



May 5, 2016

**TO:** LOCSO Board of Directors

**FROM:** Peter J. Kampa, Interim General Manager

**SUBJECT:** Agenda Item 12C – 5/05/2016 Board Meeting

Consideration of Water Shortage Emergency (Water) Rates and Declaring a Stage IV Critical Water Supply Emergency [Recommend discussion and direction to staff]

**STAFF RECOMMENDATION:**

This item is intended for Board discussion, understanding and direction as it relates to the revenue needs of the District and rates previously adopted by the Board.

**DISCUSSION:**

The purpose of this discussion is to detail for the Board of Directors the facts related to the District's revenue shortfall caused by a larger than expected decline in water sales. The District's most recent Financial Plan and Water Rate Study (referred to herein as Study) was completed in December 2014 and accepted by the Board after extensive public and committee review and input. The purpose of the Study was to consider the District's financial needs in the short and mid-term for the operation of its water enterprise and completion of necessary capital improvements. The narrative Financial Projections section of the Study is included herein as Attachment 1.

A public hearing was held to receive comments and protests against the increased water rates proposed in the Study and, lacking a majority protest, the increased rates were adopted by the Board in Resolution 2015-02, included as Attachment 2 herein. These increased rates have been implemented for the 2015/16 fiscal year, and are scheduled for the second increase to take effect on July 1, 2016.

The Study was designed to ensure that the District's revenue was high enough to meet operating costs, increases in costs and major capital projects as detailed in various memoranda to the Board from the District Engineer. The increased rates proposed in the Study would knowing result in an unknown decrease in customer water consumption. The ongoing drought and the District's adoption of a Water Supply Contingency Plan (with violation penalties and restrictions) would obviously further reduce water sales in addition to any rate impact.

To account for the variability in revenue caused by customer water demand changes, the Study contained a revenue recovery component titled Emergency Shortage Rate Structure, intended to be implemented in the event that water sales continued to decline further than estimated. Attachment 3 hereto contains the Study section related to Emergency Shortage Rate adoption.

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The Study described a number of actions required of the District to further define the implementation triggers and timing associated with implementation of the Emergency Shortage Rates. To date, the District has not developed the specific triggers for implementation of the Emergency Rates, nor has it implemented any component of the Emergency rates. The severe shortfall on the District's revenue, when compared to the revenue projections in the Plan, would appear to justify the implementation of the Emergency Shortage Rates; as summarized below:

	STUDY	ACTUAL	VARIANCE
FY 2014-15	\$ 1,850,000	\$ 1,691,402	\$ (158,598)
FY 2015-16	\$ 2,072,000	\$ 1,687,529	\$ (384,471)
TOTAL			\$ (543,069)

The District also adopted Resolution 2015-10 declaring a Stage 3 (Water Supply) Emergency and Resolution 2015-12 amending the Stage 3 Emergency to prohibit the approval of new connections to the water system. These Resolutions are included as Attachment 4. There is no current direct connection between the Emergency Shortage Rates and the Stage 3 Emergency adopted in the Resolutions, therefore their adoption did not automatically trigger implementation of the Emergency Shortage Rates, even though the Emergency Shortage rate structure contains reference to the various stages of emergency (from the Supply Contingency Plan).

Attachment 5 contains water consumption and water revenue graphs showing the continued decline in water sales and revenue. Action is necessary to ensure that the District's water enterprise is funded adequately to complete the necessary capital improvement projects. Also to be considered is the fact that rainfall within the District continues to be at a level that the District should consider a Stage 4 supply emergency pursuant to its supply contingency plan.

### Variations From Approved 2014 Financial Plan

A joint FAC/UAC committee meeting was held on April 25, 2016 to address the serious revenue shortfall being experienced by the District as a result of a continued higher than expected level of customer water conservation. The 2014 Financial Plan and Rate Study (Plan) established the basis for water rate increases to be implemented each fiscal year beginning in July 2015 through June 30, 2020. As outlined above, the Plan detailed a specific amount of revenue necessary for the District to continue to operate the water system in compliance with all regulations and standards, as well as to complete Capital Improvement Projects (CIP) required by the ISJ as included in the Basin Management Plan and other projects needed to control expenses, provide safe water and to meet the water supply needs of the community.

The revenue was to be raised through implementation of water rates to be increased by 15% in fiscal year 2015/16, and approximately 15% in FY 2016/17, 8% in both 2017/18 and 2018/19. These cumulative increases result in an overall 52.8% increase in water rates from 2015/16 through 2018/19, with an estimated resulting 39% overall water revenue increase over the four year period.

The Rate Plan had assumed only a 15.5% decrease in water sales in 2014/15 through 2016/17. In actuality, customer consumption appears to have decreased by over 41% in the last two years alone, causing the revenue shortfall shown in the table above. The result is a decrease in overall water revenue of 3.1% in the first year of rate increase implementation rather than the 15% increase in revenue planned.

### Revenue Recovery Options

Staff is evaluating several remedial courses of action and seeks the input and direction from the Board in determining our course of action. It is important to understand that the District must operate within the amount and timing of the rate increases as approved by the Board in 2015. In order to implement

water rates higher than detailed in the Plan, another rate increase Notice and Public Hearing process would need to be initiated.

Within the approved rate program, following are available options initially considered by staff. All options are presented for public understanding, but not all of which are desirable or feasible for further consideration:

1. **Reduce Water Conservation requirements to increase water sales.** Although this option would increase revenue relatively quickly, there could be unintended consequences to water quality, could violate state mandates and agreements contained within the approved Basin Management Plan. Increasing water sales is not a feasible option for further consideration for these circumstances.
2. **Reduce general operating expenditures.** There is very little elasticity in our current operating expenses, since the majority of costs are directly related to pumping, treating and delivering safe drinking water to customers. If we reduce expenses to the level needed to fund the critical CIP projects, with our current cashflow, our level of service, system maintenance, system reliability and compliance capability will be jeopardized. Operating expense reductions should continue to be considered but are not the solution to the current revenue shortfall.
3. **Reduce the number, scope and cost of Capital Improvement Projects (CIP).** The 2014 Financial Plan and Rate Study included expenditures on projects contained within the District's approved capital improvement program and those regional projects required in the approved Basin Management Plan. Reducing expenditures on these projects requires careful consideration of potential implications to water supply continuity, health and safety and regional agreements made with other entities regarding regional water supplies. At this time, staff cannot support general reductions in funding in support of CIP completion.
4. **Implement Water Shortage Emergency Rates (as adopted).** As stated in the Financial Plan, the intent of the Water Shortage Emergency Rates was to make up revenue lost as a result of higher than expected water conservation. Since this is exactly what occurred, it is logical for the Board to implement these emergency rates at the earliest possible convenience and keep them in effect until adequate revenue is received to make up the revenue shortfall. If the emergency rates are implemented immediately, and customer consumption does not reduce further as a result, our revenue will NOT recover as hoped through implementation of the Emergency Rates detailed in the Plan. We also expect that customers will respond to the Emergency rates with increased water conservation which will further defeat the purpose of the rates. Additional financial projections should be performed to verify the above statements and more closely estimate revenue generation with the Emergency Rates in place long term.
5. **Commission a revised Financial Plan and Rate Study.** The Financial Plan assumed 58% of the District's identified revenue needs would come from water sales; which did not and will not occur. The water sales projections were significantly overstated, and the Shortage Emergency Rates were never intended to be a long term replacement for lost sales revenue. This leaves the Plan and associated rate structure as inadequate to meet this financial needs of the District over the next four years. A revised financial plan and rate study should be considered to reflect accurate to current customer consumption.

## Water Shortage Contingency Plan Actions

On April 2, 2016 the Board of Directors declared a Stage III Water Shortage Emergency due to continued low rainfall amounts and concerns with the drought effects on water supply quantity and quality. Drought conditions continue to prevail, with the rainfall amounts meeting and exceeding the climate trigger for a declaration of Stage IV Severe Water Shortage in each the two, three and four year rainfall totals. The climate conditions for the two year and three year rainfall totals exceed the Stage V Critical Water Shortage trigger levels, with the four year total just 1.17 inches below the Critical level as shown below:

<b>Time Period</b>	<b>Rainfall totals From Los Osos Landfill (Inches)</b>	<b>Stage III Emergency</b>	<b>Stage IV Severe</b>	<b>Stage V Critical</b>
April 2012 - March 2013	9.87			
April 2013 - March 2014	6.59			
<b>Two Year Subtotal</b>	<b>16.46</b>	<b>&lt;=29 in rain</b>	<b>&lt;=26 in rain</b>	<b>&lt;=17 in rain</b>
April 2014 - March 2015	7.61			
<b>Three Year Subtotal</b>	<b>24.07</b>	<b>&lt;=43 in rain</b>	<b>&lt;=38 in rain</b>	<b>&lt;=26 in rain</b>
April 2015 - February 2016	11.89			
<b>Four Year Subtotal</b>	<b>35.17</b>	<b>&lt;=58 in rain</b>	<b>&lt;=51 in rain</b>	<b>&lt;=34 in rain</b>