Legislative Department
Seattle City Council
Memorandum

Date: September 13, 2011

To: Seattle Public Utilities and Neighborhoods (SPUN) Committee

From: Meg Moorehead and Patricia Lee, Council Central Staff

Subject: **2012-2014 Water Rates**

SUMMARY OF SEATTLE PUBLIC UTILITIES (SPU)-PROPOSED RATES

SPU proposes to increase 2012-14 water rates to collect $35 million more in retail rate revenue in 2014 than in 2011. The rates would fund the increased cost of continuing base services, expansion of some activities, and compliance with financial policies. Effects on monthly water bills differ somewhat among customers due to the rate structure and customer water use patterns. The typical residential customer would experience a monthly bill increase of up to 7.9% per year, with monthly bills about $8.00 higher in 2014 than in 2011. Effects of the increase on general service customers (businesses, apartments, etc.) vary based on their meter size and water use. For example, a convenience store's bills might increase by up to 10.9% per year while bills for a large industrial customer might increase over 12% per year.

ISSUES

During its July 12 and July 26, 2011 discussions of water rates, the SPUN Committee identified several issues for further investigation and development of policy options for Committee consideration. A few issues (related to fuel costs, capital improvement program [CIP] accomplishment rates, Shared Cost capital projects, and the CIP cash contribution) were investigated but were not considered priorities for developing policy options. However, some new issues related to Morse Lake pumps, workforce efficiencies, and the billing system were identified during our further investigation.

1. BASE SERVICES

A. SPU-PROPOSED BASE SERVICE REDUCTIONS

To moderate rate increases, SPU reduced 2012 base operations and maintenance (O&M) costs by $10.6 million compared to the 2011 costs assumed in the prior rate study. SPU feels that no significant impact to basic services resulted from the reductions. The reductions were made in the following areas:

Central City, Council actions, and miscellaneous	($2,200,000)

Fleet	($200,000)
Overtime	($500,000)
Position reductions (both management & represented positions)	($7,700,000)

Recommendation: Accept the base service cuts that SPU incorporated into the rate proposal, unless those cuts are addressed elsewhere in this memorandum.

B. MISMATCH BETWEEN RATES AND PROPOSED BUDGET

The City Budget Office (CBO) calculates and advises departments how much to budget for employee benefits such as health care, cost of living adjustments (COLAs) and retirement; non-labor inflation; and Central City costs such as office space. The 2012-2014 Rate Study was developed in early 2011 before final CBO direction for the 2012 budget was available. CBO continues to refine the calculations as it prepares to submit the proposed 2012 budget to Council on September 26. Although the final numbers will not be available until September 26, initial indications are that the proposed budget will include O&M reductions, primarily in central costs, of over $1 million. Incorporating these cost savings into rates will reduce the rate increase.

Recommendation: Incorporate into rates any O&M reductions from the proposed 2012 budget, as well as any related adjustments in 2013 and 2014 costs.

C. FURTHER BASE SERVICE CUTS: SPECIFIC (an alternative to, or subset of D below)

To achieve further base service savings, the Committee could consider eliminating or reducing specific activities that are less essential to the Water Fund's basic mission. Specific reductions could include:

1. Reduce operating hours and staffing at the Cedar Watershed Education Center by half, which saves $296,000/year, cuts 2 positions, and reduces a service used by 30,000 visitors/year.
2. Eliminate all Water Fund vacancies, which saves $528,000/year, cuts 9 positions, and reduces capacity in maintenance and repair, customer service and wholesale contract management.
3. Reduce external policy relations by 50%, which saves $84,000/year and reduces capacity for regional policy analysis, planning and negotiation.

Option 1: Further Specific Cuts. Remove the above-listed costs from the rates, saving over $908,000/year.

Option 2: SPU proposal. Approve the levels of base service funding proposed by SPU, except as provided elsewhere in this memorandum.

D. FURTHER BASE SERVICE CUTS: GENERAL

Instead of identifying cuts to specific base services, SPU could be asked to identify cost savings or productivity gains that would reduce rates by a certain percent. If a

1% reduction in the proposed 2012 rate increase was a goal, a cut of about $1.4 million in O&M spending would be needed.

Option 1: Further General Cuts. Reduce base O&M costs by $1.4 million to achieve a 1% reduction in the rate increase. Request that SPU develop a list of services that would be reduced or eliminated, and the labor force and service impacts of those reductions. The Committee could specify some of the reductions toward the 1% goal, such as those shown in C. above.

Option 2: SPU Proposal. Approve the levels of base service funding proposed by SPU, except as provided elsewhere in this memorandum.

E. WORKFORCE EFFICIENCIES

As part of 2011 budget review Council asked several large departments to reduce their 2012 management-related costs. This rate proposal incorporates SPU's $500,000 reduction in management-related costs.

Council also requested SPU to review its workforce practices and recommend areas where workforce efficiency and performance could be strengthened. SPU provided a written response and briefed the Council's SPUN committee on May 10, 2011. Their report identified the progress they have made in reducing non-emergency overtime through the use of shift and schedule changes, use of a Field Operations Mapping System to better group work orders so crews can be deployed more efficiently, and using performance benchmarks to strengthen customer service response time by the call center.

SPU has convened a work group of SPU employees and managers to identify how the utility can most efficiently and effectively deliver their services. Affected employees are represented by five different labor unions and SPU is committed to working collaboratively with labor.

Employees and managers bring their expertise of field operations to the work group. SPU may also hire an outside consultant to provide a perspective of industry standards and other service delivery models. A consultant could provide another source of information for SPU employees and managers to draw on as they work to identify ways to strengthen their service delivery.

Recommendation. As part of Council's review of the 2012 budget, adopt a Statement of Legislative Intent or budget proviso to ensure that enough of the consultant funding already in the rate proposal is available for evaluating workplace efficiencies if it's determined by the work group that a consultant would be useful.

2. NEW O&M EXPENSES

A. DEFERRED MAINTENANCE (Budget Issue Paper [BIP] 101)

Maintenance of in-city and regional buildings and facilities has fallen behind schedule. Roofs on some buildings are failing or in need of cleaning. The weathered coatings on water tanks and standpipes may lead to structural and water quality problems. Flooring and HVAC systems in several SPU buildings need repair. The proposed rate includes funds to begin clearing the maintenance backlog. The Council recognized maintenance needs by approving up to $1.3 million/year of added maintenance funding in the 2009-2011 water rates. When revenue shortfalls required choices among services, SPU gave maintenance a low priority, with actual spending averaging $230,000/year in 2009 and 2010. For 2012 through 2014, SPU proposes to increase deferred maintenance funding by up to $363,000/year. Based on the lower priority SPU has placed on this activity recently, the Committee could choose to reflect that priority by clearing the maintenance backlog more slowly.

Option 1: Clear the maintenance backlog more slowly. Accomplish maintenance over a longer time period and reduce added maintenance funding by $183,000 in 2013 and an additional $125,000 in 2014. Under this option new funding would be available at a level of $179,000 to $180,000 per year, so that a total of up to $410,000/year would be available for addressing deferred maintenance if 2010 base funding levels were continued.

Option 2: SPU Proposal. Include in the rate the additional deferred maintenance costs as proposed by SPU.

B. WATERMAIN CONDITION ASSESSMENT (BIP 102)

SPU proposes to add up to $150,000 per year for a pilot project to assess the condition of about 10 miles (out of the 1,640 miles) of watermains. The 3-year project would focus on locations where pipe failure could damage bridges, railroads or roads. SPU would hire a contractor to employ new technologies to identify potential pipe leaks and failures without having to dig. Information from the pilot would be used to prioritize maintenance and pipe replacement capital projects, and further reduce SPU's very low leak rate of about 7 leaks per 100 miles of pipe per year.

Up to now, the condition of pipes has been assessed based on pipe age and materials, samples of pipe material taken when new connections are made, and excavation of pipes when leaks or failure occur. To moderate rate increases, current assessment practices could be continued, with the pilot project considered during the next rate period when the technologies (which have been used by utilities for pipe condition assessment for about 3 years) will have had a longer performance history.

Option 1: Delay the pilot and consider it in the next rate period. This option would reduce revenue requirements by $50,000 in 2012 and $150,000 in 2013 and 2014.

Option 2: SPU proposal. Include in the rate the watermain condition assessment pilot project as proposed by SPU.

C. CONSOLIDATED CUSTOMER SERVICE SYSTEM (CCSS) PURGE (BIP 300)

The proposed rate includes an added $68,000 for 2012 to add archiving and data purging capabilities to the billing system shared by SPU and City Light. The new capability would allow the system to run faster and customer service representatives to provide faster service. It would be part of an ongoing technical "uplift" to bring

CCSS data base applications up to standard and supported versions. This added expense is no longer needed because City Light, the lead for operating and maintaining CCSS, identified an alternative way to meet the archiving and purging objectives. The proposed 2012 budget will not include this expense.

Recommendation. Eliminate from the proposed rates $68,000 in 2012 for CCSS archiving and data purging.

D. MORSE LAKE TEMPORARY PUMPS (BIP 302)

Aging floating pumps are used during droughts to draw water stored below the gravity outlet of the Morse Lake reservoir. The outlet channel has been dredged by SPU on an as-needed basis to maintain reservoir operations. A SPU contractor maintains the pumps. The proposed rates include added one-time funding for SPU staff to conduct more extensive pump maintenance and outlet dredging in 2013. SPU also proposes to dredge the outlet channel on a regular 3-year cycle. Because pump maintenance and dredging have always been part of reservoir operations and recent rate studies did not request new money to do this long-standing task, the Committee could direct SPU to fund this work as part of its base services. In any case, maintenance and dredging needs should be revisited after the 2017 completion of the Morse Lake pumps capital project, which will replace the aging temporary pumps.

Option 1: Do not add the $260,000 SPU requested for pump maintenance and dredging; fund activities as part of base services. This option would require the activities to be re-scoped to reduce costs and/or reductions made in other base activities to pay for these costs.

Option 2: SPU Proposal. Include in the rate the additional temporary pump repair and dredging costs as proposed by SPU.

E. MORSE LAKE LONG-TERM PUMP PROJECT AMORTIZATION OF DEFERRED COSTS

The proposed rate includes a capital project to provide a long-term solution for pumping water stored below the gravity outlet of the Morse Lake reservoir. The rate study assumed a $60.1 million project to install fixed-position pumps including construction of a pipeline and electric distribution lines to the pump site. Value engineering conducted in summer 2011 resulted in selection of an alternative $29.4 million capital project that relies on floating axial flow pumps including a discharge pipe, permanent anchors and portable power source. With the new $29.4 million capital project and $10.16 million in deferred costs from the previous alternative (*see below*), the total cost of a Morse Lake long-term solution is now estimated at $41.7 million.

The new Morse Lake alternative reduces capital costs but increases O&M funding needs, largely due to an accounting requirement that about $10.16 million in expenditures associated with the old alternative be expensed. Reflecting this change entirely in 2011 would further reduce financial policy compliance and come very close to violating bond covenants for debt service coverage (DSC). These financial impacts could be reduced by deferring the expense and amortizing it over 10 years. SPU's 2012-2014 spending plans and financial policy compliance strategy also could be rebalanced to maintain relatively even year-to-year rate increases after the changes in Morse Lake capital and O&M costs are incorporated.

This issue raises two questions: over what time period should the $10.16 million be paid, and how. The two options below assume the $10.16 million will be paid over 10 years resulting in an amortization cost of $1,016,000 a year that was not part of the proposed rate study. The two options below provide alternatives on where the funding for this $10.16 million will come from.

> **Option 1: Further increase rates: Add funding in each rate year for amortization of deferred costs associated with the previous Morse Lake project alternative.** Add $1.0 million per year to the rate revenue requirement, adding 0.8% to the proposed rate increase. Attachment A shows how the reductions discussed in this memorandum or reductions anticipated in the proposed 2012 budget could counterbalance the added amortization costs.

> **Option 2: No rate impact: Add funding in each rate year for the amortization of deferred costs associated with the previous Morse Lake project alternative.** Revenues would be gained through an equivalent reduction in other Water Fund O&M spending, so that SPU-proposed rates are not further increased.

F. CUSTOMER CARE BILLING SYSTEM (BIP 402)

The rate proposal includes $180,000 in 2014 for improvements to the billing system. No information has been provided about the improvements. Rate increases could be moderated somewhat by delaying the added cost until the next rate period.

> **Recommendation: Delay the customer care billing system improvements until the next rate period**. This recommendation would reduce revenue requirements by $180,000 in 2014.

3. CAPITAL PROGRAM

A. CAPITAL PROGRAM REDUCTIONS

Rate increases also can be moderated somewhat by reducing or delaying the capital program. Because the soon-to-be-delivered proposed 2012-2017 CIP is lower than the CIP assumed during rate development, rates can be reduced to match the proposed CIP and delay the next bond sale without impacting SPU's capital project schedule. Selection of a new Morse Lake Long-Term Pump alternative is the largest reason for the lower CIP. The new Morse Lake alternative not only has a lower overall capital cost but also delays construction until 2015-2016 so that capital costs in the 2012-2014 rate period are much lower. The lower CIP allows one $88 million bond to be issued in spring 2013 instead of the rate study's proposal to issue $84 million in late 2012 and another $77 million in mid-2014.

Lower capital spending does not reduce rates as much as lower O&M spending because O&M spending is largely funded 100% by current year rate revenues while by policy 20% of each year's capital spending is funded by cash from rates (or grants, etc), while the rest is debt financed through bond sales. That generally means that cutting $1 of capital spending in the budget reduces rate revenue needs by far less than $1. And the amount of revenue needed to meet the financial policy that requires the greatest amount of revenue generation – DSC, the "binding constraint"—also limits rate savings from capital program reductions.

Recommendation: Match the Rates CIP to Proposed Budget CIP. Adjust rates to reflect proposed capital reductions of $13.2 million in 2012, $15.8 million in 2013 and $23.8 million in 2014 as shown in Attachment B. This amount reflects the difference between CIP assumptions made early in 2011 during rate development, and those made as part of the proposed 2012 budget and 2012-2017 CIP. The lower expenditures could reduce the size of the bonds issued during the rate period by $73 million. These lower CIP-related expenditures by themselves would moderate rate increases somewhat. The net effect of this change, together with all the other recommendations and Options 1 from this memorandum, is shown in Attachment A.

4. DEMAND AND FINANCIAL ASSUMPTIONS

A. DEMAND PROJECTIONS

SPU projects 26.2 million hundred cubic feet (ccf) of retail water will be used in 2011, and that weather-adjusted demand for water will decline from 1.3% to 0.8% in each year of the rate period. In other words, water use starts at the lowest in Seattle's history and continues to decline, requiring higher rate increases to cover fixed costs based on fewer units of water being sold.

Factors used as inputs to SPU's demand models include employment growth, rate increases and population. Many of the model inputs were drawn from the June 2011 Puget Sound Economic Forecaster (PSEF) issued by Conway Pederson Economics, Inc. SPU felt that one PSEF input – employment growth – resulted in unrealistically high demand estimates and so adjusted the model input to 50% of PSEF employment growth. CBO is using 100% of PSEF employment growth to develop the proposed 2012 budget. Although a somewhat more conservative approach might be required for a 3-year rate compared to a 1-year budget, an assumption between 50% and 100% could still be conservative while moderating rate increases.

Option 1: Change the employment growth used to project demand to 75% of the June 2011 Conway report estimate, instead of 50%. This change would bring SPU's assumptions more in line with the City Budget Office 2012 budget assumptions of 100% of Conway's employment growth estimate, while leaving a cushion to allow for the 3-year rate period. The change would reduce the average systemwide rate increase by 0.2% to 0.3% per year.

Option 2: SPU Proposal. Include in the rate the demand projections as proposed by SPU.

B. TAP FEES

SPU collects tap fees to fund connection of new buildings to the City system. In 2010, 528 tap fees were paid at an average fee per tap of $5,240. However, the current method for setting the fee does not fully cover the cost of service. For example, 2010 tap fee revenue was only $2.9 million while expenditures were $5.9 million. The proposed 2012-2017 CIP includes over $4.0 million/year for new taps expenditures in 2012-2014, but proposed rates assume revenues of just over $3 million/year. The gap between revenues and expenditures is due to added mobilization time to serve more widely dispersed development sites, equipment that is charged to the New Taps project even when it sits idle, and higher than anticipated Seattle Department of Transportation pavement restoration costs. Work processes and tap fees could be adjusted to narrow the gap, and reduce the portion of this work funded by rates.

Option 1: Direct SPU to update tap fees and work processes so that the cost of service is more fully recovered starting in 2013. If a goal were set to close at least one-quarter of the gap between revenues and expenditures in this rate period, the revenue requirement could be reduced by $250,000 in 2013 and 2014.

Option 2: SPU Proposal. Include in the rate the tap fees as proposed by SPU.

C. LOW-INCOME EMERGENCY ASSISTANCE.

SPU assumed a 2011 starting point of 12,214 low-income customers, with a 5% per year dollar increase in low-income credits in 2012 through 2014. Despite the 50% rate discount received by low-income customers, some may still have trouble paying their bills. Once-a-year emergency assistance for up to 50% of delinquent bills is available to many, but not all, low-income customers who get behind in their bills. Income eligibility thresholds are one barrier to full access. Eligibility thresholds for SPU low-income rates were consolidated at 70% of the state median income in 2009, but the threshold for emergency assistance remained at 125% of the federal poverty level. In 2010 using the 125% of poverty threshold, a total of about $189,000 of emergency assistance was provided to 888 customers.

Option 1. Adopt a new emergency assistance eligibility threshold. Amend the SMC 21.76.065 emergency assistance eligibility threshold to 70% of the state median income. If 70% of state median income were used as the threshold and assistance spending grew at 5% per year, about twice as many people might receive assistance, shifting an additional $77,000 to $85,000 per year from low-income water customers to other water ratepayers. Because SMC 21.76.065 also applies to Solid Waste and Drainage/Wastewater Funds, the new threshold would shift about $66,000 to $73,000 more per year from low-income customers in each Fund to other ratepayers. This option also would increase SPU's administration costs for reviewing applications and making account adjustments, reducing time available for other billing adjustments and customer calls.

<u>Option 2. SPU Proposal</u>. Maintain current emergency assistance income eligibility thresholds.

D. CITY UTILITY TAXES.

For many years, a 10% City utility tax was imposed on water, wastewater, drainage, and solid waste revenues. Over the last decade, the cost of compliance with court orders and other factors resulted in varied tax rates of 15.54% for water, 12% for wastewater and 11.5% for drainage and solid waste. Revenues from these taxes are deposited in the General Subfund (GSF). Although there are no state limits on City taxes on SPU revenue, a 2008 state performance audit suggested that City utility taxes are high relative to other jurisdictions. The audit recommendations could be addressed without changing GSF revenue by adopting a consistent 12.88% tax rate. Because adopted 2012 solid waste, drainage and wastewater rates assume current tax rates, the effective date of a new tax rate could be delayed until new rates take effect in 2013.

<u>Option 1. Adopt consistent, GSF revenue-neutral utility taxes for water, wastewater, drainage and solid waste, effective January 1, 2013.</u> The 12.88% tax rate would reduce water revenue requirements by $700,000 in 2013 and $800,000 in 2014. The new tax rate would add $2 million to the 2013 revenue requirement for solid waste, $1.4 million for drainage, and $2.8 million for wastewater. The reduction in the water rate revenue requirement is much lower than the increase for SPU's other rates because the amount of revenue needed to meet the DSC financial policy limits rate savings from water tax reductions.

<u>Option 2. SPU Proposal</u>. Maintain the current City utility tax rates as reflected in proposed water rates.

IMPACTS OF SELECTED OPTIONS

GENERAL SUBFUND (GSF) IMPACT

The proposed 2012 budget assumes that SPU-proposed rates will be approved and City taxes on the rate revenue will be received by the GSF and allocated to various GSF departments. If the Council approves lower rates than those proposed by SPU, there will be a shortfall of GSF revenue in the proposed budget. This memorandum is structured so that Option 1 changes SPU's proposal and Option 2 maintains SPU's proposal (except for Morse Lake amortization where both options are changes because the issue was identified after rate submittal). If this memorandum's recommendations and all Options 1 are approved, there would be a GSF reduction from the Water Fund of about $192,000 in 2012, $5.1 million in 2013 and $5.7 million in 2014. However Option 1 under Issue 4E (City Utility Taxes) would increase tax rates for solid waste, drainage and wastewater, so that the net GSF change would be a $200,000 increase in 2013 and a $100,000 decrease in 2014.

RATE IMPACT

Rate and bill impacts if the Committee approves this memorandum's recommendations and Options 1 include:

	2011	*2012 SPU-Proposed*	*2012 SPUN-Revised*	*2013 SPU-Proposed*	*2013 SPUN-Revised*	*2014 SPU-Proposed*	*2014 SPUN-Revised*
Revenue Requirement	$153,661,563	$160,245,292	$159,110,700	$173,305,826	$168,705,727	$188,585,590	$181,424,939
Av. Systemwide Rate Increase 1/		9.3%	7.8%	9.4%	7.9%	9.6%	8.0%
Typical Monthly Water Bills							
Residential 2/	$31.70	$34.12	$33.77	$36.79	$36.01	$39.71	$38.45
Convenience Store	$92.81	$102.86	$101.12	$114.12	$110.30	$126.60	$120.36

1/ progress in each year toward 1.7 DSC is shifted compared to the rate proposal to smooth the rate path
2/ typical single-family water consumption is 5 c.c.f .

COUNCIL APPROVAL PROCESS

Further discussion to confirm SPUN Committee recommendations is scheduled for September 27. The SPU-proposed water rate ordinance would then be re-referred to the Budget Committee. The SPUN Committee's rate recommendation would be used to develop version 5 of C.B. 117232, which would be considered as budget legislation.