City of Palo Alto (ID # 5171)

City Council Staff Report

Report Type: Consent Calendar **Meeting Date: 11/10/2014**

Summary Title: Drought Rate Design Guidelines

Title: Finance Committee Recommendation that the City Council Approve Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study

From: City Manager

Lead Department: Utilities

Recommendation

Staff and the Finance Committee recommend that Council approve the proposed Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study (Attachment A).

The Utilities Advisory Commission (UAC) recommends that Council approve the proposed Design Guidelines with a rewording of Guideline Five, from "Rates for residential customers should provide an allowance for efficient landscaping through the use of three tiers, if feasible, and should otherwise be based on two tiers." to "Rates for residential customers should provide for efficient use of water for landscaping."

Executive Summary

The Water Utility is experiencing lower sales volumes due to calls for conservation as a result of drought conditions. If the drought continues, additional revenue may be required to preserve the Water Utility's financial position. In preparation, staff is updating the 2012 Water Utility Cost of Service Analysis (COSA) so that it includes additional rates or surcharges for use in an extended drought. The attached design guidelines set forth the parameters for the study. Following Council adoption of the guidelines, staff will engage a consultant to update the COSA and will return to the UAC, Finance Committee, and Council to commence the rate adoption process if the drought continues and additional revenue is necessary to preserve the utility's financial position.

Background

California is currently experiencing drought conditions. On January 31, 2014, the City's water supplier, the San Francisco Public Utilities commission (SFPUC), called for a 10% voluntary reduction in water use for its retail and wholesale customers. In response, Palo Altans have

reduced consumption by 15%[1] compared to last year. City facilities have reduced consumption by 25%. If the drought continues through the upcoming winter, the SFPUC will likely make these restrictions mandatory, and possibly increase them.

The current water rate schedules for the City of Palo Alto Utilities (CPAU) Water Utility are based on the 2012 COSA by Raftelis Financial Consultants. This COSA included rates based on normal year water sales, and did not include rates for drought conditions.

Discussion

The drought has not yet significantly impacted the Water Utility's financial position. The utility's revenues for February through June 2014 were lower than projected in the fiscal year (FY) 2014 budget, but this was offset by higher than budgeted revenue in the preceding months, before customers began taking concerted conservation measures. The drought is anticipated to impact the Water Utility's finances for FY 2015, however, and will impact future fiscal years if it continues beyond this winter. Staff evaluated a three-year drought scenario that assumed 10% reductions in 2015 and 20% reductions in 2016 and 2017, and the impact on reserves ranged from $1M to $3.5M per fiscal year. CPAU could offset some of this impact with temporary cost reductions or drawdowns of reserves, but drought rates would also have to be part of the solution to the financial impacts of an extended drought.

While the primary purpose for drought rates is to preserve the financial health of the utility, they are also anticipated to have a small impact on conservation. Staff predicts a 1-3% reduction in water use if the rates were put into effect. The proposed design guidelines (Attachment A) will be used by staff to guide its work on these rates. The staff report to the Finance Committee (Attachment B) provides a full explanation of the proposed guidelines.

Committee and Commission Review and Recommendation

On September 3, 2014, the UAC considered staff's recommendation. There was an extensive discussion of guidelines five and six, which describe the residential and commercial rate designs. Some Commissioners advocated for creating a system of rates with individual allocations of landscape water for each residential customer based on property characteristics. This was discussed as an alternative to imposing a uniform system of tiers for all residential customers. After discussion the UAC voted to recommend approval of the staff recommended design guidelines, but to amend guideline five to read "Rates for residential customers should provide for efficient use of water for landscaping," language which allowed various rate options to be considered. The recommendation was approved by a vote of 3-1 (with Commissioner Waldfogel voting no and Commissioners Chang, Cook, and Hall absent). The Chair of the UAC also appointed a two-member sub-committee, comprising Vice Chair Waldfogel and Commissioner Melton, to review the drought rate analysis as it progressed. The minutes from the UAC's September 3, 2014 meeting are provided as Attachment D.

[1] All customers, cumulatively, February through August, compared to 2013.

On September 16, 2014 the Finance Committee voted 3-0 (Council Member Holman absent) to approve the staff-recommended Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study without any changes. The Finance Committee asked a variety of clarifying questions about the rate structures and urged staff to clearly communicate them to residents. The minutes from the Finance Committee meeting are included as Attachment C.

Next Steps

Staff intends to have drought rates ready for potential adoption by Council by spring of 2015. This will allow for their adoption if water shortage conditions continue through this winter or worsen.

Resource Impact

This update to the water utility COSA will be completed with existing budgeted resources. The drought rate schedules, once adopted, will not take effect unless the Council puts them into effect as part of a water shortage. If the rates are put into effect, they are expected to recover the cost of operating the utility when sales are lower during a drought. Council's consideration of the proposed rates will be preceded by the notice and protest hearing procedures required by Proposition 218.

Policy Implications

The creation of drought rate schedules enables Council to implement them when it deems appropriate, which would typically occur as part of a Stage II or higher water shortage, as set forth in the City's 2010 Urban Water Management Plan.

Environmental Review

Adoption of drought rate design guidelines does not meet the definition of a project, pursuant to Section 21065 of the California Environmental Quality Act, thus no environmental review is required.

Attachments:

- Attachment A: Design Guidelines for Drought Rate COSA (PDF)
- Attachment B: Finance Committee Staff Report (ID 5063), without attachments (PDF)
- Attachment C: September 16, 2014 Finance Committee Minutes (PDF)
- Attachment D: Excerpted Final UAC Minutes of 9-3-14 (PDF)

Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study

1. Drought rates must be based on the cost to serve customers. This is the overriding principle for this study; all other rate design considerations must fall within this basic premise.

2. The drought rate design should be consistent with the water shortage response plan evaluation criteria in Appendix G of the City's 2010 Urban Water Management Plan, summarized as follows:
    a. Reduce overall City consumption to reduction target required
    b. Provide sufficient water available for personal use
    c. Design should be acceptable to the community
    d. Unemployment and business loss should be minimized
    e. Landscaping investment losses should be minimized
    f. Plan should be cost-effective, enforceable, and achievable in the given timeline
    g. Plan should allow for flexibility
    h. Plan should take into account for new water services
    i. Plan should recover penalties applied by suppliers

    These criteria are discussed in more detail in the 2010 Urban Water Management Plan.

3. Rates will be designed for the following demand targets:

San Francisco Public Utilities Commission System-wide Demand Reduction	Target Palo Alto Demand (CCF)	Projected Sales (CCF)
10/15%	4.976 million	4.571 million
20%	4.586 million	4.213 million
25%	4.261 million	3.914 million

4. Rates will be designed assuming the following allocation of water between indoor and outdoor (irrigation) use.

SFPUC System-wide Reduction in Available Supply	CPAU Sales (CCF)	Indoor Use		Outdoor Use	
		(CCF)	% reduction over normal year	(CCF)	% reduction over normal year
None	4.946 million	3.134 million	-	1.812 million	-
10/15%	4.571 million	2.977 million	5%	1.589 million	12%
20%	4.213 million	2.852 million	9%	1.359 million	25%
25%	3.914 million	2.758 million	12%	1.160 million	36%

5. Rates for residential customers should provide an allowance for efficient landscaping through the use of three tiers, if feasible, and should otherwise be based on two tiers.

6. Rates for commercial customers should provide an individual baseline allocation representing indoor use (based on winter use in a pre-drought year) and a second tier for outdoor use.

7. Water purchase costs should be passed through directly on the bill as a separate rate component.

8. Evaluate variance processes for customers needing additional water for medical necessity, health and safety, and other critical needs.

City of Palo Alto (ID # 5063)

Finance Committee Staff Report

Report Type: Action Items **Meeting Date: 9/16/2014**

Summary Title: Drought Rate Design Guidelines

Title: Utilities Advisory Recommendation that the Finance Committee Recommend that the City Council Approve Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study

From: City Manager

Lead Department: Utilities

Recommendation

Staff requests that the Finance Committee recommend that Council approve the proposed Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study (Attachment A).

The Utilities Advisory Commission (UAC) recommends rewording Attachment A Guideline number Five from "Rates for residential customers should provide an allowance for efficient landscaping through the use of three tiers, if feasible, and should otherwise be based on two tiers" to "Rates for residential customers should provide for efficient use of water for landscaping."

Executive Summary

Staff seeks feedback from the Finance Committee and Council prior to commencing a cost of service analysis (COSA) for water rates to use during an extended drought. These rates will be designed to encourage conservation and preserve the utility's financial stability should the drought continue for an extended period. The attached design guidelines set forth the parameters for the study. The guidelines include citywide demand targets for various levels of mandatory water use restrictions by the City's water supplier, the San Francisco Public Utilities Commission (SFPUC), and projections of the use of water for indoor and outdoor consumption during a drought. Lastly, the guidelines include recommended drought rate designs for both residential and non-residential customer classes.

Any drought rates that result from the COSA would be adopted as a separate rate schedule that could be activated by Council as part of a formal water shortage declaration. The development of drought rates, although not needed at this time, is prudent to ensure that the City has COSA-

based drought rates ready if they are needed to meet water usage targets and maintain the financial health of the water utility in a water shortage.

Background

California is currently experiencing drought conditions. On January 31, 2014, the City's water supplier, the SFPUC, called for a 10% voluntary reduction in water use for its retail and wholesale customers. On June 23, 2014, the SFPUC renewed its 10% voluntary reduction request and is expected to continue the request through at least the end of 2014. If the drought continues through the upcoming winter, the SFPUC will likely make these restrictions mandatory, and possibly increase them.

The current water rate schedules for the City of Palo Alto Utilities (CPAU) Water Utility are based on the 2012 COSA by Raftelis Financial Consultants. This COSA included rates based on normal year water sales. Higher rates will be necessary to fully fund water utility operations if mandatory water use reductions or voluntary drought-motivated conservation efforts result in decreased water sales.

As part of the Finance Committee's review of the Fiscal Year 2015-2024 General Fund Long Range Financial Forecast, the Finance Committee requested more information on the potential impact on the water utility rate schedule in case of an extended drought.

Discussion

CPAU customers have responded strongly to recent calls for conservation due to the drought. Water demand for February through June 2014 decreased nearly 17% compared to the same period in 2013. If additional conservation becomes necessary, drought rates will help by sending price signals to conserve. Drought rates are also essential to preserving the financial health of the water utility during an extended drought, since revenue from water sales decreases. Staff has engaged Raftelis Financial Consultants to update the 2012 COSA to include drought rates.

Drought Rates and Revenue Recovery

The drought has not yet significantly impacted the water utility's financial position. The utility's revenues for February through June 2014 were lower than projected in the fiscal year (FY) 2014 budget, but this was offset by higher than budgeted revenue in the preceding months, before customers began taking concerted conservation measures. The drought is anticipated to impact the water utility's finances for FY 2015, however, and will impact future fiscal years if it continues beyond this winter. The Council-approved Water Utility Financial Plan for FY 2015-FY 2021[1] anticipates a 10% reduction in revenue due to the drought for FY 2015. It assumes that the drought ends in this upcoming winter and that the revenue loss for FY 2015 can be offset by drawing down reserves. If the drought continues beyond the upcoming winter, however, the utility will experience additional revenue loss in FY 2015 and FY 2016 if the SFPUC's call for water use reduction is increased from 10% or made mandatory.

[1] The Financial Plans were approved by Council on June 9, 2014 (Staff Report 4799).

Figure 1 shows the revenue losses for FY 2015 through FY 2021 if CPAU experienced three more years of drought (calendar years 2015, 2016, and 2017), assuming CPAU did not implement drought rates.[2] As shown in the figure, sales are assumed to remain lower after the drought ends because some customers are expected to maintain the conservation measures they adopt.

Figure 1: Revenue Loss during a Three Year Drought[2]

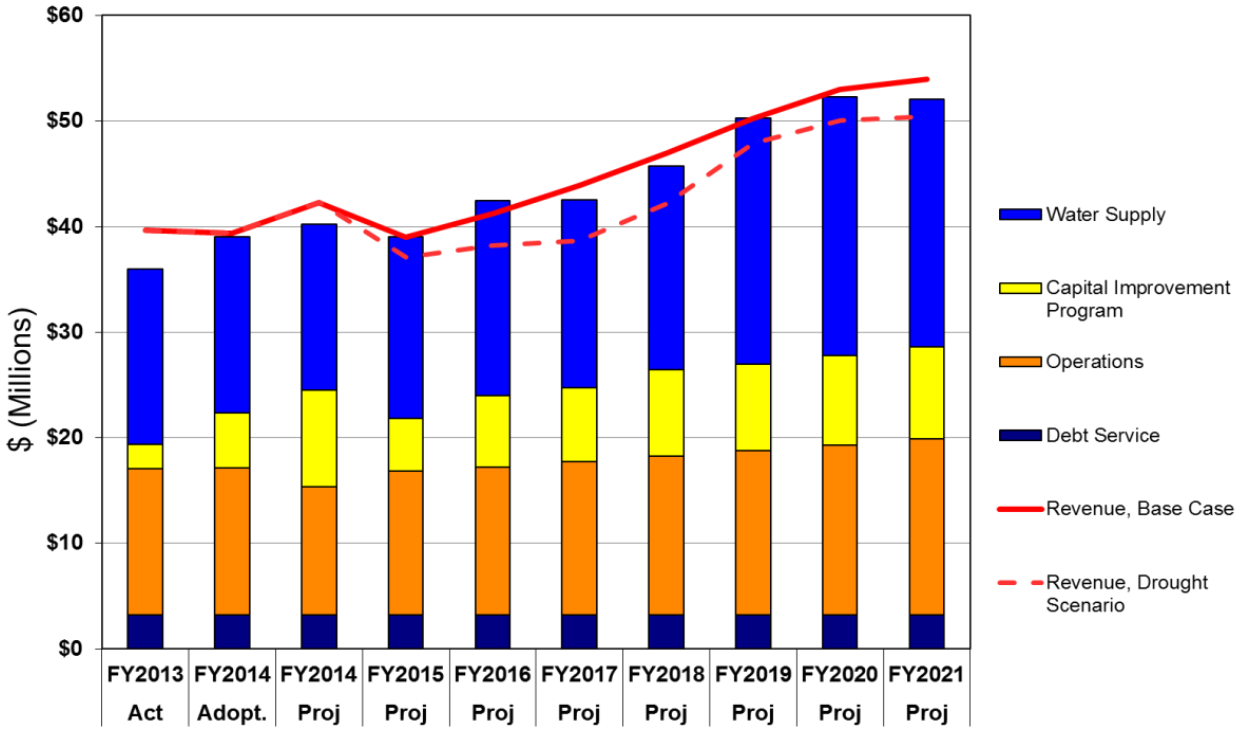

Table 1 shows the impact of a three-year drought on reserves compared to the base case in the Water Utility Financial Plan. The net losses shown in this scenario would rapidly deplete the water utility's reserves. The adoption of drought rates would prevent this by raising rates to raise additional revenue to offset those losses.

[2] The Base Case scenario assumes the rate increases projected in the FY 2015-FY 2021 Water Utility Financial Plan, but no additional increases due to the drought or the imposition of drought surcharges.

Table 1: Impact of a Three Year Drought on Financial Reserves[2]

	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
Water Demand (1000 CCF)							
Base Case	5,384	5,384	5,384	5,384	5,384	5,384	5,384
Drought Scenario	4,887	4,791	4,590	4,734	5,117	5,117	5,117
Difference	(497)	(593)	(794)	(650)	(267)	(267)	(267)
Net Income ($000)							
Base Case	(835)	(1,885)	(783)	(1,405)	(1,933)	(2,063)	(518)
Drought Scenario	(1,933)	(4,262)	(4,268)	(4,481)	(3,371)	(3,575)	(2,181)
Impact of Drought on Reserves	**(1,098)**	**(2,377)**	**(3,486)**	**(3,076)**	**(1,438)**	**(1,513)**	**(1,663)**
Projected Year-end Balance, Operations + Rate Stabilization Reserves Combined ($000)							
Base Case	13,432	12,547	12,764	13,360	13,426	11,364	10,846
Drought Scenario	12,334	9,072	5,804	3,323	1,951	(1,624)	(3,805)
Reserve Minimum	6,152	6,272	6,562	7,139	7,470	7,425	7,615

The City may also be able to offset the lower sales revenue with temporary cost reductions. Staff will design the proposed drought rate schedules to enable the adoption of rates up to the level required to cover any revenue shortfalls so that the City would be able to adopt lower rates if temporary cost reductions are put in place.

Rate Design: Consumption Targets and Revenue to be Recovered

Staff will design rates to fully offset the revenue decreases described above. The rate design methodology will be very similar to that used in the 2012 COSA, but will take into account the changed consumption patterns during a drought and may involve additional tiers, as described below.

The first step in the COSA is to identify the target levels of water demand for various levels of drought severity to be used in the COSA. Table 2 shows the demand targets CPAU would be required to achieve under various SFPUC water shortage scenarios. These targets were calculated using the water shortage allocation methodology agreed to by the agencies served by the SFPUC (members of the Bay Area Water Supply and Conservation Agency, or BAWSCA) and written into the Water Supply Agreement. Table 2 also shows the revenue loss associated with each demand target, which is calculated based on the difference between normal year and drought year demand.

Table 2: Estimated Decrease in Sales Revenue under Mandatory Reduction Scenarios

SFPUC System-wide Reduction in Available Supply	CPAU Purchases (1000 CCF)	CPAU Sales (1000 CCF)	Estimated Net Income Decrease Assuming No Drought Rates
None	5,384	4,946	-
10/15%[3]	4,976	4,571	$1.5 million
20%	4,586	4,213	$3.1 million
25%[4]	4,261	3,914	$4.4 million

Note that staff may recommend Council activate the drought rates under 10% or 15% water use reduction requests. This is because drought rates are valuable for preserving the Water Utility's financial position in addition to being a tool for reducing consumption. For example, without drought rates, Palo Alto water consumers have reduced water use by about 17% compared to 2013 since the SFPUC called for 10% voluntary water use reductions. However, if the water use restrictions persisted for an extended multi-year period, even under 10% or 15% reduction scenarios, normal water rates would have to be raised to account for reduced water sales. One advantage of having drought rates is having the ability to communicate that the rate increases are temporary (e.g. "drought rates are in effect, that's why your bill went up").

Allocation of Reductions between Indoor and Outdoor Use

The second step of the COSA will be to determine the demand levels of various customer groups during a drought for the purpose of allocating costs. This will be done by projecting the reductions in consumption expected under each scenario, and how much of the reduction will come from indoor vs. outdoor use to meet the water use reduction targets.

Table 3 shows the projections for indoor and outdoor use reductions staff plans to use. Staff assumes that most of the reductions will occur in outdoor (landscaping) use, since indoor use for both businesses and residents is fairly inelastic. The allocations assume a 5-12% reduction in indoor water use compared to a normal year, with the remainder of the reductions coming from outdoor use.

[3] Reduction targets for the 10% and 15% reduction targets are identical because of CPAU's supply guarantee under the water supply contract with the SFPUC. The supply guarantee is high relative to CPAU normal year demand.

[4] The 25% target is an estimate by CPAU staff, since the supply contract does not include an allocation methodology for system-wide reductions greater than 20%. The SFPUC operates the Hetch Hetchy system with the intention of making the water supply last through an 8.5- year "design drought" without requiring more than 20% mandatory water use reductions. If tighter restrictions were required, BAWSCA agencies would confer amongst each other and with the SFPUC to determine the allocation methodology. If the allocation methodology produces a substantially different result than what is shown in Table 2, the drought rates for the 25% reduction target would need to be modified.

Table 3: Indoor and Outdoor Allocations of Water

SFPUC System-wide Reduction in Available Supply	CPAU Sales (1000 CCF)	Indoor Use		Outdoor Use	
		(1000 CCF)	% reduction over normal year	(1000 CCF)	% reduction over normal year
None	4,946	3,134	0%	1,812	0%
10/15%[3]	4,571	2,977	5%	1,589	12%
20%	4,213	2,852	9%	1,359	25%
25%[4]	3,914	2,758	12%	1,160	36%

For example, as shown in Table 3, to meet a 20% system-wide water supply reduction target, Palo Alto's indoor water use would need to be reduced by 9% and outdoor water use would need to be reduced by 25%. There are other formulae that could be used to achieve a 20% system-wide reduction, but staff chose the indoor/outdoor reductions represented in Table 3 because they are viewed as fair and achievable.

Table 4 shows how the reduction targets would affect individual customer groups. All customer groups would face similar reductions compared to normal year consumption. In practice, most customers will compare their consumption during the drought to their calendar year (CY) 2013 consumption since CY 2013 was the last year before the SFPUC began requesting voluntary reductions in consumption. Details on current and historic consumption as well as projected water use reductions by customer group are provided in Attachment B.

Table 4: Projected Reductions by Customer Group

SFPUC System-wide Reduction in Available Supply	W-1 (Single Family and Individually Metered Multi-Family)			W-4 + W-7 (Non-Residential and Master-Metered Multi-Family)		
	Volume (1000 CCF)	reduction vs. normal year	reduction vs. CY 2013	Volume (1000 CCF)	reduction vs. normal year	reduction vs. CY 2013
None (CY 2013*)	2,648	-	-	2,601	-	-
None (Normal Year)	2,441	-	-	2,505	-	-
10/15%[3]	2,252	8%	15%	2,314	8%	11%
20%	2,075	15%	22%	2,135	15%	18%
25%[4]	1,929	21%	27%	1,988	21%	24%

* 2013 was a dry year and, accordingly, more water was used than expected in a normal year.

Rate Design

The final step in the COSA will be to create individual rates. Staff proposes creating drought rates that differentiate between indoor and outdoor consumption for both residential and commercial consumption. This is accomplished using tiered rates such that the first tier would represent indoor use and the second tier would represent outdoor use. Since larger reductions will be required for outdoor use than indoor use, the COSA will likely result in larger rate increases for outdoor use (higher tier use) than for indoor use (lower tier use). Staff's intention

is to design the rates so that customers who achieve the indoor and outdoor reductions requested by CPAU would pay roughly the same as they would if there were no drought. However, customers who fail to conserve will pay more.

1. W-1 (Individually Metered Residential) Rate Design

Existing rates for residential customers already attempt to distinguish between indoor and outdoor use for residential customers by using two tiers. Staff recommends a similar two- or three-tier drought rate design for the W-1 customer class. The first tier would represent indoor consumption determined by the average winter usage for the class. The other tier(s) would represent outdoor use. A three-tier methodology would provide an allowance of water to allow customers to protect some of their investment in landscaping and trees and to recognize those customers who have already installed drought-tolerant landscaping. Under a three-tier methodology, the second tier would represent this efficient landscape use. Smaller reductions would be required in this tier. Heavy water users with usage in the third tier would be expected to make more substantial reductions in their third tier usage. The COSA will analyze the reasonableness of the proposed three tiered method.

Alternative rate designs staff considered for the W-1 rate class, but is not recommending, are:

- *Individual allocations (budgets) based on pre-drought consumption.* Staff does not recommend this alternative because it fails to recognize customers who reduced their water consumption and implemented water efficiency upgrades and behaviors before the drought was declared. This rate design is also more complex to implement.
- *Equal percentage rate increases to all tiers.* This is the simplest method, but does not recognize the inelasticity of indoor use.
- *Individual allocations (budgets) based on factors like lot size or the number of people in the household.* Staff does not recommend this alternative because it is very complex to implement, expensive to administer and not feasible given the short timeline for developing these drought rates.

2. Non-Residential Rate Design

Existing rates for commercial customers do not have tiers due to the administrative complexity of implementing tiers for these customers. Non-residential customers are a less uniform group, and a uniform system of tiers like the one used for residential customers is not suitable during normal conditions. During a drought, however, it is more important to differentiate between indoor and outdoor consumption for these customers because some businesses have substantially less landscaping, and therefore significantly less ability to reduce. Without tiers, these businesses would pay more than businesses with landscaping.

To avoid this scenario, staff recommends creating tiered rates with the first usage tier set for each individual customer that represents indoor use. The first tier, or baseline, for each customer could be set to their pre-drought winter water consumption, a reasonable approximation of indoor use. Use up to the baseline level would be charged at a lower rate,

while any additional consumption would be charged at a higher rate. A methodology would have to be developed to set the baseline for new customers (who have no usage history).

Staff considered, but does not recommend, these alternative methodologies:

- *Do not use baselines.* With this methodology, the uniform rate for commercial customers would simply be increased to recover all required revenue. Staff does not recommend this alternative because it fails to recognize that some businesses have more landscaping than others, and are more easily able to conserve without affecting their core businesses.
- *Set the baseline usage for each customer based on their meter size.* Staff does not recommend this approach because meter size does not correspond well to consumption for commercial customers.
- *Set baseline usage levels by business type.* This approach is complex and difficult to administer. Individual businesses of the same type (such as a restaurants) can be different sizes, and more detailed methodologies for creating such baselines (such as by number of square feet, tables, or other metrics) rely on data that is not easily available to the utility.

Separate Commodity Rate Component

Staff also recommends making the cost of purchased water from the SFPUC a separate line on the rate schedule. This is recommended for all future water rates, not just drought rates. This will allow the utility to pass through increases in the water rate charged by the SFPUC and will make these types of increases more transparent to the customer. Lastly, it would allow changes to the rate on short notice, which may be important during a drought. Government Code Section 53756 allows for contractual water supply cost increases to be passed through to the customer without the formal mailing and protest process required under Proposition 218, though 30 days of notice is still required using a bill insert or similar method.

Conservation Impacts of Drought Rates

A recent economic study[5] of the water agencies served by the SFPUC identified elasticities of demand for the customers in each agency's territory. For the City of Palo Alto, the study found that a 10% increase in water rates would likely lead to a 1.5-1.7% decrease in water consumption. Based on this study, staff estimates that the cost-of-service drought rates proposed by the COSA will likely cause a 1-3% reduction in water consumption. This means that CPAU cannot rely on drought rates alone to achieve its target water use reductions. CPAU has already had success by raising its water conservation rebates and launching an extensive marketing campaign. Water use restrictions on landscaping have also been adopted. Additional restrictions can be put into effect and new marketing campaigns launched if necessary to achieve greater reductions. Drought rates will complement these efforts.

[5] *Socioeconomic Impacts of Water Shortages within the Hetch Hetchy Regional Water System Service Area*, David Sunding, Phd, The Brattle Group, March 13, 2014.

Proposed Design Guidelines for the 2014 Drought Rate COSA

The proposed design guidelines for the drought rates (Attachment A) include the primary principle that any drought rate design resulting from the COSA must be based on the cost to serve customers. This principle overrides all other goals that may be desired, but that may not necessarily be cost based. The guidelines include the parameters discussed in this report regarding the target demand reductions that are needed to achieve potential water supply limitations from the SFPUC. The drought rate guidelines also include the recommendation to include the water supply cost component separately on the rate schedules to enable a transparent pass-through of the actual cost of purchased water from the SFPUC.

Commission Review and Recommendation

On September 3, 2014, the UAC considered staff's recommendation. Several Commissioners acknowledged staff's effort to bring this item to them for discussion before proceeding with the rate study. They emphasized that it was important to create a design that was simple to communicate. There was substantial discussion about the tension between fixed charges, which provide revenue stability, and volumetric charges, which communicate a price signal. There were comments regarding the need to preserve landscape investment, and some discussion of the desirability of individual allocations for non-residential customers.

The UAC supported most of the staff-recommended guidelines, but there was an extensive discussion of guidelines five and six, which describe the residential and commercial rate designs. Some Commissioners advocated for creating a system of rates with individual allocations of landscape water for each residential customer based on their property characteristics rather than imposing a uniform system of tiers for all residential customers. After discussion the UAC voted to recommend approval of the staff recommended design guidelines, but to amend guideline five to read "Rates for residential customers should provide for efficient use of water for landscaping," language which allowed for various rate options to be considered. The motion also included an amendment to guideline six to remove the word "excess." The recommendation was approved by a vote of 3-1 (with Commissioner Waldfogel voting no and Commissioners Chang, Cook, and Hall absent). The Chair of the UAC also appointed a two-member sub-committee, comprising Vice Chair Waldfogel and Commissioner Melton, to review the drought rate analysis as it progressed. The draft minutes from the UAC's September 3, 2014 meeting are provided as Attachment C.

Next Steps

Staff intends to have drought rates ready for potential adoption by Council by February 2015. This will allow for their adoption if water shortage conditions continue through this winter or worsen.

Resource Impact

This update to the COSA will be completed with existing budgeted resources. The drought rate schedules, once adopted, will not take effect unless the Council puts them in to effect as part of a water shortage. If they do, they are expected to recover the cost of operating the utility

when sales are lower during a drought. The proposed rates will trigger the notice and protest hearing procedures required by Proposition 218.

Policy Implications

The creation of drought rate schedules enables Council to implement them when it deems appropriate, which would typically occur as part of a Stage II or higher water shortage, as set forth in the 2010 Urban Water Management Plan.

Environmental Review

Adoption of drought rate design guidelines does not meet the definition of a project, pursuant to Section 21065 of the California Environmental Quality Act, thus no environmental review is required.

Attachments:

- Attachment A: Design Guidelines for Drought Rate COSA (DOCX)
- Attachment B: Water Consumption Information by Customer Group (PDF)
- Attachment C: Excerpted Draft UAC Minutes of 9-3-14 (PDF)

ATTACHMENT C

FINANCE COMMITTEE MINUTES

Regular Meeting
September 16, 2014

Chairperson Berman called the meeting to order at 7:04 P.M. in the Council Chambers, 250 Hamilton Avenue, Palo Alto, California.

Present: Berman (Chair), Burt, Kniss

Absent: Holman

ORAL COMMUNICATIONS

None

AGENDA ITEMS

Chair Berman encouraged the community and public watching to apply for the Architectural Review Board, Historic Resource Board, and the Planning & Transportation Commission.

1. Approval of Fiscal Year 2014 Reappropriation Requests to be Carried Forward Into Fiscal Year 2015.

Walter Rossmann, Budget Director, requested the Finance Committee (Committee) recommend the full Council approve the annual process of carrying funds forward from Fiscal Year (FY) 2014 to FY 2015. The funds were generally for projects that could not be completed within the initial Fiscal Year either due to contractual issues or the Request for Proposal (RFP) process was delayed. The amount being requested to carry forward was $1.6 million in the General Fund and $800,000 in other Funds.

Vice Mayor Kniss asked why there were question marks on the Staff Report.

Mr. Rossmann explained the areas darkened and with question marks were Staff's working areas and were inadvertently printed. The City Manager had approved the reappropriation of funds for the People, Strategy and Operations (PSO) for training and for the Comprehensive Plan.

Council Member Burt asked for a status update on the reallocation of funds associated with the business registry. The Staff report noted there were

other competing priorities where the business registry was unable to be worked on. The business registry was a Council priority and he felt other actions would be informed by the business registry process.

Mr. Rossmann stated the business registry certificate program was scheduled to go before the Council on September 22nd. The issue was the Funds did not become available until later in the FY14 so Staff was unable to encumber the funds in time and recommends that the funds be carried forward to FY15.

MOTION: Vice Mayor Kniss moved, seconded by Council Member Burt that that the Finance Committee preliminarily approve the Fiscal Year 2014 reappropriations to be carried forward into Fiscal Year 2015 and direct Staff to forward the Finance Committee's recommendation to the City Council.

MOTION PASSED: 3-0 Holman absent

2. Utilities Advisory Recommendation that the Finance Committee Recommend that the City Council Approve Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study.

Jon Abendschein, Senior Resources Planner, informed the Finance Committee (Committee) of the proposed drought plans for the City. The San Francisco Public Utilities Commission (SFPUC) has asked for a voluntary 10 percent reduction from all of their wholesale customers. Palo Alto residents and businesses have responded positively to the recommendation with a 15 percent reduction in usage and the City facilities have made a 25 percent reduction. Staff proposed designing drought rate guidelines in the event the drought continued and there was a need for revenue. The Utilities Department felt updating the 2012 Cost of Service Study to include rates for drought conditions was more cost effective than requesting a new study. Staff understood altering a Cost of Services Study was difficult once it was completed; therefore, they were seeking policy guidance. There were a few reasons for having a drought rate available: 1) preserve the Utilities financial position and 2) to send a price signal to make some contribution toward water conservation goals. Drought rates modified or replaced normal rates: 1) there could be a separate set of rates that replaced normal rates or 2) there could be a surcharge on normal year rates. The rates could be implemented when the SFPUC declared a Stage 2 drought alert and could be deactivated when the restrictions were removed.

Council Member Burt said depending on which mandated reduction SFPUC implemented the corresponding costs would reflect on the rates.

Mr. Abendschein stated yes, that was the goal. If the household or business met the reduction goal their bills would not reflect a change.

Vice Mayor Kniss stated Staff mentioned the SFPUC worked with an 8.5 year design drought. She asked where Palo Alto was within that cycle.

Mr. Abendschein believed the City was in the second year of the design drought.

Vice Mayor Kniss recalled in the early 1990's there was a long term plan in place and the City was not as sophisticated in dealing with the situation. She asked whether Staff was reviewing the past to learn from the errors made.

Council Member Burt noted a lesson learned by SFPUC was not to waste water burning inexpensive hydro in the middle of a drought.

Mr. Abendschein acknowledged the SFPUC had made changes and continued to maximize the water benefits rather than the hydro benefits. Staff had an archive of past events and they had been reviewing them for reference.

Vice Mayor Kniss stated the drought in the 1990's was significant and she was pleased Staff was reviewing the events to avoid a reoccurrence.

Mr. Abendschein presented a hypothetical customer bill with and without the drought reductions.

Vice Mayor Kniss asked what the starting usage point was for determining the customer usage baseline.

Mr. Abendschein said the average baseline was the first calendar year prior to the drought. He noted there was a difference in indoor and outdoor water usage.

Vice Mayor Kniss shared a concern from a customer who had been conserving for the sake of being prepared so when the review process occurs their rate would not be reflective of a normal use.

Chair Berman asked Committee Members to refrain from asking questions until after the presentation because some of the questions may be answered.

Mr. Abendschein stated tier 1 users would need to reduce by 9 percent, tier 2 users would need to reduce by 15 percent and tier 3 users would need to reduce by 30 percent. He discussed various reduction rate options for residential and non-residential. He explained the timeline was to receive feedback from the Utilities Advisory Commission (UAC) and the Committee then provide said feedback to the Consultant to begin the analysis during the month of September. Return to the UAC and the Committee with a draft rate schedule and request preliminary approval in December.

Herb Borock understood the role of the Committee was to advice Council and not provide advice to Staff. He recalled a few years back Council did not approve a three tier process.

John Foster, Utilities Advisory Commission Chair, addressed a point of variation between the UAC and Staff recommendations. Fundamentally there were three points the UAC discussed changing of the Staff recommendation. The first change was agreed upon by the Staff and was made; therefore, was no longer an issue. The second was Staff allowing the Cost of Services Analysis to review three tiers. The third was individual allocations for residential customers. The UAC recommendation was to drop the three tier language and not to recommend the individual residential allocations.

Chair Berman clarified the language recommended by the UAC would not preclude three tiers; it was a bit more general.

Mr. Foster stated that was correct. The Staff recommendation had the firm providing the Cost of Service Study to look at three tiers. The question was whether or not the firm could review the process without the language and the reply was yes.

Vice Mayor Kniss asked if there was a new normal as far as water consumption. She understood that was not a discussion for the table; although she requested the matter be broached.

Mr. Foster agreed with the need for a new normal consumption usage. He, the UAC and Staff had discussed the subject of recycled water usage. One of the challenges with that option was the pipe systems.

Valerie Fong, Director of Utilities, noted the City Manager was requesting Staff make recycled water a higher priority. Staff was researching available funding sources for such a project.

Council Member Burt mentioned the City had a preliminary study on running a recycled water pipeline up Page Mill Road; there was already one installed running down to Shoreline Road. The Page Mill Road project was put on hold five years ago because of objections from the Stanford Research Park with concerns with the total dissolved solids and the salinity of the water. The City had driven their Total Dissolved Solids (TDS) down principally because it was discovered the incoming pipes from Shoreline Road had holes in them and the City was treating salt water. The current TDS was at a level of water quality that there should not be objections for using the water for landscaping. The scheduled TDS for 2015 were comparable to other cities drinking water. The Page Mill Road project was a Public Works project and not that of Utilities.

Ms. Fong believed the pipes portion of the project belonged to Utilities although the treatment portion was Public Works.

Council Member Burt stated the Santa Clara Valley Water District (SCVLWD) were interested in contributing to the capital costs of recycled system in ways similar to where they have in other areas of the Water District. The outstanding question was whether to perform reverse osmosis treatment rendering the water basically drinkable which was what the City of San Jose had just begun. The decision was a major policy discussion that would approve or prevent the moving forward.

Vice Mayor Kniss agreed the discussion was not the issue but the decision o use water in the correct way.

Council Member Burt said although the recycled water projects may not affect the current recommendations it was a subject that needed to be on the table. He asked whether there was a decision made on right-of-way tree watering during droughts.

Mr. Abendschein stated he would research and return an answer to the Committee at a later date.

Council Member Burt requested Staff provide the response to the full Council via electronic. He asked about indoor reduction opportunities. The primary reduction opportunity was outdoor landscaping but he asked whether Staff reviewed what reductions there might be with best practices including changed in appliances.

Mr. Abendschein stated there were quite a few programs in the area of appliance exchange.

Catherine Elvert, Communications Manager, noted it would be difficult to determine a percent reduction for indoor water use versus outdoor without further analysis. Staff discussed with the Council how the population had increased by approximately 14 percent with a reduced water usage of 4 to 6 percent.

Council Member Burt corrected the water reduction had been closer to 35 percent.

Ms. Elvert explained there were a variety of efficiency programs for indoor water use including rebates and free surveys. The programs were offered to residential and commercial customers. Staff could review the total citywide aggregate water use for indoor consumption versus outdoor and return to the Committee with further analysis with the potential. She noted there would likely be a greater potential in the residential sector then the commercial.

Council Member Burt agreed there was an interest and felt there would be interest in different levels of implementation. He believed there was a good amount of indoor opportunity for reduction but he was unaware of the percentage and what it would take to achieve it. Whether there was a new normal of available water, which may or may not happen, the City should be thinking of a new standard on their own of the amount of water consumed for other reasons; less damage to natural water ways or other reasons to state these were sustainability goals of Palo Alto. He asked out of 20 years we have had what percentage increase in the population in the City, what percentage reduction in potable water use and also what percentage reduction per capita.

Jane Ratchye, Assistant Director of Utilities, stated the 2015 Urban Water Management Plan was being released soon and many of the questioned being asked including the analysis would be performed in the Plan.

Council Member Burt asked if the Plan was the appropriate place to bring up matters such as gray water and billing code related changes.

Ms. Ratchye stated yes, the Plan should cover all of the potential water sources discussed.

Council Member Burt was pleased the information included in the utility bill was reflective of the context of reduction and conservativeness I simple terms.

Chair Berman asked for clarification on the law stating the City could only account for 30 percent of fixed costs through fixed fees.

Mr. Abendschein clarified it was not a law although it was a best management practice from the California Urban Water Conservation Council which the City was a signatory of.

Chair Berman asked was it because of that the fixed costs do not change and as the variable amounts of water use changes needed to be accounted for in the fixed rates.

Ms. Fong explained basically all costs were fixed. The City recovered the costs through part volumetric and part fixed cost rates. The goal was to balance through a conservation signal and still recover all of the costs which were fixed.

Chair Berman attempted to sum up the Utility strategy. The first tier of water used tended to be for indoor water usage. There was not a large amount of opportunity to cut usage, and because of that there would not be a significant cut. The next tier was outdoor use which had a greater opportunity to cut through certain available measures; therefore, the cost was increased in the third tier. The idea of the size of the lot did not correlate to the usage of water which was the driving force for the three tier approach.

Mr. Abendschein agreed Chair Berman relayed the process correctly.

Council Member Burt misunderstood the comment of the entire City's costs were fixed. He believed the rates were set by SFPUC for the commodity.

Ms. Fong acknowledged she may have over simplified; although, even the SFPUC costs were fixed.

Council Member Burt agreed the SFPUC costs were fixed but the City's costs from there were not.

Ms. Fong said that was correct.

Ms. Ratchye expanded on the fixed rates from SFPUC. Whether the fees were paid in advance or later the costs were fixed. San Francisco's costs were fixed if people used a lower amount the City paid those costs to San Francisco.

Council Member Burt asked if the City had no reduction in usage and San Francisco increased the rates, if San Francisco increased the rates and all customers had a proportionate across the board reduction of 13 percent; based on the 10 to 15 percent rate increase, the commodity rates remained the same. If the consumption was dropped by 25 percent in Palo Alto but only 5 percent in another city Palo Alto would have a lower commodity cost.

Ms. Ratchye agreed, the cost related to the amount of savings Palo Alto had relative to other cities. But, if all of the cities saved the same amount it was fixed.

Council Member Burt agreed the SFPUC costs were fixed although how they allocated the fees was based on the cities consumption.

Vice Mayor Kniss said water was a scarce recourse but she expressed the considered 8 year drought may not be over at that anticipated time. She stated the water conservation needed to be looked at on a regional level and her understanding was Palo Alto was doing well.

Mr. Abendschein stated over the past decade the Palo Alto residents has decreased consumption by more than other Bay Area cities.

Vice Mayor Kniss understood where the City needed to go although she expressed there would be residents speaking out about their conservation versus higher rates.

Ms. Fong was aware of the conflict between rates and consumption. During the review of the Cost of Service Study Staff would be looking at the users who used the least and the goal would be to impact them the least.

Vice Mayor Kniss suggested a Public Relations campaign to personalize the acknowledgement of consumption.

Council Member Burt noted Council Member Klein made the assertion that even though the City had greater reductions than other jurisdictions, on a per capita basis Palo Alto was still at the higher end of SFPUC customers.

Which did not necessarily give clarity on whether Palo Altans were water guzzlers or not. He was not certain what Council Member Klein was referring to when looking at total water versus night time population when the City had a much higher daytime population than other jurisdictions. He would be interested in the upcoming Master Plan meeting so that Council and the Community began to understand context, and what the true baseline comparison was versus other cities in the region.

Ms. Ratchye explained the per capita number was based on residential usage only. The calculation was residential usage divided by the nighttime population. She believed there were only 4 other cities higher than Palo Alto. Palo Alto also had higher than normal lot sizes.

Council Member Burt felt Redwood City and Menlo Park would be valid comparisons for water usage, lot sizes and house size.

Chair Berman asked the percentage the City cuts its usage of water in the past year.

Mr. Abendschein stated 25 percent cumulative savings over the previous year since February of 2014.

Chair Berman said that was City operations. He felt it was notable the City was reducing water usage as they were requesting the community to.

Mr. Abendschein mentioned the City began utilizing recycled water at the Municipal Golf Course and exchanged plantings for drought resistant greenery. Those were two examples of how the City improved their water consumption.

MOTION: Vice Mayor Kniss moved, seconded by Chair Berman to recommend the City Council approve the proposed Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study as shown in Attachment A of the Staff report.

MOTION PASSED: 3-0 Holman absent

FUTURE MEETINGS AND AGENDAS

Lalo Perez, Director of Administrative Services stated the next meeting was October 7, 2014.

ADJOURNMENT: The meeting was adjourned at 8:19 P.M.

ATTACHMENT D

CITY OF PALO ALTO

EXCERPTED FINAL MINUTES OF THE SEPTEMBER 3, 2014 UTILITIES ADVISORY COMMISSION MEETING

ITEM 5 (PREVIOUSLY ITEM 3): ACTION: Staff Recommendation that the Utilities Advisory Commission Recommend that the City Council Approve Design Guidelines for the 2014 Water Utility Drought Rate Cost of Service Study

Abendschein said staff was seeking feedback on a set of guidelines for a cost of service study for drought rates, with the goal of aligning the rate designs with policy guidance to the extent possible while respecting cost of service limitations. Drought rates are used to replace lost revenue associated with reduced water consumption and to send a price signal for customers to reduce consumption. Drought rates are one tool to manage the utility's financial position during a drought. Other tools include temporary cost reductions and use of reserves. Abendschein summarized the design considerations included in the guidelines, including ensuring that the rates are cost based, reflect the required consumption reductions, minimize business and landscaping investment losses, provide adequate water for personal use, and are flexible and easy to implement. He then gave an overview of the key rate design components of the proposed guidelines, including the separation of the commodity portion of the rate from the non-commodity portions, tiered non-commodity rates for commercial customers, and a third tier for residential customers.

PUBLIC COMMENT:
Susan Rosenberg, a Board Member of Canopy, spoke regarding the staff proposal. She said Canopy was concerned that the proposal's sole focus on conservation and financial stability did not take into consideration the impact of the proposal on trees. Canopy considered trees to be the most valuable part of the urban landscape that were not heavy water users and provided most of the benefits of the urban landscape. Ms. Rosenberg questioned the distinction between indoor and outdoor uses of water to determine what was "wasteful" and argued trees were not wasteful uses of water. She asked that staff explain the mechanism by which a third tier would enable customers to maintain their investment in efficient landscape investment. She said that in the past Canopy had advocated for an allocation-based methodology of determining water rates similar to the methodology used by the Irvine Ranch Water District. She wanted to know how long it would take to implement such a program and how much it would cost. She asked that the City undertake a citywide marketing campaign focused on preserving trees, and that the City's Arborist be included in discussions regarding the drought.

Resident Herb Borock commented on the staff proposal. He said with drought rates the utility had to balance conservation and cost of service. He agreed that a three tier pricing methodology was an appropriate strategy to look at and he recommended using the three tier proposal previously discussed by Council which had been rejected when a resident with a large lot complained about it. Mr. Borock talked about the portion of the proposal involving passing through the supply cost, saying the lower tiers would be more heavily affected by such a strategy and that one way to manage that would be to use a fixed charge to recover distribution costs. He suggested that the discussion regarding the urban forest should take place in the context of a discussion of basement dewatering. He said the rate schedule should not vary based on the number of people or size of the landscape as these were personal choices and not reason for higher water allocations.

The Commissioners generally appreciated the opportunity for UAC input prior to a cost-of-service study (COSA).

Commissioner Eglash appreciated that one of the design considerations listed in the guidelines was to minimize landscape investment losses and he recognized the value of trees in Palo Alto. He supported a structure that was easy to communicate as rate increases are difficult enough to communicate during a drought. Commissioner Eglash also stressed that drought rates should not produce a revenue windfall and ratepayers should not pay more in absolute dollars than they would have if there had not been a drought. He noted the SFPUC may also need to raise its rates due to the decreased consumption and the new rate design should take into account any need to pass through those increases as the drought proceeds.

Commissioner Melton said one of the big challenges in designing these rates will be that revenue stability is achieved through fixed charges but price signals are achieved through variable charges. Balancing those two effects was a challenge the UAC always faced with water rates. He was encouraged that the high level objective was keeping the fund solvent in the face of drought use reductions. Rates, reserves and other tools would have to be used to make sure the fund was kept on a sound basis. He said any conclusions from this COSA would likely carry over to future normal year rates. The City should think far enough ahead to understand the impacts of any pricing scheme on non-drought years.

Commissioner Cook agreed that messaging was important because it was difficult for people to understand why their bills do not decrease when they conserve. He asked how rates were designed to differentiate between indoor and outdoor usage given that there was only one meter and Director Fong explained it came down to a comparison of winter vs summer usage. Commissioner Cook said it was important to incorporate comments from Canopy and other stakeholders. He agreed it was a good idea to use a separate commodity rate component because it would make it clear how much of the rate increase came from the SFPUC.

Vice Chair Waldfogel said he was forced to disagree with some comments from colleagues. He mentioned that the president of one of Palo Alto's garden clubs had intended to be here, but was unable. He was concerned that two years ago staff completed a COSA and that costs had

not changed in that time, but instead revenues had fallen. He said that if a 10 or 15% change in demand undermines a COSA it brings into question the quality of the rate study. He said under pricing structure previously adopted there had been unwillingness to set fixed charges equal to fixed costs. He was not recommending doing that, but the consequence was that a reduction in demand sends revenues below cost. Vice Chair Waldfogel's opinion is that the original COSA was still valid and that we should be having a pricing discussion within the existing COSA, not a new COSA. He also felt that the community would be concerned that we were willing to do individual allocations for business customers but not for residential customers to accommodate landscaping issues. He said given the huge variations in lot sizes setting arbitrary limits and saying anything above that level was wasteful was not an accurate way to portray water use. The consequence was that trees and other landscaping would die.

Abendschein said the basic structure of our costs had not changed. The COSA from two years ago had not incorporated a drought scenario. This was not a new COSA but an update to the previous COSA to include drought level consumption and rates necessary to cover costs.

Vice Chair Waldfogel said that meant that the pricing used in that COSA was too sensitive to demand. He agreed that the financial viability of the fund was important, but it did not mean there was a cost analysis problem, it was a price analysis problem.

Commissioner Melton said that once the COSA was established, deviating from it was not a good idea. If the COSA did not include rates that worked during the drought, then it was insufficient and a new COSA was necessary.

Vice Chair Waldfogel said the COSA set the amount of revenue to be collected from fixed versus variable charges. He said if the COSA could not survive relatively small changes in demand it called into question of whether the City was on the right track with this study.

Abendschein said staff was comfortable with the COSA under normal conditions. It needed something added to address an extended water shortage. Every agency struggled with the issue of collecting fixed costs through variable charges. There was a constitutional mandate to not waste water. The California Urban Water Conservation Council which includes advocacy groups and water utilities established best management practices for water agencies. One of these practices was that no more than 30% of fixed costs should be recovered through fixed charges. The way other agencies dealt with lost revenue in a drought was to have different rates for different drought scenarios. Roseville was one example of an agency with that practice. What was being proposed tonight did not call into question the validity of the previous study.

Abendschein said the goal tonight was to get feedback from the Commission, and if the balance between fixed and variable costs was not what they hoped to see, this was the time to get that feedback.

Chair Foster asked whether it made sense to achieve resolution now. He asked if anyone wanted to recommend anything other than the staff recommendation.

Commissioner Cook asked how the rates would revert to normal rates if it rained.

Abendschein said staff intended to get the rates designed and ready for adoption, and if it rained in December the rates would not be adopted and would instead be adopted in June.

Commissioner Cook asked about the mechanism for reverting to normal rates.

Abendschein said that the rates would go through the Prop 218 process and be ready in case of a drought. The trigger for activating them would be the declaration of drought conditions by the SFPUC, and the trigger for deactivating them would be the end of that declaration.

Commissioner Eglash questioned staff on the purpose of this action item to approve guidelines and considered it unprecedented to have the UAC or Council approve design guidelines. Abendschein pointed to other examples of UAC review and approval of design guidelines, such as the Palo Alto CLEAN program. Abendschein also explained how the guidelines would form the basis for the COSA and it would be challenging to deviate from the COSA after the fact.

Director Fong reminded the Commission that staff had been criticized in the past for not providing the UAC an opportunity to provide more definitive action prior to completing a rate analysis. Commissioner Melton agreed and said he was a supporter of UAC input early in the process.

Commissioner Eglash explained his concerns with the guidelines as presented and his main issue with Attachment A were items 2a through 2i and what implications they had for rate design. Abendschein explained these items were a restatement of policies already included in the Urban Water Management Plan and that none of these items implied a specific rate design. They were broad goals that staff was to keep in mind when designing rates. When staff returned with a rate design, they should be able to explain how that rate design is consistent with these goals.

Commissioner Eglash also had a concern that there was a disconnect between the presentation and the guidelines. For example, the presentation said one goal was to achieve the water use reductions mandated by the SFPUC, but the guidelines did not talk about that at all.

Director Fong said she thought the presentation and guidelines were fairly similar, noted several bullets that were identical, and pointed out that guideline three discussed the need to achieve water use reductions, but she invited recommendations for changes.

Commissioner Eglash said he interpreted guideline three to mean that the rates should be designed to cover costs in the event usage dropped to those levels, but that using rates to achieve those mandated water use reduction levels was something different. Abendschein

agreed that the presentation could be worded better, and that the intent was to communicate in the presentation that guideline three was intended to mean that rates should be designed to cover costs in the event usage dropped to those levels, not that the rates would be designed to achieve those levels.

Vice Chair Waldfogel said that the staff report had documented that price signals were not the primary mechanism for achieving the reductions. He said the report noted a price elasticity of -0.15 to -0.17, which was a bit higher than he had seen in other studies for water rates, but not high enough to achieve the required reductions on their own.

Director Fong noted that the water use reduction levels noted in guideline three were from the water contract with the SFPUC. They represented the water consumption allocated under the drought formula and Chair Foster said guideline three could be reworded to reflect that.

Vice Chair Waldfogel and Commissioner Eglash debated how conservation signals and design of rates to reflect the level of water use reductions should be handled. Further clarification that the rate design was intended to collect the revenue requirement and was not intended to be the primary mechanism for achieving water use reductions, thereby potentially over-collecting revenues, resulted in Commissioner Eglash's withdrawing his objections to the guidelines.

Chair Foster said there were three options: first, recommend the staff language, second, provide some general guidance to staff on changes, but not specific language, or third, provide staff with specific language.

Commissioner Eglash said he was now willing to recommend Attachment A (the design guidelines) as written.

Vice Chair Waldfogel said he would not support the design guidelines as written. He would support it with two changes. Guideline five should say "Rates for residential customers should provide an allowance for efficient landscaping," without saying anything about the number of tiers to be implemented. The number of tiers should fall out of costs and be cost driven. He also wanted to change "commercial customers" to "all customers" under guideline six and remove the word "excess."

Commissioner Eglash said he would not support the changes. He said rate design could be an important part of encouraging conservation. It was important to speak to tiers in guideline five because all landscaping was not equally important. He said that trees were a longer term investment requiring only a modest investment of water. Shrubs and lawns were a lower priority. He thought that weakening guideline five would make it too easy for people to keep all of their landscaping, and this was not the right approach during a drought. He supported guideline five as written. He thought they recognized the need to preserve trees during a drought.

Director Fong said staff agreed with deleting the word "excess" in guideline six.

MOTION: Chair Foster moved, seconded by Commissioner Eglash, to approve the staff recommendation with the removal of the word “excess” from guideline six.

SUBSTITUTE MOTION: Vice Chair Waldfogel moved, seconded by Commissioner Melton, to approve the staff recommendation with the following amendments: 1) modify guideline five so it reads “Rates for residential customers should provide an allowance for efficient landscaping,” without the subsequent language regarding tiers, 2) change “commercial customers” to “all customers” under guideline six, and 3) remove the word “excess” from guideline six.

Commissioner Melton said he had seconded the motion, but suggested to Vice Chair Waldfogel that guideline six not be modified. They were not in a position to do individual allocations for each residential customer.

Vice Chair Waldfogel said it was important to acknowledge different levels of reasonable landscape water use for smaller and larger lots. Setting the same tiers for all customers would result in the acceleration of dying landscape. He was already seeing both brown lawns and stressed trees around his neighborhood. He thought they were on track to accelerate this trend, and that there would be backlash from the community if there were individual allocations for commercial but not for residential customers.

Commissioner Eglash said that the individual allocations for commercial customers mainly had to do with economics, not landscaping.

Vice Chair Waldfogel agreed. He said this was about protecting the capital base of the city and the landscape investment. He asked if other Commissioners had a suggestion on how to capture his comments regarding capturing number of people and lot size in residential rate design.

Commissioner Eglash said that the word "excessive" in guideline six was unfortunate, and really the discussion was just about a second tier for landscaping. He asked whether staff had considered ways to deal with unusual landscape situations.

Abendschein said that guideline eight regarding variances addressed some of those concerns. He noted that non-residential customers were far less homogeneous than residential customers, and that the only way to make a distinction between indoor and outdoor use for non-residential customers was via individual allocations for indoor outdoor use. The indoor use represented the business use of water.

Vice Chair Waldfogel said he understood that argument, but still thought it would rub people the wrong way. Given the recent concerns about development in Palo Alto and the impact on neighborhoods, he thought that individual allocations that potentially might reflect businesses loading 8-10 people per thousand square feet versus 6 people per thousand square feet into a

commercial space might rub people the wrong way. He did not want to support that in the context of all the other land use discussions going on in the community.

Commissioner Melton said that to him, Vice Chair Waldfogel's proposed edits to guideline five meant that, for residential customers, an allowance for efficient landscaping would be required, which would take into consideration lot size. That data was in the City's database. Lot size was a relatively good measure of landscaping.

Commissioner Eglash said that such a revision to guideline five turns the intent of the guideline on its head. He said that although the guideline used the word "allowance," the intent of the third tier was to be a higher rate that would provide a disincentive for using water for landscaping.

Vice Chair Waldfogel said the rates still had to be cost based. He said the cost basis for that tier would fall out of the COSA if there were one. All of the elasticity studies he had seen said that the largest users were the least price elastic consumers, so to create an incentive for them to reduce would require a high rate. This would lower the rate for low users, the ones with the highest price elasticity, sending them a price signal to use more.

Commissioner Eglash was sympathetic to Vice Chair Waldfogel's concerns, and the concern that there might be some unusual situations that required special consideration, but he was concerned that the modifications being proposed to the design guidelines would be a disaster for water conservation. He thought it would lead to too much bad behavior by too many people. He said Vice Chair Waldfogel was trying to engineer the rate structure to provide a small benefit to a small number of people and it would cause an overwhelming number of people to do the wrong thing. He thought they really did need a third tier that was moderately, not extremely, more expensive than the other two tiers.

Chair Foster said he did not support removing the language regarding three tiers, but asked whether removing it would really affect the outcome of the rate study.

Commissioner Melton asked whether tiers were even the only way to do it.

Chair Foster said he was asking a slightly different question. The revised language said "Rates for residential customers should provide an allowance for efficient landscaping."

Commissioner Eglash said that was an ambiguous sentence because of the word allowance. If that sentence were rewritten to say that the rates should provide an incentive to water landscapes efficiently, to use less water, that would be one thing, but as worded, without a reference to tiers, it could be interpreted to mean that customers should be allowed to water their landscaping like crazy, and that was not what was intended.

Chair Foster said that was an intriguing point. He was trying to figure out whether staff needed the reference to three tiers in the guidelines in order to implement a three tier rate structure.

Abendschein thought the wording left open a range of other possibilities. It did postpone the discussion the UAC was currently having until the rate study was completed.

Commissioner Eglash asked staff to elaborate on the word "allowance."

Abendschein asked whether there had been some previous discussion of wording saying "Rates for residential customers should provide for efficient use of water for landscaping."

Vice Chair Waldfogel said this wording put the city on a slippery slope. "Efficient" and "excess" were two sides of the same coin. The fact was, the City was already seeing a great response to its calls for action without changing any prices. He said the price signal was superfluous. The community was being responsive, perhaps excessively responsive with respect to trees and landscape. Now the discussion was about recovering from that response.

Commissioner Eglash said it was a feature of rate structures statewide that fixed costs were not fully recovered through fixed charges. To do so would send the wrong price signals. That bridge had been crossed many years before.

Vice Chair Waldfogel said he was not arguing to change that. The last COSA had settled on charges that had gone too far for some people and not far enough for others. Now the point was to develop prices that would withstand a decrease in demand, and to decide what other efficiency programs were needed to achieve the required reductions without destroying the entire urban forest and urban landscape.

Commissioner Eglash said there was no scenario where the rates would become significantly more aggressive than they are. He did not want to do anything to convey a desire to roll back the fact that current rates send a price signal and that the City might want to send a slightly stronger price signal. He did not want to paper over a disagreement, and thought it might be getting toward time to indicate to the Council that there is disagreement among UAC members.

Chair Foster asked if it would be possible to indicate to Council agreement on the staff recommendation but a split vote on the wording of guidelines five and six.

Director Fong said there was no decision if there was a 2-2 vote. The UAC could break the other language out from the main motion.

Mullan said there were two motions pending to be dealt with.

Vice Chair Waldfogel asked Commissioner Melton to reiterate his previous suggestion regarding guideline six.

Commissioner Melton said he suggested leaving guideline six as it was and removing the word "excess."

Vice Chair Waldfogel asked whether he would be willing to remove guideline six altogether.

Commissioner Melton said that would leave no guidance with respect to commercial customers.

Vice Chair Waldfogel said it would indicate a desire to leave commercial rates structured as they currently are, with a single tier.

Commissioner Melton said the City had to change that due to drought conditions.

Vice Chair Waldfogel said with all the other discussions about development going on he did not want to support a proposal that would lead to lower rates for businesses with 80 people sitting in a small amount of space. He thought that was untimely. There was a discussion going on about retail spaces Downtown becoming offices and office spaces becoming more heavily used than had been anticipated when they were permitted. By setting up these individual allocations the UAC was stepping into that land use debate and he did not want to do that.

Chair Foster asked whether there was additional text Vice Chair Waldfogel could suggest adding to guideline six to address those concerns given the diversity of consumption patterns mentioned previously by staff.

Vice Chair Waldfogel said it was a defined customer class and it was not the UAC's problem if it had a lot of diversity.

Chair Foster asked whether it would make sense to remove the language regarding individual allocations from guideline six but keep the reference to tiers.

Commissioner Eglash did not think guideline six was relevant to the issue of densely populated buildings. The intention of staff was to make it a bit more difficult for commercial facilities with large lawns to continue to water them seven days a week, while not affecting their winter water consumption.

Vice Chair Waldfogel recommended an allocation based on the square footage and density of the planned occupancy.

Commissioner Eglash said the virtue of the staff proposal was that it worked for other types of occupancy as well. There were industrial operations and retail space. Staff did not want to come up with 1800 different types of allocations, instead basing it on winter water consumption for all customers.

Chair Foster asked what Commissioner Melton's concern was regarding the language of guideline five.

Commissioner Melton said he was comfortable with the language mentioned by staff earlier in the meeting. He was trying to provide more flexibility so that staff could consider allocation-based rates in addition to tiers.

Commissioner Eglash said the problem with that approach is that it would postpone the discussion until after the COSA was done.

SUBSTITUTE MOTION: Chair Foster moved, seconded by Commissioner Eglash, to approve the staff recommendation with the following amendments: 1) modify guideline five so it reads "Rates for residential customers should provide for efficient use of water for landscaping," and 2) remove the word "excess" from guideline six.

Chair Foster said he would nominate an ad hoc subcommittee with Commissioners Eglash, Melton, and Waldfogel to work with staff on the rate design, which would provide Commissioners Melton and Waldfogel the opportunity to comment on staff's proposed designs. He asked whether the absence of the words "three tiers" would prevent staff from pursuing a three tier structure.

Abendschein said the language provided enough leeway to staff to pursue different rate structures.

Commissioner Eglash said he was not available to be on the subcommittee.

Chair Foster said the ad hoc subcommittee would only include Commissioners Melton and Waldfogel.

ACTION: Motion approved (3-1, Vice Chair Waldfogel "no" with Commissioners Chang, Cook and Hall absent)

Commissioner Melton asked what the next steps were and whether the guidelines would go to Council.

Abendschein said the proposal would go to Finance Committee on the 16th. They would have to discuss with the Finance Committee whether it made sense to send the guidelines to Council.

Chair Foster appointed an Ad Hoc Committee of the UAC consisting of Commissioners Melton and Waldfogel to work with staff on rate design issues.