CITY OF SANTA BARBARA

COUNCIL AGENDA REPORT

AGENDA DATE: February 27, 2024

TO: Mayor and Councilmembers

FROM: Water Resources Division, Public Works Department

SUBJECT: Water and Wastewater Rate Studies Revenue Requirements

RECOMMENDATION: That Council:

A. Receive a presentation on the City's water and wastewater rate studies and the required rate revenue increases; and

B. Direct staff to complete a cost-of-service analysis and return with a proposed rate notice.

EXECUTIVE SUMMARY:

In accordance with State law, the Water Fund and Wastewater Fund revenues must be sufficient to meet the City's expenditures for providing water and wastewater services. Several factors are requiring an increase in funding such as: higher than anticipated inflation, revised methodologies for allocating costs for internal services, lower than anticipated water sales, and increasing policy reserves to keep pace with increasing capital costs. Below are the revenue requirement options for Water with staff recommending Option 2:

Option	FY25	FY26	FY27	FY28
Water Option 1 Funds Planned Capital Reserves at Policy	16.0%	12.0%	5.0%	5.0%
Water Option 2 Funds Planned Capital Reserves Below Policy	12.0%	12.0%	9.0%	9.0%
Water Option 3 Reduced Capital Reserves Below Policy	10.0%	9.5%	9.5%	9.5%

Below are the revenue requirement options for Wastewater with staff recommending Option 2:

Option	FY25	FY26	FY27	FY28
Wastewater Option 1 Funds Planned Capital Reserves Below Policy	12.0%	12.0%	12.0%	12.0%
Wastewater Option 2 Defers Planned Capital Reserves Below Policy	10.5%	10.0%	10.0%	9.5%

Both staff-recommended options for Water and Wastewater result in funding planned capital needs while mitigating rate increases to customers by utilizing reserves. Reserves will return to policy levels by the end of the rate-setting period (FY28) for both funds.

DISCUSSION:

Background

The City regularly conducts water and wastewater rate studies, which include rate revenue projections for the next 10 years. On October 3, 2023, City Council approved a contract with HDR Engineering Inc. (HDR) to conduct a comprehensive study. The last water rate study was completed in 2021 and the last wastewater rate study was completed in 2022.

The City provides water and wastewater services to a population of 95,000, with a service area of 20 square miles. The City's water and wastewater utilities depend on customer rate revenue to fund most of the operations, maintenance, and capital improvements needed to keep the utility functioning reliably and in compliance with federal and state regulations.

HDR is creating 10-year financial plans and multi-year rate studies for both water and wastewater with the intention to set rates for the next four fiscal years. A comprehensive rate study consists of three interrelated analyses to address the adequacy and equity of a utility's rates: a revenue requirement analysis, a cost-of-service analysis, and a rate design analysis. The rate studies are currently in the revenue requirement analysis phase, in which staff and HDR determine the amount of revenue that must be generated from the proposed rates to sufficiently fund the costs of operations and maintenance, capital improvements, mandated standards, debt obligations, contributions to reserves, and other obligations. The projected costs and the revenues generated must be in line to meet the costs of the City's water and wastewater systems.

As mentioned, some of the main drivers contributing to the rate increases include:

- Inflation outpaced assumptions in previous water and wastewater models for both operations & maintenance and capital.

- Significant increases in allocated costs for internal services (IT, Fleet).
- Property and liability insurance rates increasing 20% and 17% annually over the rate-setting period.
- Reduction in water demand and thus revenues (10%) due to an above average wet winter in calendar 2023.
- Increased capital policy reserve minimum due to increased capital costs.

Reserves

The City's Reserves Policy (Resolution No. 23-124, adopted on October 11, 2023) established guidelines regarding minimum reserve levels for the various City funds to ensure ongoing fiscal security. There are several types of reserves detailed below that apply to the Water Resources Enterprise funds:

- *Disaster* – calculated at 15% of the most recently adopted fiscal year operating expenditure budget. This reserve is restricted for use in addressing impacts of natural disasters, such as storms, fires, droughts, etc. and may be used only after other available funds are exhausted, including Contingency reserves. The use of this reserve requires Council action.
- *Contingency* – calculated at 10% of the most recently adopted fiscal year operating expenditure budget. This reserve may be used to address the fiscal impacts of unexpected events such as economic recession. The use of this reserve requires Council action.
- *Capital* – calculated at the lesser of 5% of the value of capital assets or the average of the planned capital program for the upcoming three years. This reserve is intended to address unexpected capital projects or unanticipated increases in capital project costs.
- *Rate Stabilization* – required by debt agreements, the minimum requirement is $1M for Wastewater and $2.9M for Water. These reserves are unique in that they can be considered revenue for the purpose of debt service coverage in a given year. Staff may make additional contributions to these reserves if there are anticipated threats to revenues, such as mandatory water conservation or other negative impacts on revenues.

For options where the proposed use of reserves brings reserves below Policy level, staff are recommending only the use of Capital Reserves. The recommendation is that Disaster, Contingency, and Rate Stabilization Reserves remain at Policy levels in all options. In addition, for all options, reserves will return to Policy levels by the end of the rate-setting period (FY28).

WATER

Three options have been developed for meeting the Water revenue requirement that balances the different levels of capital improvements and funding from reserves. It is important to note that before the recent spike in inflation, the 2021 water rate study identified the need for a 5% rate revenue increase in FY25, 4.5% in FY26, and 4% in FY27 and FY28.

Option 1 – Fund the Planned Capital Program and Maintain Reserve Levels at City Policy
The water system will need to maintain rates that support upcoming projects identified in the Water Distribution Infrastructure Plan and other capital improvements, including replacing ~2% or six miles of water mains annually. Approximately $178M in necessary capital investments in the water system have been identified over the four-year rate study period (FY25-28). A combination of financing (long-term borrowing) and pay-as-you-go funding will be utilized to meet these capital improvement needs in addition to the use of reserves at a level that will keep reserves at or above City policy.

Option 2 – Fund the Planned Capital Program and Allow Reserve Levels to Drop Below City Policy
This option includes the same planned capital program as Option 1 but funds the program using capital reserves to mitigate rate impacts. Under this option, capital reserves go below City policy by about $6M (~20%) before returning to City policy levels by the end of the rate-making period (FY28).

Option 3 – Reduce Water Main Replacement Funding and Allow Reserve Levels to Drop Below City Policy
This option reduces the Water Main Replacement Program funding by 17%, which equates to approximately five miles of mains annually, gradually restoring funding for the full six miles of replacement in the fourth year of the rate study. This will bring the necessary capital investments down to approximately $170M over the four-year rate study period (FY25-28). In addition to a combination of long-term borrowing and pay-as-you-go funding, this option uses capital reserves to mitigate rate impacts. Capital reserves drop below City policy by about $2.8M (~10%) before returning to City policy levels by the end of the rate-making period (FY28).

Analysis of the three options indicates the approximate annual revenue increases in the table below will be sufficient to meet the needs of the water system.

Option	FY25	FY26	FY27	FY28
Water Option 1 Fully Funded Capital Reserves at Policy	16.0%	12.0%	5.0%	5.0%
Water Option 2 Fully Funded Capital Reserves Below Policy	12.0%	12.0%	9.0%	9.0%
Water Option 3 Reduced Capital Reserves Below Policy	10.0%	9.5%	9.5%	9.5%

It is important to note that revenue increases do not equate to rate increases (or bill impacts) to individual customer classes of service. During the cost-of-service analysis phase of the project, the revenue requirements (e.g., costs) are proportionally distributed

to each customer class, which may result in rate increases that are lower and/or higher than the revenue requirement percent increase for each customer class.

Water Conservation

Water usage in FY23 was lower than in past years due to the wet winter the City experienced in early 2023. The unplanned drop in water use in FY23 resulted in a decrease in planned revenue of $4.6M. The Enhanced Urban Water Management Plan had anticipated around 3% increases in water use annually between WY2020-2027, which assumed some moderate growth in demand as the City emerges from the last drought, along with decreases in demand from typical water conservation associated with changes in landscaping and plumbing fixtures. However, rate increases of the magnitude proposed in this study and the recent wet winter are anticipated to keep water usage at relatively low levels. For this rate study, water usage is assumed to remain steady (similar to FY23) for the next four years. The model also assumes 0.5% annual growth in the number of customers within the multi-family customer class as a result of new developments.

Water Customer Class Prioritization

One aspect of creating the City's volumetric water rates is assigning and distributing the City's various water supplies to the different customer classes and tiers. The water sources are allocated based on priority levels set by the City Council. The highest priority customer tiers receive the least expensive sources of water. The current prioritization is as follows:

Existing Customer Class Prioritization			
Customer Class/Tier	Priority	Usage (HCF)	% of Total
Tier 1 Irrigation Agriculture	1	43,662	1.19%
Tier 1 Irrigation Recreation	2	46,360	1.26%
Tier 1 Single Family Residential	2	681,764	18.53%
Tier 1 Multi-Family Residential	2	819,235	22.27%
Tier 1 Commercial	3	665,981	18.10%
Tier 2 Single Family Residential	4	685,009	18.62%
Tier 2 Multi-Family Residential	4	203,482	5.53%
Tier 1 Irrigation Urban (Res/Comm)	4	94,672	2.57%
Tier 2 Commercial	5	120,122	3.27%
Tier 3 Single Family Residential	5	219,400	5.96%
Tier 3 Multi-Family Residential	5	67,879	1.85%
Tier 2 Irrigation Agriculture	5	688	0.02%
Tier 2 Irrigation Recreation	5	3,406	0.09%
Tier 2 Irrigation Urban (Res/Comm)	5	26,973	0.73%
	Total	*3,678,632*	*100%*

The residential customer classes have three tiers of service, reflecting basic health and sanitation water usage, discretionary water usage, and excessive water usage. Irrigation and commercial customer classes have two tiers of usage, reflecting water usage within their customized water budgets, and water usage above their budgets.

The effect of the current ranking shown in the above table is that water usage in tiers considered excessive use or outside the customer's water budget are allocated to more expensive water sources, resulting in a higher $/HCF* rate. Staff recommendation is to retain this existing prioritization.

*HCF = Hundred Cubic Feet (1 HCF = 748 gallons)

Fixed vs. Volumetric

The City's water rates consist of a fixed monthly service charge based on meter size, and volumetric charges based on metered customer water use. Historically, the City's rate design has resulted in a collection of 30% of revenues through fixed charges and 70% of revenues through volumetric charges. It is considered both a water conservation and water rate affordability best management practice to keep fixed charges low so customers may control their bill to the greatest extent possible through their water use.

However, lower revenues from fixed charges create more revenue instability for the Water Fund. About 85% of Water Fund costs are fixed, so decreases in customer demand do not result in a reduction in these fixed operational costs. Therefore, the Water Fund must balance the ratio of revenues from fixed and volumetric rates while considering water conservation, affordability, and financial stability goals.

Staff does not recommend dropping the target percentage of revenue from fixed rates below 30%. This would make the Water Fund increasingly vulnerable to unexpected decreases in customer demand. Decreases in demand would result in decreased revenues and require unplanned use of reserves to cover costs, or delay maintenance and capital projects to reduce costs. In the long term, it is staff's recommendation that the target revenue derived from fixed charges increase above 30% to elevate the financial stability of the Water Fund. However, as increased fixed charges could have an undesired affordability impact on low-income customers, staff does not recommend adjusting the target now. This adjustment to the target should be investigated following the implementation of low-income water rate affordability programs to help offset increases that would disproportionately impact low-income customers with low water use.

It is important to note that the revenue ratio from the fixed vs. volumetric rate components is a design target for the City's rates. However, the rates proposed will be based on the cost-of-service analysis and the appropriate and proportionate allocation and distribution of costs to meet the intent of Proposition 218 and its requirements.

WASTEWATER

Two options are presented for meeting the necessary revenue requirements for Wastewater, which balance different levels of capital improvements and funding from reserves. It is important to note the last rate study completed in 2022 anticipated the need for a 6.5% rate increase in FY25, and a 6% increase in FY26-28.

Option 1 – Fund the Planned Capital Program and Allow Reserve Levels to Drop Below City Policy
The wastewater system will need to maintain rates that support upcoming capital improvements to the collection and treatment systems and fund reserves to meet City policy levels. In FY24, reserves were used to balance the budget to offset the record-high inflationary impacts not captured in the existing rates. Approximately $69M in necessary capital investments have been identified over the four-year rate study period (FY25-FY28) which will be funded with a combination of financing (long-term borrowing), pay-as-you-go funding, and the use of capital reserves. Under this option, capital reserves dip below City policy by about $1M (10%) before returning to City policy levels by the end of the rate-making period (FY28).

Option 2 – Reduce Capital Funding and Allow Reserve Levels to Drop Below City Policy
This option defers several capital projects totaling $6M to outside of the rate-setting period (FY25-FY28), including rehabilitation of six lift stations, the implementation of an Air Pollution Control District Master Plan, and collection system capacity improvements at the 101 Freeway and near Santa Barbara Junior High School. Funding for the Sanitary Sewer Overflow program is prioritized over this period. Approximately $63M in necessary capital investments have been identified over the four-year rate study period under this option which will be funded with a combination of financing (long-term borrowing), pay-as-you-go funding, and the use of capital reserves. Under this option, capital reserves drop below City policy by about $300K before returning to City policy levels by the end of the rate-making period (FY28).

Analysis of the two options indicates the approximate annual revenue increases in the table below will be sufficient to meet the needs of the wastewater system.

Option	FY25	FY26	FY27	FY28
Wastewater Option 1 Fully Funded Capital Reserves Below Policy	12.0%	12.0%	12.0%	12.0%
Wastewater Option 2 Defer Capital Reserves Below Policy	10.5%	10.0%	10.0%	9.5%

It is important to note that revenue increases do not equate to rate increases, or bill impacts, to individual customer classes of service. During the cost-of-service analysis phase of the study, the revenue requirements (e.g., costs) are proportionally distributed

to each customer class, which may result in rate increases that are lower and/or higher than the revenue requirement percent increase for each customer class.

BUDGET/FINANCIAL INFORMATION:

The proposed revenue requirements ensure that both the Water and Wastewater Funds will remain solvent and continue to fund critical capital improvements and ongoing operations. The next step is the cost-of-service analysis, which determines how to equitably allocate the revenue requirements to the different customer classes.

WATER COMMISSION RECOMMENDATION:

This item was presented to the Water Commission on January 18, 2024, and February 15, 2024. The Commission voted 4:0:1 on February 15, 2024, in support of the following actions:

- Water revenue requirement Option 2,
- Wastewater revenue requirement Option 2,
- Maintain current Water customer class prioritization; and
- Maintain the target balance of Water revenues at ~30% from fixed charges and ~70% from volumetric charges.

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SUBMITTED BY: Clifford M. Maurer, Public Works Director

APPROVED BY: City Administrator’s Office