

Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Les White

**SUBJECT: MUNICIPAL WATER SYSTEM
WATER RATE INCREASE FOR
2007-08**

DATE: 06-20-07

COUNCIL DISTRICT: 2, 4, 7, 8

REASON FOR SUPPLEMENTAL MEMO

In response to the administration recommendations to increase the San José Municipal Water System (SJMWS) potable water rates and charges by 7.3% effective July 1, 2007, Vice Mayor Dave Cortese submitted a memorandum dated June 18th, recommending that the City Council 1) deny the request of the City Manager to proceed with a rate increase for the SJMWS, 2) direct the City Manager to retain an independent outside auditor by August 2007 to do a financial audit of the SJMWS, establishing the monetary differential between total past fees collected by each ratepayer and the amount of fees that should have been paid under Proposition 218 (with a focus on, but not limited to, “in-lieu” fees, “rate of return” or “return on investment” transfers, inverted (conservation) rates, connection fees collected from property owners, and overhead charges transferred to the General Fund), and 3) direct the City Attorney and City Manager to prepare and bring back to the City Council by August 28, 2007, the necessary ordinance changes to prohibit such transfers and to reimburse the ratepayers for all in-lieu fees and other excessive fees since inception of Proposition 218. The City Council deferred the recommendations from these items to the June 26, 2007 City Council meeting. At the Rules and Open Government Committee, it was noted that a supplemental memo would be released. This memo has been prepared in response to Vice Mayor Cortese’s recommendations.

RECOMMENDATION

It is recommended that the City Council:

- a. Adopt, as previously recommended, a resolution to increase the San José Municipal Water System (SJMWS) potable water rates and charges by 7.3% effective July 1, 2007.
- b. Direct staff to include options for elimination or multi-year phase out of the Enterprise In-Lieu and Rate of Return transfers from the Water Utility Fund to the General Fund, during the 2008-2009 budget process.

OUTCOME

Approval of these recommendations will allow SJMWS to increase retail water rates and charges by 7.3%, effective July 1, 2007, in order to increase operating revenues by approximately \$1.6 million to cover increased wholesale water costs, Integrated Billing System costs, and maintain reserve levels per the Municipal Code. In addition, this action would direct staff to include options for elimination or multi-year phase out of the Enterprise In-Lieu and Rate of Return transfers from the Water Utility Fund to the General Fund during the 2008-2009 budget process.

BACKGROUND

In response to recommended increases to the San José Municipal Water System (SJMWS) potable water rates and charges by 7.3% effective July 1, 2007, Vice Mayor Dave Cortese submitted subsequent recommendations to 1) deny the request of the City Manager to proceed with a rate increase for the SJMWS, 2) direct the City Manager to retain an independent outside auditor by August 2007 to do a financial audit of the SJMWS, establishing the monetary differential between total past fees collected by each ratepayer and the amount of fees that should have been paid under Proposition 218 (with a focus on, but not limited to, “in-lieu” fees, “rate of return” or “return on investment” transfers, inverted (conservation) rates, connection fees collected from property owners, and overhead charges transferred to the General Fund), and 3) direct the City Attorney and City Manager to prepare and bring back to the City Council by August 28, 2007, the necessary ordinance changes to prohibit such transfers and to reimburse the ratepayers for all in-lieu fees and other excessive fees since inception of Proposition 218.

Annual enterprise “in-lieu” fee payments from the Water Utility Fund to the General Fund was approved by the City Council in 1993-1994, following a consultant study (David M. Griffith) conducted in 1993.

A “rate of return” transfer from the Water Utility Fund was approved in 1995-1996. This payment is consistent with the practice used by private water companies regulated by the California Public Utilities Commission, and the practice and methodology that has historically been used by other municipal water utilities.

Finally, on June 10, 2003, the City Council approved Ordinance 26903, which established capital (7% of water revenues) and rate stabilization reserves (5% of water revenues); allowed for the continuation of “in-lieu” fee payments calculated in the same manner as non-exempt potable water utilities; but restricted the total indirect overhead and “rate of return” transfers to the General Fund to an amount no greater than 8% of water revenues starting July 1, 2005.

ANALYSIS

Water Rate Increase

As previously described in the original memorandum dated May 29, 2007, the two principal sources of revenue to SJMWS are water sales and fixed monthly meter service charges. Approximately 54% of SJMWS's operating budget is allocated to the purchase of wholesale water. Proposed San Francisco Public Utilities Commission (SFPUC) and Santa Clara Valley Water District (SCVWD) rate increases of 7.5% and 6.6%, respectively, are expected to increase SJMWS costs for wholesale water by approximately \$853,000. The proposed SJMWS rate increase of 7.3% would recover these costs and generate additional revenue (\$782,000) to cover increases in administrative and overhead expenses as well as cover reserve requirements. With the proposed rate increase, as detailed in the original May 29, 2007 memorandum, average water rates for customers of the SJMWS will continue to remain among to lowest within Santa Clara County.

If the proposed rate increase of 7.3% is not approved, these costs will negatively impact the unrestricted ending fund balance in the Water Utility Fund. It should be noted that an unrestricted ending fund balance goal has been set at one month of operating expenses in the event of an unforeseen emergency. The unrestricted ending fund balance in the 2007-2008 Proposed Operating Budget, which was built assuming a 12% rate increase based on wholesale water cost information from the SFPUC and SCVWD at that time, totals approximately \$2.14 million, compared to the one month operating expenses of approximately \$2.15 million. However, based on updated SFPUC and SCVWD rate increase information, if the proposed 7.3% SJMWS rate increase is not approved, the unrestricted ending fund balance in the Water Utility Fund is expected to decrease to approximately \$500,000 compared to one month operating expenses of \$2.09 million.

Enterprise "In-Lieu" Fees and Rate of Return Transfers

Attachment A details all transfers from the SJMWS to the General Fund since 1995-1996. As previously mentioned, these payments were approved by the City Council. In the most recent audit of the SJMWS presented to the Public Safety, Finance, and Strategic Support Committee on April 19, 2007, the City Auditor found that "the San José Municipal Water System transferred monies from the Consolidated Water Utility Fund (Fund 515) to the General Fund and maintained established reserve funds in accordance with the City of San José Municipal Code (Muni Code)."

Under the Municipal Code, the In Lieu Fee and Rate of Return payments are optional, not mandatory, and are to be made only if adequate revenues remain after other expenditures. The City Council has already approved the 2007-2008 General Fund budget, which includes these transfers as a source of revenue. However, the budget process has not yet started for 2008-2009 and if the City Council approves the amended staff recommendation contained within this memorandum, options for eliminating or phasing out the transfers can be presented during the

budget process next year. The future impact from this action is expected to total approximately \$1.1 million annually, based on estimates used to develop the 2007-2008 Proposed Operating Budget.

Vice Mayor Cortese's recommendation related to reimbursement of "in lieu" fees and "other excessive fees since the inception of Proposition 218" would not only require legal analysis, but would require reopening a budget process that has closed a projected \$16 million budget shortfall, and would create significant impacts across City services including, but not limited to, public safety, transportation infrastructure, and neighborhood services. Budgeting for full reimbursement of "in-lieu" and rate of return transfers since 1995-1996, as described in Attachment A, would require identification of additional revenue and/or budget cuts totaling \$26.3 million. As indicated above, the transfers that are now in issue have been common practice among California water utilities and we know of no other city that is contemplating such refunds or reimbursements.

City-wide Overhead Payments

As detailed in Attachment A, overhead payments since 1995-1996 total \$7.0 million. These amounts are transfers to the General Fund for city-wide overhead, a cost of doing business which include the Water Utility Fund's fair share of direct General Fund expenses, such as services received from departments such as the Finance, Information Technology, and Human Resources Departments; and the Mayor and City Council, City Manager's, and Attorney's Offices. These costs are determined by the Finance Department based on general accounting practices and calculated consistently across all city-wide special and capital funds. There is no indication that the continued collection of these charges is not completely appropriate. It is recommended that these costs continue to be paid by the Water Utility Fund.

Inverted (Conservation) Rates and Connection Fees Collected from Property Owners

The City has utilized inverted block rates to encourage water conservation since the early 1980's. On March 24, 1995, the City became a signatory to a Memorandum of Understanding with the California Urban Water Conservation Council (CUWCC) that committed the City to implement best management practices related to water conservation. The current four-tiered rate structure became effective July 1, 1995 with the passage of Council Resolution 65466. Inverted block rates are consistent with CUWCC BMP 11: Conservation Pricing.

It should be noted that San Jose Water Company has recently filed an advice letter with the California Public Utilities Commission (CPUC) requesting approval to implement a similar block rate structure. Recognizing that water is in limited supply, the CPUC is encouraging all private regulated water utilities to develop similar rate structures to encourage conservation.

Consistent with previous Council direction that "Growth pays for Growth" and pursuant to San José Municipal Code Section 15.08, SJMWS collects five connection related fees. These include the Area and Frontage, Meter, Service Installation, Engineering and Inspection (E&I) Fees

collected in the Water Utility Capital Fund, and the Major Water Facilities Fee, accounted for in the Major Water Facilities Fee Fund. There are no direct General Fund transfers from either of these capital funds.

The Area and Frontage Fees are collected entirely to reimburse developers who have constructed water pipelines in excess of what was needed for their particular need. All of the revenue collected as a result of this fee is returned to developers. The Meter Fee recovers only the cost of the purchase of the meter for the new water service. The Service Installation fee recovers only the cost of the construction of the new water service with which any fee deposit in excess of the actual cost is refunded to the applicant. The E&I Fees are calculated at 6.5% of the estimated construction amount. This revenue funds the plan review and construction inspection of the new services or tracts. While the amount of time spent on plan review and inspection on individual projects varies, this fee closely approximates full cost recovery. The Major Water Facilities Fee is assessed to developers to provide funding for major improvement projects, such as reservoirs, large water transmission mains, and wells that will be required due to the cumulative impact of new developments. None of the funding collected pursuant to these fees are transferred to the General Fund.

Financial Audit of the Municipal Water System

The SJMWS operates in strict compliance with Council Policy and requirements contained in the San José Municipal Code. There are challenges in determining the total water billing paid by each and every rate payer. While true for several classes of customers including commercial/industrial and multi-family residential customers, many commercial/industrial properties are leased with "triple-net" terms for which property owners pay the bill and assess tenants for their share of the utility costs as defined in the terms of the lease. In many multi-family units, the apartment managers pay the water bill with funds collected from individual renters through rent payments.

As indicated above, the most recent audit of the SJMWS presented to the Public Safety, Finance, and Strategic Support Committee on April 19, 2007, the City Auditor found that "the San José Municipal Water System transferred monies from the Consolidated Water Utility Fund (Fund 515) to the General Fund and maintained established reserve funds in accordance with the City of San José Municipal Code (Muni Code)." In considering this recent audit, therefore, an independent outside audit of the SJMWS is not recommended or considered necessary.

POLICY ALTERNATIVES

Not Applicable.

PUBLIC OUTREACH/INTEREST



Criterion 1: Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**

- ✓ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

- Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

SJMWS published a notice in the newspaper on May 30, 2007, in advance of City Council consideration. In addition, SJMWS also sent a direct mailing to all customers notifying them about the scheduled Council hearing for a maximum proposed rate increase of 12 percent. The SFPUC and SCVWD held public hearings in May and June 2007.

COORDINATION

This memo has been coordinated with the Environmental Services Department, the City Manager's Budget Office, and the City Attorney's Office.

COST SUMMARY/IMPLICATIONS

With the elimination or phase out of the Enterprise In-Lieu and Rate of Return transfers, savings in the Water Utility Fund and a decrease of General Fund revenues, estimated at \$1.1 million would occur.

BUDGET REFERENCE

Not applicable

CEQA

Not a project.

for Kay White
LES WHITE
City Manager

**ATTACHMENT A - SAN JOSE MUNICIPAL WATER SYSTEM TRANSFERS TO THE GENERAL
FUND SINCE 1995-1996**

<u>Fiscal Year</u>	<u>Rate of Return Transfer</u>	<u>In-Lieu Fee</u>	<u>Overhead Transfer</u>	<u>Combined Transfer</u>
1995-1996	1,000,000	199,000	363,056	1,562,056
1996-1997	1,750,000	206,000	371,160	2,327,160
1997-1998	2,070,000	236,000	497,683	2,803,683
1998-1999	2,080,000	250,000	373,280	2,703,280
1999-2000	2,100,000	270,000	407,447	2,777,447
2000-2001	2,164,000	275,400	386,318	2,825,718
2001-2002	2,167,496	275,400	568,145	3,011,041
2002-2003	2,200,000	275,400	594,174	3,069,574
2003-2004	2,244,000	289,200	621,378	3,154,578
2004-2005	1,437,083	404,200	696,679	2,537,962
2005-2006	1,184,899	439,600	431,901	2,056,400
2006-2007	1,282,190	452,800	476,210	2,211,200
2007-2008*	567,509	492,800	1,189,392	2,249,701
Total Revenue*	22,247,177	4,065,800	6,976,823	33,289,800

* Projected based on 2007-2008 Proposed Operating Budget