

**FINAL
REPORT ON REVIEW OF
WATER UTILTY
COSTS OF SERVICE
RATE STUDY**

**CITY OF MODESTO
DECEMBER 15, 2006**

Prepared By:
RICHARD R. RUDNANSKY
Special Counsel
Meyers, Nave, Riback, Silver & Wilson
401 Mendocino Avenue, Suite 100
Santa Rosa, CA 95401

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PREFACE

Although I have prepared this report, much credit goes to a number of people who have assisted and participated in the process which has resulted in this report. I would like to take this opportunity to thank Council Member Kristen Olsen, the Council Member liaison to this review and investigation, for her support, insight and patience through this process. Thanks also to John Farnkopf and Kathleen Catton of Hilton Farnkopf and Hobson, the consultants I retained to assist me and to Mark Roberts of Shibumi Consulting Services Inc, the City's consultant who provided data extracts from the City system, for their expertise and assistance. In addition I want to publicly express my appreciation and gratitude to City staff, particularly Finance Director Wayne Padilla, Deputy Finance Director Greg Baird, City Attorney Susana Wood and Assistant City Attorney Roland Stevens whose assistance, open minded approach, and knowledge of the City of Modesto was extremely valuable to me, Mr. Farnkopf and Ms Catton. Finally, I wish to acknowledge the citizens who have taken an interest and have participated in this review process and who have provided input and attended the Public Workshops.

Richard R. Rudnansky
Special Counsel
December 15, 2006

FINAL REPORT ON REVIEW OF WATER UTILITY COSTS OF SERVICE RATE STUDY

INTRODUCTION

This report is a culmination of a City Council directed investigation and review of a previously performed Water Utility Cost of Service Rate Study and review of previously adopted water rates to determine:

- (i) Whether the projected revenues from the Water Utility Cost of Service Rate Study and the adopted water rates are, and/or will be, more or less than what has actually been received to date and what is anticipated to be received in the future; and
- (ii) If the conclusion is that revenues were significantly more or less, determine why this discrepancy occurred.

On March 28, 2006, the City Council directed the then Interim City Attorney Richard R. Rudnansky to perform such a review and authorized the process for such a review. The concern of the Council at the time was that there had been a preliminary determination that the projected revenues in the 2004 Water Utility Cost of Service Rate Study with respect to increased rates were greater than what was actually being billed, therefore possibly resulting in a shortfall of revenue which might result in an inability to fund infrastructure requirements previously determined to be necessary.

A process of review was adopted by the Council that provided for citizen participation.

BACKGROUND

At a City Council meeting in December of 2003, the Council selected Foresight Consulting Services ("Foresight") to conduct a water and wastewater user fee and infrastructure fee study. At the City Council meeting of March 23, 2004, staff recommended water rate increases and direction from the Council to initiate steps to begin the process necessary for implementation of water rate increases. At that time, it was pointed out that over the previous approximately 9 years, the number of wells in the water system were reduced from 140 to 112 (i.e., roughly a 20% reduction in less than 10 years). The reason for this reduction in wells was that decreased maximum contaminant levels were adopted by state and federal government. It was felt that this trend would continue. Reduction of these wells led to a number of other system

concerns, including supply, pressure and drought storage. Removing wells from the system also had an impact on storage capacity.

Because of these issues, staff opined that it was critical at that time to begin the design of the Phase 2 portion of the service water treatment plant immediately. In addition to the Phase 2 treatment plant, at that time estimated at \$37.6 million, there were a number of other system improvements necessary. It was estimated at that time that the City's share of the project, including downstream improvements, was approximately \$64 million. Although the project as a whole was anticipated to be financed through revenue bonds, preliminary costs were to be absorbed by the water fund but the water fund reserve was not sufficient to permit issuance of revenue bonds.

There was estimated at that time the need for "pay as you go" projects for the water system with additional capital improvement projects necessary to improve the system performance. The estimate of "pay as you go" capital needs necessary was \$51.2 million over the period of five years. These included storage tanks, pipeline replacements, upgrades, new wells, well head treatment and other projects. The total cost estimated at that time over five years was \$152.8 million.

Therefore at that time, the recommendation was for an immediate water rate increase necessary to pay for system costs associated with:

1. Preliminary design and downstream improvements for Phase 2 of the surface water treatment plant;
2. System-wide infrastructure needs for the next five years, including storage tanks, pipelines (replacement and upgrade), new wells, well head treatment and other water projects and studies;
3. Maintaining water quality under strict water quality standards;
4. Funding for operations and maintenance; and
5. Reserve levels adequate to meet bonding requirements.

It was noted that at that time there had not been a water rate increase since 1994 (almost 10 years at that time) for most City of Modesto water customers.

Complicating the situation was the fact that there were multiple zones, different rates within and among zones, the existence of metered and non-metered customers, and the need to comply with Proposition 218. In other words, this was not to be your typical rate study and establishing of water rates. It was acknowledged that the three zones would need to be converted into a single unified rate structure.

At that time, two alternatives were proposed. One alternative was a total revenue requirement over five years with a rate increase of 35% the first year, 30% the second year, 30% the third year, 5% the fourth year and 5% the fifth year.

The second alternative was a single year increase of 35% across the board with further rate increase recommendations being brought forward once the cost of service analysis and master water plans were finalized and reviewed. It was noted that this option would delay the proposed bond financing for the service water project (estimated 12 months).

On September 14, 2004, the Council accepted the Water Utility Cost of Service Rate Study prepared by Foresight ("Foresight Rate Study") (**Exhibit A** attached hereto) and the West Yost Justification and Cost Allocation for Proposed Water System Improvements Report (**Exhibit B** attached hereto). In addition, the City Council adopted a resolution to initiate the Proposition 218 process.

Subsequently, at the November 23, 2004, Council meeting, the Council took the following actions:

1. Adopted a Resolution Rescinding All Previous Water Fee Resolutions, Establishing a Single Rate Base, and Establishing Fees for the Provision of Water and All Fees Associated with Water Operations and Management (**Exhibit C** attached hereto), and
2. Introduced an Ordinance Amending 11-1-04 and 11-1-06 of Chapter 1 of Title 11 of the Modesto Municipal Code Relating to Water Rates and Regulations, and Amending Chapter 6 of Title 11 of the Modesto Municipal Code Relating to Collections of Public Utility Charges (**Exhibit D** attached hereto).

The ordinance was adopted by the Council on December 7, 2004.

In the fall of 2005, staff initiated review of the actual water rate fee generation for the period from January 1 through June, 2005 in accordance with the direction given by the Council to provide a report on the performance of new water rate structure that was developed by Foresight. This direction was given at the time the new rate structure was adopted in December of 2004. In preparing its review, staff compared the actual levels of revenue that were being billed with the forecast of revenue for the same period shown in the Foresight Rate Study. While it is normal to see minor variances based on differences in actual number of customer accounts, the effects of weather, consumption, and other variables, staff became concerned when it appeared that actual revenues generated during the six month period were materially lower than the level that was forecast in the Foresight Rate Study.

Concerned with what appeared to be a significant shortfall in actual billed revenue compared to projected revenue in the Foresight Rate Study, Mayor Ridenour called for a review and investigation of the situation. At the City Council meeting of March 28, 2006, the City Council directed Richard R. Rudnansky, a principal with the law firm of Meyers Nave, and at that time the Interim City Attorney, to perform such review and authorized a process for such a review. The specific charge of the Council was to determine:

"(1) Whether the projected revenues from the Water Utility Cost of Service Rate Study ('Study') and the adopted water rates are, and/or will be, more or less than what has actually been received to date and what is anticipated to be received in the future; and

(2) If the conclusion is that revenues were significantly more or less, determine why this discrepancy occurred."

The Council also authorized a process to be followed which allowed for public involvement and input. The process was as follows.

- (1) Public workshops to allow the public to comment and provide input on the issues.
- (2) Authorize the City Attorney's Office (Interim City Attorney) to use any sources, including staff, consultants who had previously participated in the Water Rate Study (Foresight Rate Study), members of the public and new consultants and experts that are reasonably necessary to conduct this review.
- (3) Direct City Staff to cooperate fully with this review.
- (4) Authorize the City Attorney's Office (Interim City Attorney) to retain any consultants and experts that are deemed in his estimation to be necessary.
- (5) Issuance by the City Attorney's Office (Interim City Attorney) of a Draft Report and notice to members of the public by publication of such notice in the Modesto Bee that the Draft Report would be available for review and/or copying and that any written comments that the public wishes to make about the draft report could be submitted to the City Clerk by a date certain.
- (6) Presentation of the Draft Report at a City Council meeting at which time City Council would provide for public comment on the Draft Report.
- (7) After the City Council meeting on the Draft Report, a Final Report will be prepared
- (8) A presentation of the Final Report at a City Council meeting and provide opportunity for public comment on the Final Report.

On April 11, 2006, pursuant to the Council's authorized process and after multiple notices in the local newspaper and announcements at Council meetings, a public workshop was held which essentially confirmed that there was in fact a variance between the revenue projections in the Foresight Rate Study and the actual audited billed amounts for the same periods. Based on information available at that time, an attempt was made to project what the shortfall or variance would be for calendar year 2005/06. At that time, based on the information available, it was estimated that the shortfall for fiscal year 2005/06, depending on various scenarios, would likely be in the range of \$4.2 million to \$5.8 million. It was also confirmed that the variance for fiscal year 2004/05 was approximately \$2.2 million. Those in attendance at

that workshop were advised at that time that the next step would be an attempt to refine and update the data and projections for not only Fiscal Year 2005/006 but also Fiscal Years 2006/07 through 2008/09 and determine the causes of the variances.

Subsequent to this Public Workshop, and pursuant to the previous authorization of the City Council, John Farnkopf of Hilton Farnkopf & Hobson Consultants was retained to assist in this investigation and review. Mr. Farnkopf worked closely with the staff and Mr. Rudnansky and solicited input from Greg Clumpner of Foresight and Mark Roberts of Shibumi Consulting Services, Inc. ("Shibumi"). Kathleen Catton assisted Mr. Farnkopf in his review. In addition, Mr. Farnkopf attended the public workshop on September 28, 2006.

Mark Roberts of Shubumi was asked to extract data that was determined to be more specific and updated than the data that had been provided to Foresight and specifically focused to assist in the analysis necessary in order to respond to the charge of the Council. Those extracts were provided to the City in late March of 2006 and are attached hereto as **Exhibit E**.

There were discussions with and information and data provided to citizens. In addition, staff and Mr. Rudnansky met with citizens to discuss the review and receive comments and input. Mr. Farnkopf had contact with Mr. Clumptner of Foresight.

Subsequently pursuant to the Council's authorized process and after multiple notices in the local newspaper and announcements at Council meetings, a second Public Workshop was conducted on September 28, 2006. The variances between the revenue projections in the Foresight Rate Study and the actual/audited and Updated Revenue Projections and the reasons given for the variances which were discussed at that time are more fully discussed in this report and in a memo prepared by Mr. Farnkopf attached hereto as **Exhibit F**.

Following the public workshop, and pursuant to the process authorized by the Council, a Draft Report was prepared and released to the public on October 18, 2006. Through publications in the local paper, the public was notified that the Draft Report was available through the City Clerk's office and, pursuant to the Council authorized process, that the public would have until November 6, 2006 to submit written comments to the City Clerk's office on the Draft Report. This comment period was then extended to November 13, 2006 which was also publicized in the local paper.

Citizen Danny Gottlieb submitted written comments (attached as **Exhibit L**) to the Clerk's office on November 13, 2006. Eric Reimer¹ and Dave Thomas provided written comments (attached as **Exhibit M**) on November 14, 2006. Attached, as **Exhibit N**, is a written response by City Finance Director Wayne Padilla to the Reimer/Thomas written comments.

¹ Mr. Reimer previously provided material dated May 2, 2006 which he has requested be included in the final report. Although obviously not a written comment on the Draft Report, as a courtesy to Mr. Reimer and for the Council's information it is attached as **Exhibit O**. Attached, as **Exhibit P**, is a response dated June 14, 2006 by Wayne Padilla, City Finance Director, to Mr. Reimer's May 2, 2006 material.

At the November 14, 2006 City Council meeting a presentation was made to the City Council regarding the Draft Report. The written comments received were provided to the Council at the meeting. The Council by motion accepted the Draft Report and directed that the Final Report be prepared.

This Final Report is hereby submitted.

FINDINGS

I

WERE THE REVENUES PROJECTED IN THE FORESIGHT RATE STUDY AND THE ADOPTED WATER RATES MORE OR LESS THAN WHAT HAS ACTUALLY BEEN BILLED TO DATE AND WHAT IS NOW ANTICIPATED TO BE BILLED IN THE FUTURE?

After considerable review of this matter in conjunction with John Farnkopf of Hilton, Farnkopf Hobson who was retained to assist in this analysis, along with assistance from City staff and in particular Finance Director Wayne Padilla and Deputy Finance Director Greg Baird, it is my conclusion that there are and will be significant variances between the projected revenues in the Foresight Rate Study and what has actually been billed and what is anticipated to be billed in the future.

For the fiscal years noted below, the variances (shortfall in revenue) between the Foresight projections, actual audited billed revenue amounts, and new and Updated Revenue Projections by Mr. Farnkopf are as follows:

Fiscal Year 2004/05*	\$2,213,322.00
Fiscal Year 2005/06**	\$5,508,086.00
Fiscal Year 2006/07***	\$6,811,347.00
Fiscal Year 2007/08***	\$7,266,814.00
Fiscal Year 2008/09***	\$7,751,728.00
Total Variance for Fiscal Years 2004/05 through 2008/09	 \$29,551,297.00

- * Using actual/audited revenue amounts
- ** Using actual/unaudited revenue amounts
- *** Using "Updated Revenue Projections"

II

WHY DID THESE DISCREPANCIES OCCUR?

The reason for the variance between the revenue projected in the Foresight Rate Study and the revenue generated from the actual revenue billings and the Updated Revenue Projections relate to three main areas:

1. Customer Count, Consumption and Billing Revenue Data.
2. What is called in this report the "35 percent factor."
3. The manner in which the assumed 1.6 percent annual growth rate was applied in the Foresight Rate Study to forecast revenue.

1. CUSTOMER COUNT, CONSUMPTION AND BILLING REVENUE DATA

In order for Foresight to conduct its analysis and projections it was necessary to obtain key data from the City. The nature of the City's data system requires that an outside consultant be used to extract data from a system that is very complicated and not very user-friendly. The outside consultant, Shibumi Consulting, provided extracts to Foresight. Mark Roberts of Shibumi stated at the public workshop on September 28, 2006, that he merely provided data for which he had been asked after some modifications were made to the original request based on his concerns and understanding of how Foresight intended to use the data for its analysis.

In essence, the annual revenue forecasts from the rate increases were overestimated despite the fact that the rate increases designed to meet the assumed revenue requirements were actually calculated too low. The reason in part was Foresight's use of the unfiltered data which included a number of customer accounts which included duplicate accounts and non-active accounts. Use of this unfiltered data resulted in lower unit values per customer class. That is to say, because the total revenue requirements were projected over a larger customer base, in actuality the result was lower rates per individuals in the various classes than were needed to meet the revenue requirements. In this regard, Foresight used data showing 75,454 accounts. Based on more recent data extracted from the City's system and provided by Shubumi this year (see **Exhibit F, Schedule D and Exhibit E**), there appears to have been 74,396 "active" accounts at that time (i.e., duplicate and non-revenue accounts were excluded from the data).

In addition, the consumption rates used for the fiscal year 2004/05 projections were based on the six months in FY 2003 which typically are high usage months rather than taking into account the lower usage

months for the other half of the fiscal year. Therefore the consumption rates used for the projections were too high. It appears that Foresight used as consumption for a half year of 6,391,192 hcf (see Exhibit A (Foresight Table 7A-3)) which was from the high usage months rather than taking into account the consumption for the lower usage months when making his projections. Shibumi data (see Exhibit E) revealed that with respect to metered water sales for January through June of 2005, which was unseasonably cool and wet, the consumption was 3,720,342 hcf (see Exhibit F, Schedule C). In other words, the volume used by Foresight for the January through June period is almost twice as much as the actual amount and is almost equal to the July-December 2004 volume. Therefore, the revenue from existing rates before the rate increase in fiscal year 2004/05 was estimated too high due to the overstated revenues based on the unfiltered data used in the Foresight Rate Study.

2. 35 PERCENT FACTOR

Another significant source of the variance is what is being called in this report the "35 Percent Factor." Table 7-1 of the Foresight Rate Study (see Exhibit G attached hereto and page 30 of Exhibit A attached hereto) appears to reflect that the rate increases that went into effect on January 1, 2005 would result in an overall 35 percent revenue increase over the previous year's revenue. However, if the amount of the increase shown on Table 7-1 for the period January 1 through June 30, 2005 (i.e. \$3,855,305) had been validated using the data available at that time, it would have shown that the forecast revenue increase shown in Table 7-1 of the Foresight Rate Study would be an increase of only 27.2 percent. In other words, Table 7-1 purports to reflect a 35 percent revenue increase effective January 1, 2005. This was not the case. The \$3,855,305 increase in revenue shown in Table 7.1 is an effective 27.2 percent increase for that 6 month period (i.e., $\$3,855,305 \times 2 \div 28,322,000 = 27.2\%$).

It appears that Foresight derived the \$3,855,305 from using Table 7A-2 and 7A-3 of Appendix E (see pages 5 and 6 of Exhibit A-1 found behind Exhibit A attached hereto) to the Foresight Rate Study. However, this amount resulted in only the 27.2 percent increase. This is an example of how certain numbers in Table 7-1 originated from another source but appear to be derived from Table 7-1. In other words, although \$3,855,305 appears to have been shown as a 35 percent across the board increase as purported in Table 7-1, the actual source of that amount was from a different set of Tables (Table 7A-2 and Table 7A-3 of Appendix E to the Foresight Rate Study) which actually resulted in a 27.2 percent increase. It should be noted that in hindsight, based on the actual data that is available today from the Shibumi extracts (see Exhibit E), which Foresight Consulting would not have had at the time of its study, the actual increase using actual audited amounts was only 21.2 percent.

To compound the problem, the revenue projections in the Foresight Rate Study for the out years (i.e., fiscal year 2005/06 through 2008/09), were calculated in the Foresight Rate Study by the application of a 35 percent factor to revenue despite the fact that the initial rate increase would not generate more than 27.2% and it is now known that the effective annual increase resulted in only a 21.2% increase. In other words, when calculating the outgoing years, the 35 percent increase factor is carried through to the calculations for the remaining "outgoing" years. Table 7-1 of the Foresight Rate Study reflects that the increases for the outgoing years attributable to the initial increase were calculated by using the 35 percent and multiplying it by the revenue that was thought would result from the rates (which we know now were overstated) rather

than the 27.2 percent based on the data that was available to them at the time and which we now know in hindsight actually resulted in only approximately a 21.2 percent increase. This is demonstrated on **Exhibit H** attached hereto.

3. GROWTH RATE

The third major source of the variance was the manner in which the assumed 1.6 percent growth rate was applied in the Foresight Rate Study to obtain forecasted revenues for fiscal year 2005/06. That is to say that 1.6% was used as a multiplier. The Task Force directed Foresight to consider a 1.6 percent annual growth rate. However, the problem was that the 1.6 percent growth rate was applied in Table 7-1 to all revenue (including industrial which was not to be included per Task Force direction) and which, therefore, resulted in an overestimation of revenue from growth. In addition, although the Task Force directed use of 1.6 percent annual growth rate which Foresight applied to revenue, 0.8 percent (which is the effective annual weighted growth factor) should have been applied for the Fiscal Year 2004/05 projections.

The reason for this is that even if you assume a 1.6 percent annual growth rate, when one calculates the revenue from growth, such calculation needs to reflect the fact that growth does not all occur at the beginning of the year. Rather, growth occurs during and over the course of the entire year. The amount of revenue paid by growth over the course of a year is roughly equivalent to half of the new customer growth paying revenue all year. Therefore, if an annual growth rate of 1.6 percent is assumed, the average effective increase in new revenue would be 0.8 percent for the year.

In subsequent years, each year's incremental percentage growth in revenue is determined by adding half of the prior year's growth to half of the next year's growth. Hence, the 1.6% incremental growth revenue from Fiscal Year 2004/05 to Fiscal Year 2005/06 is the same as the 1.6% annual growth in accounts and consumption. Therefore, assuming the 1.6% annual growth rate as directed by the Task Force, the effective 1.6% effective growth factor is applied for the fiscal years following the first year of 2004/05.

Exhibit I, attached hereto, demonstrates the impact of using the 1.6 percent factor as opposed to using the correct 0.8 percent effective growth factor for the Fiscal Year 2004/05 Foresight revenue projections.

III

UPDATED REVENUE PROJECTIONS

Using as a base revenue the audited revenue for Fiscal Year 2003-04, assuming the Task Force directed 1.6% annual growth rate, and applying an overall 21.2% increase for revenues from the Fiscal Year 2004/05 rate increase and applying the future rate increases adopted by the City Council (i.e., 20% on July 1, 2005, 15% on July 1, 2006, 5% on July 1, 2007 and 5% on July 1, 2008), Mr. Farnkopf in his memo (Exhibit F), sets forth his revenue projections for 2005-06 through Fiscal Year 2008-09 ("Updated Revenue Projections").

Using actuals for Fiscal Years 2004/05 and 2005/06 and the Updated Revenue Projections for Fiscal Years 2006/07 through 2008/09 and comparing them to the Foresight Rate Study projections, the resulting variances are:

FORECAST COMPARISON

Fiscal Year	04/05	05/06	06/07	07/08	08/09	Total
Actual/ Updated Revenue Projection	\$30.0 million	\$41.1 million	\$47.7 million	\$50.8 million	\$54.2 million	\$223.8 million
Foresight	\$32.2 million	\$46.6 million	\$54.5 million	\$58.1 million	\$61.9 million	\$253.3 million
Variance	(\$2.2 million)	(\$5.5 million)	(\$6.8 million)	(\$7.3 million)	(\$7.7 million)	(\$29.5 million)

- Note: Projections for 06/07 through 08/09 and total variances are merely estimates based on certain assumptions that may or may not be what actually occurs in the future.
- Note: The actual/audited revenue figures for Fiscal Year 2004/05 and the actual/unaudited revenue figures for Fiscal Year 2005/06 were obtained from the City Finance Department. The backup materials for those amounts are attached hereto as **Exhibit J**. The projected revenue amounts for Fiscal Years 2006/07 through 2008/09 ("Updated Revenue Projections") found in this report and Mr. Farnkopf's memo were calculated by Mr. Farnkopf (see schedules in **Exhibit F**) using the Task Force directed 1.6% annual growth rate.

CONCLUSION

The City's water rate study conducted in 2004 was complex when compared to the typical water rate study. A number of factors that are rarely present in a single rate study needed to be addressed in the City's study and the variances discussed herein appear to be a result and symptom of this comparatively complex rate study. The comparatively complex rate study which included (1) a complete overhaul of the rate structure, (2) reliance on significant amounts of data that were difficult to extract, (3) a billing system that was not user-friendly in terms of obtaining needed data, along with (4) the involvement of numerous parties with various directions being given and (5) conducted over a very short time frame due to time restraints, all perhaps contributed to the major factors outlined as causing the significant variance between the Foresight

projected revenues and the actual and updated projected revenues. Therefore, based on the information we have to date and Mr. Farnkopf's revised and Updated Revenue Projections, it appears that the City's billed revenue from 2004/05 to 2008/09 will be approximately \$29.5 million less than what was projected in the Foresight Rate Study.

The reasons for such a variance are many but include as a major contributor, the use of unfiltered data that resulted in skewed numbers early on that when outgoing years were projected resulted in a compounding of the problem. The combination of the overstated original base rate, the overstated amounts for the increase of January 1, 2005, and the use of a 1.6 percent factor for growth (which was to be assumed to be the annual growth rate rather than the use of 0.8 percent) is the effective revenue rate increase for the Fiscal Year 2004/05 projections and, when compounded over time, results in revenue projections in the Foresight Rate Study which are much higher than what we now know to be actual revenue amounts for Fiscal Years 2004/05 and 2005/06 and what can reasonably be anticipated to occur, based on what is now known, in the outgoing years of Fiscal Years 2006/07 through 2008/09.

NOW WHAT?

Although investigation and review of this question was not the charge of this study and certainly would involve significant discussion and additional updated information and deliberation by the Council, I do offer some further observations and information.

(1) It is my understanding that through the budget and CIP process, staff did not use the revenue projections of the Foresight Rate Study but rather chose to take a more conservative approach and used lower revenue amounts. The amounts used by staff to date appear to be closer to the actual audited amounts and the Updated Revenue Projections in the Farnkopf memo.

(2) Some members of the public have questioned the assumed annual net revenue requirements in the Foresight Study. My review did not involve revisiting that issue, but based on information from staff, it appears that in any event the necessary costs for anticipated infrastructure and needs will increase significantly regardless of what the projections were in the Foresight Rate Study. It is my understanding, and I believe that Council has been so advised by staff, that there is anticipated to be significant increases in costs for materials as well as anticipated and potential additional infrastructure.

(3) The entire revision of the rate structure was very complex with a number of moving parts and the variances described in this report involve, and are a result of, a number of contributing factors. Just as the estimates in the Foresight Rate Study were mere "projections," so are the Updated Revenue Projections in the Farnkopf memo. That is to say, they are only estimates. They are only projections. The definition of "projection" in the dictionary is a "prediction or advance estimate based on known data or observations". We all know about predictions and how hindsight, time, and changed circumstances often result in actual events and outcomes that are sometimes brutally different than the original predictions. The future will not necessarily follow predictions or the projections in this report given the number of factors and variables involved including weather, conservation activities, increased number of private wells, leakage rates, growth, and consumption. Just as it is difficult to forecast personal and family budgets the farther out

in time one goes due to uncertainties and unexpected and unanticipated events, so is it difficult to do so for a City given the many variables that come into play. Periodic reviews and the ability to adapt within restraints that exist are and will be critical as was suggested in the Foresight Rate Study (Exhibit A at page 47, Point 5) of September 2004 when it said:

“The City is undergoing significant rate-related changes: (1) creation of a single service area, (2) significant rate increases, and (3) residential customers are being converted from flat- to metered rates. The combined effects of these changes on water consumption and total rate revenue should be closely evaluated in the next few years and the city should plan to periodically evaluate these cost-of-service issues and equity among customer classes. To ensure that capital and operating costs are being equitably allocated, the city should plan to update this cost-of-service analysis not later than Year 3, or sooner if warranted.”

(4) The City's data system has been revised and hopefully the updated system is a move away from what appears from all indications to be an overly complex and difficult system to work with and to obtain data from, and will be more helpful it extracting necessary and more focused information in the future.

(5) Although the Task Force directed Foresight to use an annual 1.6% growth rate, in reality and hindsight over the last few years the actual annual growth rate has been closer to 1.2%. In the Updated Revenue Projections by Farnkopf, the Task Force assumed annual growth rate of 1.6% was used. However, if a 1.2% growth rate is used, this would result in a reduction in total revenue of approximately \$2.4 million for Fiscal Years 2004/05 through 2008/09 and the total variance would be approximately \$31.9 million. The backup material from Farnkopf for this factor is shown in Schedule D of **Exhibit F** and **Exhibit K** attached hereto.

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