TO: HONORABLE CITY COUNCIL
FROM: CITY MANAGER DEPARTMENT: UTILITIES
DATE: JUNE 11, 2007 CMR: 282:07

SUBJECT: TRANSMITTAL OF FINANCE COMMITTEE AND UTILITIES ADVISORY COMMISSION RECOMMENDATION FOR APPROVAL OF A WATER REVENUE INCREASE OF $2.2 MILLION FOR FISCAL YEAR 2007-08, CONCEPTUAL APPROVAL OF A WATER REVENUE INCREASE OF $2.5 MILLION FOR FISCAL YEAR 2008-09, AND ADOPTION OF A RESOLUTION AMENDING WATER UTILITY RATE SCHEDULES W-1, W-2, W-4 AND W-7, INCLUDING RATE CHANGES, ESTABLISHMENT OF MONTHLY WATER SERVICE CUSTOMER CHARGES, AND DISCONTINUANCE OF DISCOUNTED IRRIGATION RATES.

RECOMMENDATION
The Finance Committee and the Utilities Advisory Commission (UAC) recommend that the City Council adopt the attached resolution to:

(a) Approve a 10 percent increase to the average system retail water rate, for Fiscal Year (FY) 2007-08, effective July 1, 2007, which will increase annual revenue by $2.2 million. This increase includes the reinstatement of monthly fixed charges, discontinued at the beginning of FY 2003-04, for all customer classes, in order to collect a portion of the utility’s fixed operating costs. Revenues from the fixed “customer charge” comprise $1.6 million of the requested $2.2 million increase.

(b) Approve the changes to the Water Utility Rate Schedules, as attached;

(c) Approve the discontinuance of the current discounted rate for commercial, industrial and institutional irrigation customers; and,

(d) Conceptually approve, in concept, of a 10 percent average system water rate increase for FY 2008-09, which will increase annual revenue by an additional $2.5 million.
BACKGROUND

Proposition 218 Notice and Public Communications
Water, wastewater and refuse fees are subject to the requirements of Proposition 218, codified in Article 13D of the California Constitution. Pursuant to Proposition 218, the City must provide written notice of any new or increased water, wastewater, or refuse utility fee to those subject to the proposed fee. A public hearing on the new or increased fee must be held not less than 45 days after mailing notice to those subject to the proposed increase. At the hearing, the Council will consider all protests, and if written protests against the proposed fee are presented by a majority of those subject to the fee, the City may not impose the fee.

On April 23, 2007, Utilities and Public Works jointly mailed over 27,000 “Notice of Utility Rate Change” letters to impacted customers at a cost of $17,000. Wastewater customers were not notified since there is no proposed rate increase for wastewater collection for FY 2007-08.

As part of the public notification campaign, City staff posted an electronic copy of the “Notice” on the Utilities Department Internet web site, released two “Frank’s Memos” explaining the rate increases at the beginning and end of May, placed a notification in all May 2007 Utilities bills in the “Utility Community Announcements” section, and posted a “Frequently Asked Questions” list on the Utilities Department web site. In addition, staff had conversations with media representatives and continues to meet with interested members of the public. A Utilities bill insert outlining the Council-approved rates changes is anticipated for July distribution.

DISCUSSION

Water Utility Revenue Requirement
In June 2006, the City Council approved a 7 percent average system water rate increase for FY 2006-07. The Water Utility sales levels for FY 2006-07 have remained flat, and projections for Fiscal Year 2007-08 and beyond assume either flat or declining sales due to voluntary reductions due to drought conditions in California.

The key drivers for this water rate increase are: a decrease in sales volume, increased wholesale water rates from San Francisco Public Utilities Commission (SFPUC) that were received after Council approval of the FY 2006-07 Budget, and increases in Water Utility operating costs.

Customer Charge
The Water Utility has fixed operating costs to provide water service to any customer, regardless of the amount of water used. These costs include customer service and administrative expenses that do not vary significantly over time, such as Phone Center staffing, meter reading, billing, and collections.

The current Water Utility volumetric pricing methodology, where all utility revenues are collected from the price of the water consumed, creates fluctuations in revenues due to reduced
customer water consumption from conservation and efficiency improvements, unusually long wet weather patterns, or customer drought response. These fluctuations result in under-collection of fixed operating expenses from customers and can contribute to the annual variability of water rates.

Even with the proposed $2.2 million revenue increase, a 10% drop in sales during FY 2007-08 due to drought-related conservation would result in a revenue loss to the Water Fund of $2.4 million.

A $5 monthly “customer charge” is proposed for most residential customers, which represents 48 percent of the fully allocated monthly customer costs of $10.40 based on the Water Utility’s cost-of-service study.

Table 1: Residential Water Costs (per CCF)

<table>
<thead>
<tr>
<th></th>
<th>First Tier</th>
<th>Second Tier</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2006-07 (current)</td>
<td>$4.040</td>
<td>$4.270</td>
</tr>
<tr>
<td>FY 2007-08</td>
<td>$4.507</td>
<td>$4.737</td>
</tr>
<tr>
<td>FY 2007-08</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Without Customer Charge</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FY 2007-08</td>
<td>$3.949</td>
<td>$4.510</td>
</tr>
<tr>
<td>With $5 Customer Charge</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 2: Monthly Water Bill Comparison for Residential Users

<table>
<thead>
<tr>
<th>5/8” meter</th>
<th>No Customer Charge</th>
<th>With $5/month Customer Charge</th>
<th>Number &amp; Percentage of Residential Customers (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Residential User (4-7ccf/month)</td>
<td>$17.35 ($1.19 increase)</td>
<td>$20.80 ($4.64 increase)</td>
<td>6,145 (38.2%)</td>
</tr>
<tr>
<td>Average Residential User (10-14ccf/month)</td>
<td>$64.66 ($6.49 increase)</td>
<td>$64.21 ($6.04 increase)</td>
<td>4,661 (29.1%)</td>
</tr>
<tr>
<td>Large Residential User (&gt;14ccf/month)</td>
<td>$241.01 ($29.13 increase)</td>
<td>$226.57 ($14.68 increase)</td>
<td>21,286 (32.7%)</td>
</tr>
</tbody>
</table>

For commercial customers, the monthly customer charge will be based on meter size, and be effective July 1, 2007. The monthly customer charge will range from $5 for the 5/8 inch meter to $383.67 for the 8 inch and 10 inch meters.

Staff recommends establishing the residential monthly customer charge at $5 per month resulting in a 48 percent cost-of-service recovery of fixed operating expenses until completing an analysis of the monthly charges of other regional water utilities. This analysis will be presented to
Council during the FY 2008-09 Budget process. The commercial charges will continue to be fully allocated based upon updated cost-of-service studies.

**Conservation**

Collecting each customer’s portion of fixed operating expenses from that customer (for the service to provide them with water) continues to provide an accurate price signal for the water itself. This is consistent with City of Palo Alto’s Comprehensive Plan (Natural Resources Section, Program N-62) to encourage responsible use of water and conservation of a valued natural resource, by charging customers an increasing amount for increased water usage.

**Discounted Irrigation Rate**

The Water Utility established Water Rate W-7 for irrigation-only customers in FY 2002-03. The unit cost at that time was the same as the commercial W-4 Water Rate Schedule. In FY 2003-04, a discount was established that charged W-7 customers 10 percent less than W-4 customers. The purpose of the discount was to provide a financial incentive to large landscape users to install the dedicated irrigation meters required under the W-7 Rate Schedule. The W-7 discount was decreased to 5 percent for FY 2006-07, and is proposed to be eliminated for FY2007-08.

The reason for establishing the W-7 discount was to provide an incentive for irrigation-only customers to split their domestic water systems into indoor and outdoor services and to install dedicated irrigation meters in order to: 1) allow the Water Utility to provide the proper price signals to customers during drought periods; 2) support “Best Management Practice #5 for Large Landscapes” by providing water consumption information to customers for both their indoor and outdoor systems with the goal of identifying and implementing cost-effective efficiency improvements; and 3) allow the customer to better manage limited water availability during an emergency condition.

There are 280 customers currently on the W-7 Water Rate, and the goals established for the incentive discount have been met. Therefore, discount prices are no longer necessary to encourage customer participation. The loss of the discount can be offset by each customer through efficiency and conservation improvements.

**Reserves**

With the approval of the proposed 10 percent increase, the Water Rate Stabilization Reserve (W-RSR) balance is projected to be $12.4 million by the end of FY 2007-08 or $200,000 above the Maximum Guideline level approved by Council. This $12.4 million includes $8.5 million in funds to be returned from closed water supply Capital Improvement Program (CIP) projects. This amount would be used to provide partial funding for the City’s Emergency Water Supply project starting in FY 2008-09. With the proposed Fiscal Year 2008-09 rate increase, the W-RSR balance at the end of FY 2008-09 is expected to be $3.4 million, which is $200,000 below the Minimum Guideline level and below the Risk Assessment level of $3.6 million.
FINANCE COMMITTEE REVIEW AND RECOMMENDATIONS
On April 17, 2007, the Finance Committee voted 4 to 0, to recommend that the City Council:

(a) Approve a 10 percent increase to water retail rates for Fiscal Year (FY) 2007-08, effective July 1, 2007, which will increase annual revenue by $2.2 million and result in a projected year-end W-RSR balance of $12.4 million;

(b) Approve the discontinuance of the current discounted rate for commercial, industrial and institutional irrigation customers;

(c) Approve a fixed monthly “customer charge” for all customer classes, irrespective of their monthly water consumption, in order to collect a portion of the utility’s fixed operating costs; and

(d) Approve the changes to the Water Utility Rate Schedules, as attached.

In addition, for biennial budgeting purposes, Finance Committee recommended approval, in concept, of a 10 percent average system water rate increase for FY 2008-09, which will increase annual revenue by an additional $2.5 million resulting in a projected year-end W-RSR balance of $3.4 million.

UTILITIES ADVISORY COMMISSION REVIEW AND RECOMMENDATIONS
On April 4, 2007, the UAC voted 4 to 0, with one absent, to recommend that the City Council:

(a) Approve a 10 percent increase to water retail rates, for Fiscal Year (FY) 2007-08, effective July 1, 2007, which will increase annual revenue by $2.2 million;

(b) Approve the discontinuance of the current discounted rate for commercial, industrial and institutional irrigation customers; and,

(c) Approve a monthly “Customer Charge” for all customer classes, irrespective of their monthly water consumption, in order to collect a portion of the utility’s fixed operating costs.

The UAC voted to withhold conceptual approval of a 10 percent average system water rate increase for Fiscal Year 2008-09 due to uncertainties associated with future costs time, but instead to wait for next year’s budget process to evaluate the necessary rate increase.

ALTERNATIVES
Staff evaluated the impact of alternative rate proposals to the proposed $2.2 million revenue requirement. Any smaller rate increase would require reducing some combination of the operating budget, Capital Improvement Program (CIP), or depleting the W-RSR. Reducing the operating budget would negatively impact ongoing system maintenance, thus increasing system
water losses and leading to higher capital costs. Reducing the CIP would hinder water main replacement projects, where the infrastructure has exceeded its system design life. Withdrawals from the W-RSR are not recommended, since even the proposed rate increase will result in the Reserve balance being below both the Minimum Guideline level and the Risk Assessment target.

POLICY IMPLICATIONS
This proposed rate increase meets the Utilities Strategic Plan objective of providing superior financial performance to the City and investing in utilities infrastructure to deliver reliable service. The reinstatement of a monthly customer charge for water service represents a return to former rate design, but does not represent a change in current City policies.

ENVIRONMENTAL REVIEW
The adoption of the resolution does not constitute a project under the California Environmental Quality Act, California Public Resources Code section 21080, subdivision (b)(8). Therefore, no environmental assessment is required.

ATTACHMENTS
A: Resolution
B. Water Rate Schedules W-1, W-2, W-4, and W-7
C. Report to the UAC from its April 4, 2007 meeting: Proposed Water Rate Increase
D. Extract from the City of Palo Alto Utilities Department web site
E. “FAQ’s on Proposed Water Rates for FY 2007-08” (City of Palo Alto web site)
F. “Notice of Utility Rate Change”, letter dated April 23, 2007, to customers of record

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