



MAYOR & COUNCIL COMMUNICATION

February 12, 2008

Subject: **Tucson Water's Financial Plan, FY 2008 through FY 2013: CWAC Report and Recommendations (City-Wide and Outside the City)** Page: 1 of 5

Issue – Tucson Water's Financial Plan for FY 2008 through FY 2013 and related Citizens' Water Advisory Committee (CWAC) recommendations.

Plan Overview – Tucson Water's Financial Plan provides the Mayor and Council with an overview of the Utility's projected revenues and operating, capital improvement, and debt service requirements for a six year period (current fiscal year plus next five). The potential for Colorado River shortages in the coming years has increased the importance of the City fully exercising its CAP water rights as quickly as possible.¹ During the time frame covered by the Plan, the City will begin utilizing its entire allocation of Colorado river water, which will increase capital costs (for construction of recharge and recovery/delivery facilities, including reservoirs and transmission mains) and operating costs (for operation of the facilities and purchase of CAP water for recharge). To meet these needs, the Plan indicates a revenue/rate increase of 8% annually is necessary, beginning in July 2008.

Recommendation – The Mayor and Council is respectfully requested to review the CWAC report and recommendation regarding Tucson Water's Financial Plan for FY 2008 through FY 2013 (Attachment C), and then approve Tucson Water's Financial Plan (Attachment A) by resolution. If the Plan is approved, Tucson Water will work with CWAC to return with a proposed water rate schedule on April 15, 2008 to implement the FY 2009 revenue increase (8%) required by the Plan.

Background – The Tucson Code requires that the CWAC, created by the Mayor and Council in 1977 as the official advisory body to the Council on water issues, present its review of water revenue requirements and revenue/rate recommendations to the Governing Body. The CWAC received a proposed Financial Plan at its December 2007 meeting and a revised proposed Plan at its January 22, 2008 meeting. After review, CWAC approved the revised Financial Plan (attached) by a 10-0 vote on January 22.

Scheduling the Financial Plan for review today continues Tucson Water's practice of aligning the Utility's financial planning with the City's budgetary processes. By indicating the revenue increases necessary to fund Water's budgets, the Plan reveals the "cost" of those budgets to customers of Tucson Water. For FY 2009, the Plan indicates that the proposed Water budgets require an increase in water sales revenues greater than those projected to be generated by existing water rates, and therefore, the requested revenue increase.

¹ By purchasing the full allocation of CAP water in Fiscal Year 2009, the City will avoid limitations on future purchases in the event a water shortage is declared on the Colorado River, which may occur as soon as FY 2010. Should a shortage occur, the City would be permitted to order a percentage of the prior year's actual order level rather than a percentage of the City's total allocation.

A ten-year history of Tucson Water revenues/rate adjustments is provided in Attachment B.

CWAC Report and Recommendations – The CWAC report is provided as Attachment C. The Plan calls for annual water sales revenue/rate increases that, in combination with other utility revenues and reserves, are estimated to generate the required funding. The Plan’s water sales revenue/rate increases are 8% in each of the next five years. All water sales revenue increases in the Plan are assumed to occur in early July, at the beginning of each fiscal year.

The CWAC report provides details and comments on Tucson Water’s revenue projections, capital projects, operating and debt service requirements, and the resulting Financial Plan that is built on these financial elements. A brief summary of the elements and the Plan follows:

- **Revenues:** The Plan includes a more conservative forecast of water sales revenues at existing (2007) rates than the prior adopted Plan. The lower forecast reflects (a.) the decline in new service additions related to the slowdown in new home construction and sales, (b.) the actual usage patterns in recent years, and (c.) the reductions anticipated from expanded water conservation programs. Also reflecting the steep slowdown in new home construction, development-related fee revenues (System Equity Fee, CAP Water Resource Fee, connection fees) have been significantly reduced from the prior forecast. A gradual recovery in these revenues is projected to begin in FY 2011 and accelerate during FYs 2012 and 2013.

The Plan also assumes that the Mayor and Council will adopt on December 5, 2008, the Notice of Intent to increase water miscellaneous fees as approved by CWAC. The revised fees are expected to generate approximately \$600,000 in additional FY 2009 fee revenues even at the lower projected growth rate.

- **Capital Project Requirements:** In addition to the projected FY 2008 capital spending of \$58.2 million, the Plan provides for a FY 2009 - FY2013 capital program of \$352.7 million. The five-year program focuses on completion of the Southern Avra Valley Storage and Recovery Project (SAVSARP) and related recovery reservoir and transmission mains (\$110.5 million). The SAVSARP facilities, along with existing facilities, will provide the Utility with annual *recharge capacity* of over 180,000 acre-feet and annual *recovery capacity* of nearly 115,000 acre-feet.² The recharge capacity is greater than the City’s full CAP allocation (144,191 acre-feet), thereby providing some capacity for recharge by other entities, such as the Arizona Water Banking Authority.

The Plan also provides \$33.4 million for main replacements/relocations associated with road improvement projects, primarily those associated with the Regional Transportation Authority, and \$7.7 million for continuation of the meter replacement program.

² Annual recovery capacity will be expanded further in fiscal years beyond 2013 by drilling and equipping additional recovery wells at the SAVSARP facility.

- Capital Financing: The Plan continues to finance the capital program with a combination of revenues and bond proceeds. This plan relies more heavily on bond proceeds than the prior approved Financial Plan during the first three years on this new plan (FY’s 2008-2010). The Plan proposes about 65% bonds and 35% revenues/reserves during that period, reflecting the more conservative revenue forecasts and pressures on cash reserve balances. The Plan also indicates that a new water revenue bond authorization will be required, with the first issue from the new authorization needed in FY 2009.³
- Water Revenue Bond Debt Service: Upon recommendation from the City Finance Department and its Financial Advisor, the Plan provides for interest-only debt service payments on all new water revenue bonds issued during the Plan period. New water revenue bond debt is assumed to be repaid over 22 years with interest rates ranging from 5% to 5.5%.
- Operating Requirements: The Plan provides for purchasing the City’s recently approved additional CAP *water right* allocation (8,206 acre-feet) via five annual installment payments of approximately \$1.2 to \$1.3 million (beginning this fiscal year). In addition, the plan provides for *commodity* purchase of 144,191 acre feet of CAP water annually (the City’s full allocation) for recharge, as well as covering operating costs required to meet the recharge and recovery objectives mentioned above. Total CAP-related expenses will range from approximately \$13 million in the current fiscal year to over \$18.5 million in FY’s 2011 and 2012.

Power costs, incurred as water is recovered from well fields and moved throughout the distribution system, continue to be substantial, increasing from \$16 million in FY 2008 to \$19 million in FY 2013. Projected increases in power costs reflect the projected increases in sales volumes as well as increases in natural gas and electricity rates.

The Plan includes an expanded conservation program, incorporating some of the programs recommended in the Community Conservation Task Force’s final report. Those programs are funded at \$455,000 each fiscal year, and initially focus on rebates for replacing high volume toilets in older housing stock (single family and multi-family customers), and for irrigation system upgrades (multifamily customers).

The Plan includes \$800,000 in FY 2008 to cover estimated costs associated with the current sick leave payment retirement incentive offered to all City employees (the retirement incentive is an additional payment of 50% of accumulated sick leave). In addition, the Plan requires a reduction of \$1.2 million in personnel costs in FY 2009 to be attained by holding staff vacancies for six to twelve months. Vacancies will be managed to mitigate impacts on customer service.

³ The Plan indicates the need for a \$156.8 million bond authorization election in May 2009 with a subsequent June 2009 sale. If necessary, both the election and the sale may be deferred until November 2009, and available short-term financing instruments utilized in the interim.

The Plan does not include:

- costs for merits or cost-of living increases in FY 2009
- additional costs that may result from an accounting change pertaining to post retirement health care benefits.⁴

The Plan indicates that the Mayor and Council Water Policies covering debt service coverage will *not* be met in two years of the Plan (FY 2008 and FY 2009), and prior Council direction related to year-end cash reserves will *not* be met in three years of the Plan (FYs 2008 through 2010):

- The combination of the significant reduction in projected water sales and development fee revenue (discussed above) and the general “fixed” nature of the majority of the Utility’s operating costs, indicates the Mayor and Council’s 175% policy on total debt service coverage will not be met in FY 2008 and FY 2009. In those years projected coverage is 156% and 168% respectively. **However, the 175% coverage required in the bond ordinance for water revenue bonds, calculated on ‘senior lien’ debt, will be met in all years of the Financial Plan.**
- Like the Financial Plan adopted in April 2007, the current Plan does not meet in all years the cash reserve requirement established by Mayor and Council when the Governing Body adopted the FY 2002 Financial Plan (10% of annual water sales revenue). Reserves in FY 2008 through FY 2010 are below the 10% level. In all three years, however, the cash reserves are in excess of the official 5% policy set out in the *Mayor and Council Water Policies*. Reserves return to the 10% level in the last three years of the Plan period.

Legal Considerations – The City Attorney’s Office has prepared the attached resolution by which the Mayor and Council may approve the FY 2008 – FY 2013 Tucson Water Financial Plan.

⁴ A recent Governmental Accounting Standards Board statement dictates a change in recording expenses and liabilities related to retirement health benefits. Previously, retiree health insurance costs were recorded on the pay-as-you-go (cash outlay) basis. The Finance Department is working with an Actuary to determine the liability amounts; the results of the actuarial analysis are not currently available. The reporting of this expense and liability, and whether the annual expense is to be included in the calculation of Tucson Water’s debt service coverage, has not yet been determined. The proposed Financial Plan does include annual amounts for retiree medical expenses, based on the pay-as-you-go method, that range from \$515,000 (FY 2008) to \$667,000 (FY 2013).

MAYOR AND COUNCIL COMMUNICATION

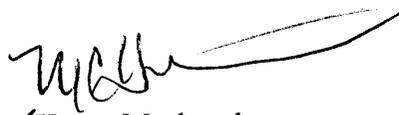
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Schedule for Developing and Approving New Water Rate Schedule– The following steps lead to adoption of the FY 2009 water rate schedule, beginning with adoption of the Financial Plan today:

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| February 12, 2008 (today) | The Mayor and Council reviews and approves Tucson Water’s FY 2008 – FY 2013 Financial Plan in Regular Session. |
| April 15, 2008 | The Mayor and Council receives CWAC’s recommended FY 2009 rate schedule in Study Session, and in Regular Session adopts the notice of intention to increase water rates, files supporting report with the City Clerk, and sets the public hearing for May 20, 2008. |
| May 20, 2008 | The Mayor and Council holds public hearing and adopts (or not) the new rate schedule. |
| July 7, 2008 | New rates become effective if adopted. |

Respectfully submitted,


for Karen Masbruch
Assistant City Manager

KM:dc/David Modeer
Director, Tucson Water
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- Attachments:
- A. Financial Plan
 - B. Water Revenue/Rate Increases Last 10 Fiscal Years
 - C. Citizens’ Water Advisory Committee Report
Resolution