Council Meeting Date: April 18, 2011 **Agenda Item: 7(b)**

CITY COUNCIL AGENDA ITEM

CITY OF SHORELINE, WASHINGTON

AGENDA TITLE:	Update to Council Goal #7 – Acquire SPU Water System
DEPARTMENT:	Public Works
PRESENTED BY:	Mark Relph, Public Works Director

PROBLEM/ISSUE STATEMENT:

City Council Goal #7 is stated as the acquisition of the Seattle Public Utilities (SPU) potable water system in the City of Shoreline. Staff has been negotiating with SPU over the past several months trying to determine if a reasonable price can be obtained. Those negotiations are not complete and therefore the details are simply unavailable. However, enough progress has been made to prepare this report and the opportunity for discussion with City Council to review the progress to date, the reasons for considering such an acquisition, the parameters that would suggest a successful acquisition and the extent of a public participation process.

FINANCIAL IMPACT:

There is no immediate impact to Shoreline residents. However, if the acquisition is to proceed, the financial mechanism to purchase the system would be a Revenue Bond issued at the time of acquisition and paid for only by the utility rate payers within the SPU service area. Repayment of the Revenue Bond, or debt service, is explained in further detail later in the report and specifically how this cost fits within a proposed rate structure.

RECOMMENDATION

No action is required. This is intended as an update and for Council discussion.

Approved By: City Manager JM City Attorney ____

INTRODUCTION

The intent to purchase the SPU water system has been discussed perhaps as far back as the time of the City's incorporation. The central issues have been no direct citizen representation on issues such as rates and service since it is owned by Seattle and the decisions that affect infrastructure improvements. The current Council's purpose with the acquisition has been to address such concerns, but within a rate structure that would be equal to or less than what SPU would forecast over a reasonable time. This report is intended to review the progress to date, to review the reasons for considering such an acquisition, and the parameters that what suggest a successful acquisition.

BACKGROUND

The SPU water system is located approximately west of I-5 (see attachment B) and serves roughly 2/3 of the City. The water system within Shoreline is a distribution system. It includes water storage tanks and pump stations, but does not include a watershed or water treatment. There are larger transmission lines that pass through the City providing treated water supply to larger wholesale customers (e.g. Shoreline Water District, Olympic View Water & Sanitation District) and south to Seattle distribution systems. With the SPU system in Shoreline being solely a distribution system, the costs and responsibilities are more narrowly focused and less substantial had it included the water supply.

The infrastructure itself varies in age from the 1930s to present day with a large phase of construction in the 1950's through the 1960's as this area developed into an unincorporated suburb of King County. While the age of the pipelines are perhaps moderate in age, the question that many have raised is whether or not the level of maintenance performed over that time has been adequate and if the investment in capital improvement programs (CIP) have met the demands of redevelopment and fire protection. This has been one of the central issues staff has discussed with SPU during the past several months as we negotiated for the acquisition.

Reasons for Acquiring the SPU System

A. Long-term Strategic Interests
In 2009, the City Council adopted a **Community Vision Statement** and a series of **Framework Goals** through a diverse and extensive public process of community meetings and open houses. The resulting Framework Goals provide the overall policy foundation for the Comprehensive Plan and support the City Council's vision. Acquisition of the SPU system would be a significant step towards achieving the intent of Framework Goals #2 and #14:

> *FG 2: Provide high quality public services, utilities, and infrastructure that accommodate anticipated levels of growth, protect public health and safety, and enhance the quality of life.*

FG 14: Designate specific areas for high density development, especially along major transportation corridors.

While the City and SPU may disagree on the appropriate level of maintenance and capital investment, it has been one of the City's expressed goals for acquiring the system to gain local control for our citizens in the decisions that allows for a more aggressive investment strategy, thereby facilitating more effectively the redevelopment of such corridors as Aurora Avenue. The timely and strategic installation of utilities is perhaps one of the greatest inducements any city can perform to encourage redevelopment, which for the City of Shoreline is key in growing and diversifying the City's tax base. This direct control of the CIP would also allow a more direct opportunity to address fire protection issues the City and the Fire Department have identified throughout the SPU system.

B. Representation

Direct control of the utility by the City perhaps has its most significant meaning when it comes to the decision of rates. Currently, those Shoreline citizens that are within the SPU system have no say in the rates, including the current 14% surcharge for Shoreline residents simply because they are outside the City of Seattle. The ultimate decision makers are the Seattle City Council for all rates and CIP decisions. This issue of direct representation was perhaps the key reason this City incorporated in 1995. Back then, residents decided they no longer wanted to live within the shadow of King County and wanted to make decisions directly for themselves. Under the right financial circumstances, the acquisition of the SPU system is another opportunity for local control.

C. Construction Coordination

Another reason to acquire the SPU is to allow the City to better plan and manage construction activity within the public rights-of-way. The significance of this issue should not be overlooked. Improper coordination may be seen by the public as a project in front of their home or business in one year, followed by another project in the same location a short time later. This is not only inconvenient to the public, but it is very inefficient and ultimately costs both the utility rate payers and the general public. Currently, the City has to rely upon working relationships to facilitate City goals, but the City cannot require certain actions or improvements. Properly planning for capacity, financing the projects and coordinating the timing of construction allows for maximum efficiency to the utility and to the rate payer. The Aurora Corridor Project is perhaps the most notable example of difficult utility coordination.

D. Operational Efficiencies

One of the key responsibilities of owning any utility is providing adequate operation and maintenance (O&M) that provides for long-term, efficient use of the system. Properly performed the investment of O&M provides for a longer service life and a more reasonable and stable rate structure over time. If the acquisition does proceed, how the O&M will be performed and at what cost will be a significant issue. There are advantages to be explored by either contracting a portion of the O&M, or by bringing the services internal to the City. The latter does have challenges to put the systems in place for proper service, but sharing the costs with the City's other utility or even general fund operations could provide cost effective service and reduced cost to all utility rate payers

and the general public. However, this is an issue to be formally explored later in the process if the acquisition proceeds.

E. Staff Expertise

One of the issues to consider is the City's experience with utilities. The City's Surface Water Utility has a very similar set of responsibilities. Granted, it is simpler in some ways to the SPU system, but has much more in common than not, such as in master planning, O&M, CIP, rate studies, pipeline and pumping facilities, asset management, and customer service. The City has clearly demonstrated effective management and service of the Surface Water Utility since its inception in 1996.

There are two key management positions essential in moving the acquisition forward to create a successful City utility: the Public Works Director and the Administrative Services Director. Prior to the current experience of the Public Works Director in Shoreline, Mark Relph was the Public Works & Utilities Director for the City of Grand Junction, Colorado. In 2006, that Department included over 180 employees and a $45M operational and capital budget. Besides a full service Public Works and Engineering Department, he managed a series of utilities including solid waste and recycling, wastewater collection and treatment, laboratory services, plus a potable water supply and distribution system.

Added to his utility management experience is a considerable career as a professional engineer both in design and construction of all types of public works and utility projects. Water related projects alone have included such projects as reservoirs, dams and spillways, treatment facilities, transmission lines, distribution improvements and pump stations. Having a blend of design and construction experience, coupled with management of several utilities, provides the City of Shoreline with a unique advantage in preparing for a possible SPU acquisition and ultimately the creation of a City water utility.

Debbie Tarry, the City's Administrative Services Director, has worked for two cities that operated a surface water utility and at the City of Wenatchee which operated sewer, water and solid waste utilities. She served as the Wenatchee City Treasurer and Accounting Manager and was responsible for overseeing the City's utility billing and customer service functions along with managing various financing programs (such as revenue bonds, local improvement districts, latecomer agreements, etc.) used to finance utility CIP projects, assisted with utility rate design and rate analysis, and provided required financial reporting on utility activities. Ms. Tarry was also responsible for the implementation of a surface water utility billing system at the City of Mill Creek.

Financial Parameters

In establishing Council goal #7, the City Council set some specific parameters. The first and most significant would be:

To acquire the system at a price that when added to the other costs to operate and maintain the system, would fall within a rate structure equal to or less than what SPU would forecast over a reasonable period of time.

This specific requirement has set the parameters for the City in the negotiations with SPU. If this is achieved, then the Council goal would be met and those citizens affected would have a unique opportunity to control their long-term future. If those parameters cannot be met, then the service would continue under the franchise agreement with SPU. In order to conclude if this is possible, two issues had to be pursued: concurrence with SPU on an appraisal methodology that ultimately would establish a sale price, and a budget for operating the system that included the debt payment of the utility purchase.

The negotiations to date have considered three (3) standard valuation methodologies: (1) the Cost Approach, (2) the Market Approach, and (3) the Income Approach. Within the Cost Approach are the Replacement Cost Approach and the Original Cost Approach. **Attachment A – Appraisal Methodologies** provides a more detailed explanation of each approach.

Another parameter the Council established was the development of a budget that reasonably accounted for the costs to own and operate a utility. This work would occur over two phases: the first during the negotiation phase to test the reasonableness of the purchase price and the second as a more detailed review and confirmation of the costs once and if the two parties reach some level of a tentative agreement on the purchase price. Included in the proposed utility budget are such costs as:

- A proposed revenue stream for the utility based largely on historical data and rate projections from SPU.
- Debt service for the purchase price
- The purchase of "wholesale" water by contract from SPU
- Operating and Maintenance costs
- Separation costs between Shoreline and Seattle
- Capital Improvement Program (CIP)

All of those issues are significantly complex and have been explored during the negotiation process and in the development of a financial model. To provide some level of understanding to the complexity of the issues, O&M is used as an example and can include such detail as:

- Utility billing system
- Meter readers
- Maintenance facility
- Rolling stock equipment and an equipment replacement program
- Small tools & inventory
- Field personnel and management
- Operating and utility costs for pump stations and other facilities
- Engineering expertise for maintenance, planning, design and construction management
- Administrative support services (e.g. purchasing, legal, accounting & budgeting, etc.)

The financial mechanism to purchase this system would be the use or sale of Revenue Bonds. These very specific bonds are paid back by the rate payers of the utility and no

one else. They are guaranteed by the revenue of the utility and that utility alone. These bonds are **not** General Obligation (GO) Bonds, which are typically guaranteed by General Fund revenues (e.g. sales tax, property tax, etc.). The issuance of Revenue Bonds does not reduce the City's ability to pursue other bonds in the future, including GO Bonds. In fact, state law specifically provides for additional debt capacity for utility purposes, which is in addition to any capacity allowed for general purposes.

Another parameter established by state law for a utility of this nature is the requirement that all revenues collected for the utility be spent for purposes of operating and maintaining the utility. A utility is expected to operate much like a private business in that the resources collected (utility fees/rates) have to pay for all the costs of the utility without any tax subsidy. As such, the financial operations of the utility are accounted for as an Enterprise Fund. The utility itself is charged its share – of which there has to be specific criteria subject to auditing standards to determine the appropriate amount – of overhead such as accounting and legal services, human resources, facility costs, etc.

Current Status

City staff has been negotiating with SPU for over a year. Both parties agreed in the beginning that the detail of such discussions would remain confidential until we reached a point when a sale price may be mutually agreed upon. Those discussions continue to date, but there is no concurrence on the sale price as of this date. However, considerable discussions have yielded some possibilities.

Staff has had considerable support from a firm that specializes in such issues, EES Consulting in Kirkland, Washington. Together, we have explored the details of the appraisal methodologies specifically applied to the SPU system, budget development for all costs and revenues, plus financial models to test assumptions and alternatives. All of this effort has provided staff a high degree of confidence in understanding the complexity of such an acquisition and whether or not this effort can ultimately meet the Council's established financial parameters.

Assuming that a reasonable sale price is tentatively reached, the next phase of the process would turn to the completion of a detailed financial or feasibility analysis, drafting of a sale contract and an in-depth public process. The complexities of this acquisition are significant, and engaging our residents in a meaningful public process will be a challenge. However, if the Council's financial parameters are met, then our residents within this specific service area will be presented with a very unique and positive opportunity to control their water service and future.

Next Steps

The next steps are contingent upon the City and SPU reaching a tentative agreement on a sale price. If this can be achieved, then the next phase would include the completion of the feasibility analysis. Since the parties started with such a varied opinion on price, the detail of the financial or feasibility models have been preliminary and will need to be reconfirmed. At the completion of this report, there would be full transparency of the details and the City Council would determine if the utility could be purchased and operated at rates equal to, or less than SPU rates. If the Council decides

to pursue the acquisition, then a robust and engaging public process would begin, culminating in a public vote.

The public participation process is anticipated to be extensive. Sharing the details will be a focus, but soliciting input on the level of water service problems, the CIP, maintenance, rates, and expectations on customer service will be important to determine if a proposed budget will meet the public expectations and ultimately the financial parameters established by Council. The types of opportunities for public participation could include:

- Attending neighborhood, business, and civic group meetings;
- Providing open houses, forums and workshops;
- Distributing information to neighborhood newsletters, *Currents*, the cable channel, as well as with direct mailers to rate payers; and
- Conducting formal public hearings.

A timeline for this work is difficult to determine since staff is still negotiating with SPU. However, it is anticipated that the negotiation process will conclude later this summer.

RECOMMENDATION

No action is required. This is intended as an update and for Council discussion.

ATTACHMENTS

Attachment A – Appraisal Methodologies

Attachment B – SPU Water Service Area with the City of Shoreline

Attachment A – Appraisal Methodologies

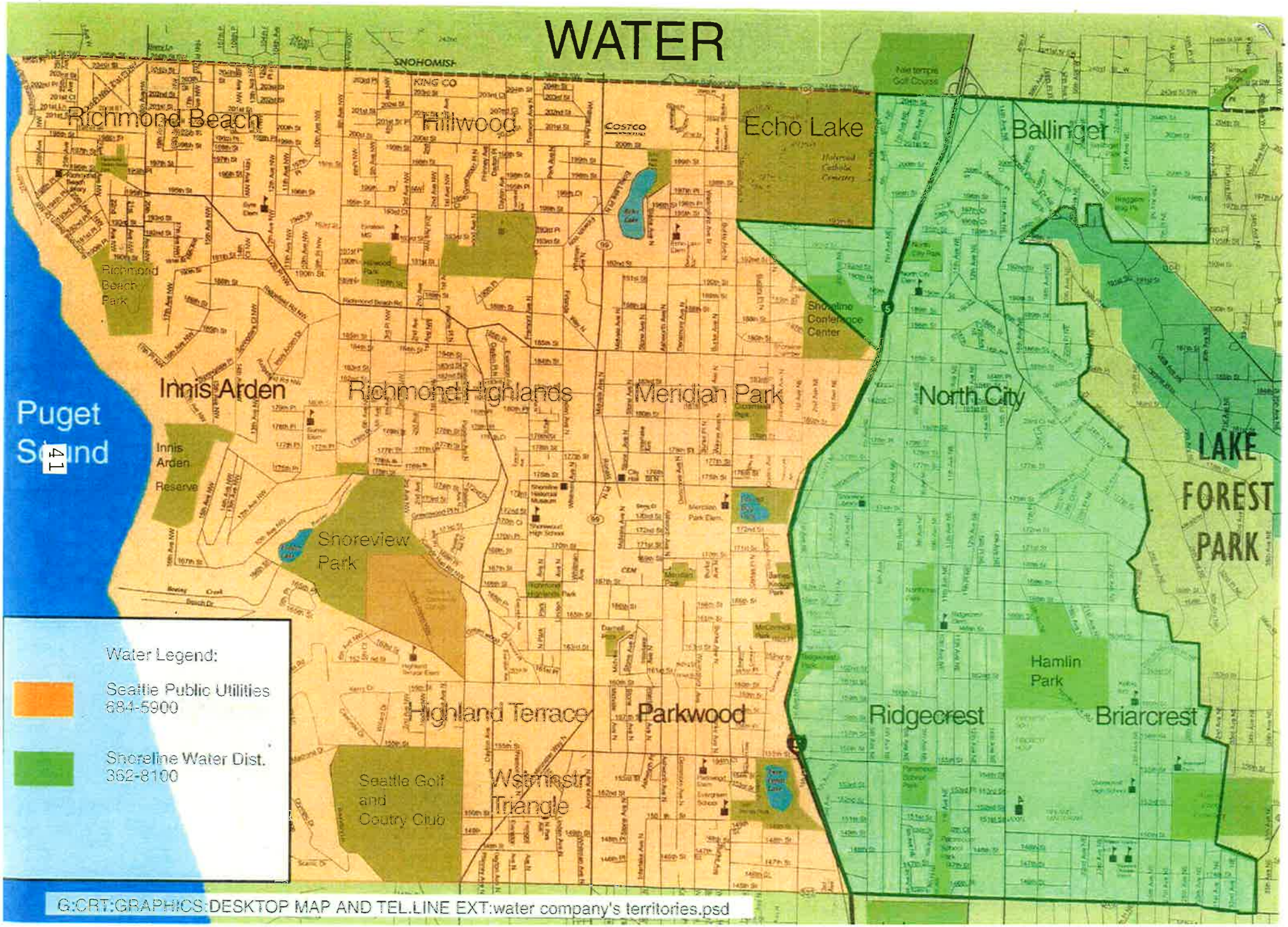
There are three commonly accepted and independent methods for valuing utility properties based on recognized and objective industry standards. Independent in the sense that the ultimate goal of each methodology is to determine the fair market value for the subject property and equipment in a hypothetical open and free market transaction with a willing buyer and a willing seller. All three valuation methods are being considered: (1) the Cost Approach, (2) the Market Approach, and (3) the Income Approach. Within the Cost Approach are the Replacement Cost Approach and the Original Cost Approach.

1a. Replacement Cost Approach: This approach looks at the cost of replacing or reproducing the existing facilities. This amount is then reduced to reflect the amount of depreciation that has accrued to the improvements being valued. The valuation under such a method is generally referred to as the Replacement Cost New Less Depreciation (RCNLD) value. Straight-line depreciation is typically used for the calculation of depreciation in the RCNLD value. This valuation methodology generally results in a very high value and is usually not used for price-setting purposes.

1b. Original Cost Approach: The Original Cost or Net Book Value Approach looks at the original cost of the existing facilities and reduces this amount by the depreciation that has accrued since these facilities were placed into service. This is commonly referred to as the Original Cost Less Depreciation (OCLD) value. This value usually sets the floor for utility valuations, assuming no contingent liabilities.

2. Market or Comparable Sales Approach: The comparable sales/market approach uses sales of comparable properties to determine the value of property to be acquired. The standard used in this type of appraisal is the fair market value. Fair market value is the amount that would be paid for the water utility facilities in its highest and best use as determined in a competitively structured market. This approach for appraising the value of a water utility can be challenging because generally there is not an active market for water utility systems or the systems are unique. However, there is a history of sales of water systems approved by the Washington Utilities and Transportation Commission that can be used for comparison purposes.

3. Income Approach: The last valuation approach applicable to utilities is the Income Approach, sometimes referred to as the Capitalized Earnings or Discounted Cash-Flow Approach. This approach determines the value of property on the basis of the future net revenues that it can be expected to produce. The basic calculation of net revenues takes the expected revenue stream from the facilities purchased and subtracts the cost to own and operate the facilities. The present value of the future stream of net revenues is then calculated to arrive at a value of the facilities.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Richmond Beach
Hillwood
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Ballinger
Richmond Beach Park
Innis Arden
Richmond Highlands
Meridian Park
North City
Puget Sound
Innis Arden Reserve
Shoreview Park
LAKE FOREST PARK
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Seattle Public Utilities 684-5900
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