

**City of Salem
Water, Wastewater, and Stormwater Utility
Rate Proposal for 2021 and 2022**

August 13, 2020

The 2020 rate proposal for 2021 and 2022 is as follows:

- Water – 3 percent
- Wastewater – 3 percent
- Stormwater – 5 percent

The proposal is consistent with the Council adopted and Water /Wastewater Task Force endorsed 2018 COSA framework. No additional policy changes or recommendations are incorporated in the rate proposal.

Financial Planning and Rate Proposal Review

The City of Salem conducts financial planning to support the operation, maintenance, and capital investment of the water, wastewater, and stormwater systems – collectively referred to as the Utility. As part of this process, every two years the Water / Wastewater Task Force (W/WWTF) is convened to consider the biennial rate proposal. The W/WWTF is advisory to the Salem Public Works Director and in 2020 is comprised of:

- Four City Councilors;
- Representatives from City of Keizer and City of Turner;
- A representative of Marion County;
- A representative of East Salem Suburban Water District;
- Representatives from Salem Chamber of Commerce and SEDCOR; and,
- Two members at-large.

The W/WWTF receives updates on issues related to the Utility, reviews the rate proposal, and makes a recommendation that is forwarded to the City Council for consideration. The following is a description of the policy framework and financial considerations that support the rate setting process.

Cost of Service Framework

Salem City Council approved a Cost of Service Analysis (COSA) in 1993 as the strategy for establishing Utility rates and fairly allocating costs to customers. Long-term financial planning is integral to the Utility’s success and stability as it allows for regular balancing of funding levels for operations and maintenance, capital investment, financial reserves, and debt coverage against the desire for smaller, more predictable annual rate increases for customers. In addition, Council Policy C-14 requires COSA updates every four years. The next update will be developed in 2022 for the 2023 – 2024 biennial rate proposal.

An updated COSA was adopted by Salem City Council in 2018 implementing two policy objectives endorsed by the W/WWTF:

1. Increase recovery of water system revenue through fixed charges from 20 to 25 percent.
2. Increase the stormwater revenue slope to 5 percent per year for five years (2019-2023) to more closely align cost recovery with the revenue.

Financial analysis in 2020 shows that water rate revenue from fixed charges has increased to 25 percent, so the first objective has been realized because of the implementation of rates in 2019 and 2020. These two years also represented the first two out of five years of the five percent revenue slope for stormwater. Three years remain to be implemented from 2021 through 2023.

Management Goals for Financial Planning

Many economic and other variables are reviewed to develop assumptions for the Utility's financial plan. Water consumption and conservation are examined as well as their impact on wastewater flows. The debt service and reserve requirements are reviewed to ensure bond covenants and adopted Council policies will be met and adequate resources are available for emergencies. Operational and capital expenditures are evaluated to manage cost increases and anticipate future program needs. When these variables are updated and used to develop projections, a final review is conducted to weigh the operating and capital needs of the Utility against the impact on the ratepayers.

Over the past decade, an overarching financial goal of the Utility has been to implement small, smooth annual rate increases to address longer term operational and capital needs, thereby avoiding large rate spikes in any given year. When adopted rate increases have deviated from the revenue slope, greater rate increases have been necessary in a future year to maintain the Utility's financial stability over time.

Following are some additional facts and values guiding the financial planning process:

- Fixed costs represent a high proportion of the total cost to provide services.
- Water consumption continues to decline.
- Sustained capital investment is critical to the long-term financial and operational health of the Utility.

The following management goals are also reflected in the financial modeling:

- Increase rate-funded capital as existing debt is retired.
- Manage expenditures responsibly and carefully.
- Maintain projected debt coverage ratios in excess of 1.25 for parity debt and 1.0 for subordinate debt.
- Maintain one year of debt service in reserve as required by covenant.
- Maintain the required 120-day operating/rate stabilization reserves.

Many of the management goals are guided by Council Policy C-14 that governs the financial planning of Salem's Utility Fund. Each financial modeling cycle requires development of conservative assumptions reflecting current customer base/demand and operational/capital needs of the Utility balanced against the impact a change in revenue slope will have on customers.

Significant Changes Since 2018

Several important events have occurred since 2018 that are reflected in the 2020 financial modeling. The appearance of cyanotoxins in the finished water in 2018 prompted significant operational and capital investments for water treatment including the hiring of additional personnel and the use of powdered activated carbon and chlorine. In March 2020, a \$60 million revenue bond was issued to fund an ozone treatment facility, resulting in an increased debt service requirement of \$4.3 million annually.

In 2020, the COVID-19 pandemic has significantly impacted the Utility. Early in the pandemic, a decision was made to suspend water service disconnections to assure that everyone would have Utility services for proper hygiene. Over 2,000 accounts, representing over \$700,000 in delinquencies, have benefitted from this policy from mid-March through mid-August 2020. Although City Council recently approved a plan for return to normal enforcement procedures, the delinquent revenue will be deferred for up to one year without interest as customers are placed on payment plans. There has also been a decrease in revenue from commercial and public customers who have experienced reductions in operations and associated water consumption.

Although the Capital Improvement Plan is adopted annually, the City's capital planning efforts are continually adjusted based on system needs, resources, and changing information. During the 2020 update to the financial plan, the City was informed of the loss of \$20 million from state lottery funding related to COVID-19. Recently, however, the Legislature approved an award of \$20.3 million in state revenue. A significant portion of the funding will be directed to construction of the Aquifer Storage and Recovery (ASR) treatment facility and wells. These projects are intended to increase the redundancy and resiliency in the water system.

Variable Assumptions and Financial Considerations

Annual financial plan updates are performed to monitor customer account and consumption patterns and economic trends. There are many specific adjustments to variables in the 2020 financial plan to reflect current economic conditions and trends:

- Interest earnings have been reduced to 1 percent for two years, and 1.5 percent thereafter based on the current Local Government Investment Pool rate.
- Water conservation has been refined by customer class, and more significant assumptions have been implemented for two years for commercial and public customers.
- Repayment of deferred revenue is reflected over the next two years, as well as the reduction in revenue from disconnection fees.
- Escalation rates are applied to personal services and materials and services costs.

- Industrial customer wastewater flows and loads are adjusted for known changes in the customer base or operations for specific customers and annualized for the future.
- Non-rate revenues have been adjusted to add principal and interest from interfund loans for the next several years and the reduction resulting from the final payment for the sale of water rights in 2022.
- Natural savings assumptions are applied to budgeted expenses for personal services, materials, and capital outlay; all savings accrue to the beginning fund balance for the following year.
- Updated debt service schedules have been incorporated including the \$4.3 million for the 2020 revenue bonds.
- Capital investment targets have been adjusted to reflect the maximum funding available in fiscal years 2026 through 2029, and rate-funded capital investment increases as debt service payments decline.
- Reserves are maintained at required levels: rate stabilization of \$6.9 million in combination with the 120-day operating reserve and one year of annual debt service.

Results

Two summary financial tables are included as Attachment A. Operating expenses are anticipated to exceed operating revenues in the early years of the plan. The revenue from the prior sale of water rights (a non-operating revenue) ends in 2022. Based on the proposed revenue slope and the assumptions above, the unrestricted fund balance declines to approximately \$500,000 in 2023 and 2024. Financial conditions will improve with the additional \$20.3 million from the State of Oregon, although timing of the disbursement of this revenue is unknown.

Conclusion

The planned/proposed revenue slopes of 3 percent for water and wastewater and 5 percent for stormwater in 2021 and 2022 are the minimum possible to maintain a minimum level of unrestricted fund balance while fully funding operations, capital investment, and debt service requirements.

	Proposed		Planned				
	20-21	21-22	22-23	23-24	24-25	25-26	26-27
Planned Revenue Slope <i>(Water, Wastewater, Stormwater)</i>	3,3,5%	3,3,5%	3,3,5%	3%	3%	3%	3%
Rate Revenue - Operating	\$92.5	\$94.5	\$98.0	\$101.4	\$104.1	\$106.9	\$109.8
Other Revenue - Operating	16.0	15.8	16.2	16.6	17.0	17.3	17.8
Other Revenue - Nonoperating	3.8	3.5	0.7	0.7	0.7	0.7	0.5
Total Revenue	\$112.2	\$113.8	\$114.8	\$118.7	\$121.9	\$124.9	\$128.1
Operations and Maintenance	73.9	76.9	79.3	83.2	85.5	88.4	91.4
Debt Service	19.1	19.1	19.1	17.3	14.4	13.3	4.5
Rate-Funded Utility Capital Transfer	19.5	16.9	21.8	18.7	21.5	23.0	25.0
Total Expenditures	\$112.5	\$112.9	\$120.1	\$119.2	\$121.4	\$124.6	\$120.9
Fund Balance	\$49.5	\$50.3	\$45.1	\$44.6	\$45.1	\$45.4	\$52.6

Fund Balance Components	Proposed		Planned				
	20-21	21-22	22-23	23-24	24-25	25-26	26-27
Operating Reserve (120 days)	\$23.7	\$24.7	\$25.5	\$26.8	\$27.5	\$28.4	\$29.4
Debt Service Reserve (one year)	19.1	19.1	19.1	17.3	14.4	13.3	4.5
Unrestricted Fund Balance	6.7	6.5	0.5	0.5	3.2	3.7	18.7
Total Fund Balance	\$49.5	\$50.3	\$45.1	\$44.6	\$45.1	\$45.4	\$52.6
Operating Expense/ Operating Revenue Ratio	107.2%	102.4%	105.2%	101.0%	100.2%	100.3%	94.7%
Debt Coverage Ratio (1.25 min)	2.1	1.9	1.8	1.9	2.1	2.6	2.8

Rate Proposal Goals

- Maintain 120-day operating reserve.
- Maintain required debt reserves (one year of annual debt service)
- Increase the rate-funded utility capital transfer as debt service decreases, targeting \$34 million annually.
- Maintain an unrestricted fund balance of \$10 million.
- Debt coverage ratios exceed covenant requirement of 1.25 and improve in later years.

Assumptions

- Does not include \$20.3 of state revenue.
- Operating expenses exceed operating revenue in early years.
- Reflects 2020 revenue bond and associated debt service.
- Reflects impacts from COVID-19 on consumption, deferred revenue, and other economic impacts.