



# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Kerrie Romanow

**SUBJECT:** MUNICIPAL WATER SYSTEM  
WHOLESALE WATER COSTS

**DATE:** August 20, 2012

Approved

Date

8/31/12

**COUNCIL DISTRICTS:** 2, 4, 7, 8

## RECOMMENDATION

1. Accept this report on the City's due diligence regarding escalating wholesale water costs.
2. Discuss proposed wholesale rate increases at the annual Joint Study Session between Council and the Santa Clara Valley Water District Board

## OUTCOME

Acceptance of this report will ensure that rates are fair and appropriate, and that an audit of wholesale costs is not necessary at this time. Projected wholesale water rates will be placed on the agenda at the annual Joint Study Session.

## BACKGROUND

On June 12, 2012, Council directed staff to return to Council with a report on the City's due diligence regarding escalating wholesale water costs that are increasing rates for Municipal Water System (Muni Water) customers and to coordinate with the City Auditor to determine whether an audit of the wholesale water costs is necessary (see Attachment). Muni Water is one of three water retailers within the City and serves approximately 12% of the population. The other two local retailers are San Jose Water Company and Great Oaks Water Company.

The retailers purchase wholesale water from the Santa Clara Valley Water District (SCVWD) and/or the San Francisco Public Utilities Commission (SFPUC). Muni Water purchases water supplies from both SCVWD and SFPUC (76% of total supplies from SCVWD and 24% from SFPUC). On July 1, 2012, SCVWD and SFPUC increased wholesale water rates by 9.3% and 11.4%, respectively. SCVWD and SFPUC charge the same wholesale water rates to all retailers,

including Muni Water, and typically pass wholesale rate increases on to customers in the form of higher retail water rates. Since July 2008, Muni Water's retail rate has increased by 44%, while wholesale costs have increased over 52%. In the past, Muni Water has reduced or delayed non-urgent infrastructure and maintenance activities to mitigate retail rate cost increases; however, the purchase of wholesale water alone is approximately 70% of Muni Water's operating budget, resulting in limited flexibility to absorb these costs.

## **ANALYSIS**

The reasons behind a wholesale water rate increase can vary from year to year depending upon the specific circumstances impacting the wholesaler. Some factors that contribute to increases include: estimated revenue, bond payments, imported water supply availability, the amount of local rainfall, water storage in reservoirs and tanks, groundwater supplies, and infrastructure improvement and rehabilitation programs. Annually, SCVWD and SFPUC staff recommends a proposed budget and corresponding rate recommendation to their Board of Directors and Commissioners, respectively, for approval. SCVWD Board of Directors is composed of seven members, each elected from equally-divided districts drawn through a formal process. SFPUC Commissioners consists of 5 members, nominated by the Mayor of San Francisco and approved by the San Francisco County Board of Supervisors. The budgets and rate adjustments are approved in public meetings and are subject to public input.

Because wholesale water rates are the same for all retailers, the City is the beneficiary of scrutiny given to rate changes by all 31 retailers who purchase water from SCVWD and/or SFPUC. In addition, both wholesale agencies retain the services of outside consultants for external audits and reviews. During the rate review process, City staff participates in the public review process and vets proposals for both agencies as discussed below. The existing process provides assurance that rates are fair and appropriate, and additional audit work is not recommended at this time.

### **Santa Clara Valley Water District**

SCVWD currently has 12 distinct water retailers with Muni Water purchasing approximately 6.5% of the total volume of water sold. For 2012-2013, SCVWD staff recommended a rate increase to primarily fund additional infrastructure repair and capital rehabilitation projects. SCVWD refers to its wholesale rate setting process as Groundwater Production/Treated Water Charge Planning. All retailers that purchase water from SCVWD participate in the rate setting process throughout the fiscal year.

The SCVWD Board of Directors, comprised of seven elected officials, approves the annual budget and capital improvement program through a public review process. SCVWD is only allowed to fund work from wholesale water rate revenue which directly relates to the Water Utility Enterprise. Historically, City staff has provided comments on the proposed wholesale budget in multiple retailer meetings throughout the fiscal year to ensure that wholesale water

rates are structured to mitigate rate spikes to Muni Water customers, as the costs of capital projects are incorporated into the rates. In addition, staff reviews the justification for the infrastructure improvement program, including scrutinizing individual projects and priorities.

The City has an opportunity to provide comments and recommendations both to SCVWD staff and directly to the SCVWD Board of Directors. Due to concern on the impact of wholesale rates on residents and businesses, City staff recommended that SCVWD investigate cost reducing measures to limit the wholesale rate increases. Subsequently, SCVWD has eliminated positions (12% over the last 5 years); re-negotiated union contracts to reduce personnel costs; and implemented a lower cost Tier 2 retirement system for new SCVWD employees.

SCVWD retains the services of consultants for external financial and performance audits, the results of which are presented and reviewed by retailers at the quarterly retailer meetings. Audit findings are also presented to the Board and made available for public review. In addition, the Civil Grand Jury periodically audits SCVWD policies and expenditures.

City staff performs due diligence in reviewing proposed SCVWD budgets and in general agrees with the justification for a rate increase. City staff has not taken significant exception to proposed wholesale water rate increases in recent years.

Although the amount of water Muni Water purchases is not significant when compared to the total volume of water sold by SCVWD, the City and SCVWD have a collaborative relationship, and the City's perspective has influenced rates in the past.

City staff participates in the following budget and rate setting process:

- Quarterly water retailer meetings to provide feedback on the previous fiscal year's rate setting process, outreach, and timelines.
- In October, SCVWD staff sets capital project construction schedules, including project cost estimates, and projects revenue and water purchase demands. SCVWD staff provides a schedule for determining wholesale rates and outreach.
- In November, SCVWD staff updates its Water Utility Financial Model based on the information described above.
- In December, SCVWD Board conducts a budget development study session to review SCVWD staff assumptions used in determining the next fiscal year budget, budget process schedule, estimated budget, and evaluation of prior year projections on a possible rate increase; see SCVWD Board Agenda Item 4.1 (Planning for Fiscal Year 2012-2013 Groundwater Production Charges) and Item 7.5 (Fiscal Year 2012-2013 Financial Planning and Budget Development Process Overview)  
[http://cf.valleywater.org/About Us/Board of directors/Board meetings/ 2011 Published Meetings/PublishedMeetings.htm](http://cf.valleywater.org/About%20Us/Board%20of%20directors/Board%20meetings/2011%20Published%20Meetings/PublishedMeetings.htm).
- SCVWD staff provides a new preliminary financial model and estimated projections for the following year's rate increase; staff present projections at Water Retailers Quarterly Meeting and SCVWD Board sessions in January.

- The Retailer Finance Subcommittee convenes to discuss financial details and specific feedback from retailers. In compliance with Prop 218, SCVWD notifies well owners (its direct customers including local retailers) in February of a possible groundwater rate increase up to, but not to exceed, a specified amount.
- SCVWD staff presents its proposed rate increase recommendation at the quarterly water retailer meeting in March.
- In April, the Board conducts Public Hearings and study sessions on proposed rate changes.
- In May, the Board adopts Groundwater Production Charges, which may lead to a retailer rate increase for the following fiscal year.

### **San Francisco Public Utilities Commission**

SFPUC currently has 26 distinct retail customers, with Muni Water purchasing approximately 3% of the total volume of water supplied to all retailers. For 2012-2013, SFPUC staff recommended a wholesale rate increase primarily to fund bond payments related to the on-going Water Supply Improvement Program.

The City of San José is a member of the Bay Area Water Supply and Conservation Agency (BAWSCA) along with 25 other local agencies that purchase water from SFPUC, and Mayor Reed serves on the BAWSCA Board of Directors. BAWSCA provides a coordinated member agency response on proposed rate changes to SFPUC as directed by its Board. BAWSCA also provides guidance to the City on when direct correspondence and interaction with SFPUC could be beneficial during the rate setting process.

SFPUC retains the services of external consultants to perform an annual audit which is then submitted to BAWSCA for review. BAWSCA, by utilizing both internal resources and external consultants, reviews the compliance audit and suggests additional adjustments, resulting in the issuance of an annual statement by SFPUC reflecting these comments. This audit is then used as a basis for setting wholesale rates. City staff relies on BAWSCA's analysis to help determine whether the proposed wholesaler budget is justified. With recent years having lower than estimated water sales, SFPUC has increased rates to generate more revenue in order to meet fixed bond payments obligations. City staff has provided verbal comments in the past to BAWSCA to be incorporated into a coordinated multi-retailer response to SFPUC rate proposals. In the past City staff has not had significant concerns regarding the proposed rates.

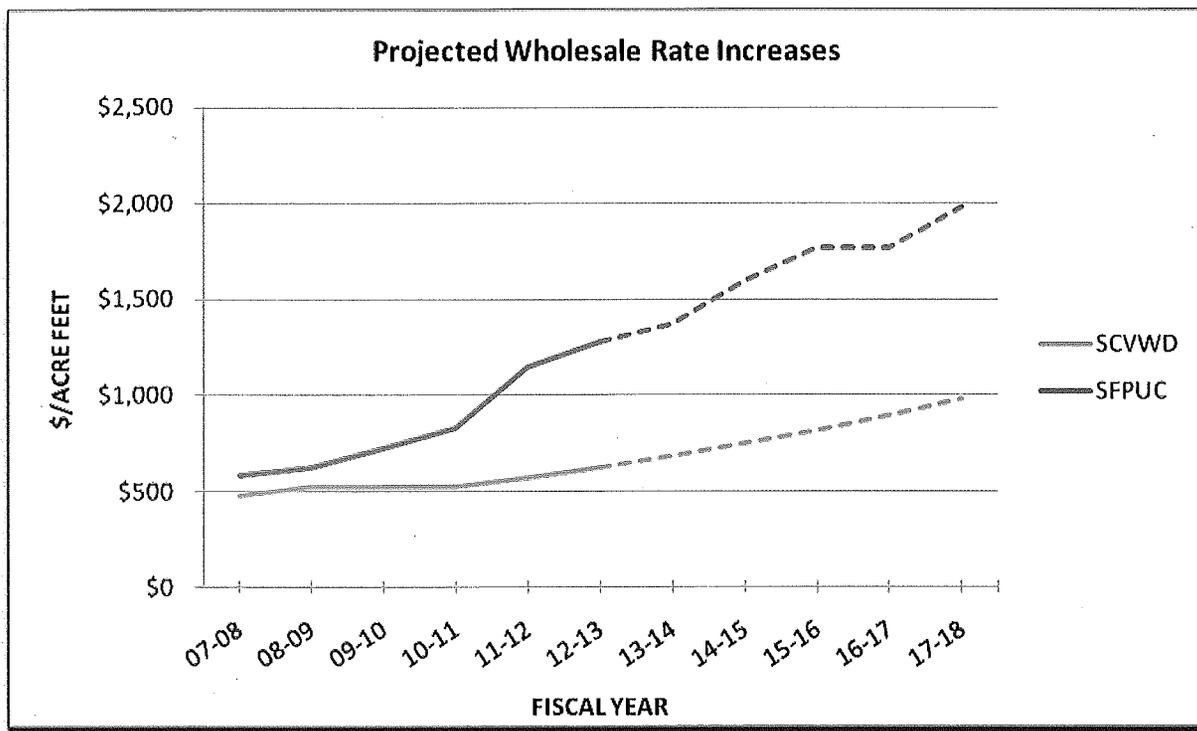
City staff participates in the following budget and rate setting process:

- Per BAWSCA's request, SFPUC has been providing preliminary information on potential rate adjustments and long-term rate projections in January.
- If SFPUC staff proposes that the Commission consider adopting a change in the wholesale rate structure, a report describing the proposed changes is sent to the wholesale customers and BAWSCA.

- SFPUC provides a sixty day comment period for wholesale water customers and BAWSCA.
- After comments have been considered, SFPUC's General Manager submits a final recommendation and report to the Commission for specific changes in the rate structure.
- Per the 2009 Water Supply Agreements between the wholesale agencies and SFPUC, SFPUC sends copies of the General Manager's report to all agencies and BAWSCA at least 30 days prior to the Commission meeting at which the changes will be considered. The meeting is usually held in May. The wholesale water rate is adopted by the Commission before the start of the next fiscal year. The new rate takes effect on July 1.

### Wholesale Rate Increase Projections

Over the next 5 years, SCVWD and SFPUC project wholesale water rates to increase by approximately 58% and 55%, respectively. Although there are various factors behind a wholesale water rate increase that can vary from year to year, the main driver behind these projections are the investment in infrastructure improvement and rehabilitation programs.



### EVALUATION AND FOLLOW-UP

To provide Council with more input on wholesale water rates, staff has requested SCVWD to include information on wholesale rate increases at the annual Joint Study Session between Council and the SCVWD Board. The next Study Session is tentatively scheduled for April 2013.

In conjunction with BAWSCA, City staff is evaluating a bond issuance proposal to pre-pay capital debt owed to SFPUC, to reduce wholesale water rates paid by retailers. Staff is currently planning to return to Council in late 2012 with a resolution to support this action for Council consideration.

If Council determines that additional assurance is needed to ensure fair and appropriate rates, the City Auditor would add such a project to her work plan.

### 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)**

This recommendation does not meet any of the above criteria; however, this memorandum will be posted on the City's website for the September 11, 2012 City Council meeting agenda.

### COORDINATION

This memo was coordinated with the City Auditor's Office and the City Attorney's Office.

HONORABLE MAYOR AND CITY COUNCIL  
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**CEQA**

Not a project, File No.PP10-068 (b), General Procedure & Policy Making.

/s/  
KERRIE ROMANOW  
Acting Director, Environmental Services

For questions please contact Jeff Provenzano, Acting Division Manager, Environmental Services Department, at (408) 277-4218.

Attachment



# Memorandum

**TO:** MAYOR AND CITY COUNCIL

**FROM:** Mayor Chuck Reed  
Councilmember Rose Herrera  
Vice Mayor Madison Nguyen  
Councilmember Kansen Chu  
Councilmember Ash Kalra

**SUBJECT:** Municipal Water System  
Rate Increases for 2012-2013

**DATE:** June 8, 2012

Approved

*Chuck Reed* *Kansen Chu* Date: 6/8/12  
*Rose Herrera (A.G.)* *Madison Nguyen*

**RECOMMENDATION**

1. Return to the City Council with a report on the City's due diligence regarding escalating wholesale water costs that are increasing rates for Municipal Water customers and
2. Coordinate with the City Auditor to determine whether or not an audit of the wholesale water cost increases is necessary

**ANALYSIS**

With water rates increasing throughout Santa Clara County, it is important for the City Council and the public to have an accurate understanding of the causes of these rate increases. The San José Municipal Water System (Muni Water) provides high-quality water at low rates for residents and businesses throughout District 8 and parts of Districts 2, 4, and 7. Though rates for Muni Water customers have increased over the past 4 years, Muni Water remains competitive compared to other water agencies in San José and in surrounding communities. However, a report on the City's due diligence regarding cost increases for wholesale water would fully explain the impacts of costs that are outside the City's control.

Muni Water purchases wholesale water from the Santa Clara Valley Water District and San Francisco Public Utilities Commission. When the costs for these water supplies increase, these costs are passed along to residents in the form of higher rates. At the City's budget study session in May, Staff indicated that the proposed increase in Muni Water rates were due to the increased price for wholesale water. Ratepayers would benefit from a full explanation of how a fair price for wholesale water is determined and the steps taken to protect residents from paying for unnecessary costs.

**CONCLUSION**

The City should do everything possible to ensure that Muni Water continues to provide the residents of San José with high-quality water at fair prices. A report on the City's due diligence regarding wholesale water increases and evaluation of a potential audit of this process would help confirm that residents are not bearing unnecessary costs passed through from other agencies.