

July 21, 2018

To: Civil Rights, Utilities, Economic Development and Arts Committee
From: Peter Lindsay, Council Central Staff
Subject: Res 31760 – Seattle Public Utilities 2018-2023 Strategic Business Plan Update

This memo summarizes the proposed Seattle Public Utilities (SPU) rate increase and identifies issues, options, and tradeoffs for Council’s consideration.

EXECUTIVE SUMMARY

Resolution 31760 would adopt Seattle Public Utilities (SPU)’s 2017 Strategic Business Plan Update (the Plan Update). The Plan is updated every three years (last updated in 2014 wherein rates were projected to increase 4.6 percent on average). The Plan Update identifies operating and capital program requirements at a cost of approximately \$1.2 billion in 2018 growing to \$1.4 billion in 2023. To partially pay for these projects, as well as address flooding, climate change, seismic vulnerabilities, aged infrastructure and other emergency needs, the drinking water, drainage, wastewater and solid waste rates will need to be increased by an **average** of 5.5 percent per year for the next six years (2018 to 2023). See Table 1 for average annual rate summaries.

SPU arrived at the 5.5 percent average annual rate by (a) assuming an average annual rate increase of 5.4 percent to meet current service levels, (b) finding savings and project deferrals worth \$276 million, reducing the 5.5 percent average annual rate to 5.1 percent, and (c) identifying another \$229 million for new initiatives to arrive at the 5.5 percent annual average increase over six years (2018-2023).

Table 1: 2017 SPU Strategic Business Plan Update – Rate Paths by Line of Business 2018 - 2023

Projected Six-Year Rate Path	2018	2019	2020	2021	2022	2023	2018-2023 Average
Drinking Water	3.5%	4.1%	5.2%	5.3%	4.1%	5.6%	4.6%
Wastewater	1.2%	12.2%	12.6%	3.2%	4.0%	2.7%	5.9%
Drainage	7.5%	14.2%	15.9%	6.1%	2.8%	7.1%	8.8%
Solid Waste	3.1%	3.3%	4.6%	2.8%	3.7%	2.9%	3.4%
Combined	3.2%	8.2%	9.5%	4.1%	3.7%	4.2%	5.5%

There is a three-year overlap (2018-2020) between the proposed 2014 Plan and the 2017 Plan Update. The Plan Update projects 2018 rates at 3.2 percent—24 percent lower than the 2014 Plan. However, the Plan Update projects rates in 2019 and 2020 to be 49 percent and 83 percent higher respectively than projected in the 2014 Plan. For 2021-2023, the average annual rate is more modest than in the previous three years reflecting lower levels of capital project spending. All things being equal, residential customers can expect cumulative rate increases of 21 percent from 2018 to 2020. Based on the proposed rate path, the average residential bill would increase \$6.45 in 2018, \$15.84 in 2019 and \$19.79 in 2020.¹

BACKGROUND - 2017 STRATEGIC BUSINESS PLAN UPDATE

SPU's 2017 Plan Update follows a strategic planning process established in [Resolution 31429](#) (adopted in 2014) to achieve the following goals:

- set a transparent and integrated direction for all of SPU's lines of business;
- reflect customer values in the utility's decision making;
- provide rate predictability for utility customers; and
- deliver best value for the rate payer.

[Resolution 31534](#) prescribed a specific process for developing the plan, including a six-year rate path for water, drainage, wastewater and solid waste; and requiring SPU update the business plan on a three-year cycle.² The next plan update is scheduled for 2020.

The Plan Update prioritizes reductions and additions to current utility expenditures including:

- Potential savings and efficiencies in the provision of existing services;
- Identifying low-priority existing services that may be reduced or eliminated;
- Evaluating new investments known as Action Plans to respond to future needs such as climate change and growth; and
- Refreshing baseline financial assumptions to reflect changes in regulatory conditions, capital markets (i.e., borrowing rates for municipalities), inflation, labor contracts, etc.

To deliver the projects, the Plan Update anticipates capital expenditures ranging from \$292 million to \$348 million annually over the six-year planning period. Assumed in the baseline capital spending are projects largely focused on sewer rehabilitation, facilities management and sewer cleaning; adopted in the 2014 Plan.

2017 PLAN UPDATE: A RETROSPECTIVE COMPARISON

SPU's business plan update provides a concrete framework for evaluating SPU's investment decisions and budget requests now and in the future. Table 2 compares combined annual rates as proposed in the Plan Update with the rates projected in the 2014 Strategic Business Plan.

¹ A summary table of typical monthly bills over the 6-year planning period for residential, multi-family and commercial customers is included in Attachment A to Resolution 31760.

² Note the three-year cycle for business plan updates allows SPU to set rates at least once for each line of business prior to the next update.

Table 2: Comparison of 2014 Plan Rate Path to 2017 Plan Update

	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>AVERAGE</u>
A: 2014 Plan*	Projected 2.7%	Projected 5.0%	Projected 4.7%	Projected 4.2%	Projected 5.5%	Projected 5.2%	4.6%
B: Proposed Plan Update Rates **	Adopted 2.9 %	Adopted 4.1%	Adopted 5.3%	Proposed 3.2%	Proposed 8.2%	Proposed 9.5%	5.5%
Above/ (Below) 2014 Plan [B-A]	0.2%	(0.9%)	0.6%	(1.0%)	2.7%	4.3%	0.9%

***Combined Weighted Average** across all lines of business – Water Drainage Wastewater and Solid Waste

** Reflects combination of **rates adopted through 2017 and SPU’s proposed Plan Update rate path**

The substantial increase in rates for 2019 and 2020 is largely driven by the concentration of capital spending on projects like the Ship Canal Water Quality project, Move Seattle infrastructure improvements and new facilities for Drainage and Wastewater line of business. A deeper discussion of rate pressures facing SPU was included in a previous [Central Staff memo](#) presented at the April 25 Civil Rights, Utilities, Economic Development and Arts Committee.

To decrease rate growth in 2019 and 2020, Council will need to identify (a) cuts to expenditures-capital, operations and maintenance or taxes, (b) new non-rate revenue, (c) changes to financial assumptions such as the CIP accomplishment rate or (d) some combination of the preceding rate factors. As a guideline, to decrease rates a tenth of a percent (0.1), Council will need to cut \$63 million in capital spending or \$15 million in O&M expenditures over the six-year planning period.³ Potential rate decreasing measures are identified and discussed beginning on page 4 of this memo.

CUSTOMER REVIEW PANEL RECOMMENDATIONS

SPU transmitted the proposed Plan Update with supporting documentation including a letter to the Council and Mayor from the nine-member Customer Review Panel (CRP). The CRP is the principal review body for the Plan Update and provides stakeholder engagement (from commercial, residential and institutional perspectives) and input into the business planning process. The CRP endorsed the Plan Update generally while acknowledging concerns about the cost pressures facing rate payers, especially the impact on affordability for those customers on a fixed income.

³ Reductions made in alternative years or all in one fund may have different impacts than what is described.

The CRP requested Council consider the following issues:

- cost impacts of City initiatives (like Move Seattle) on utilities while developing capital-intensive levy proposals;
- re-opening drainage and wastewater rates to spread costs across the six-year rate path;
- linking growth in the utility tax rate either (a) to inflation or b) to population growth instead of being an output of rate growth;
- enhancing stakeholder involvement by extending the role of the CRP and establish a twice-yearly meeting to evaluate SPU's progress on Plan Update milestones; and
- increasing system development charges to reduce the amount of revenue required from rates and to ensure growth pays for growth.

Each recommendation described above is addressed in the ISSUE IDENTIFICATION section below.

ISSUE IDENTIFICATION

Central Staff reviewed the Plan Update, looking for issues and options to (a) identify opportunities to reduce rates, (b) strengthen accountability and improve governance of the utility. Below are the issues and options as identified by Central Staff, organized by theme. If an issue was also raised by the CRP in the letter to Council, it is noted in the heading. Please note that some options are mutually exclusive whereas others are complimentary.

Rate Adjustment Opportunities

1. Rate Smoothing – *raised by CRP*

The Plan Update projects combined annual rate increases of 8.2 percent and 9.5 percent in 2019 and 2020 respectively. Seattleites have not experienced year-over-year rate increases of that magnitude since the mid-2000s. One technique to maintain stable and predictable bills is rate smoothing; increasing rates early in the rate cycle and decreasing them in “out years” to balance the trajectory of increases. In the context of the Plan Update, rate smoothing would require changing drainage and wastewater rates earlier than scheduled—currently drainage and wastewater rates are set through 2018. Rate smoothing increases the 2018 combined rate from 3.2 percent to 4.7 percent and decreases rates in 2019 from 8.2 percent to 6.6 percent and in 2020 from 9.5 percent to 7.2 percent. Table 3 provides a comparison of the combined Plan Update rate path with and without rate smoothing.

Table 3: Rate Smoothing Comparison – 2018 to 2023 Average Annual Rates for All Lines of Business

	2018	2019	2020	2021	2022	2023	Average 2018-2023
A: Rate Path w/o Smoothing	3.2%	8.2%	9.5%	4.1%	3.7%	4.2%	5.5%
B: Rate Path w/ Smoothing	4.7%	6.6%	7.2%	6.9%	3.2%	4.3%	5.5%
Difference [A-B]	(1.5%)	1.6%	1.8%	(2.8%)	0.5%	0.1%	-

According to SPU, rate smoothing has the added benefit of improving the drainage and wastewater fund (DWF) debt service coverage ratio--the multiple of net operating income to debt. SPU’s current financial policy is to maintain a ratio of 1.8 or higher. However, bond rating agencies *prefer* a debt service coverage ratio of 2.0. Due to increased spending on DWF capital projects SPU is concerned that DWF debt service coverage ratio will dip below 2.0, resulting in a negative outlook by bond rating agencies. Based on SPU’s calculations, a smoothed rate structure will increase short-term DWF revenues and result in a debt service ratio of at least 2.0 from 2018 to 2023.

Options -- (Options are mutually exclusive)

- A. Do Nothing – keep rate path as proposed
- B. Amend the resolution to reflect a drainage and wastewater utility rate smoothing policy. Since drainage and wastewater rates are set, Council will need to pass an ordinance implementing rate smoothing.

2. New Tap Fees—*raised by CRP*

In 2017, SPU expects to collect about \$6.6 million in new tap fees – a separate charge assessed for the physical costs of connecting properties to the water system. The new tap fee has not been updated since 2013 and the current fees do not cover the cost of service. If fees are raised to cover the cost of service, SPU would increase its non-rate revenue by \$900,000 annually. As proposed, the business plan update assumes and maintains the current fees.

Options – (Options are mutually exclusive)

- A. Do Nothing – keep resolution and Plan Update silent as it applies to new tap fees.
- B. Amend the resolution and request SPU increase tap fees to partially or fully cover the cost of service.

3. System Development Charges—*raised by CRP*

In 2017, SPU expects to collect \$2.8 million in water connection charges—a type of system development charge that represents buying into the water system. [RCW 35.92.025](#) grants authority to collect connection fees based on the value of existing infrastructure and interest charges on existing assets. SPU's current water connection charges only include costs for existing infrastructure in its calculations; and the charge has not been updated since 2013. There is no connection charge for drainage or wastewater. A new connection charge that includes interest payments for water, drainage and wastewater could be used to offset system costs, thereby lowering rates, or could be earmarked for growth projects (or a combination of the two). As proposed, the business plan update assumes and maintains the status quo structure for all system development charges.

Options – (Options b and c are not mutually exclusive)

- A. Do Nothing – maintain the status quo system development charge structure.
- B. Amend the resolution and request SPU adopt an updated water connection charge to potentially reduce rate pressure. Central Staff would work with SPU to determine the magnitude of impacts from any potential change.
- C. Request SPU complete its analysis on reforming system development charges for all lines of business to take full advantage of the RCW and provide consistency across the funds.

4. Action Plan Prioritization

SPU has identified thirteen new projects (known as “Action Plans” in the Plan Update) to address emergent issues and needs for all SPU lines of business. SPU plans to spend \$230 million over the six-year plan on new Action Plan projects as well as \$154 million on Action Plans identified in the 2014 Plan. Note the 2014 Action Plans are assumed in SPU's baseline rate. Since new expenditures result in higher rates, Council would amend the list of Action Plans to lower costs and decrease rates.

Options – (Options are mutually exclusive)

- A. Do Nothing
- B. Amend the list of projects included in Attachment A to reduce spending and decrease rates. Council would also need to amend the resolution to reflect a change in the rate path. Council could explore reductions to facility improvements like the Seattle Municipal Tower space consolidation or re-phasing aspects of the various SPU facility plans.

5. CIP Accomplishment Rate

The Plan Update assumes 100 percent of annual capital appropriations will be spent from 2018 to 2023—the ratio of actual spending to annual capital appropriations is known as the accomplishment rate. The accomplishment rate is a critical financial planning input because it guides the level of debt and cash SPU requires to complete capital projects. In 2015, SPU’s accomplishment rate ranged from 81 percent to 90 percent depending on the utility. Council could request that SPU revise this assumption downward based on historical performance to reduce rate increases. For instance, reducing the accomplishment rate from 100 percent to 95 percent would decrease the average annual rate from 5.5 percent to 5.3 percent. However, if actual capital spending exceeded the assumed accomplishment rate, SPU would need to delay or eliminate lower priority projects to ensure funding is available for higher priority capital projects.

Options – (Options are mutually exclusive)

- A. Do nothing – assume a 100 percent accomplishment rate.
- B. Amend the rate path in the resolution to assume an accomplishment rate in line with historical trends.

6. Utility Taxes—*raised by CRP*

The CRP’s letter to Council highlighted the concern that utility taxes for water, drainage, wastewater and solid waste are high compared to other municipalities. The CRP identified two issues in relation to taxes: (1) the bi-monthly utility bill does not itemize the tax portion of a customer’s bill and (2) the tax rates themselves are too high and should be linked to either inflation or a different rate of growth. Utility tax rates for solid waste, drinking water, drainage and wastewater are set and SPU’s Plan Update does not assume a change in tax rates. However, increases in utility rates will result in higher utility tax revenues. For instance, if Council adopts the resolution without amendment, SPU’s tax receipts to the City grow from \$97 million in 2017 to \$134 million in 2023.

Options -- (Option A is exclusive; Options B and C are not mutually exclusive)

- A. Do nothing – maintain status quo
- B. Amend the resolution and request SPU improve the transparency of tax impacts on utility rates by developing a specific line item for tax on each customer bill—an implementation timeline could be developed by the utility.
- C. Amend the rate path in the resolution to reflect a Council-directed change in utility tax policy such as growing utility taxes at the rate of inflation. Council would also need to draft additional legislation—in the form of an ordinance—to affect the change in tax policy.

Accountability and Improved Governance

7. On-going CRP Oversight and Involvement – *raised by the CRP*

The CRP disbands at the end of every business plan update. Based on recommendations from the CRP and in the interest of providing on-going, customer-centered oversight of business plan milestones and accomplishments, Council could direct SPU to develop a regular and permanent meeting structure in support of business plan implementation. Meetings could occur twice a year per the recommendation included in the CRP's letter to Council. If councilmembers wish, Central Staff can evaluate whether additional legislation would be necessary to maintain the existing membership structure.

Options – (Options are mutually exclusive)

- A. Do Nothing – Keep the status quo oversight structure. The next CRP meeting would occur in 2019 as SPU prepares another plan update in 2020.
- B. Amend the resolution to formalize expectations for an on-going CRP oversight. Council could choose to follow the recommendation of the CRP for meeting frequency—twice a year—or a different interval.

8. Efficiency Targets – *raised by the CRP*

SPU's 2014 business plan identified specific efficiency targets over the six-year planning period to reduce costs and maintain existing service levels. The utility experienced mixed results in meeting the efficiency targets articulated in the original plan. Although SPU identified \$276 million in savings to reach the proposed 5.5 percent average annual increase, the 2017 Plan Update does not include a specific list of proposed operational efficiency targets similar to the 2014 Plan. Council could amend the resolution and request that SPU develop a plan to evaluate efficiency opportunities across all lines of business now or in the short term. Council could subsequently adopt the efficiency targets in a separate resolution.

Options – (Options are mutually exclusive)

- A. Do Nothing -- keep resolution silent as it applies to efficiency targets.
- B. Amend the resolution and request SPU conduct a utility-wide efficiency analysis documenting opportunities for leaner business practices and cost reductions that could reduce rates. Council could adopt recommended efficiency targets in a subsequent resolution.
- C. Amend the resolution and request SPU conduct a utility-wide efficiency analysis immediately and delay business plan deliberations until efficiency targets are incorporated into the proposed plan update.

OTHER ISSUES

Construction Escalation and Project Delivery

SPU indicates that construction escalation—the assumed rate of growth for construction cost inputs like labor and materials—has recently increased at an unprecedented rate in the Seattle area. Consequently, significant capital projects like the Ship Canal Water Quality Project and SPU’s North and South DWW Operations Facilities are at risk of increased cost pressure. Given that many of the forces facing SPU are market-based, it will be incumbent upon the utility to develop risk reducing alternatives to maintain services, meet future regulatory requirements and stay within the proposed rate path.

Water Rates

SPU transmitted water rates ordinances to Council on July 18. According to SPU, water rates from 2018 to 2020 are lower than rates proposed in the Plan Update. When the revised water rates are combined with the proposed rates in the Plan Update, the six-year average annual growth rate is 5.4 percent as opposed to 5.5 percent—a 0.1 percentage point difference.

NEXT STEPS

At the next meeting of the Civil Rights, Utilities, Economic Development and Arts Committee on August 8, Central Staff will present any specific changes to Resolution 31760 proposed by councilmembers as well as any impacts and trade-offs related to each proposal.

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