

MEMORANDUM

Date: June 5, 2020

To: Rosemary Menard, Santa Cruz Water Director

From: Linda Wilshusen, Water Commissioner representing Outside-City Customers, and First District Supervisor John Leopold

RE: Discontinuing the Santa Cruz Outside-City Water Surcharge

Purpose

The purpose of this memorandum is to outline a rationale for the City of Santa Cruz (City) to permanently discontinue the outside-City water surcharge (currently 14.5%) as part of the FY2022-2026 City water rate analysis and adoption.

Summary

As summarized here and described in more detail in the sections below, there is no legitimate rationale for continuing the outside-City water rate surcharge. This surcharge, while a City tradition, is not consistent with utility rate-setting requirements. The outside-City surcharge results in a subsidy to inside-City ratepayers, which is not allowed under State law.

1. **Background and History of the Outside City-Surcharge.** A review of the historical record shows that for much of the nearly 90 years that the City has provided water service to urbanized or urbanizing areas outside of City boundaries, the surcharge rate has been based on 1) political considerations related to annexations, 2) the myth that outside-City ratepayers do not pay for water infrastructure, 3) Water Department budget shortfalls, and 4) lack of direct representation by non-City customers.
2. **City Cost Allocation Plan.** The City uses an internal cost allocation plan to ensure that all City departments pay their fair share of general City administrative, legal and financial costs. The Water Department pays its share of these allocated costs, and operates as an enterprise fund supported by ratepayers. There is no rationale for an outside-City water surcharge to cover general City administrative services.
3. **Water Department Long Range Capital Investment Program and 10-Year Financial Plan.** The current (2020) Plan includes nearly \$600 million in capital costs related to major upgrades and rehabilitation of the Treatment Plant and Loch Lomond Reservoir, water conveyance and delivery, and new water supply systems. There is no rationale for outside-City customers to pay more for this systemwide overhaul/enhancement via continuing to levy the surcharge.
4. **Rate Setting Process and Timeline.** The City Water Department, together with consultants and the City Water Commission, is currently in the early stages of its

next 5-year rate setting process, expected to be implemented in July 2021. Utility rate setting relies on the analysis of the “cost of service by customer class.” There is no documented basis to identify outside-City customers as a separate customer class.

5. ***Proposition 218, Proposition 26, and California Government Code 54999 Requirements.*** Utilities and other providers of government services are required to establish a “nexus” between the cost of providing services and rates by customer class, and to hold a public hearing on the proposed rates prior to adoption. The City must prove in its documentation that the rate structure meets the requirements of State law.

Background and History of the Santa Cruz Outside-City Water Surcharge

A 10% “surcharge” on water use was first levied on non-City customers in 1932 when the City of Santa Cruz extended water service through unincorporated Live Oak to 41st Avenue. This tax was justified as a “guaranteed return” on the City’s investment (up to 1932) in the municipal water system.¹

As water service was extended over time to other unincorporated areas surrounding the City, the City levied a surcharge of varying amounts for different areas. The wide range of these surcharges reflected location, service extension cost, Water Department budget needs, and the views of Council Members and City Administration on the desirability of service extensions to a particular area, including consideration of the likelihood of future annexation of that area to the City. The City modified the surcharges levied on various unincorporated areas over time, moving beyond the original “guaranteed return” concept to a more ad-hoc revenue strategy.

Sometimes the extensions were controversial: in 1954, the City Council adopted a policy opposing any future water service extensions.² In 1963, the City increased the outside-City surcharge to +25%; the Water Director at the time explained that “the differential will give the city working capital for water system improvements, and is justified by city residents’ investment in the water plant, which is not shared by out-of-city users.”³ The statement that outside-City users were not paying for the water treatment plant was not true, but the myth that only City residents pay for City water system infrastructure nevertheless became a part of City water lore. The Graham Hill Water Treatment Plan, Newell Creek Dam, Loch Lomond Reservoir, and other major, water system improvements of that era were financed by a \$5.5M water revenue bond in 1958.⁴ By definition, all utility ratepayers pay for debt service on revenue bonds, as well as for system operations, maintenance, and other types of financing and services.

In 1967, a couple of years after the new University of California campus opened on the old Cowell Ranch and in anticipation of annexing Live Oak and 41st Avenue, the City purchased the Live Oak Beltz Water Company wells along Rodeo Gulch, adding a

¹ *Santa Cruz Evening News*, 1/12/32, p.2

² *Santa Cruz Sentinel*, 8/11/54, p.1.

³ *Santa Cruz Sentinel*, 10/31/63, p.8.

⁴ *Santa Cruz Sentinel*, 11/5/58, p.1.

groundwater resource to the City's surface water system. Former customers of the Beltz system were levied a +35% outside-City surcharge for increased reliability in the form of "higher and more uniform pressure".⁵ By 1969, one argument in Live Oak for annexing to Santa Cruz was that water rates would drop substantially. In 1970, the Water Director told the Water Commission that "other means should be adopted for arriving at outside city rates, rather than simple percentage additions over city rates".⁶

By the mid-1970's however, Live Oak had not annexed to the City and 41st Avenue ended up being annexed to Capitola. The outside-City surcharge had increased to +50% by 1976, and that year, against the recommendation of its water consultants,⁷ the City Council further increased the surcharge to a whopping +100%. The City Manager at that time noted that "the benefits of municipal ownership go to the people who are running the operation." He added, "The people inside the city are responsible for bond debts...since they are taking the risks they should get the benefits."⁸ That myth, from the early 1960's, persists in City water rate setting policy to this day.

Reacting to double rates, a group of outside-City residents and business owners organized themselves in 1978 into a group called Double Rates Oppress people (DROP) and filed a class action suit against the City. The County of Santa Cruz joined in the suit, and in 1980, the City lowered the surcharge to +55%. From the late 1990's (post-Proposition 218) to 2016, the surcharge was about +28%. In 2016 (post-Proposition 26), the City determined that the outside-City tax rate should be 14.5% based on meter size and location of water infrastructure (see detail below about the 2016 rate setting process).

City Cost Allocation Plan

Cost allocation plans were required by the Federal government in the early 1970's as a way to systematize State and local government overhead rates charged to Federal grants and health and welfare funding programs.

The City of Santa Cruz had an internal cost allocation plan in place by 1979. The City's Cost Allocation Plan for distribution of general City administrative service costs includes city management, finance, legal, tech support, and personnel services. An updated cost allocation plan study was initiated in 2015, and the City's 2018 Budget FAQs noted: "The General Fund does allocate costs to the Enterprise Funds and Internal Service Funds for administrative services (HR, Finance, IT, City Manager, City Attorney) through its cost allocation plan...About 8% of personnel costs are recuperated through this plan."⁹

The Water Department operates as an Enterprise Fund, which means that its revenues (primarily from ratepayers) support 100% of water operations, maintenance, and capital costs. As noted, the cost to the City of providing City administrative services to the Water Department, and thus to its ratepayers, is paid via the City's annually-updated cost

⁵ *Santa Cruz Sentinel*, 6/9/67, p.24.

⁶ *Santa Cruz Sentinel*, 1/27/70, p.18.

⁷ *Santa Cruz Sentinel*, 3/15/76, p.19. The consultants were Brown and Caldwell.

⁸ *Santa Cruz Sentinel*, 5/5/76, p. 1.

⁹ "Focus Group – Frequently Asked Questions (FAQs), Work in Progress – Examples of common City of Santa Cruz budget questions (as of 5/31/18)". City of Santa Cruz website, 2020.

allocation plan. All ratepayers are therefore paying the full cost borne by the City as the entity that hosts the Water Department.

The cost allocation plan model, which is used by all levels of government pretty much everywhere as a way to distribute general administrative costs, is particularly useful in a situation such as ours where some customers/ratepayers are not located within the boundaries of the utility's host entity. Outside-City ratepayers are able to pay their fair share of general administrative costs in the same way as inside-City ratepayers: via the City Cost Allocation Plan. However, this system doesn't work if outside-City ratepayers are levied a surcharge *above and beyond* the charge already included in the Water Department's budget via the cost allocation plan: in that case, outside-City ratepayers pay *more* than their fair share of general City administrative costs.

Therefore, once the City started applying a cost allocation plan charge to the Water Department,¹⁰ an argument that the surcharge was a way for outside-City customers to pay for the City's general administrative costs would not have been valid.

Long Range Capital Investment Program and 10-Year Financial Plan

The Water Department's 10-year Draft Capital Investment Program and Long-Range Financial Plan/ProForma (2021-2030) estimates that \$590 million in essential future capital costs will have to be paid by ratepayers over the coming decades. While State and Federal grants and discounted loans are expected to help cover projected costs and accompanying debt service, water rate increases over the coming era will be substantial.

Major improvements to the existing water system include:

- Complete rehabilitation and renewal of the 60-year old Graham Hill Water Treatment Plant, including water transmission pipelines to and from the Plant and improved storage, treatment and quality control systems.
- Replacement of key operational assets and systems at the Loch Lomond Reservoir and Newell Creek Dam.
- Development and construction of new water supply systems, including using the existing Beltz wells and wellfield along Rodeo Gulch in Live Oak for Aquifer Storage and Recovery projects.
- Significant storage and distribution system maintenance and upgrades, due to age.
- Ongoing water distribution and other systemwide improvements to ensure high water quality, water conservation, and system reliability.

There is no documented rationale for having outside-City ratepayers shoulder a significantly higher burden of these systemwide capital costs via continued application of an outside-City surcharge.

Rate Setting Process and Timeline

The City's water rate setting process has changed in recent years as data on best practices has become available and applied by the City during its analyses. The Water Department's

¹⁰ The Water Department's current share of the City's Cost Allocation Plan is approximately \$1.9M. The Department's rate revenue in FY2020-21 is estimated at \$44M.

current rate setting process is assisted by Raftelis, a consulting firm that specializes in advising public and private utilities on industry practices.

Various methodologies have been used in the past to set City water rates, many of them controversial and not necessarily data-driven; this is similar to many public and private water districts throughout the country and world. The City currently establishes water rates on a 5-year schedule of annual adjustments/increases by customer class:

- Residential – Single-family
- Residential – Multi-family
- Commercial
- Irrigation
- North Coast agriculture
- UCSC

Generally speaking, the current rate setting process involves the following steps:

1. Update long-range financial plan/proforma, incorporating ongoing operations, maintenance, planned capital projects, and debt service.
2. Conduct cost-of-service analysis which considers how to distribute costs to users in proportion to their use of the system, with the goal that each customer class pays its own way without being subsidized by another class. This distribution considers water demand patterns by season, delivery systems, water supply and usage, fire protection requirements, and billing/customer service costs.
3. Balance competing pricing objectives through a participative process, with input from the Water Commission, the City Council, and the public:
(not in priority order)
 - a. Affordability
 - b. Revenue Stability
 - c. Equity
 - d. Conservation
 - e. Customer Understanding
 - f. Administrative Ease
 - g. Financial Stability
 - h. Defensibility
4. Evaluate uniform and tiered rate structure options based on cost-of-service data and priority pricing objectives.¹¹
5. Assign customer classes to two separate rate schedules: one for City ratepayers and one for outside-City ratepayers.¹² *This memorandum proposes to permanently eliminate this step from the rate setting process.*
6. Recommend an updated rate structure and schedule which finances the upcoming 5-year portion of the long-range financial plan.
7. Santa Cruz City Council adoption of water rates for FY2022-2026 (Spring 2021).

Outside-City Surcharge. Outside-City customers represent over 35% of all water customers in the Santa Cruz Water Department service area. We are located in urbanized,

¹¹ The City will be moving into this stage of the rate setting process in Summer/Fall 2020.

¹² City Water Department financial reports summarize water use by customer class. Rate revenue is not identified by customer class or inside-outside City in the Department's public budget and finance summaries.

unincorporated County areas which include Live Oak, Santa Cruz Gardens, Dominican Hospital and Dignity Health medical facilities, Sutter Health/PAMF medical facilities, Soquel Drive commercial corridor, Safeway/Home Depot, Pasatiempo, Branciforte Drive, Graham Hill Road, State Beaches, County Parks, schools, Capitola Mall and Kings Plaza in Capitola, and the D.A. Porath Sanitation Facility along Rodeo Gulch.

Until 2016 (the City's most recent 5-year rate setting process), outside-City rates had been determined by adding an ad-hoc, across-the-board "surcharge" onto the inside-City rates. As described in the Background section, over the nearly 90 years since the City started extending water service into adjacent unincorporated areas, the surcharge has ranged from +10% to +100% of the inside-City rates, regardless of customer class; for much of that time, the rate varied by area.

During the 2016 rate setting process and because of new State requirements, it was necessary for the Water Department to document how the outside-City rate is determined. The Water Department and its consultants proposed a system based on allocating existing water system infrastructure to inside-City and outside-City areas.¹³ No rationale was presented for how divvying up existing water system infrastructure provided a legitimate basis for an outside-City surcharge.¹⁴ The question about the rationale for having an outside-City surcharge *at all*, given decades of evidence that the surcharge is arbitrary, was sidestepped by the City at that time.

The outside-City surcharge for FY2017-2021 (the current rate period) was reduced from +27.5% to +14.5% by City Council action as a result of the Water Department's analysis.¹⁵

Proposition 218, Proposition 26, and California Government Code 54999

Proposition 218, Proposition 26, and California Government Code 54999 are the California statutes that govern how local government can levy taxes, fees, benefit assessments, and charges. Proposition 218 (1996) is a constitutional amendment that requires voter approval for a broader range of public service taxes, fees, assessments and charges than did Proposition 13 (1978), which focused on property taxes. Proposition 26 (2010) further distinguished between a tax and other charges levied by local governments. CA Government Code 54999 addresses distribution of capital costs to public entities.

¹³ Here's the math: "Equivalent Meter Units" (EMUs) were established based on the size and capacity of water meters in the inside and outside areas. Once water infrastructure was allocated by the Water Department to either exclusively inside (21%) or outside (16%) or shared (63%), the assets in the shared category were then further allocated to inside and outside based on the EMU ratio (65% inside, 35% outside). The sum of the total assets allocated to each area (shared assets + exclusive assets) was then divided by the EMU's by area, arriving at a cost/EMU by area. The differential between this cost ratio (15%) was proposed as the outside-City surcharge; the adopted 2016-2021 surcharge is +14.5%.

¹⁴ If best practices suggest that allocating water infrastructure resources is a legitimate aspect of rate setting and defining customer classes, then the practice should be applied to the entire water service area during the customer class definition stage of the rate setting process. In fact, non-City residents pay, and have paid over the past seventy years, proportionately *more* for water system infrastructure, operations, and maintenance than City residents because of the surcharge. Non-residents have, therefore, been subsidizing City residents' (and businesses and UCSC) water use for decades.

¹⁵ The surcharge between 2004 and 2016 (+27.5%) was about twice the adopted 2016 surcharge (+14.5%), and during the three decades prior, the surcharge averaged three to four times the 2016 rate.

Per Proposition 26, water fees paid by ratepayers are classified as “a charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of providing the service or product.”¹⁶ If it remains in the City’s proposed rate plan for FY2022-2026, the outside-City water surcharge will have to be documented as consistent with this definition.

The Santa Cruz City Council makes the final decision on the water rate structure. Prior to noticing a public hearing to ratepayers for a water rate increase, the City must have a complete administrative record detailing the nexus between the cost of providing water service and the proposed rate structure. During the public hearing process, which involves a mailer to all ratepayers with an option to protest, ratepayers may indicate their agreement or disagreement with the proposed rate structure. The City carries the burden of proving that the rate structure is consistent with, and does not violate, State law.

In the event the outside-City surcharge is not permanently discontinued by City Council action prior to the Proposition 218 hearing, the information presented in this memorandum shall be considered part of the public record for the FY2022-2026 City of Santa Cruz Proposition 218 water rate approval process.¹⁷

Conclusion

As detailed in the information presented above, we assert that there is no legitimate way to rationalize the outside-City surcharge as consistent with State law. Without further arguing whether or not there ever was a legitimate rationale (beyond the very early concept of 10% return on investment, long since paid), nor requesting reparations for overpayments in the range of tens of millions of dollars caused by the earlier, deliberately arbitrary City water rate setting policies discussed above,¹⁸ we request that the *City of Santa Cruz permanently discontinue the outside-City water rate surcharge as part of its water rate setting process for FY2022-2026.*

The Water Commission is set to continue the water rate setting process at its August 24, 2020 meeting. We would appreciate a written response to this request by August 7th, and would especially value corrections or clarifications you may have to the information presented herein.

Thank you very much for your consideration.

¹⁶ *Proposition 26 and 218 Implementation Guide*, League of California Cities, May 2019, page 53.

¹⁷ The information in this memorandum may be corrected, as necessary.

¹⁸ During the time of the DROP suit in 1980, Santa Cruz County Counsel Dwight Herr told the Santa Cruz City Council that “the City owes the outside customers about a million dollars because of the excess rates charged during the past five years.” [1975-1980] *Santa Cruz Sentinel*, 8/6/80, p.9.