OTAY WATER DISTRICT

SPECIAL MEETING OF THE BOARD OF DIRECTORS
DISTRICT BOARDROOM

2554 SWEETWATER SPRINGS BOULEVARD
SPRING VALLEY, CALIFORNIA

WEDNESDAY
November 18, 2015
3:30 P.M.

AGENDA

1. ROLL CALL

2. PLEDGE OF ALLEGIANCE

3. APPROVAL OF AGENDA

4. PUBLIC PARTICIPATION – OPPORTUNITY FOR MEMBERS OF THE PUBLIC TO SPEAK TO THE BOARD ON ANY SUBJECT MATTER WITHIN THE BOARD'S JURISDICTION BUT NOT AN ITEM ON TODAY'S AGENDA

WORKSHOP

5. DISCUSSION OF CONSERVATION'S IMPACT ON REVENUES AND THE CITY OF SAN DIEGO'S PROPOSED RECYCLED WATER RATE INCREASE; PRESENTATION OF A NUMBER OF FINANCIAL CONSIDERATIONS WITH REGARD TO THE CURRENT BUDGET IMPACT AND FUTURE RATE INCREASES; AND A REQUEST FOR BOARD CONSIDERATION AND DIRECTION (BEACHEM)

6. ADJOURNMENT

All items appearing on this agenda, whether or not expressly listed for action, may be deliberated and may be subject to action by the Board.

The Agenda, and any attachments containing written information, are available at the District's website at www.otaywater.gov. Written changes to any items to be considered at the open meeting, or to any attachments, will be posted on the District's website. Copies of the Agenda and all attachments are also available through the District Secretary by contacting her at (619) 670-2280.

If you have any disability which would require accommodation in order to enable you to participate in this meeting, please call the District Secretary at 670-2280 at least 24 hours prior to the meeting.

Certification of Posting

I certify that on November 13, 2015, I posted a copy of the foregoing agenda near the regular meeting place of the Board of Directors of Otay Water District, said time being at least 24 hours in advance of the special meeting of the Board of Directors (Government Code Section §54954.2).

Executed at Spring Valley, California on November 13, 2015.

/s/ Susan Cruz, District Secretary

AGENDA ITEM 5

STAFF REPORT

TYPE MEETING:	Special Board	MEETING DATE:	November 18, 2015
SUBMITTED BY:	Rita Bell, Finance Manager Kevin Koeppen, Finance Manager Andrea Carey, Customer Service Manager	PROJECT:	Various DIV. NO. ALL
APPROVED BY:	☒ Joseph R. Beachem, Chief Financial Officer ☒ German Alvarez, Asst. General Manager ☒ Mark Watton, General Manager		
SUBJECT:	Due to Conservation's Impact on Revenues and the City of San Diego's Proposed Recycled Water Rate Increase, Staff is Presenting to the Board a Number of Financial Considerations with Regard to the Current Budget Impact and Future Rate Increases. Staff is Seeking Board Consideration and Direction.		

GENERAL MANAGER'S RECOMMENDATION:

Due to conservation's impact on revenues and the City of San Diego's proposed recycled water rate increase, staff is presenting a number of financial considerations with regard to current budget impact and future rate increases. Staff is seeking Board consideration and direction.

COMMITTEE ACTION:

See Attachment A.

PURPOSE:

To update the Board on the financial impact of both conservation and the City of San Diego's recycled water rate increase. Conservation is projected to reduce net water revenues for this fiscal year by $1.55 million from the budgeted levels.

The City of San Diego has proposed a unitary recycled water rate increase which will cause an addition unanticipated water cost of $740,000 in this fiscal year and $1.9 million in the following years.

Staff is working very diligently to have the City of San Diego consider and implement a zone rate for recycled water. Staff has reviewed financial information from the City, has met with numerous community leaders, and has also met with many City staff and officials.

On November 17, 2015, the City of San Diego Council will vote on this issue. A vote for unitary recycled water rates will have a substantial impact on this year's budget as the rates are proposed to increase on January 1, 2016. A vote for zone rates will also produce a negative budget impact; however, not as substantial.

Staff provides this information to the Board and looks to discuss with the Board possible directions to protect the District's finances and credit rating.

ANALYSIS:

A State mandated water conservation target of 20% is in effect, and Otay's customers have achieved an even greater monthly water savings percentage. With this savings, water sales have significantly decreased. Each 1% of conservation brings the District's net revenues down by $136,000. This, along with the City of San Diego's proposed water rate increase, places the District in a difficult financial position where it might not have sufficient net revenues to meet its bond covenants. The Board can react using many options, a few are discussed below:

1) Using only the savings staff has identified below and without an additional rate increase this year the District is able to mitigate much of the financial impact. No additional rate increase is certainly one strategy; however, this delays the necessary increase and heightens the impact on rates in January 2017. This, however, leaves the District with a strong possibility of violating the commitment to meet the debt coverage ratio.

    a. If the City selects zone rates, and no increases in expected conservation or expenses occur, then the District is within $150,000 of violating the bond covenants. This is a narrow margin and would require ongoing monitoring to insure that a violation of the bond covenant does not occur. The recommended rate increase in 2017 would be approximately 10.0%.

    b. If the City selects a unitary rate, the District's net revenues will be $290,000 below the point of violating the bond covenant. Additional savings would need to be identified to avoid violation of the bond covenant. The proposed rate increase in 2017 would be approximately 11.7%.

c. Options 1a and 1b reflect the entire impact of conservation and the City of SD recycled cost increase in 2017. If the District were to spread the rate impact between 2017 and 2018, then the 2017 fiscal year only has low to moderate protection from violating the District's bond covenants. Extending this risk for another year.

2) Raise rates in March of 2016 solely to cover the City's rate increase. Under both the following options the 2017 rate increase would be held down to approximately 7.0%.

   a. If the City selects a zone rate, an additional rate increase of 1.2% would be needed this year. The District's net revenues would be at $420,000 above the minimum needed to maintain debt coverage, a fairly narrow margin.

   b. If the City selects a unitary rate, an additional rate increase of 2.8% would be needed this year. The District's net revenues would be $500,000 above the minimum to maintain debt coverage, again a fairly narrow margin.

   c. Options 2a and 2b do not bring the District's protection from violating debt coverage to the level that was budgeted. By implementing a 4.1% increase, this would reduce the impact on 2017 rates bringing them down to a projected 4.4% if the City selects zone rates and 5.4% if the City selects unitary rates.

3) If the City defers the proposed rate increase to July 2017, the District is still under significant financial stress in 2016 due to the unanticipated levels of conservation. Rate increases could be implemented in March 2016 to offset the effects of conservation. Staff remains confident that the budgeted level of debt coverage will keep the District on sound financial footing with the proposed future increases.

   a. A March 1, 2016 rate increase of 2.3% would return the District to the budgeted debt coverage levels, including and excluding growth, of 142% and 123%, respectively. The District's 150% target debt coverage level excluding growth will be achieved in 2018.

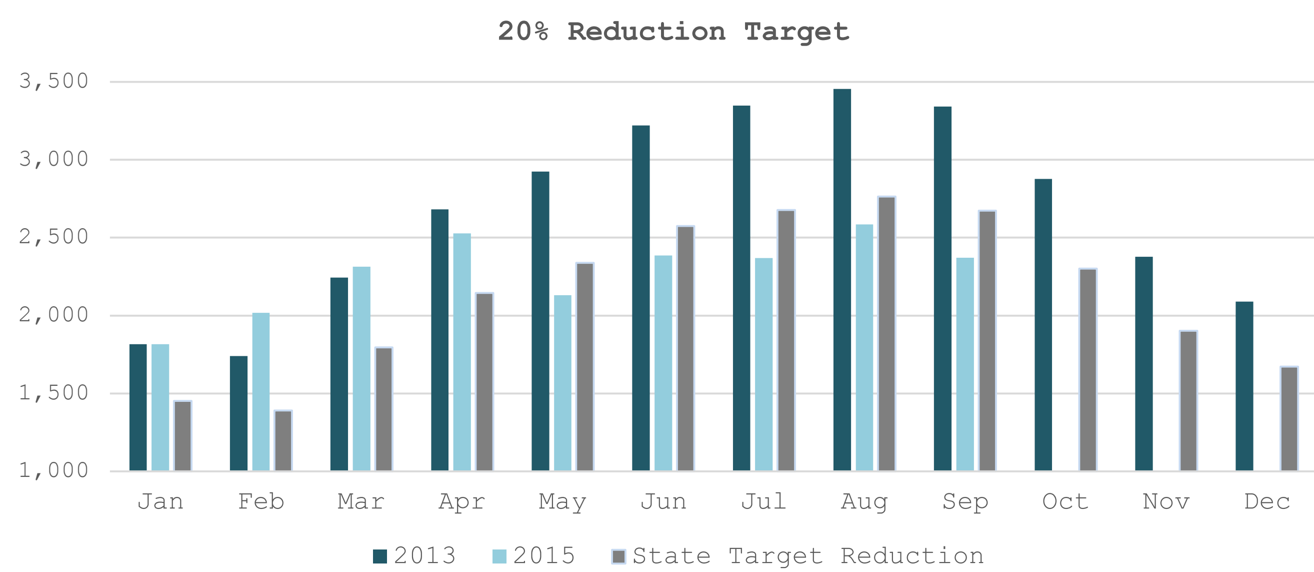
   b. A March 1, 2016 rate increase of 4.4% would return the District to the budgeted debt coverage levels, including and excluding growth, of 146% and 128%, respectively. The District's 150% target debt coverage level excluding growth will be achieved in 2018.

Conservation Financial Impact on the District's Debt Coverage Ratio

Currently, staff's projections indicate that the actual conservation levels will exceed the budgeted conservation levels. As a result, the lower than budgeted potable water sales revenue adds significant pressure to the District's ability to meet debt coverage covenants.

In the FY 2016 budget process, a 12% conservation percentage off the FY 2013 volumes was used. This would allow the District to bear a 17.2% conservation level before the debt coverage ratio was compromised. Staff has projected that potable water sales will have a conservation level of 25.7% at year-end and 5% conservation for recycled water sales. These conservation levels are in terms of reductions from the 2013 levels.

The chart below compares the monthly actual potable water usage from 2013, 2015, and the 20% state target level. The District's customers have consistently outperformed the target from May through September. To meet the 20% state target through February, when the order expires, the District would only need to conserve 14% per month going forward.



	May	June	July	August	September	October
Target	20%	20%	20%	20%	20%	20%
Actual	27%	26%	29%	25%	29%	22%
Budget	-	-	12%	12%	12%	12%

Impact of Failing to Meet the Debt Coverage Ratio Covenants

In the event that the District violates the coverage requirements, it will be placed on credit watch by the rating agencies and will be subject to 90-day reviews. Any action taken by the rating agencies would be dependent on the actions the District takes to bring itself back into compliance. If the District continues to violate the coverage compliance in consecutive years, the District can expect to have its credit rating downgraded. Also, the bond holders can force the District to hire a rate consultant to oversee the budget and rate setting process.

There are no legal requirements to disclose a debt coverage ratio violation early; however, it is recommended to keep communications open with the rating agencies so that they are aware of the District's financial position. It is advisable that the District be proactive and reports any violation to rating agencies prior to the annual review, the District will then be required to update the status on a regular basis. If the District is proactive in reporting the violation, our financial advisor, Suzanne Harrell, recommends that the District file a notification upon completion of the FY 2017 budget process, during which time the District should perform a preliminary debt coverage forecast for FY 2016.

Debt Restructuring

Staff has reviewed all options of debt restructuring with the District's financial advisor. Only one option has the ability to lower the rate impact in the current fiscal year. However, this option has such an overall narrow cost savings. It is not advisable nor does it comply with the District's Debt Policy. Staff examined the following options to reduce the District's debt service funding:

- Debt Retirement – Retiring debt would bring the District's reserves below the minimum recommended levels, which would require the District to increase rates or issue additional debt.
- Refinancing Variable Rate COPS – The refinancing of the variable rate COPS would result in no rate savings in FY 2016. The current variable rate interest environment results in this debt being extremely cost effective. As a result, refinancing the debt would likely increase the District's future debt service requirements, negatively impacting rates.
- Refinancing $35MM of Outstanding 2007 COPS – An advanced refunding of the 2007 COPS would reduce the FY 2016 debt service by $729,000 and has a projected net present value debt savings of 1.76% ($605,000). The Debt Policy requires a beginning savings of at least 5% to protect the District's ability to achieve at least a 3% savings. These minimum savings levels are a standard practice of issuers intended to protect agencies from

a refinancing that become marginally cost-effective or result in a loss after the entire issuance process is complete. In this case, a 25 basis point increase in market rates would eliminate the entire savings.

- Wrap-around Debt Option – This option is used in cases where the borrower is issuing new debt and would like to smooth out the debt service requirements. The District is not projecting the need to issue debt in the next six-years and the current debt service requirements have already been smoothed.
- Short-term Borrowing – The Debt service calculation is based on debt service payments and not the funding source for debt service payments; therefore, this option does not provide a benefit to the debt-service coverage covenant.

Potable Water Rate Increase

With an additional 4.1% rate increase on top of the already approved 5.8% rate increase, the significant financial impacts of conservation and the City of San Diego's rate increase will be absorbed over two-years instead of all falling to the 2017 rate increase. The increase will also coincide more closely with the City of San Diego's rate increase.

If the City of San Diego approves a zone rate, and if there is no additional rate increase to address the added costs and reduced revenues, staff projects that one-time savings and other budget modifications will make it possible to avoid violation of the bond covenants. However, this is not sustainable and the financial impact of this would fall solely on the 2017 rate increase. The current projection of the 2017 rate increase, with a favorable zone rate, goes from the current 5.4% to 8.8%. As mentioned above, this jumps to 10.8% if the City selects the unitary rate.

Recycled Water Rate Increases

On November 17, 2015, the City of San Diego will have a Proposition 218 hearing for water rates, including increasing the recycled water rates.

The City of San Diego's own analysis for a zone rate calculates separate rates of $1.17 hcf for the South system and $2.14 hcf for the North system. A unitary rate of $1.73 hcf could also be adopted by the City which would mean that South Bay customers would pay $1.2 million annually more than what it costs to serve them, and North customers would pay $1.2 million less than what it would cost to serve them. South Bay customers would be subsidizing the North by $7.2 million over the next six-years, paying for a North system they do not use.

In the FY 2016 Rate Model, staff had no indication that the City of San Diego would raise recycled water rates. The rates the City adopts will determine the financial impact on the District.

Recycled Rate Notices and Proposition 218 Notices

The District's Proposition 218 notices completed in 2013 allow the District to pass through all water rate increases from our providers. The potential City of San Diego increase qualifies as a pass-through and therefore no additional Proposition 218 hearing is required. The District would however, be required to send a rate increase notice to all customers no less than 30-days prior to the affected usage.

Timeline for a Mid-Year Rate Increase

Should the Board make a decision to raise rates at November 18, 2015 Board Workshop, it is advised the increase would take effect on March 1, 2016. The rate increase notices would be sent to Infosend, the District's bill print vendor, for printing. The notices would then be inserted in all water customer's bills during the month of January. The new rates would be tested by staff in the months of January and February, and would then become effective March 1, 2016.

Recycled Pricing Impact on the District's Debt Coverage Ratio

Staff has analyzed both the zone rate and unitary rate scenarios and has determined the shortfall that would need to be overcome in order to achieve the obligation to keep a minimum debt coverage of 125%. The two scenarios are the zone rate at $1.17 hcf and the unitary rate at $1.73 hcf.

Below are the items that are projected to bring the District's net revenues below the minimum debt coverage ratio of 125%. These projections are as of year-end. What is not shown is an additional $1 million loss of revenues that is projected to bring the debt coverage ratio down from a budgeted 140% to a minimum of 125%.

Description	**Recycled $1.17 hcf**	**Recycled $1.73 hcf**
Impact of Conservation Efforts	$ 550,000	$ 550,000
City of San Diego Pricing	300,000	740,000
Impact of Legal/Outreach	100,000	*100,000
Total Required Savings	**$ 950,000**	**$1,390,000**

*If the unitary rate is approved by the City of San Diego, additional legal/outreach costs are likely to be incurred which will impact the 2017 rates. This cost is potentially significant.

Operational Budget Cuts and/or Deferrals

Finance staff has worked with the departments to identify budget savings and/or deferral of costs which are outlined below:

On-going reductions in costs or increases in revenues		**FY 2016**
Property Tax Collections	$	116,000
Current & Projected Vacancies		170,000
Desalination consultant		*24,000
OPEB		120,000
Conservation Efforts		**200,000
Total on-going savings	**$**	**630,000**

*This amount will increase to $48,000 in future years.
**Projected to decrease by 50% in future years.

One-time savings		**FY 2016**
Temporary Services	$	50,000
Emergency kits/emergency response supplies		75,000
Engineering Outside Services & misc. admin costs		54,000
Estimated reductions for leak detection program		195,000
Variable Debt Interest		100,000
Total one-time savings	**$**	**474,000**
Total Savings	**$**	**1,104,000**

Conclusion

Conservation has put the District and all the water districts in difficult financial positions. On top of this, Otay is being challenged with the City of San Diego's pending decision to raise recycled water rates. To meet these challenges the Board can select one of the options listed above or can consider a number of other approaches.

FISCAL IMPACT: ☒ Joe Beachem, Chief Financial Officer

Staff has identified a number of options that the Board might use to meet the current financial challenge. Each option has different financial impacts. Staff is looking for direction from the Board on how to mitigate the impact of the City of San Diego's rate increase and impact of conservation.

STRATEGIC GOAL:

Maintain the District's financial strength.

LEGAL IMPACT:

None.

Attachments:

A) Presentation

Attachment A

Fiscal Impact of

City of San Diego Rate Increase
&
Conservation

November 18, 2015

Conservation

- 26.24% Actual conservation (July-October)
- 25.7% Projected conservation
- 20.0% State mandated conservation
- 17.2% Conservation above which violates the debt coverage
- 12.0% Budgeted conservation

- $102,000 Net budget impact of 1% potable conservation
- $34,000 Net budget impact of 1% recycled conservation

City of San Diego

$0.80/unit	Current rate	
$1.17/unit	Zone rate	46.25% rate increase
$1.73/unit	Unitary rate	116.25% rate increase

Fiscal Impacts

- $1,550,000
  - Lower revenues than budgeted
  - Due to <u>conservation</u>
  - $1M is absorbed prior to violating the bond covenant
- $740,000
  - Higher expenses than budgeted
  - Due to <u>unitary rate</u> increase by City for ½ the fiscal year
  - $300,000, if the zone rate is approved
- $100,000
  - Legal and outreach costs to promote equitable rates at the City of San Diego

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$2,390,000 Total Fiscal Impact ($1,950,000, if zone rate)

Financial Context of These Changes

- The Balanced budget anticipated 12% conservation and allowed for the use of Reserves and the Lowering of the Debt Coverage to absorb this change so that Rates would not be impacted dramatically. ($4M under target levels and a 143% debt coverage.)

- $1M - Is the Fiscal Impact that can be absorbed prior to violating the Bond Covenants.

- $1.1M - Staff has identified costs that can be avoided and some revenue that is greater than anticipated.

Net Fiscal Impact (beyond what the Debt Coverage can absorb)

Unitary Rates

- -$1,390,000 Fiscal impact
  - +$630,000 On-going savings
  - +$474,000 One-time savings
- -$286,000 Net negative fiscal position below debt coverage

Zone Rates

- -$950,000 Fiscal impact
  - +$630,000 On-going savings
  - +$474,000 One-time savings
- +$154,000 Net positive fiscal position above debt coverage

Numerous other financial challenges might occur during the rest of this fiscal year. After what is shown above, which is an estimate, there is no other identified financial leeway.

Ongoing Fiscal Impact

- Conservation is expected to remain a factor into the following fiscal years.
- The City of San Diego's increase will have an ongoing impact.

- The sooner the increase is passed through, the smoother the rate impact can be on the District.
- The sooner the increase date, the more connected it is to the City's actions and the Governor's mandate.

Rate Impact of the City’s Action and Conservation

Assumes <u>no rate response this year</u>.

Assumes the City raises recycled rates.

Budgeted	2016 5.8%	2017 5.4%	2018 5.4%
One year impact*	5.8%	11.7% or 10.0%	5.4%
Smoothed impact over 2 Years*	5.8%	10.0% or 8.5%	10.0% or 8.5%

*Unitary and Zonal Rates, respectively

- Under an unitary rate the District will likely violate it’s bond covenants in 2016.
- Under a zone rate the District has very low protection against violating the bond covenants.
- Smoothing the rate impact over 2017 and 2018 gives the District low to moderate protection of violating bond covenants in 2017, increasing the possibility of a credit downgrade.

Rate Impact of the City’s Action and Conservation

<u>Assumes a rate response this year.</u>

Assumes the City raises recycled rates.

Budgeted	**2016 5.8%**	**2017 5.4%**	**2018 5.4%**
Pass-Through then smooth*	8.6% or 7.0%	7.2%	7.2%
9.9% then smooth*	9.9%	6.4% or 4.9%	6.4% or 4.9%

*Unitary and Zonal Rates, respectively

- The pass-through option gives low protection against violating the bond covenants in 2016, while the 9.9% option provides moderate protection.

Rate Impact of a Deferred City Action and Conservation

Assumes no rate response this year.

Assumes the City raises recycled rates in July of 2017.

Budgeted	2016 5.8%	2017 5.4%	2018 5.4%
One year impact*	5.8%	11.0% or 9.3%	5.4%
Smoothed impact over 2 years*	5.8%	9.2% or 8.1%	9.2% or 8.1%

*Unitary and Zonal Rates, respectively

- In 2016 the protection from violating the bond covenant in both options is low. In 2017 the protection from violating the bond covenants increases in each case to a moderate level.

Rate Impact of a Deferred City Action and Conservation

Assumes a rate response this year.

Assumes the City raises recycled rates in July of 2017.

Budgeted	2016 5.8%	2017 5.4%	2018 5.4%
Back to budget option*	8.1%	7.5% or 6.5%	7.5% or 6.5%
9.9% option*	9.9%	6.3% or 5.2%	6.3% or 5.2%

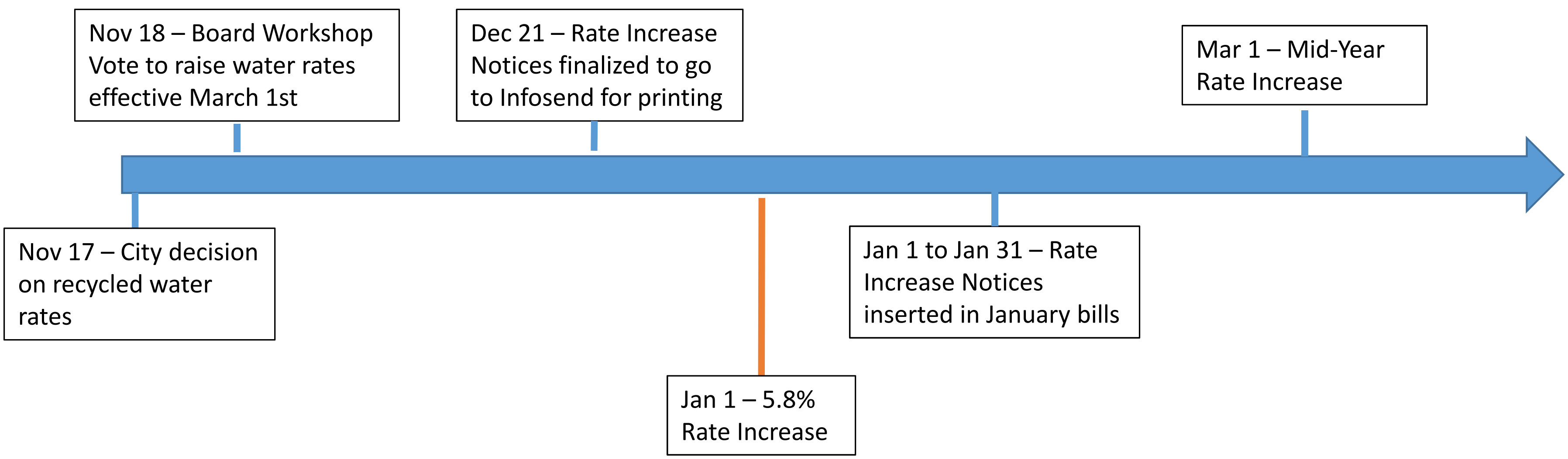
*Unitary and Zonal Rates, respectively

- In 2016 the protection from violating the bond covenant in both options is moderate. In 2017 the protection from violating the bond covenant increases in each case but does not reach the target levels until 2018.

Debt Options

- Debt Retirement
  - Results in reserve levels falling below minimum levels, which would require additional debt or additional rate increases to recover.
- Refinance Variable Rate COPS
  - No debt service savings in FY2016 and increased debt service in future years.
- Refinance the 2007 COPS
  - $729,000 FY2016 debt service savings and $605,000 (1.76%) total net present value (NPV) savings.
  - District Policy requires a minimum 5% NPV savings estimate to protect a minimum 3% NPV savings on debt refinancing. Having a NPV savings of at least 5% is a common practice by issuers.
  - Savings under the 3% NPV savings is not considered cost effective as it does not give enough financial cushion to complete the refinancing. In this case, a 25 basis point increase in market rates would eliminate the entire savings.
  - No long-term rate benefit.
- Wrap-around Debt
  - Option in cases where new debt is being issued and the issuer wishes to smooth out debt payment.
  - Otay is not projecting to issue new debt and the District's current debt service has been smoothed out.
- Short-term Borrowing
  - Debt service calculation is based on debt service payments and not the funding source for debt service; therefore, this option does not provide a benefit to the debt-service coverage calculation.

Timeline for Mid-Year Rate Increase



Questions?