



SPECIAL MEETING OF THE MILPITAS CITY COUNCIL

AGENDA

**THURSDAY, NOVEMBER 29, 2018
MILPITAS CITY HALL
COUNCIL CHAMBERS – 2ND FLOOR
455 E. CALAVERAS BOULEVARD, MILPITAS, CA
6:30 P.M.**

SUMMARY OF CONTENTS

I. CALL MEETING TO ORDER by Mayor and ROLL CALL by City Clerk

II. PLEDGE OF ALLEGIANCE

III. PUBLIC FORUM

Those in the audience are invited to address City Council on any subject not on tonight's agenda. Speakers must come to the podium, state their name and city of residence for the Clerk's record, and limit spoken remarks to three minutes. As an item not listed on the agenda, no response is required from City staff or the Council and no action can be taken. Council may instruct the City Manager to place the item on a future meeting agenda.

IV. ANNOUNCEMENTS

V. ANNOUNCEMENT OF CONFLICT OF INTEREST AND CAMPAIGN CONTRIBUTIONS

VI. APPROVAL OF AGENDA

VII. BUSINESS ITEMS

- 1. Receive a Report and Move to Approve the Fiscal Year 2018-19 Central Services Full Cost Allocation Plan Update (Staff Contact: Will Fuentes, 408-586-3111)**
- 2. Receive Staff Report on Sewer Rates Study, Direct Staff to Proceed with Community Engagement on Proposed Rates, Including Identifying a Date for the Public Hearing and Mailing a Notice of the Public Hearing (Staff Contact: Tony Ndah, 408-586-2602)**
- 3. Receive Staff Report on Water Rates Study, Direct Staff to Proceed with Community Engagement on Proposed Rates, Including Identifying a Date for the Public Hearing and Mailing a Notice of the Public Hearing (Staff Contact: Tony Ndah, 408-586-2602)**

VIII. ADJOURNMENT

KNOW YOUR RIGHTS UNDER THE OPEN GOVERNMENT ORDINANCE

Government's duty is to serve the public, reaching its decisions in full view of the public. Commissions and other agencies of the City exist to conduct the people's business. This ordinance assures that deliberations are conducted before the people and the City operations are open to the people's review.

For more information on your rights under the Open Government Ordinance or to report a violation, contact the City Attorney's office at Milpitas City Hall, 455 E. Calaveras Blvd., Milpitas, CA 95035
e-mail: cdiaz@ci.milpitas.ca.gov / Phone: 408-586-3040

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Materials related to an item on this agenda submitted to the City Council after initial distribution of the agenda packet are available for public inspection at the City Clerk's office at Milpitas City Hall, 3rd floor 455 E. Calaveras Blvd., Milpitas and on the City website. All City Council agendas and related materials can be viewed online here: www.ci.milpitas.ca.gov/government/council/agenda_minutes.asp (select meeting date)

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Commission application forms are available online at www.ci.milpitas.ca.gov or at Milpitas City Hall. Contact the City Clerk's office at 408-586-3003 for more information.

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Para sa Tagalog, tumawag sa 408-586-3051
Para español, llame 408-586-3232

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AGENDA REPORTS

VII. REPORTS

1. Receive a Report and Move to Approve the Fiscal Year 2018-19 Central Services Full Cost Allocation Plan Update (Staff Contact: Will Fuentes, 408-586-3111)

Background: On January 21, 2014, the City Council reviewed and approved the City of Milpitas Cost Allocation Plan (CAP) and methodology via Resolution No. 8338. The CAP identified the full cost of providing specific City services and included not only the direct costs of servicing a program, but also administrative and overhead costs (also known as indirect costs) which are assigned to each program indirectly using cost allocation formulas. A cost allocation plan is a rational and accepted method to distribute indirect costs which support multiple activities within an agency and is used by most all public agencies. An alternative to using a cost allocation plan to charge indirect costs, such as those in Payroll, to direct cost functions, such as a water utility, would be to charge time in 15 minute increments using a timecard recording process. However, this would be neither a reasonable nor a cost effective manner to capture these costs and it not readily used by public agencies due to the costs far outweighing the benefits.

Since 2014 there have been various changes in the City that include reorganizing City departments, taking services in-house which had been previously outsourced, and other organizational changes requiring a review and update of the CAP. In addition, at the October 18, 2017 Special City Council Meeting, the Water Rates Task Force recommended and Council directed staff to re-examine the CAP methodology and modify if necessary to meet industry best practices and ensure that the Water and Sewer utility funds are charged a fair, reasonable, and justifiable portion of General Fund indirect costs.

At the September 18, 2018 City Council meeting, staff along with consultant from ClearSource Financial Consulting presented an update to the Fiscal Year (FY) 2018-19 Central Services Full Cost Allocation Plan as requested. During this meeting, City Council directed staff to conduct additional outreach to the community and members of the former Water Rates Task Force concerning the CAP since the October 18, 2017 Council direction to assess the CAP methodology was based on a request from the former Water Rates Task Force. Council also expressed interest in having a more robust and comprehensive discussion concerning the impact of the CAP on the Sewer and Water rate studies.

Analysis: On September 24, 2018 staff along with the City's CAP consultant, presented the CAP Update to the Finance Subcommittee, which was attended by several members of the former Water Rates Task Force; upon staff invitation to the entire membership of the former Water Rates Task Force. Announcement of the Finance Subcommittee meeting was also posted for public view on the City's Twitter and Facebook page. Several members of the former Water Rates Task Force attended and one additional member of the public attended. During the meeting, staff and the City's CAP consultant provided a presentation similar to the one that was shared with City Council during the September 18 meeting and also addressed any questions and concerns from the Subcommittee, the public and former Water Rates Task Force members in attendance.

One concern raised by a member of the former Water Rates Task Force was that the updated CAP did not fully explain allocation bases used. Thus, staff and the City's CAP consultant enhanced the description of allocation bases so that the manner in which they are applied and the reason for applying specific allocation bases is more detailed, more transparent, and easier to understand. Another concern raised by a member of the former Water Rates Task Force is that the City does not use a timecard system to charge indirect central services costs for areas such as Finance, Human Resources, the City Manager's Office, City Council, etc. It was

further stated by the member that the City of Sunnyvale uses a timecard system to track this time. Staff has spoken directly with the Finance Director at the City of Sunnyvale and similar to the City of Milpitas, Sunnyvale uses a cost allocation process to assign indirect central services costs. The City of Sunnyvale only uses a timecard system to track direct costs, such as employee time worked on capital projects.

A final concern raised by a member of the former Water Rates Task Force was that the City may not be properly assigning direct costs for areas such as Utilities Maintenance and Utilities Billing between the Water and Sewer Funds. While this is outside the scope of a cost allocation plan which addresses indirect costs only, staff did explain its current method of assigning direct costs. The City currently estimates this time annually through discussion during the budget development process and assigns a predetermined percentage of employee time each payroll period to the Water and Sewer Funds. This is necessary so that staff may properly budget expenditures and plan for the upcoming fiscal year. Nevertheless, staff will explore whether directly tracking the time of those employees in Utilities Maintenance, Utilities Billing, and other direct cost areas via a new electronic timecard process each payroll period would be beneficial and produce greater accuracy. Staff is currently implementing and testing an electronic timecard system, which could make tracking of and assignment of direct personnel costs to utility funds easier. Estimated completion of the electronic timecard systems is early calendar year 2019.

The Fiscal Year 2018-2019 Central Services Full Cost Allocation Plan Update (“CAP Update”) prepared by the City’s CAP consultant is included in the agenda packet. The CAP Update been revised from what was presented to City Council on September 18, 2018 and includes an enhanced description of cost allocation bases (page 16) as well as central services indirect rates for every City department and not just one citywide central services rate (Exhibit 9). In summary, while it was determined by ClearSource that the previous Plan was based on sound methodology, it was in need of update due to organizational changes since 2014 and some minor flaws. As a result, there are several important financial items to note, mainly relating to indirect costs charged to utility funds by the General Fund:

1. The currently budgeted indirect charge from the Water Fund to the General Fund in FY 2018-19 is \$3,162,936. The CAP Update sets this at \$2,705,884; a difference and negative revenue impact to the General Fund of **\$457,052**.

As a percentage (%) of Water Fund direct costs, the FY 2018-19 Adopted Budget sets the indirect charge to the Water Fund at 12.2%. The CAP Update sets the indirect charge to the Water Fund at 10.4%; a decrease of 1.8 percentage points.

2. The currently budgeted indirect charge from the Sewer Fund to the General Fund in FY 2018-19 is \$2,006,252. The CAP Update sets this at \$1,544,274; a difference and negative revenue impact to the General Fund of **\$461,978**.

As a percentage (%) of Sewer Fund direct costs, the FY 2018-19 Adopted Budget sets the indirect charge to the Sewer Fund at 13.7%. The CAP Update sets the indirect charge to the Sewer Fund at 10.6%; a decrease of 3.1 percentage points.

3. The currently budgeted indirect charge from the Solid Waste Fund to the General Fund in FY 2018-19 is \$286,244. The CAP Update sets this at \$99,748; a difference and negative revenue impact to the General Fund of \$186,496. This is due to decreased effort required by the Finance Department to provide solid waste billing services since the City transferred this function to Milpitas Sanitation in December 2017. There were some transition issues that City staff worked through, but this indirect charge should decrease and was inadvertently budgeted too high in FY 2018-19.

In total, due to the CAP Update, there is a **\$1,105,526** negative revenue impact to the General Fund in FY 2018-19. However, staff believes that this can be mitigated for the following reasons:

- A. The FY 2018-19 Adopted Budget set aside **\$465,483** in non-departmental General Fund expenditures to protect against potential negative impacts as a result of the CAP Update; thereby leaving a remainder of \$640,043 to address.
- B. Continued economic strength could result in actual General Fund revenues in various categories exceeding budgetary expectations for FY 2018-19. Staff will provide an update to City's Five-Year Financial Forecast at the December 4, 2018 and February 5, 2019 City Council Meetings.

Furthermore, Matrix Consulting Group is currently conducting a development fee study to access user fees charged to developers and other parties. This fee study will look to capture the full cost of services and as a result, it is anticipated that development based fees could increase. This will ensure that developers and other parties pay a fair and reasonable share of City costs in relation to the services provided to them. The projected revenue increase as a result of the fee study is unknown at this time, but any increase revenue realized could help to fully offset the remaining \$640,043 negative impact to the General Fund caused by the CAP Update. The development fee study is expected to be completed by early April 2019 and will be presented to Council along with an update to the Master Fee Schedule by end of April 2019. Any increased revenue as a result of the development fee study and updates to the Master Fee Schedule will be incorporated into the FY 2019-20 Budget.

In conclusion, the recommended updated CAP more accurately captures the indirect costs to the various direct services and in order to ensure compliance with Prop 218, must be approved prior to setting new rates for water and sewer services.

Next Steps:

1. Finance staff will collaborate with the Public Works staff on improving the tracking of direct costs. Staff is currently implementing and testing an electronic timecard system, which could make tracking of and assignment of direct personnel costs to utility funds easier. Estimated completion is early calendar year 2019.
2. Staff will return to Council at February 5, 2019 City Council Meeting to present final plans to offset any negative General Fund revenue impacts as a result of the CAP Update. Staff will also provide an update to City's Five-Year Financial Forecast at this meeting as previously discussed.
3. Staff along with Matrix Consulting Group will continue working on studies for fees charged to developers and other parties to fully capture City costs; both direct costs of service and indirect overhead costs. Such studies may help to mitigate any negative General Fund impacts resulting from a modified CAP. If studies result in revised recommended fees, they will be brought before Council for review and consideration in April 2019 as part of the Master Fee Schedule process and be included in revenue estimates for the FY 2019-20 Budget.

Fiscal Impact: As a result of the FY 2018-19 CAP Update, the General Fund will receive \$1,105,526 less indirect cost revenue charged to the Water Utility, Sewer Utility, and Solid Waste Utility Funds in total. Staff has several solutions to address this shortfall and will formally present them to Council during February 5, 2019 Phase II mid-year budget adjustments if needed. However, at this time, no budget adjustment is proposed by staff so that it may fully access all the options available to the City and get a clearer sense of any additional sales tax revenue received as a result of the recent Quill/Wayfair Supreme Court decision and any other City revenue sources that could exceed approved budgetary estimates for FY 2018-19.

Recommendation: Receive report and move to approve the Fiscal Year 2018-2019 Central Services Full Cost Allocation Plan.

Attachment: Central Services Full Cost Allocation Plan

2. Receive Staff Report on Sewer Rates Study, Direct Staff to Proceed with Community Engagement on Proposed Rates, Including Identifying a Date for the Public Hearing and Mailing a Notice of the Public Hearing (Staff Contact: Tony Ndah, 408-586-2602)

Background: The City of Milpitas owns and operates its municipal sewer collection system consisting of 179 miles of gravity pipe and 5 miles of force main. The system also includes two pump stations, which lifts sewer out of a low-lying neighborhoods and pumps all City sewage through dual 2.5 mile force mains to the San Jose/Santa Clara Water Pollution Control Plant (WPCP).

The City of San Jose operates the WPCP and by a “Master Agreement,” accepts sewage flow from the City for treatment. The WPCP serves eight cities and four sanitation districts in the region. By the terms of the agreement, the City pays a proportionate share of the Plant’s operations, maintenance, and capital improvement cost each year. The infrastructure at the WPCP is at or near the end of its useful life, and is overdue for renewal and modernization.

Per Title 4, Chapter 3, Section 4.00 of the Milpitas Municipal Code, the City must set sewer rates to ensure sufficient revenues to fully recover 100% of the cost to collect and convey all the wastewater and to have it treated at the WPCP.

In August 2015, Council conducted a public hearing and adopted a new sewer rate structure for the City. The rates became effective on August 4, 2015. It has been more than three years since a formal cost of service/rate study has been performed for the City’s sewer system, and major capital improvements have been made since then, and will continue to be made.

In January 2018, the City contracted with Municipal and Financial Services Group (MFSG) to conduct a cost of service analysis for the sewer system. The purpose of the analysis was to evaluate the City’s sewer system revenue requirements and prepare a comprehensive sewer rate and cost of service study, to include an update of the City’s existing rate structure, and financial obligations, and to develop a rate structure that identifies and projects all revenue requirements and rate adjustments needed over the five year period between FY 2018-19 to FY 2022-23, to meet all wastewater related costs, operation and maintenance costs, capital improvement projects, capita and financial obligations, and reserve requirements for the sewer utility enterprise during this period.

MFSG presented the preliminary results of their analysis at the City Council’s September 18, 2018 meeting and Council voted to continue discussion on the sewer rate study to a future date to allow more time to consider the sewer rate study results in more depth, and for staff to return with responses to questions posed by Councilmembers during the meeting.

Analysis: The City’s sewer system is operated as a self-supporting enterprise and the City must charge customers for these commodities at a rate that covers the City’s costs. The revenue requirements for the sewer enterprise includes expenses for the City’s operation and maintenance, capital improvements, existing debt service, and the City’s share of the WPCP operations and capital expenses. Based on the results of MFSG’s study, staff has determined that an increase in sewer service rates, fees and charges is necessary to recover current and projected costs of the City’s operation and maintenance, capital improvements, existing debt service, and the City’s share of the WPCP operations and capital expenses. The draft sewer rates study is a five year analysis for the period from fiscal years 2018-19 to 2022-23, which includes a multi-year financial forecast, a projection of revenue requirements, and rate review and analysis.

Proposed Sewer Rate (FY 2018-19 to FY 2022-23)

The Sewer Rate Study proposes an update to the current rate structure to meet the revenue requirements of the sewer fund. Rates are allocated proportionally based on recognized cost of service principles as required under Proposition 218.

The proposed rates include a “Flat Fee” to recover the City’s personnel services cost, and the fee is allocated between Residential and Non-Residential customers, based on dwelling units. The “Flat Fee” for residential customers would be added to the bi-monthly fee charged. The “Flat Fee” for Non-Residential customers in FY 2019 would be \$24.30, and the fee would increase between \$0.73 and \$0.80 in each fiscal year thereafter.

The proposed sewer rates realign the City’s rate calculation for mobile home parks with the allocation recommended in the City of San Jose’s Residential Flow Study (2015). This results in a rate based on 141 gallons per day per unit, as opposed to the 114 gallons per day per unit used in the City’s 2015 sewer rate study.

The proposed sewer rates include several increases over time, instead of a one-time more significant rate increase. The City’s proposed bi-monthly rate for FY 2019 is \$97.60 for single family residential, \$74.96 for multi-family residential, and \$76.03 for mobile home parks.

Staff recommends Council implement a policy alternative to subsidize the mobile home park rate. San Jose’s 2015 Residential Flow Study notes that data provided by the City to determine sewer flows for mobile home park customers was disregarded due to insufficient data. As a result, a weighted average of the San Jose and West Valley Sanitation District data was used to set the City’s share for mobile home park contributions for the WPCP. The City’s 2015 sewer rate study set rates for mobile home parks to be equivalent to the flow of the City’s single and multi-family values, due to the inconsistencies noted in San Jose’s Residential Flow Study.

The proposed rate structure would realign the flow for the mobile home parks with the values recommended in San Jose’s 2015 Residential Flow Study (i.e. 141 gallons per day per unit, as opposed to the 114 gallons per day per unit). This would increase the mobile home park bi-monthly service charge by \$19.06 in FY 2019. The recommended policy alternative would subsidize the rate for the mobile home park customer class over the course of the five-year rate projection from the City’s general fund, to reduce the rate impact on Mobile Home Park rate payers to equal the proposed rate impact on Single Family and Multiple Family users.

As a result of the proposed rates, fees, and charges for sewer service, the standard bill for residential customers for FY 2018-19 would be as follows:

Residential Customer Class	Current Bi-monthly Rate	Proposed Maximum Bi-monthly Rate FY 2018-19	Maximum Monthly Increase
Single-Family Residential	\$90.27	\$97.60	\$3.67
Multi-Family Residential	\$69.32	\$74.96	\$2.82
Mobile Home Park (without subsidy)	\$56.97	\$76.03	\$9.53
Mobile Home Park (with subsidy)	\$56.97	\$61.61	\$2.32

In addition to the rate adjustments recommended in FY 2018-19 for the residential customer class, the rates study estimates the sewer enterprise requires overall rate increases in FY 2019-20 through FY 2022-23. Rate increases for the Non-Residential customer class will vary from

year to year due to varying levels of the operating and capital cost requirement for the sewer system. The proposed maximum rates are set forth in the table included in the agenda packet.

The proposed rates include the assumption that the City will utilize bond proceeds to pay for the City's contribution for the WPCP, which would help mitigate the rate impact on customers and allow for long-term planning of rate increases. The projected total debt service obligation for the City would result in two debt issues: a debt issuance in FY 2020 for \$20 million and a debt issuance in FY 2021 for \$15 million. Staff will bring forward a discussion of various financing options to Council in early 2019, prior to proceeding with any external financing.

Follow-up Actions/Requests from September 18, 2018 Council meeting

- 1. Update San Jose's 2015 Flow Study for the City's Mobile home parks** – At the September 18, 2018 Council meeting, Council directed staff to work with the City of San Jose to explore options to update San Jose's 2015 Residential Flow Study with updated sewer flow numbers for mobile home park customers in Milpitas. In order to ensure costs are distributed to all customer classes in accordance with Propositions 218 and 26, the study had recommended aligning the sewer rate structure for the mobile home parks with values used in San Jose's 2015 Residential Flow Study (i.e. 141 gallons per day per unit, as opposed to the 114 gallons per day per unit). This would result in an increase to the mobile home park bi-monthly service charge of \$19.06 in FY 2019. Recognizing the significant impact of this increase, staff had proposed a mobile home park rate subsidy from unrestricted funds over a 5-year period.

City staff have been coordinating with City of San Jose staff to explore the feasibility of updating San Jose's Flow Study. San Jose staff have informed City staff that an update to the flow study data for Milpitas mobile home parks could have implications on the other tributary agencies of the WPCP. As such, San Jose staff will be working internally to determine the feasibility of updating their Flow Study prior to the scheduled ten year update in 2025, which would include an update to the City's mobile home park sewer flow data and may also include an update for all tributary agencies of the WPCP. City staff will continue to work with San Jose staff on an update to the flow data for Milpitas mobile home parks. In the interim staff is recommending proceeding with the proposed subsidy amounts shown in the table below, and if the flow study is updated prior to 2023, this subsidy can be sunset.

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Mobile Home Park Rate Subsidy	\$45,100	\$47,400	\$51,400	\$54,800	\$57,600

- 2. Public outreach to the mobile home community** – Council directed staff to conduct outreach to the mobile home parks on the recommendations of the sewer rate study, the proposed rate, and proposed subsidy of the mobile home park sewer rate. City staff have held outreach meetings with the property managers for the 3 mobile home park community's in the City, to discuss the proposed sewer rates, its impact on the mobile home park customers, and the proposed mobile home park subsidy. As part of the Proposition 218 noticing and community engagement process for the proposed sewer rates, staff will be distributing mailers and conducting community meetings with mobile home park residents to provide information on the proposed sewer rates.
- 3. Explore additional subsidy programs for the City's disadvantaged sewer customers** – At the September 18, 2018 Council directed staff to explore additional subsidy programs for other disadvantaged sewer customers. Staff is recommending that development of this type of program and any additional subsidy programs be analyzed and discussed during the City's fiscal year budget process, in the context of other spending priorities.

Proposition 218 Noticing and Community Engagement

Proposition 218, a state proposition approved by California voters in 1996, added Article XIII D to the California Constitution which requires voter approval prior to the imposition of and new or increases in any existing taxes, assessments, and certain user fees. It also requires local agencies imposing any new or any increases in any existing property-related fees and charges to comply with certain procedural requirements prior to their adoption. Sewer Service fees and charges are subject to these procedural requirements. Pursuant to Article XIII D, section 6, the City is required to hold a public hearing to consider the proposed sewer service rates, fees, and charges. Additionally, it is required to provide ratepayers and property owners with a written notice of the proposed rate increases, and the date, time and location of the public hearing on the proposed rate increase. Subdivision (a) of Section 6 of the California Constitution's Article XIII D requires that 45 days must elapse from the time the notices are mailed until the public hearing on the proposed rate increases.

Staff will work to prepare the Proposition 218 notice and will ensure it is clear, transparent and understandable. The notice will include a full recitation of all of proposed maximum rates for FY 2018-19 through FY 2022-23, the reasons for and the basis upon which the rates are calculated, an explanation of the Proposition 218 process, and a description on how to participate in the process. A dedicated webpage on the City's website will be established and updated regularly, including a frequently asked questions section, rate calculator, and other pertinent information. The Proposition 218 mailer will have a callout in multiple languages directing residents to the City's website for translation into their preferred language and printed material can be translated upon request. In addition, outreach will include postings to the City's social media accounts (i.e., Facebook, Nextdoor, Twitter), on the City's government access television channel and flyers will be placed in City facilities and shared with stakeholder groups.

The Draft Sewer Rates Study will be finalized prior to the public hearing on the proposed rates (tentatively scheduled for February 5, 2019). In the interim, staff will conduct community meetings and a public workshop on the proposed rate increases and draft sewer rates study in December 2018 and January 2019.

Below is the proposed schedule for the Proposition 218 notification, community meetings, public workshops, public hearing, and external financing.

Date	Meeting	Milestone/Venue
November 29, 2018	Special Council Meeting	Council consideration of staff recommendation to initiate notification of proposed sewer rates
December 2018 (Dates to be determined)	Community Meeting and Public Workshop	To be determined
January 2019 (Dates to be determined)	Community Meeting and Public Workshop	To be determined
February 5, 2019 (Tentative)	City Council Meeting	- Public Hearing at City Hall - Council consideration of proposed sewer rates
February 2019		Initiate process to secure external financing
March 2019		Adopted sewer rates go into effect
July 2019		External financing in place in time to make payments for the City's contributions

Policy Alternative:

Alternative 1: Do Not Accept Sewer Rates Study and Defer Community Engagement and Notification on Proposed Rate Increases

Pros: The existing sewer rates would remain in place.

Cons: This action would delay community engagement efforts and delay action on adjusting sewer rates. The sewer fund would be in violation of the Municipal Code, which requires that the sewer fund be operated as a self-supporting enterprise. This, in turn, will also negatively impact future credit ratings for external financing needed to fund the City's share of the capital program at the WPCP, due in July 2019. A delay in adjusting sewer rates also impacts the City's ability to fund critical capital improvement projects needed to maintain system reliability and replace/rehabilitate the pipeline infrastructure.

Reason for not Recommending: Delaying consideration of proposed rate increases would negatively impact the City's ability to obtain external financing in a timely manner and to meet its contractual obligations on the WPCP capital improvement program. This could put the City at legal and financial risk and also negatively impact any future external financing required for rehabilitation of any of the City's infrastructure. Delaying consideration of rate adjustments would also impact the ability to invest in the collection system's aging infrastructure, potentially impacting the utility's ability to operate in a safe and reliable manner.

Fiscal Impact: If the Proposition 218 majority protest process is concluded without a majority protest and the sewer fee adjustments are adopted as presented, the new sewer rate structure would generate adequate revenues, along with external financing, to ensure the fiscal sustainability of the Sewer Fund.

California Environmental Quality Act: This action is exempt from CEQA as there will be no physical change to the environment.

Recommendations:

1. Receive staff report on Sewer Rates Study.
2. Direct staff to proceed with community engagement on proposed rates, including identifying a date for the Public Hearing and mailing a notice of the Public Hearing not less than 45 days prior to the Hearing date.

Attachments:

- a) Proposed Maximum Bi-Monthly Rate Schedule FY 2018-19 to FY 2022-23
- b) Draft Sewer Rates Study - November 2018

3. Receive Staff Report on Water Rates Study, Direct Staff to Proceed with Community Engagement on Proposed Rates, Including Identifying a Date for the Public Hearing and Mailing a Notice of the Public Hearing (Staff Contact: Tony Ndah, 408-586-2602)

Background: The City of Milpitas owns and operates a safe drinking water distribution system in accordance with State regulations, and per Title 4, Chapter 3, Section 4.00 of the Milpitas Municipal Code, must set water rates to ensure sufficient revenues to fully recover 100% of the cost to provide water to approximately 17,000 customer accounts, serving a population of about 77,000 residents in the City.

The City purchases potable water from the San Francisco Public Utilities Commission (SFPUC), which delivers treated water through its Hetch Hetchy Aqueduct from the Sierra Nevada mountain range. The City also purchases potable water from the Santa Clara Valley Water District (SCVWD), which receives its raw water from the Sacramento-San Joaquin River Delta, delivered through the State Water Project and Federal San Felipe Project. The City also purchases Recycled water from South Bay Water Recycling (SBWR) and the water is retailed to customers in the City. Historically, the City's potable water supply has consisted of 67% SFPUC treated water and 33% SCVWD treated water.

In December 2015, Council adopted a uniform rate structure for the City, which was implemented over two years, with the first rate increase occurring in January 2016, and the second rate increase occurring in April 2016. There have been no increases in the water rates since then to keep pace with inflation and increases in the cost to purchase wholesale water from SCVWD and SFPUC. As a result, the water utility operating fund is projected to lose \$2.4 million by the end of FY 2018-19 and not meet the reserve fund target of 30% (110 days) of annual operating and maintenance expenses, as required by the Council's reserve policies.

In September 2016, Council approved the creation of a citizen's task force on water rates and one of the objectives of the task force was to explore the feasibility of alternative water rate structures. At a special Council meeting in October 2017, the citizen's task force on water rates recommended Council direct staff to work with a consultant to prepare a comprehensive water rate study, and include an assessment of alternative rate structures for the City that does not violate the conditions of Proposition 218. In November 2017, Bartle Wells Associates (BWA) was retained to prepare a comprehensive water rate and cost of service study, to include an update of the City's existing uniform rate structure and analyze feasible alternative water rate structures for Council consideration. BWA presented the preliminary results of their analysis at the City Council's April 17, 2018 meeting. Since then, staff has continued to work with BWA, City Attorney's Office, Finance Department, and City Manager's Office to review and update the results of the study to ensure the proposed rates and structure are in accordance with the provisions of Article XIII D, Section (6)(b) of the California Constitution (commonly referred to as Proposition 218). Proposed rates for the remainder of FY 2018-19, and for Fiscal Year 2019-20 to Fiscal Year 2022-23 are based on the updated results of BWA's study.

Analysis: Based on the updated results of BWA's study, staff has determined that increases in water service rates, fees and charges are necessary to recover current and projected costs of operations and maintenance, including cost increases in purchased wholesale water, and continue the capital infrastructure improvements necessary to provide safe and reliable drinking water; maintain the operational and financial stability of the City; ensure favorable credit ratings to minimize debt services costs related to financing necessary infrastructure improvements; avoid operational deficits and the depletion of reserves; and continue to maintain our high levels of service.

The draft water rates study is a five-year analysis for the period from fiscal years 2018-19 to 2022-23, which includes a multi-year financial forecast, a projection of revenue requirements, and a rate review and analysis. The rate review and analysis includes modifications to the current rates to improve the City's revenue and financial stability and fund the City's water system capital program.

The City is committed to efficiently providing high quality, reliable water service at the lowest possible rates for residents, while protecting the water resources and public health of our community. In addition, it is critically important that the City continually invests in its water system and the assets it holds and keeps pace with inflation and other cost increases.

Operating Costs

For sound financial operations of the City's water system, the revenues it generates must be sufficient to meet its operating expenditures. Revenue needs are defined as the amount of revenues that must be recovered through water service rates, fees and charges to cover annual operating expenditures. Use of the City's General Fund is not recommended to support water operating expenditures since General Fund revenues largely consist of tax payments from individuals such as property owners that may not be the consumers of water. This is especially true for commercial property owners and residential rental property owners. Using General Fund revenues to support water operating expenditures presents an inequitable disconnect between those who pay and those who benefit. Additionally, these tax revenues are required to fund the City's general services, such as police, fire, and parks. Operating

expenses for the water fund consists of the costs to purchase wholesale water, direct personnel costs, indirect personnel costs, and costs for services and supplies. Approximately 63% of the City's operating expenses is attributed to the purchase of water from SFPUC and SCVWD. In 2018-19, it is estimated that the operating costs of the water utility system will be approximately \$28.5 million. BWA's study estimates that the total volume of potable water purchased from water wholesalers will increase slightly each fiscal year and operating costs for the water utility will increase by 4% each year through FY 2022-23.

Capital Improvement Program

As a water service provider, the City must maintain the distribution system that provides water to our customers in compliance with numerous federal and state laws and regulations. This includes 200 miles of pipeline, 4 pump stations, 5 storage tanks and other equipment. The City has identified approximately \$46.3 million of high priority projects in its water system Capital Improvement Program needed over the next 5 years. Some of the critical projects include:

- **Well Upgrade Project** – project would be used to construct a new well and improve the reliability, taste, odor, and water hardness at the City's existing wells. Historically, the City's wells have provided the City with emergency water supply, in case SFPUC and/or SCVWD systems are not available due to an earthquake or other catastrophe.
- **Aging Water System/Seismic Improvements Projects** – project components include seismic rehabilitation to the City's "back-bone" water system and purchase of water system materials and equipment for emergency response to a major disaster. These seismic features provide additional reliability and redundancy to the City's water system.
- **Water Supervisory Control and Data Acquisition (SCADA) Project** – SCADA also allows for remote monitoring and operation of pumps and valves to implement corrective actions and maintain water supply. Currently operators rely on unsophisticated alarms at limited locations and customer complaints to become aware of water system problems. Operators must drive to sites to evaluate the problem and implement corrective action, such as starting a back-up pump, when the main pumps fail.

These projects are needed to improve the reliability of the City's water system and ensure the safe delivery of potable water to its customers.

The City's Reserve Policies also require the City to maintain Infrastructure Replacement funds for the Water Utility, and accumulate at least \$2 million a year from the water fund to set-aside for replacement of infrastructure as the infrastructure reaches the end of its useful life. Portions of the City's water infrastructure are over 60 years old and as the pipelines continue to age, the risk of infrastructure failure increases.

Reliability of water infrastructure can be measured by physical integrity indicators that include the rate at which buried water pipelines fail or leak. When buried water pipelines fail, they often form craters or sink holes in the ground which can cause damage to vehicles and nearby property and structures. Since 2013, City staff has responded to approximately 318 mainline and service lateral leaks and breaks. These failures in our water infrastructure highlight the fact that our system is aging and in need of replacement, as most of our water infrastructure will reach the end of its service life in the near future.

The failure of the water infrastructure deprives households and businesses of water for hours to days. Leaking pipes can allow hazardous materials to leach into treated water, creating a public health threat. The delivery of tainted water to households in Flint, Michigan has

heightened consumer awareness of water quality. Criminal charges against water and environmental officials in Flint demonstrate the social responsibility inherent in the water delivery sector; hence, it is important to make key investments in our pipeline infrastructure to ensure the system continues to function as intended.

The City implemented a capital surcharge in FY 2016-17. The surcharge is designed to provide adequate ongoing cash funding for water enterprise capital projects, pipeline infrastructure renewal/replacement, and associated debt service. The rate study utilizes a combination of cash and \$20 million in debt financing to fund capital projects, smooth the impact of rate increases on customers, and ensure intergenerational equity. Intergenerational equity means that all those who benefit from infrastructure improvements pay for those improvements over the expected life of the improvements and that the costs are not borne exclusively by the current generation or future generations of water customers. Rather, the costs are equitably shared by all generations through rate adjustments which in turn help to support debt payments on long-term external financing, with terms that are matched to the expected life of the improvements. A brief report on financing options has been attached for reference. Staff, along with the City's Financial Advisor, will engage the Council on a more in-depth discussion about financing options at the January 29, 2019 Budget Study Session. This will allow staff to receive input prior to proceeding with any external financing for water utility capital improvements.

Operating Reserve Requirement

The City's water enterprise was in good financial standing, with an estimated \$7 million in operating reserves as of July 1, 2017; however, under the City's current water rates, the water operating fund is projected to lose about \$2.4 million and the City would need to utilize reserve funds to meet the operating expenses needs for FY 2018-19. As such, the fund target of 30% of the annual operating and maintenance expenses will not be met, as required by the Council's reserve policies.

Tiered Rate Structure Consideration

As part of the water rates study, BWA analyzed the feasibility of implementing a tiered rate structure for the City. Recent court decisions have focused on how tiered rates are calculated. The appellate court decision in *Capistrano Taxpayers Association v. City of San Juan Capistrano* clarified that tiered rates must reflect the proportionate cost of providing the service within each tier. The most common ways agencies justify tiers include the following:

1. Differentials in source of supply costs (i.e. stacking of water supply resources to tiers);
2. Direct assignment of specific costs to specific (upper) tiers (e.g. conservation program costs);
3. Peaking costs associated with operations and maintenance; and
4. Peaking costs associated with capital improvements.

BWA's analysis determined that the City could not use differentials in source of supply costs to justify tier prices because the City does not have wholesale water purchase agreements with different pricing structures tied to amount of water used. BWA's analysis also noted that City could not use direct assignment of specific costs to specific tiers because the City does not, at this time, have direct water conservation program costs significant enough to justify establishing a tiered rate structure.

BWA also analyzed the feasibility of justifying tier costs based on peaking associated with operations and maintenance, and capital improvements. The time of greatest demand on a water system is known as "peak demand." Agencies must construct infrastructure to deliver water at peak times. There are incremental costs associated with creating this excess, peak capacity ("peaking costs") including designing (i.e., sizing), constructing, and operating and maintaining the facilities. These costs may be appropriately allocated to those water users

who place greater demands and burdens on a water system. BWA's study determined that the City doesn't have sufficient data at this time to justify a tiered rate structure on the basis of peaking; however, City may begin to gather the necessary data over a multi-year period to justify a tiered rate structure in the future based on peaking factors.

Proposed Rate

The proposed rate alternative maintains the City's uniform rate structure and includes increases to the fixed Service Charge and increases to the volumetric charge for all customer classes. The proposed rate adjustments result in a decrease in the capital surcharge due to the proposed \$20 million water revenue bond.

As a result of the proposed rates, fees, and charges for water service, the bill for the average single family residential customer, with a 5/8-inch water meter and using 14 HCF (10,473 gallons) in a two-month period will increase by approximately \$3.52 per month in FY 2018-19 as shown in the table below:

Item	Current Rates	Proposed Maximum Rates FY 2018-19
Fixed Meter Charge	\$19.44	\$27.01
Volumetric Charge	\$5.13 x 14 HCF = \$71.82	\$5.31 x 14 HCF = \$74.34
Capital Surcharge	\$1.30 x 14 HCF = \$18.2	\$1.08 x 14 HCF = \$15.12
2-month Bill Amount	\$109.44	\$116.47
1-month Bill Amount	\$54.72	\$58.24
Monthly Difference		\$3.52

In addition to the rate structure adjustments recommended in FY 2018-19, the rate study estimates the water enterprise requires overall rate increases to potable and recycled water consumption and meter charges (excluding the capital surcharge) in FY 2019-20 through FY 2022-23. The proposed maximum rates are set forth in the table included in the Council agenda packet.

The proposed rate structure would phase in rate increases to meet the City's reserve policy overtime. The City's reserve policy requires the accumulation of 30% of the annual operating and maintenance expenses of the water system. The proposed rate structure does not provide funds to meet this reserve target until FY 2022-23. BWA determined that the City would need to raise rates by 36.5% in FY 2018-19 to meet the reserve target in that year. Staff recommends that the City phase in the rates to meet fund reserve targets by FY 2022-23 to prevent rate shock and smooth in rate increases.

Rate Subsidy Program Consideration

California public agencies providing water service may implement low-income water rate assistance programs, but rate discounts must be funded from non-rate sources of revenues – e.g., lease revenues and revenues from fines and penalties other than a civil liability imposed for violations of the City's water conservation program. The City may choose to implement a low-income water rate assistance program, and qualify low-income water customers based on those already enrolled in the Pacific Gas and Electric (PG&E) Care program to minimize administration costs. Implementation of a low-income rate assistance program and any additional subsidy programs would need to be analyzed and discussed during the City's fiscal year budget process.

Proposition 218 Noticing and Community Engagement

Proposition 218, a state proposition approved by California voters in 1996, added Article XIII D to the California Constitution which requires voter approval prior to the imposition of and new or increases in any existing taxes, assessments, and certain user fees. It also requires local agencies imposing any new or any increases in any existing property-related fees and charges to comply with certain procedural requirements prior to their adoption. Water Service

fees and charges are subject to these procedural requirements. Pursuant to Article XIII D, section 6, the City is required to hold a public hearing to consider the proposed water service rates, fees, and charges. Additionally, it is required to provide ratepayers and property owners with a written notice of the proposed rate increases, and the date, time and location of the public hearing on the proposed rate increase. Subdivision (a) of Section 6 of the California Constitution's Article XIII D requires that 45 days must elapse from the time the notices are mailed until the public hearing on the proposed rate increases.

Staff will work to prepare Proposition 218 notice and will ensure it is clear, transparent and understandable. The notice will include a full recitation of all of proposed maximum rates for FY 2018-19 through FY 2022-23, the reasons for and the basis upon which the rates are calculated, an explanation of the Proposition 218 process, and a description on how to participate in the process. A dedicated webpage on the City's website will be established and updated regularly, including a frequently asked questions section, rate calculator, and other pertinent information. The Proposition 218 mailer will have a callout in multiple languages directing residents to the City's website for translation into their preferred language and printed material can be translated upon request. In addition, outreach will include postings to the City's social media accounts (i.e. Facebook, Nextdoor, Twitter), on the City's government access television channel and flyers will be placed in City facilities and shared with stakeholder groups.

The Draft Water Rates Study will be finalized prior to the public hearing on the proposed rates (tentatively scheduled for February 5, 2019). In the interim, staff will conduct community meetings and a public workshop on the proposed rate increases and draft water rates study in December 2018 and January 2019.

Below is the proposed schedule for the Proposition 218 notification, community meetings, public workshops, public hearing, and external financing.

Date	Meeting	Milestone/Venue
November 29, 2018	Special Council Meeting	Council consideration of staff recommendations to initiate notification of proposed water rates
December 2018 (Dates to be determined)	Community Meeting and Public Workshop	To be determined
January 2019 (Dates to be determined)	Community Meeting and Public Workshop	To be determined
February 5, 2019	City Council Meeting	- Public Hearing at City Hall - Council consideration of proposed water rates
February 2019		Initiate process to obtain external financing
March 2019		Adopted water rates go into effect
July 2019		External financing is in place to fund critical capital projects

Policy Alternative:

Alternative 1: Do Not Accept Water Rates Study and Defer Community Engagement and Notification on Proposed Rate Increases

Pros: The existing water rates would remain in place.

Cons: This action would delay community engagement efforts and delay action on adjusting water rates. The water fund is projected to lose \$2.4 million by the end of FY 2018-19, which will result in depletion of the operating reserves, with reserves falling below the level required by Council policy. Furthermore, the water fund will be in violation of the Municipal Code, which requires that the water fund be operated as a self-supporting enterprise. This, in turn,

will also negatively impact future credit ratings for any external financing. A delay in adjusting water rates also impacts the City's ability to fund critical capital improvement projects needed to maintain water system reliability and replace/rehabilitate the pipeline infrastructure.

Reason for not Recommending: Delaying consideration of proposed rate increases would result in continued operating losses for the utility, thus placing it at financial risk and negatively impacting future credit ratings for any external financing. The delay would also result in inadequate investment in aging infrastructure, potentially impacting the utility's ability to operate in a safe and reliable manner.

Fiscal Impact: If the Proposition 218 majority protest process is concluded without a majority protest and the water rate adjustments are adopted as presented, the new water rate structure would generate enough revenues that would help to ensure the fiscal sustainability of the Water Fund.

California Environmental Quality Act: This action is exempt from CEQA as there will be no physical change to the environment.

Recommendations:

1. Receive staff report on Water Rates Study.
2. Direct staff to proceed with community engagement on proposed rates, including identifying a date for the Public Hearing and mailing a notice of the Public Hearing and proposed rates not less than 45 days prior to the Hearing date.

Attachments:

- a) Proposed Maximum Bi-Monthly Rate Schedule FY 2018-19 to FY 2022-23
- b) Draft Water Rates Study - November 2018

VIII. ADJOURNMENT