



City of Gilroy

STAFF REPORT

Agenda Item Title:

Presentation of the Comprehensive Water and Wastewater Utilities Rate Study; Adoption of a Resolution Commencing the Proposition 218 Noticing Process, and Setting October 16, 2023, as the Date for the Public Hearing to Adopt Water and Wastewater Rates

Meeting Date:

August 21, 2023

From:

Jimmy Forbis, City Administrator

Department:

Finance

Submitted By:

Harjot Sangha, Finance Director

Prepared By:

Harjot Sangha, Finance Director

STRATEGIC PLAN GOALS

Develop a Financially Resilient Organization
Maintain and Improve City Infrastructure

RECOMMENDATION

1. Receive report; and
2. Adopt a resolution:
 - a. declaring intent to adjust water and wastewater rates;
 - b. commencing the Proposition 218 noticing process; and
 - c. Setting October 16, 2023, as the date for the Public Hearing to adopt the new proposed water and wastewater rates.

EXECUTIVE SUMMARY

The City engaged a consultant, NBS Government Finance Group, to conduct a Comprehensive Water and Wastewater Rate Study (Rate Study) with several objectives, including meeting revenue requirements, reviewing rising costs of providing services, funding capital improvements and change in costs, and complying with specific legal requirements, such as Proposition 218 which requires that rates not exceed the cost of providing the service and be proportionate to the cost of providing service to all customers. The City's goal is to ensure both utilities maintain adequate

funding for operational and capital costs, reasonable reserves, and revenue stability in the utility rates. The Rate Study has yielded that both utilities will need to establish multi-year rate adjustments to continue investing in the critical infrastructure and keep pace with the rising operating costs. The overall rate adjustments (as a percentage) necessary for both utilities for a five-year period are as follows:

	FY24*	FY25	FY26	FY27	FY28
Water	8%	8%	6%	4%	4%
Wastewater	4%	4%	4%	4%	4%

*First-year adjustments will vary for each customer based on their customer classification, as the cost-of-service analysis has been updated to reallocate costs recovered between customer classes.

Staff recommend the City Council accept the Rate Study report, authorize the commencement of the required Proposition 218 Noticing requirements, and set October 16, 2023, as the date for the Public Hearing to adopt the new proposed water and wastewater rates. If approved, the proposed rates for FY24 will become effective on January 1, 2024, and annually on January 1 for subsequent fiscal years thereafter.

BACKGROUND

As a full-service City, Gilroy owns and operates its own water and wastewater utilities, providing services to over 15,000 customers and growing. To ensure both utilities collect revenue sufficient to meet the growing demand, keep pace with the rising operational costs, and fund the multi-year capital improvement plans, the City has conducted a utilities' rate study. The last utility rate study was completed in 2015, and the City has kept its water and wastewater rates the same since 2019.

The City's operational costs for the water utility continue to increase due to inflationary cost increases for materials/services, electricity, and continued increases in water extraction charges from Valley Water. Statewide conservation efforts enacted in recent years due to the droughts also impacted the revenues collected as the City was mandated to reduce water consumption. In 2021, the City issued wastewater revenue bonds to finance the City's share (approximately \$50 million) of the \$86 million expansion of the South County Regional Wastewater Authority (SCRWA) plant due to be complete in 2025. In addition to the annual debt payment requirements, the City's cost for the wastewater utility is also expected to increase for its share of the treatment plant expense as the expansion becomes operational and state mandates require additional compliance.

In April 2023, the City approved the updated Water and Wastewater Master Plans. The Plans assess utility systems against the desired level of service and identify infrastructure improvements needed to fix existing systems' deficiencies and service growth. The plans collectively identified over \$50.3 million in new improvements, of which \$21.7 million is for existing users (ratepayers) and \$28.6 million for future developments.

For the City to continue investing in critical utilities' infrastructure and keep pace with rising operational costs, the City needs to establish multi-year rate adjustments.

ANALYSIS

A comprehensive rate study, such as the one City initiated, typically includes three components and is intended to follow industry standards:

1. Financial Plan – compares the current sources and uses of the funds and determines the revenue needed from rates and project rate adjustments. The net revenue requirement is the amount of rate revenue required to fund operations, capital improvement (including debt service), and reserves. As current rates fall short of that net revenue requirement, rate adjustments are typically warranted.
2. Cost-of-Service Analysis – An analysis that classifies expenses and allocates costs to different customer classes in a fair and equitable manner. These classifications include commodity, capacity, and customer service-related costs.
3. Rate Design Analysis – An analysis of the rate structure which considers the relationship between fixed (personnel, debt service, etc.) and variable costs (purchased water, electricity, etc.) to be recovered. Most rate structures contain a fixed, or a minimum, charge in combination with a volumetric charge. Ideally, utilities should recover all their fixed costs from fixed charges and all their variable costs from volumetric charges.

The Rate Study is attached to this staff report. The below sections highlight notable changes within respective utilities and the recommended rate adjustments for the next five-year period.

Water Utility and Rates

Financial Plan

- The Rate Study determined that the projected net revenue requirements for the water system range annually from \$15.9 million in Fiscal Year 2023-24 (FY24) to \$18.8 million in FY28. Without rate adjustments, the water utility is projected to have a gap in the net revenue requirement of approximately \$2.0 million in FY24, increasing to \$3.9 million by FY28.
- Reserves:
 - The operating reserve is recommended to equal six months of operating and maintenance expenses, which is approximately \$8.2 million in FY24. An operating reserve is intended to promote financial viability in the event of any short-term fluctuation in revenues and/or expenditures, such as those caused by weather patterns and variability in demand-based revenues (volumetric charges).
 - The capital rehabilitation/replacement reserve is recommended to be equal to 50% of the average annual capital improvement costs over the five-year period. The five-year average is approximately \$8.2 million, with

the recommended annual reserve being approximately \$4.1 million. This reserve is intended to be a cash resource set aside to address long-term capital system replacement and rehabilitation needs.

- The water utility is projected to meet the total recommended operating and capital reserve target during the five-year period, FY24 through FY28.
- Capital improvement Projects: The water system has approximately \$41 million in planned capital expenditures over the next five years, an average of \$8.2 million annually. The City has accumulated fund balances programmed to be utilized for the capital improvement program. The Rate Study assumes the City will need to issue approximately \$16 million in revenue bonds in the latter years of the five-year period. However, whether the new debt will be required will depend on the actual delivery of capital projects (i.e., the timing and costs) in the current budget cycle.

Cost-of-Service and Rate Design Analysis

- The City currently charges residential and non-residential customers a monthly fixed water charge, also known as a base charge, based on meter size. In addition to a fixed monthly charge, all customers pay a variable charge, also known as volumetric rate, per 1,000 gallons consumed, consisting of two rate tiers of consumption (under and above 30,000 gallons) and three different pump pressure zones.
- The City's current rates collect revenue in proportions of approximately 30% fixed and 70% variable. The cost-of-service analysis determined the actual cost distribution of the fixed and variable costs to approximately 40% fixed and 60% variable. The current rate design is not reflective of the actual cost distribution; thus, a change in the water utility rate structure is recommended to align with the actual distribution. For comparison purposes, the Rate Study also evaluated the current rate structure (30%/70%), and it is presented as an alternative 2 in the study.
- The City's current variable (volumetric) charge consists of two rate tiers of consumption (under and above 30,000 gallons) and three different pump pressure zones. Given that the City receives its water supply from a single source, it is recommended that the City transition to a uniform tier for all customers.

Water Rate Adjustments

The table below outlines the current and proposed water rates for FY24 through FY28.

It is important to note that since the last rate study in 2015, factors such as the number of meters and consumption of each customer class have changed. The cost-of-service analysis rebalances the allocation based on these factors, including the shift to 40% fixed and 60% variable proportions. As a result, there is an uneven adjustment in the first year. In subsequent years, the proposed charges are adjusted by the proposed percentage increases in total rate revenue needed for the net revenue requirement.

Presentation of the Comprehensive Water and Wastewater Utilities Rate Study; Adoption of a Resolution Commencing the Proposition 218 Noticing Process, and Setting October 16, 2023, as the Date for the Public Hearing to Adopt Water and Wastewater Rates

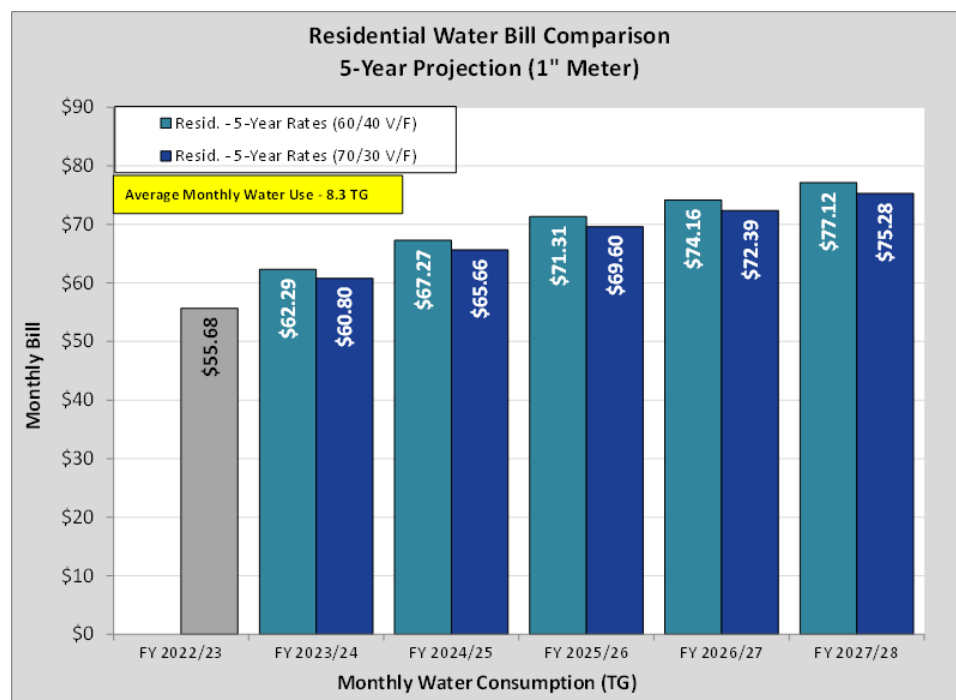
Water Rate Schedule	Current Rates	Proposed Rates				
		FY 2023/24	FY 2024/25	FY 2025/26	FY 2026/27	FY 2027/28
Monthly Fixed Service Charges						
Meter Size						
3/4 inch	\$11.53	\$20.67	\$22.32	\$23.66	\$24.61	\$25.59
1 inch	\$19.24	\$29.05	\$31.38	\$33.26	\$34.59	\$35.98
1 1/2 inch	\$38.47	\$50.02	\$54.02	\$57.26	\$59.55	\$61.93
2 inch	\$61.55	\$75.17	\$81.18	\$86.05	\$89.50	\$93.08
3 inch	\$115.39	\$142.24	\$153.62	\$162.84	\$169.36	\$176.13
4 inch	\$192.30	\$217.70	\$235.12	\$249.23	\$259.20	\$269.57
6 inch	\$384.62	\$427.32	\$461.50	\$489.19	\$508.76	\$529.11
8 inch	\$615.37	\$678.85	\$733.16	\$777.15	\$808.23	\$840.56
10 inch	\$884.50	\$1,768.83	\$1,910.34	\$2,024.96	\$2,105.95	\$2,190.19
Variable Charges for All Water Consumed (\$/1,000 gallons (or TG))						
Residential Customers - Tiered Volumetric Rates		Uniform Vol. Rates				
Tier 1 - Zone 1	\$4.39	\$4.00	\$4.32	\$4.58	\$4.77	\$4.96
Tier 1 - Zone 2	\$4.93	\$4.37	\$4.72	\$5.00	\$5.20	\$5.41
Tier 1 - Zone 3	\$5.52	\$4.73	\$5.11	\$5.41	\$5.63	\$5.85
Tier 2 (more than 20 TG)						
Tier 2 - Zone 1	\$4.93	N.A.	N.A.	N.A.	N.A.	N.A.
Tier 2 - Zone 2	\$5.47	N.A.	N.A.	N.A.	N.A.	N.A.
Tier 2 - Zone 3	\$6.06	N.A.	N.A.	N.A.	N.A.	N.A.

Note: The proposed rates for FY23/24 will be implemented on January 1, 2024, and annually on January 1 for subsequent fiscal years thereafter

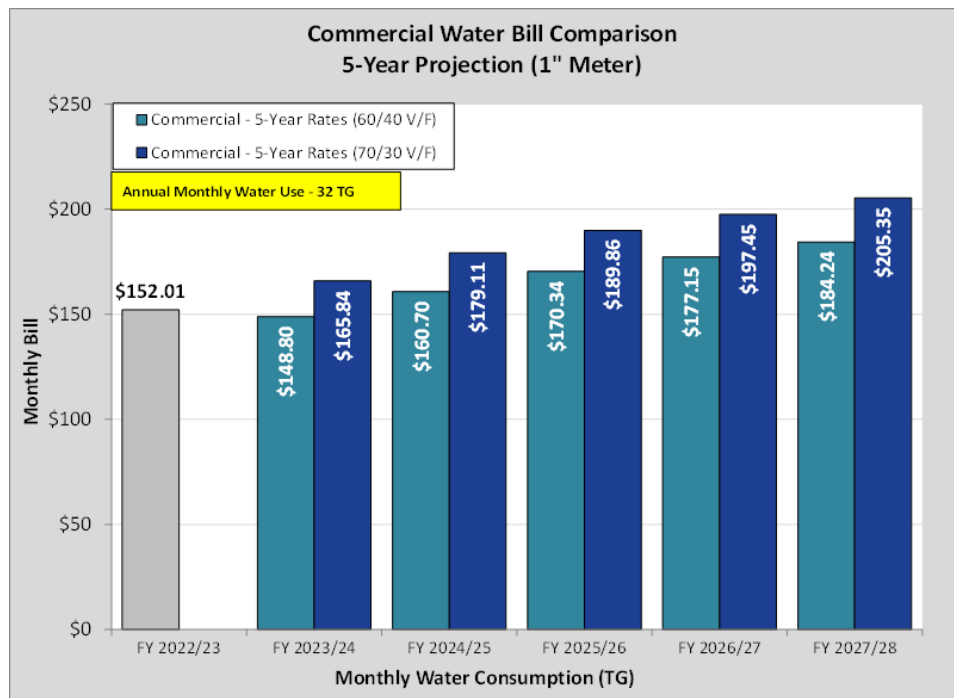
Impact on Water Bills

The Rate Study also compares the current and proposed water rates on the customer bills. The following two charts illustrate a five-year comparison of the average monthly water bill impact for a single-family residential and commercial customer.

Based on an average of 8,300 gallons monthly consumption for single-family residential, the water bill will increase from the current \$55.68/month to \$62.29/month in the first year and \$77.12/month by FY28.



Based on an average of 32,000 gallons of monthly consumption for commercial customers, the water bill will decrease from the current \$152.01/month to \$148.80/month in the first year and subsequently increase annually to \$184.24/month by FY28. The change in the first year is attributed to the shift in rate design to align with the actual 60% fixed and 40% variable distribution.



Wastewater Utility and Rates

Financial Plan

- The Rate Study determined that the projected net revenue requirements for the wastewater system range annually from \$13.1 million in Fiscal Year 2023-24 (FY24) to \$17.1 million in FY28. Without rate adjustments, the wastewater utility is projected to have a gap in the net revenue requirement of approximately \$0.3 million in FY24, increasing to \$2.7 million by FY28, and would struggle to meet its debt service coverage requirements on the existing 2021A sewer revenue bonds.
- Reserves:
 - The operating reserve is recommended to equal six months of operating and maintenance expenses, which is approximately \$6.8 million in FY24. An operating reserve is intended to promote financial viability in the event of any short-term fluctuation in revenues and/or expenditures, such as those caused by weather patterns and variability in demand-based revenues (volumetric charges) or costs of wastewater treatment.
 - The capital rehabilitation/replacement reserve is recommended to be equal to 50% of the average annual capital improvement costs over the five-year period. The five-year average is approximately \$8.8 million, with

the recommended annual reserve being approximately \$4.4 million. This reserve is intended to be a cash resource set aside to address long-term capital system replacement and rehabilitation needs.

- The wastewater utility is projected to meet the total recommended operating and capital reserve target during the five-year period, FY24 through FY28, as well as the debt service coverage ratio required by the 2021A bond covenants.
- Capital improvement Projects: The wastewater system has an average of \$8.8 million annually in planned capital expenditures over the next five years. The City has accumulated fund balances and bond proceeds (SCRWA Expansion Project) that are programmed to be utilized for the capital improvement program. Thus, the rate increases required for the wastewater utility are less than those needed for the water utility.

Cost-of-Service and Rate Design Analysis

- Currently, the wastewater utility's residential customers are charged a fixed monthly charge, and non-residential customers are charged a fixed monthly charge and a volumetric charge. The non-residential fixed monthly charge is based on City's wastewater monitoring and pretreatment program costs and is determined by the use of the facility. Similarly, the non-residential variable charge is based on the strength category (low to high), also determined by the use of the facility, which takes into account the biochemical oxygen demand (BOD) and total suspended solids (TSS) in accordance with industry standards.
 - Low Strength (example: offices, schools, retail, and department stores)
 - Domestic Strength (example: hotel/motel, auto dealers, service stations, and beauty shops)
 - Medium Strength (example: commercial laundries, multi-use facilities, and hotels with restaurants)
 - High Strength (example: food processors/manufacturers, restaurants, grocery stores, etc.)
- It is recommended that the wastewater utility maintain the existing rate design, which utilizes the wastewater strengths for various customer types based on State Water Resources Control Boards' guidelines, and it provides consistency and continuity for the customers.

Wastewater Rate Adjustments

The table below outlines the current and proposed wastewater rates for FY24 through FY28. Like the water rates, the first year's rates reflect the cost-of-service adjustments that occur based on changes in customer classes, consumption, and other factors. The projected rates for subsequent years are adjusted by the proposed 4% annual increases.

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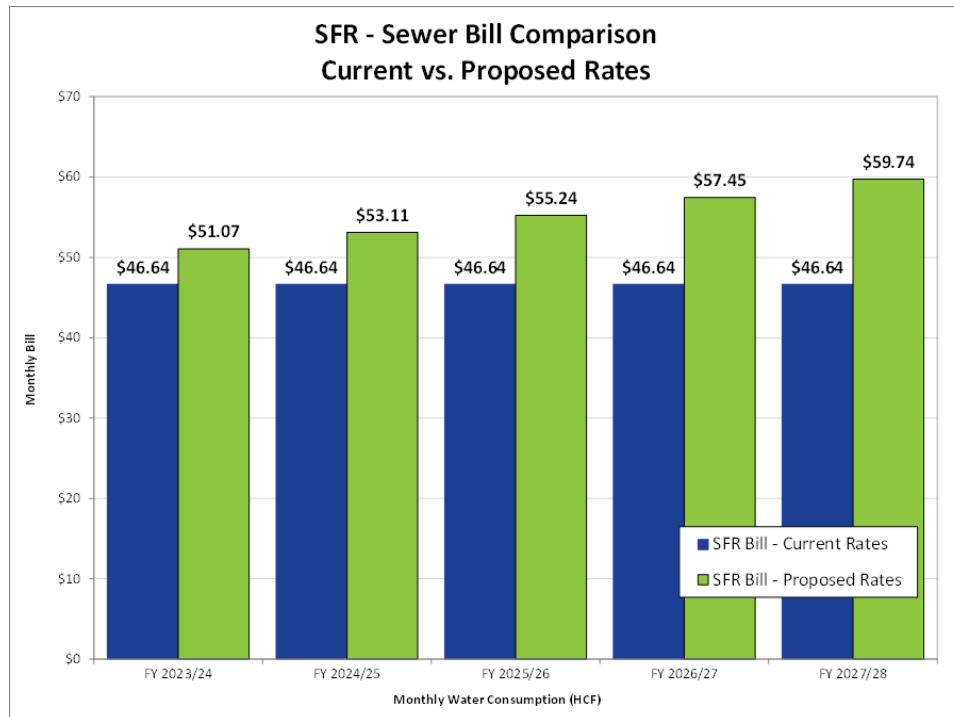
Sewer Rate Schedule	Current Rates	Proposed Sewer Rates				
		FY 2023/24	FY 2024/25	FY 2025/26	FY 2026/27	FY 2027/28
Monthly Fixed Charge						
Residential (100% Fixed)						
Single-Family Residence	\$46.64	\$51.07	\$53.11	\$55.24	\$57.45	\$59.74
Multi-Family Residence	\$33.13	\$34.39	\$35.77	\$37.20	\$38.69	\$40.23
Non-Residential Volumetric Rates						
Low Strength	\$7.41	\$8.36	\$8.69	\$9.04	\$9.40	\$9.78
Domestic Strength	\$9.21	\$9.51	\$9.89	\$10.29	\$10.70	\$11.12
Medium Strength	\$12.08	\$13.15	\$13.67	\$14.22	\$14.79	\$15.38
High Strength	\$18.63	\$21.56	\$22.42	\$23.32	\$24.25	\$25.22
Non-Residential - Monitoring & Pretreatment Program Base Rate Monthly Charges						
Significant/Categorical	\$240.95	\$287.19	\$298.68	\$310.63	\$323.05	\$335.98
Non-Significant/Categorical	\$95.22	\$114.64	\$119.22	\$123.99	\$128.95	\$134.11
Other Non-Residential	\$11.47	\$15.47	\$16.09	\$16.73	\$17.40	\$18.09

Note: The proposed rates for FY23/24 will be implemented on January 1, 2024, and annually on January 1 for subsequent fiscal years thereafter

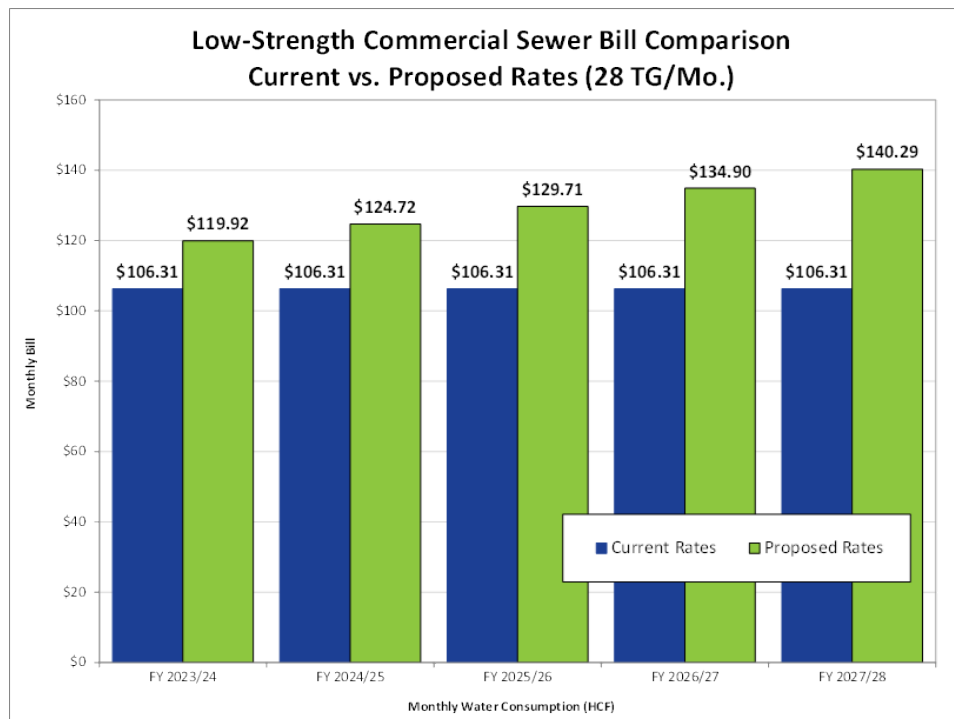
Impact on Wastewater Bills

The Rate Study compares the current and proposed wastewater rates on the customer bills. The following two charts illustrate a five-year comparison of the average monthly wastewater bill impact for a single-family residential and commercial customer.

For single-family residential, the average monthly will increase from the current \$46.64/month to \$51.07/month in the first year and increase to \$59.74/month by FY28.



For non-residential customers, the average monthly will increase from the current \$106.31/month to \$119.92/month in the first year and increase to \$140.29/month by FY28. Bill comparisons for other strength categories are included in the Rate Study.



Next Steps

In order to implement the fee adjustments, the City is required to follow Proposition 218 majority protest proceedings. Proposition 218 requires specific procedures to be followed with regard to property-related fee increases. The California Constitution requires local governments to give mailed notice of any property-related proposed fee changes at least 45 days before holding a public hearing where the City Council may adopt or reject the changes. Those opposed to the proposed rate adjustments can submit written protests to the City. If a majority (50% plus one) of customers oppose the proposed rate adjustments, City Council cannot implement the proposed increases.

This process includes the following steps:

- Schedule a public hearing requiring 45 days' of mailed public notice to adopt the rate adjustments. Draft of the 45-day Proposition 218 Public Notice is included as attachment 3.
- Mail the Public Notice describing the proposed rate adjustments to all property owners and occupants subject to the rate adjustments.
- During the 45 days following the Public Notice, the City will accept any eligible written protests from property owners and occupants subject to the rate adjustments (protests can be received until the end of the public hearing).
- Only one rate protest per property will be counted. For example, if the property owner and their tenant file a protest, only one will be counted for that property.

Presentation of the Comprehensive Water and Wastewater Utilities Rate Study; Adoption of a Resolution Commencing the Proposition 218 Noticing Process, and Setting October 16, 2023, as the Date for the Public Hearing to Adopt Water and Wastewater Rates

- After the public hearing, and assuming a majority of protests (50% plus one) is not received, conduct a vote of the City Council to adopt the rate adjustments.
- The proposed rate adjustments will become effective on January 1, 2024, after the public hearing and annually on January 1 of each subsequent fiscal year through FY28.

Staff recommends the City Council adopt a resolution (attachment 2) declaring intent to adjust the water and wastewater rates, authorizing the staff to commence the Proposition 218 noticing process, and setting October 16, 2023, as the date of the public hearing where Council will consider adoption of the rates.

ALTERNATIVES

Council could elect not to adopt the resolution of intent to adjust the water and wastewater rates. This is not recommended as the water and wastewater utility rates have not been adjusted since 2019, and it is vital for the City to continue investing in critical utilities' infrastructure and keep pace with rising operational costs.

FISCAL IMPACT/FUNDING SOURCE

The fiscal and resource impact of preparing the report is included in the staff's annual workplan. The total cost for the comprehensive water and wastewater rate study is \$72,325, which was budgeted and funded by the Water (705) and Wastewater (700) Funds.

The cost of printing/mailing the Proposition 218 notices is estimated at \$15,000 and will be funded by the Water and Wastewater Funds.

If the Proposition 218 process concludes without the majority protest, and the water and wastewater rates are adopted as presented, the new rates would generate an average of \$2.7 million annually for the water utility and an average of \$1.8 million for the wastewater utility, over the next five-year period.

PUBLIC OUTREACH

Each property owner will receive a mailed Proposition 218 public hearing notice. In addition, the notice will also be included with the monthly utility bills for the September statements to notify all current customers. Staff will also conduct a community meeting in September 2023, a date to be determined, to present the Rate Study.

Attachments:

1. Utilities Rate Study
2. Draft Resolution
3. Draft Proposition 218 Notice