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City Council
City of Belmont
One Twin Pines Lane
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Subject: **Report Addendum: Sewer Rate Update – FY 2009-10**
a. Option 1, Cost Saving Option
b. Option 2, Hybrid Option

Honorable City Council Members:

On March 24, 2009, City Staff and HF&H Consultants, LLC (HF&H) presented to the City Council a financial plan and rate model update for the City's Sewer Enterprise for FY 2009-10. Council provided direction for further analysis of alternative plans, which is briefly described in this addendum to the March 19, 2009 HF&H report.

1. Council Direction

The results of the Sewer Rate Update were presented to the Belmont City Council at its March 24, 2009, meeting. The City Council requested revisions to the analysis to address water conservation, potential cost savings, and funding options for the capital program.

Water Conservation

Water consumption decreased 3.8% between the 2008 winter (the most recent winter used in the calculation of average winter water use, which is how each customer's charge is calculated) and the 2007 winter. One City Council member expressed concerns that customers that conserved should pay lower bills that reflected their conservation efforts.

We looked at developing a tiered rate structure (also know as "increasing block rates") that would charge less to those who consume below-average amounts of water (and thus have lower wastewater flows) and more to those who use above-average amounts of water. While the practical aspects of creating such a rate structure are relatively easily, the legal risks may be problematic. Tiered rate structures are a common pricing tool used in setting water rates to encourage conservation and are sometimes found in setting sewer rates. The City's special counsel advised that such a structure for sewer rates might be difficult to justify.

Cost Savings

In the March 19, 2009 HF&H report, a 9.0% rate increase was recommended for FY 2009-10. The City Council expressed concerns about increasing rates given the current economic climate and requested a review to determine if costs could be reduced or deferred. Two costs were identified that result in decreasing the Sewer Enterprise's Revenue Requirement for FY 2009-10 by about half a million dollars. First, the cost of depreciation has typically been included in the revenue requirements and transferred to the capital reserves for future use in funding maintenance, renewal, and replacement of the infrastructure. It was decided not to recover depreciation in the FY 2009-10 rates, which results in a savings of $330,000.

The second savings can be achieved by delaying the expected bond sale from late in 2009 to the spring of 2010. The result of this delay is that the first interest payment on the debt (estimated to be $214,000) would be pushed from the second half of FY 2009-10 to the first half of the following fiscal year.

These two measures combined effectively balance the Sewer Enterprise's operating budget for the coming fiscal year. However, both of these measures directly impact the ability of Staff to complete planned capital projects because they reduce the available funding. This will also cause projects in future years to lag unless a special effort is made to catch up.

Since the March 19, 2009 HF&H report was prepared, SBSA billed the City $935,000 for the City's share of the SBSA improvements. This unexpected cost poses a short-term cash flow problem that can be addressed by advancing funds from the Sewer Fund's capital reserves to repay SBSA. The reserves will be reimbursed when the City issues bonds in FY 2009-10 to pay SBSA for the City's share of the SBSA capital improvements (not to be confused with the bond that is planned for issuance in late FY 2009-10 to fund local capital improvements). This temporary cash flow impact compounds the capital funding shortfall in FY 2008-09 and FY 2009-10 because the loan from the reserves will not be available for funding capital improvements.

Capital Funding Options

We evaluated what rate increases it would take to convert the City from using bond funding for capital projects to cash funding on a pay-as-you-go (PAYGO) basis. We looked at two pay-as-you-go scenarios: immediate and gradual conversion conversion from bond to cash funding. Immediate conversion would require a 60% increase in rates in FY 2009-10. Gradual conversion would occur as a series of four 19% rate increases. Gradual conversion cumulates in a larger overall rate increase than the immediate transition method. Staff reviewed these scenarios and decided that today's economy is an unacceptable time to recommend increases of these magnitudes.

2. Financial/Rate Options

The City Council's direction led to two options that are considered viable for funding the revenue requirements over the next five years: (1) continued use of debt and (2) transition toward pay-as-you-go financing. Both options benefit from the foregoing cost reductions (i.e., cut depreciation in FY 2009-10 and delay the bond sale). The results of the analysis of these two options are compared in **Figure 1**.

Option 1 is a bond funding option in which an $8.5 million bond would be issued in FY 2009-10 followed by a second $8.5 million bond in FY 2012-13. Option 2 also begins with an $8.5 million bond in FY 2009-10. However, rather than a second bond later, rates would be increased to generate cash for funding subsequent capital improvements. Under Option 2, which requires a series of 12% annual increases, rates are sufficient at the end of the projection period (FY 2013-14) to fund approximately two-thirds of the annual capital spending. We estimate that three more years of 12% rate increases beyond FY 2013-14 would be necessary to transition fully to pay-as-you-go. One consequence of Option 2 is that Capital Reserve balances would be below target for a few years while pay-as-you-go funding is slowly ramped up. This could cause short-term cash flow shortfalls for funding capital projects.

Figure 1. Rate Options

	Option 1 - Cost Savings, Continued Debt					Option 2 - Debt then PAYGO Transition				
	FY 2009-10	FY 2010-11	FY 2011-12	FY 2012-13	FY 2013-14	FY 2009-10	FY 2010-11	FY 2011-12	FY 2012-13	FY 2013-14
Increase in Rates	**5.0%**	**10.5%**	**10.5%**	**10.5%**	**10.5%**	**6.0%**	**12.0%**	**12.0%**	**12.0%**	**12.0%**
Cumulative Increase	*5.0%*	*16.0%*	*28.2%*	*41.7%*	*56.5%*	*6.0%*	*18.7%*	*33.0%*	*48.9%*	*66.8%*
Increase in Revenue	*2.8%*	*11.1%*	*11.3%*	*11.3%*	*11.1%*	*3.8%*	*12.6%*	*12.8%*	*12.8%*	*12.6%*
Cumulative Increase	*2.8%*	*14.1%*	*27.1%*	*41.5%*	*57.1%*	*3.8%*	*16.8%*	*31.8%*	*48.7%*	*67.4%*
Annual Account Charge	$250.07	$276.33	$305.34	$337.40	$372.83	$252.45	$282.74	$316.67	$354.67	$397.23
Low-Strength Rate / HCF	$3.28	$3.62	$4.00	$4.42	$4.88	$3.31	$3.71	$4.16	$4.66	$5.22
High-Strength Rate / HCF	$6.38	$7.05	$7.79	$8.61	$9.51	$6.44	$7.21	$8.08	$9.05	$10.14
Operations Reserve										
Balance	$2,585,326	$2,376,072	$2,580,070	$3,301,612	$4,038,975	$2,642,139	$2,588,464	$3,072,586	$3,721,770	$3,704,718
Target	*$3,040,000*	*$3,230,000*	*$3,420,000*	*$3,620,000*	*$3,830,000*	*$3,040,000*	*$3,230,000*	*$3,420,000*	*$3,620,000*	*$3,830,000*
% of Target	85%	74%	75%	91%	105%	87%	80%	90%	103%	97%
Capital Reserve										
Balance	$7,041,842	$4,248,479	$2,137,308	$7,818,962	$6,182,576	$7,778,225	$4,270,570	$2,160,063	$192,344	$255,659
Target	*$1,425,567*	*$1,425,567*	*$1,425,567*	*$1,425,567*	*$1,425,567*	*$1,425,567*	*$1,425,567*	*$1,425,567*	*$1,425,567*	*$1,425,567*
% of Target	494%	298%	150%	548%	434%	546%	300%	152%	13%	18%
Total Debt Service	$926,354	$1,479,116	$1,485,060	$1,480,375	$2,036,352	$926,354	$1,479,116	$1,485,060	$1,480,375	$1,480,162
Debt Coverage Ratio	1.64	1.31	1.55	1.94	1.73	1.72	1.42	1.74	2.16	2.65

Both options reduce the 9.0% rate increase proposed in the March 19, 2009 report in FY 2009-10. Lowering the proposed FY 2009-10 rate increase causes subsequent increases to be slightly higher than projected earlier due to the need to stay ahead of potential cash flow shortfall.

In summary, the FY 2009-10 rate increases are nearly equal for both options. The cumulative rate increase for Option 2 (66.8%) is somewhat greater than for Option 1 (56.5%). In both cases, the annual increases during the five-year projection period are slightly higher than the average historical increases since 2000. Both options maintain adequate net operating revenue to provide for debt service coverage and restore the Operating Reserve to its target balance.

We hope this addendum addresses the Council's concerns and directions.

Very truly yours,

HF&H CONSULTANTS, LLC

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