



# CITY OF SANTA BARBARA

## COUNCIL AGENDA REPORT

**AGENDA DATE:** September 23, 2014

**TO:** Mayor and Councilmembers

**FROM:** Water Resources Division, Public Works Department

**SUBJECT:** Reserve Management Policy Direction For The Stage Three Drought Water Rate Study

### **RECOMMENDATION:**

That Council receive a presentation and provide direction on assumptions for the Stage Three Drought Water Rate Study, specifically for the assumed repayment term of debt needed to finance the Desalination Project and the planned reserves management during drought conditions.

### **DISCUSSION:**

On July 29, 2014, Council authorized the Public Works Director to execute a City Professional Services contract with Raftelis Financial Consultants, Inc. (Raftelis), in the amount of \$33,917 for the development of the Stage Three Drought Water Rate Model Study (Study), and authorized the Public Works Director to approve expenditures of up to \$8,480 for extra services that may result from necessary changes in the scope of work.

The Study is being developed in preparation for continued drought conditions and the need for the reactivation of the City's Charles Meyer Desalination Facility (Plant). The scope of the Study is to update the Water Fund Financial Plan and develop a rate structure that generates sufficient revenues to cover the cost of the Plant's reactivation, along with other expected drought related costs. The new rates will also be structured to increase the incentive for reduction in customer water use to ensure that the planned 20% reduction in demand is achieved.

Raftelis has begun to update the City's existing water rate model, based on preliminary cost information available for a Plant capacity of 3,125 acre-feet per year (AFY), which is considered the first phase of the Plant's reactivation. Preliminary capital costs are estimated at \$32.4 million. Annual operating costs are estimated at approximately \$5.2 million per year for full Plant production, and approximately \$2.5 million per year for standby mode. The Study assumes that the Plant will produce 3,125 AFY of desalinated

water for one year, beginning in the summer of 2016, and then be put in standby mode, where it will produce a minimal amount of water to keep the Plant in a ready state. If drought conditions continue, prompting the need for extended operations or increased Plant capacity, a subsequent rate study will be performed.

For water rate modeling purposes, assumptions need to be made regarding the repayment period for the debt contemplated to finance the Desalination Project and, to what extent, if any, Water Fund reserves are used during drought conditions.

Repayment Scenarios

Two capital payment periods have been considered: 10 years and 20 years. The table below shows a comparison of the annual payments and total interest paid for each.

<b>Parameter</b>	<b>10-Year Payment Scenario</b>	<b>20-Year Payment Scenario</b>
Interest Rate*	2.12%	3.36%
Annual Debt Service	\$3.8 million	\$2.3 million
Cumulative Present Value of Debt Service Payments**	\$31.1 million	\$33.8 million

\*Based on market conditions as of August 2014

\*\*Based on 3% discount rate

Given the relatively small difference in annual debt service payment costs staff recommends minimizing the term of the debt to a 10-year payment scenario. At its regular meeting on August 11, 2014, the Water Commission agreed with the staff recommendation to use the 10-year payment period for purposes of the water rate model. Since the August Water Commission meeting, staff have been discussing lending options with State Water Board staff administering Safe Drinking Water State Revolving Loan Fund programs regarding a low interest loan. Such a loan may not have a 10 year repayment option, yet may offer attractive interest rates. Given this information, staff recommends continuing to use the 10 year repayment scenario for rate planning purposes, but will pursue the financing option that is most advantageous to rate payers.

Reserve Management Scenarios

Water Fund reserves consist of policy reserves and a separate reserve account established as a “Rate Stabilization Fund” (RSF). The RSF was established in connection with the most recent bond issuance and, unlike other reserves, can be used and treated as revenue for purposes of meeting debt service coverage ratios required by outstanding bond covenants. While staff believe it is prudent to maintain such reserves, there is no requirement to maintain it.

As of June 2014, reserve balances were approximately \$23.4 million plus \$5.0 million in the RSF, for a total of \$28.4 million. Projected use of Fiscal Year 2015 reserves is approximately \$5.3 million (based on adopted FY15 budget and July 29, 2014 authorization to appropriate \$686K from reserves), resulting in a projected balance of

\$23.1 (\$18.1 million in reserves and \$5.0 million in the RSF) at June 30, 2015. Under adopted financial policies, the Water Fund Policy reserves should total an estimated \$16.5 million in Fiscal Year 2016.

Two reserve management scenarios are being proposed for discussion:

Scenario 1 - No Use of Reserves: The first scenario assumes no use of any reserves to meet projected expenses for the 10-year financial period starting in Fiscal Year 2016. This scenario assumes that all projected expenses would be met entirely with revenues recovered from water rates. This would result in planning to maintain reserves at \$23.1 million in FY 16.

Scenario 2 – Some Use of Reserves: Under the second scenario, the funds currently in the RSF are considered as part of the total policy reserves (although they will continue to be managed as a separate reserve fund for accounting purposes). In this scenario, reserves above policy are used for one-time drought expenses, while maintaining a total reserve balance equal to or slightly above policy targets.

Preliminary results show that projected increase in revenue requirements range between approximately 24-30 percent for FY16 depending on reserve management; however, the analysis continues to be refined and updated information will be presented.

Given the volatility in water demands and supply conditions, staff does not recommend water rate planning that assumes a drop of reserves below Council policy. Staff recommends the second scenario in which funds currently in the RSF will be considered part of the total policy reserves, and rate planning is developed with the assumption that total reserve funds remain equal to or above Council policy. Staff recommends that reserves above policy only be used to cover extraordinary one-time drought costs (capital or operating), and that reserves are not used to cover expected ongoing costs.

**PREPARED BY:** Joshua Haggmark, Acting Water Resources Manager /KD/mh

**SUBMITTED BY:** Rebecca J. Bjork, Public Works Director

**APPROVED BY:** City Administrator's Office