leased by the City.

C. RATES:

Monthly Customer Charge:	<u>Per Meter</u> <u>Per Month</u>
For 5/8-inch meter	\$5.00
For 3/4 inch meter	5.00
For 1 inch meter	6.50
For 1 1/2 inch meter	12.27
For 2-inch meter	19.37
For 3-inch meter	77.65
For 4-inch meter	130.60
For 6-inch meter	260.43
For 8-inch meter	383.67
For 10-inch meter	383.67

Commodity Rate: (To be added Customer Charge and applicable to all pressure zones.)

<u>Per Meter</u> <u>Per Month</u>	<u>Per Hundred Cubic Feet</u> <u>All Pressure Zones</u>
First 7 Ccf	\$3.949
Over 7 Ccf	4.510
Temporary unmetered service to residential subdivision developers, per connection	\$6.00

{End}

CITY OF PALO ALTO UTILITIES

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CITY OF PALO ALTO
UTILITIES

Supersedes Sheet No. W-1-1 dated 7-1-2006

Effective 7-1-2007
Sheet No. **W-1-1**

WATER SERVICE FROM FIRE HYDRANTS

UTILITY RATE SCHEDULE W-2

A. APPLICABILITY:

This schedule applies to all water taken from fire hydrants for construction, maintenance, and other uses in conformance with provisions of a Hydrant Meter Permit.

B. TERRITORY:

Within the water service area of the City of Palo Alto.

C. RATES:

1. Monthly Customer Charge.

METER SIZE

5/8 inch	50.00
3 inch	125.00

2. Commodity Rate: (per hundred cubic feet) \$4.34

D. SPECIAL NOTES:

1. Monthly charges shall include the applicable monthly customer charge in addition to usage billed at the commodity rate.
2. Any applicant using a hydrant without obtaining a Hydrant Meter Permit or any permittee using a hydrant without a Hydrant Meter Permit shall pay a fee of \$50.00 for each day of such use in addition to all other costs and fees provided in this schedule. A hydrant permit may be denied or revoked for failure to pay such fee.
3. A meter deposit of \$750.00 may be charged any applicant for a Hydrant Meter Permit as a prerequisite to the issuance of a permit and meter(s). A charge of \$50.00 per day will be added for delinquent return of hydrant meters. A fee will be charged for any meter returned with missing or damaged parts.
4. Any person or company using a fire hydrant as described in D.1 above or who draws water from a hydrant without a meter installed and properly recording usage shall, in addition to all other applicable charges be subject to criminal prosecution pursuant to the Palo Alto Municipal Code.

{End}

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Sheet No. **W-2-1**

GENERAL NON-RESIDENTIAL WATER SERVICE

UTILITY RATE SCHEDULE W-4

A. APPLICABILITY:

This schedule applies to non-residential water service in the City of Palo Alto and its distribution area. This schedule is also applicable to multi-family residential customers served through a master meter.

B. TERRITORY:

Inside the incorporated limits of the City of Palo Alto, on land owned or leased by the City, and any other land serviced by the Palo Alto Water Utility.

C. RATES:

Monthly Customer Charge	<u>Per Meter Per Month</u>
For 5/8-inch meter	\$5.00
For 3/4-inch meter	5.00
For 1-inch meter	6.50
For 1 1/2 inch meter	12.27
For 2-inch meter	19.37
For 3-inch meter	77.65
For 4-inch meter	130.60
For 6-inch meter	260.43
For 8-inch meter	383.67
For 10-inch meter	383.67

Commodity Rates: (to be added to Customer Charge)

<u>Per Meter Per Month</u>	<u>Per Hundred Cubic Feet All Pressure Zones</u>
Per Ccf	\$4.341

{End}

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IRRIGATION WATER SERVICE

UTILITY RATE SCHEDULE W-7

A. APPLICABILITY:

This schedule applies to non-residential water service supplying dedicated irrigation meters in the City of Palo Alto and its distribution area.

B. TERRITORY:

Inside the incorporated limits of the City of Palo Alto, on land owned or leased by the City, and any other land serviced by the Palo Alto Water Utility.

C. RATES:

	<u>Per Meter</u> <u>Per Month</u>
Monthly Customer Charge	
For 5/8-inch meter	\$5.00
For 3/4-inch meter	5.00
For 1-inch meter	6.50
For 1 1/2 inch meter	12.27
For 2-inch meter	19.37
For 3-inch meter	77.65
For 4-inch meter	130.60
For 6-inch meter	260.43
For 8-inch meter	383.67
For 10-inch meter	383.67

Commodity Rates: (to be added to Customer Charge)

<u>Per Meter</u> <u>Per Month</u>	<u>Per Hundred Cubic Feet</u> <u>All Pressure Zones</u>
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Per Ccf	\$4.341
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UTILITIES

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