



CITY OF SANTA BARBARA

COUNCIL AGENDA REPORT

AGENDA DATE: November 10, 2020

TO: Mayor and Councilmembers

FROM: Water Resources Division, Public Works Department

SUBJECT: Water Rates Update

RECOMMENDATION:

That Council receive an update on the status of Fiscal Year 2021 water rate changes, and the development of water rates for Fiscal Years 2022, 2023, and 2024.

DISCUSSION:

Staff is recommending that the City forgo an anticipated three percent water rate increase budgeted for in Fiscal Year 2021 (FY 2021). This has been made possible by recent adjustments to the Water Fund's capital improvement plan in the FY 2021 Budget, which is described in detail in this report. Although the COVID-19 pandemic continues to present financial challenges, staff is confident that the Water Fund will be able to absorb any financial impacts from forgoing a rate increase while continuing to provide a high level of service to the community.

Background

In October 2019, the City contracted with HDR Engineering, Inc. (HDR) to conduct a comprehensive rate study and cost-of-service analysis for water rates. The cost-of-service analysis examines all current assumptions, supporting data, and policy points of the existing rate structure, and ensures that proposed rates are compliant with Article XIII D, Section 6 of the California Constitution. This section of California law is commonly referred to as Proposition 218, which was approved by voters in 1996. Proposition 218 includes the requirement that rates may not exceed the estimated cost of providing the service, and must be reasonable, equitable, and proportional.

At the start of the calendar year, staff began working with the Water Commission to review the major policy and planning inputs for the rate study, including the planned adoption period, operating and capital costs, water supply outlook, projected water demands, customer classes, and rate design. At the time, staff intended to recommend a three-year rate adoption schedule that would go into effect at the start of FY 2021 (July 2020) and continue through FY 2023. HDR's preliminary analysis of the revenue requirement found that revenue increases of six percent would be necessary to meet the Water Utility's

financial needs, with a large driver being the planned capital investments in the water system. However, the COVID-19 pandemic introduced significant uncertainty into the rate model, and caused immediate financial hardships for community members and businesses. In response to this unplanned disruption, staff went to the Finance Committee on April 28, 2020 to consider various rate adoption scenarios, as well as the forecasted impacts on future rate increases, capital funding, reserve levels, and debt coverage.

As anticipated, the largest impact on the Water Fund from COVID-19 has been reduced rate revenue in the commercial customer class. Commercial water demand, which is heavily influenced by commuters and tourism, declined in the last quarter of FY 2020 – April, May, and June. This drop in commercial demand, coupled with community-wide water conservation that was higher than expected, led to a shortfall of \$3.66 million in rate revenues. However, savings in salary and benefits, discretionary spending, and water supply fees partially offset these shortfalls in revenue. Discretionary spending, in particular, saw substantial savings as Water staff deferred or curtailed all non-essential spending in anticipation of revenue-related impacts from COVID-19. Additionally, FY 2021 funding for the Water Main Replacement Program was reduced to \$4.25 million from \$9.0 million in an effort to bolster available reserves and prepare for revenues to continue to fall short of expectations. More recently, water rate revenue from the first quarter of FY 2021 has shown some rebounding to pre-COVID levels, but staff continues to watch this closely as the long-term financial effects from COVID-19 are still unclear.

Rate Adoption Schedule and Anticipated Rate Increases

On May 27, 2020, the Public Works Budget, including the Water Fund, was presented to City Council. In that presentation, staff recommended the deferral of water rate increases planned for July 1, 2020, instead opting to target a three percent increase to go into effect in January 2021. Since that time, the rate model has been updated with the most current capital project needs, timelines, cost estimates, and funding sources, including the planned revenues that will come from the executed Water Supply Agreement with the Montecito Water District. Additionally, the City's rate consultant is recommending that the Water Utility debt finance certain projects, instead of using pay-as-you-go funding. The overall effect has reduced the level of planned cash outlays for capital projects. Given these revisions to the capital improvement plan, the financial stresses placed on the community from COVID-19, and Council's desire to provide relief where possible to the community, staff is recommending a complete deferral of rate increases for FY 2021.

As presented in the April 2020 Finance Committee meeting, initial analysis showed that foregoing a rate increase in FY 2021 would require a combination of reducing capital funding and/or choosing to debt finance certain projects, and also looking at opportunities to reduce operating costs. To that end, the rate model has been updated with the most current capital planning information, a key component of which is taking on new debt to fund capital projects. This has substantially reduced the level of cash that needs to be generated from water rates and curtailed otherwise large capital funding cuts. Additionally, in the next several years, two State Revolving Fund loans will be retired,

which will partially offset any new debt financing obligations. With that, HDR is estimating rate revenue increases of approximately five percent each year for Fiscal Years 2022, 2023, and 2024.

Staff returned to Finance Committee on October 27, 2020, to provide an update on FY 2021 water rates and planned increases for future years. The committee members were supportive of forgoing a rate increase in FY 2021, and asked staff to utilize its media channels to communicate with the public on what to expect in terms of rate increases in the future so members of the community are aware of and able to plan for these changes in advance.

Staff will initiate the public noticing process on the proposed rate increases in spring 2021, with a public hearing tentatively scheduled for June 2021.

BUDGET/FINANCIAL INFORMATION:

Recent adjustments to the Water Utility's capital improvement plan has afforded the opportunity to provide financial relief to the community by forgoing water rate increases for FY 2021. However, HDR is recommending that the City resume annual rate increases in FY 2022 to sufficiently fund the costs of operations and maintenance, capital improvements, mandated standards of treatment, debt obligations, contributions to reserves, and other financial obligations. In the short term, the Water Fund has reserves in excess of Council Policy that may be used to supplement a gap in revenue from a one-year pause on rate increases.

ENVIRONMENTAL REVIEW:

The recommended action in this report is not subject to the California Environmental Quality Act.

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APPROVED BY: City Administrator's Office