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Memorandum 20-182

TO: City Council

THROUGH: Rob Dumouchel, City Manager

FROM: Jan Keiser, PE, JD, Director of Public Works

DATE: October 16, 2020

SUBJECT: History of Water/Sewer Rates

I. Issue: The City adopts a new water/sewer rate on an annual basis. It is time to adopt the rate for 2021. The Rate Model is a complex equation that considers multiple, intertwining factors, each of which come with their own policy questions and issues. One of these factors involves the policy relating to the Water and Sewer Reserve Funds. This factor raises numerous complex questions: How much money should the City keep in its Reserve Funds? How should the Reserves be funded? How should money in the Reserves be spent? And, that's just the start! The purpose of this memorandum is to unpack the Rate Model process into smaller units so it can be digested more easily.

II. Background:

A. The 2013 Water& Sewer Rate Task Force. The current rate model was developed by Water & Sewer Rate Task Force that was created by the City Council in 2013. (See Resolution 12 - 027(A).) The Task Force consisted of five Homer residents, including Ken Castner, and two City Council Members. The Task Force was formed after the 2012 rate increase triggered numerous public comments and complaints. One of the primary complaints was that the rate structure was unfair.

One of the Task Force's primary policies was that rates should *"accurately reflect the cost of customer billing, banking and accounting".* Another was that *"system maintenance and treatment expenses should be billed in accordance with customers' actual usage"*. The Task Force noted that *"Homer has some unique characteristics that increase the cost of; operations and maintenance"*. One key characteristic is the nature of Homer's water source; turning surface water into clear, potable water requires sophisticated treatment. Another key characteristic is geography. There is a big elevation difference between Homer's water source and its customers in town. This requires the water system to use pressure reducing stations to manage the pressure differences. On the other hand, the in-town area is relatively

flat, requiring the sewer system to rely on sewer lift stations to move sewage from customers to the sewage treatment plant. All this mechanical equipment is expensive to install, operate and maintain. Further, the Task Force noted "the water delivery system has been sized to provide adequate flows and pressure for fire sprinkler flow and hydrants, making the water distribution pipes and other appurtenances larger than they would need to be for domestic water service only.

The Task Force met twice a month for over 10 months. They extensively researched industry guidelines, rates from other communities, previous consultant-authored rate studies for Homer, and other documentation in their quest for information and best practices. They relied strongly in the recommendations of the American Water Works Association Manual, M54, Developing Rates for Small Systems. The Task Force also studied Homer's costs of administration and water/sewer service. It found that 80% of the combined water/sewer budgets were related to providing water/sewer service and the other 20% was the allocated cost of administrative service. The Task Force developed a rate model, which they believed would not *"resolve all the complaints regarding fairness regarding the allocation of expenses…but…the concerns identified…through the public comment have been appropriately addressed…"*

The Task Force made the following key recommendations that the City:

- Continue to periodically review the allocation of administrative and other overhead expenses to ensure they properly reflect the actual expenses being charged to water/sewer.
- Clearly delineate water/ sewer rates applied to all City facilities, in budget documents.
- Renew the contract with Kachemak City and ensure the rates adequately reflect the cost of this area on the system as a whole, including any added administrative costs.
- Conduct rate-setting in a manner that will not allow political influences to result in the collection of future rates.

There was no discussion about capital costs or reserves in the Task Force's 2013 Final Report. Mayor Castner remembers this is because the HAWSP Fund had been created by that time and the understanding was that capital costs would be covered by the HAWSP Fund.

The water rate recommended was $0.0111 per gallon for water and $0.013 per gallon for non-lift station sewer service, with a service fee of $18. The City Council adopted substantially similar rates in Resolution 13-048(S-2)(A-3).

B. Modifications to the Water/Sewer Rate Model

When the time came to develop the rate structure in 2018, Finance Director Elizabeth Walton used the Water/Sewer Rate Model. This was the first time she had the opportunity to do so, since no rate changes had been made in 2017. Ms. Walton noted the Model had been modified since 2013. She described her observations in a memo, dated July 18, 2018, in which she said, *"The format of the rate model has changed from the one the Water and Sewer Task Force generated, but the basic principles and assumptions remain the same. These changes [appear to have been] made to more accurately reflect the City's budget structure".* Among the changes made over the years, was the introduction of an accumulating reserve

built from a line item in the Model equal to *"15% of the total revenue required"*. Ms. Walton noted, *"This percentage was [apparently] derived by conversations with the Water and Sewer Superintendent, our three year average transfer and by industry standard research… The infrastructure is aging and the City needs to be prepared for upcoming maintenance expenses."* The rates, using the Water/Sewer Rate Model Ms. Walton had available to her in 2018, were computed to be:

	2013	**2018**
Water service	$0.0111 per gallon	$0.0132 per gallon
Sewer, Non-lift station Service	$0.013 per gallon	$0.0145 per gallon
Service Fee	$18	$13

The 2018 rates were adopted by the City Council in Resolution 18-064, dated 8-13-18.

C. Setting rates for 2021.

It is now time to set the rates for 2021. There are some differences of opinion about what should be included in these rates. The key questions are:

1. Should we change the rate model?

2. How should the water/sewer rate setting exercise be connected to the City's Budget Process?

3. What should the relationship between the 15% Reserve element and the HAWSP Fund?

4. How should the 15% Reserve element be administered?

5. What projects should the 15% Reserve be used for?

6. Does the allocation of administration and other overhead expenses properly reflect the actual expenses being charged to water and sewer, as recommended by the 2013 Task Force?

Each one of these questions is complex. I recommend unpacking them to clarify the decisions that need to be made:

1. **Should we change the rate model?** The 2013 Task Force did all the right things when they did their work. They researched best practices, connected the rate setting exercise with the City's Budget processes, considered public comment and spent months deliberating on how to make the rate schedule fair. The Task Force's conclusions were accepted by the City Council and have been practiced, with minor modification, ever since. Any such modifications seem to have been made in the interests of updating the rate setting process with the City's changing budget processes, not in changing the basic principles established by the 2013 Task Force.

Recommendation: We should resist the opportunity to second guess the work of the Task Force. Instead, we should continue to rely on the principles and conclusions established by the 2013 Task Force and the rate setting model they created.

2. **How should the water/sewer rate setting exercise be connected to the City's Budget Process?** The rate setting exercise needs reliable input as to revenues and costs, which are developed as part of the Budget Process. Currently, the timing of the two processes is not synched, which creates some challenges.
   Recommendation:
   We recommend the timing of the two processes be better correlated so the rate setting process benefits from more reliable and current data. This involves some administrative functions, which admittedly, may create some awkward transitions at first. But, after the initial learning curve, the City will settle into a routine and the outcomes will benefit from more current data.

3. **What should the relationship between the 15% Reserve element, established by the City Council in 2018, and the HAWSP Fund?** The City Council must have felt additional capital funds, beyond HAWSP, were needed, because HAWSP had been in existence for some years before the 15% Reserve element was established.
   Recommendation: We recommend (a) the Reserve Funds be used for repairs/replacements of existing equipment/facilities that serve existing customers and (b) the HAWSP Fund be used for extensions of services for new customers or to increase system-wide capacity. These policies should be memorialized in a HAWSP Policy Manual and Reserve Fund Manual to document the strategies and processes, which govern how these funds are built and administered.

4. **How should the 15% Reserve element be administered?** Ken Castner remembers that the 15% was added as a contingency, but it was not intended to create an ever-increasing savings account. Indeed, the City needs a healthy reserve, but I agreed with Mayor Castner. The level of our Reserves needs to be reasonable and based on demonstrated needs.
   Recommendation: We recommend using the Reserve Funds to keep the utility systems in a state of good repair for existing customers, using tools such as an Asset Management Plan to guide repairs/replacements of facilities and equipment. This policy should be memorialized in a Reserve Fund Manual to document the strategies and processes, which govern how the Reserves are built and administered.

5. **What projects should the 15% Reserve be used for?**
   We have drafted a Water Capital Improvement Plan, a Sewer Capital Improvement Plan and an Asset Management Plan. The combination of these tools allows us to assess the utility systems' needs for repairs/replacements/expansions as part of the Budget Cycle. We can use the data to identify our needs and adjust the Reserve element accordingly. For the 2021 rate year, I feel comfortable reducing the Reserve element.

Recommendation: We continue to develop the tools we have started and use them to help govern the water/sewer systems' business. In the meantime, we can reduce the Reserve element from 15% to 10%, for the 2021 rates.

6. **Does the allocation of administration and other overhead expenses properly reflect the actual expenses being charged to water and sewer, as recommended by the 2013 Task Force?** The water/sewer rates currently include a $13 per month Service Fee. Yet, allocations are also made from the Water/Sewer Funds to the General Fund to compensate the General Fund for costs of administration and overhead related to the administration of the water/sewer accounts. Is this double dipping? We need more data to address this question.
   Recommendation: We analyze administrative costs, which are allocated from the water/sewer accounts to the General Fund, to make sure the water/sewer accounts are paying their proper share, and no more.