

CITY OF SALEM, OREGON

WATER AND SEWER FUND

FIVE YEAR FINANCIAL FORECAST

FISCAL YEARS 2013-14 THROUGH 2017-18

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WATER AND SEWER - FUND 310

Executive Summary

The city continues to manage its resources in a fiscally prudent manner and has made changes in service delivery as needed to work our way out of this prolonged recession. The water and sewer fund provides funding for labor, materials, and equipment to: treat, store and deliver the highest quality drinking water to homes and businesses; collect, convey and treat wastewater before returning to the Willamette River; and, collect and convey runoff from streets, buildings and other hard surfaces through the stormwater system to prevent flooding.

The forecast presented this year shows the city must continue to be fiscally conservative with spending and maintain an adequate ending working capital balance. In the water and sewer fund, this is particularly important because there are a number of required reserves for bonded debt and recommended reserves for rate stabilization and operations. These reserves provide financial stability for a revenue stream that can vary substantially as a result of customer demand. In addition, the water, sewer and stormwater utility systems represent nearly \$3.38 billion dollars of capital infrastructure which must be continually maintained and replaced. In any given year, an unanticipated failure or new economic development project may require several million dollars in capital investment. Highlights of this forecast include:

- Growth rates for customer accounts are established by system, but growth rates for all systems are projected to be between zero and 0.5 percent.
- Water consumption has been declining at an average of 2.75 percent per year for the past ten years and this trend is anticipated to continue.
- Wastewater revenue continues to decline as customers conserve water.
- The first phase of stormwater rate implementation begins in January 2013 as wastewater and stormwater rates are separated over the next four years.

Forecast Results

The water and sewer fund forecast provides a view into the financial impact on the city's services, priorities and policies in relation to projected economic activity through 2018. This view is influenced by US and State economic factors and trends, local business activity and property development, and the growth in primary revenue sources. Water, sewer, and stormwater rate revenue is anticipated to provide 95 percent of the fund's total revenue. Additionally, the forecast includes a variety of assumptions for expenditure activity over five years. The primary drivers of expense increases include labor agreements, PERS and health care costs, energy costs and inflationary increases on contracted goods and services. The tables for the expenditure assumptions are included in the appendix.

Development of a forecast for water, wastewater, and stormwater utilities requires establishment of specific assumptions regarding the customer base, growth, consumption, economic trends, operating needs, and capital requirements. All assumptions have been reviewed based on historical data through FY 2011-12 and in the context of current economic trends and industry standards. Each assumption about economic variables can have a restrictive or expansive effect on projected cash flow. The goal has been to be realistically conservative while not overly reducing financial capacity for operations and capital improvements.

Current Service Level – Schedule A

The water and sewer fund forecast is presented in Schedule A; the values are in millions of dollars and have been rounded to the nearest hundred thousand. The schedule builds out the forecasted years using the projected FY 2012-2013 as the base year. The base year uses current information to re-project revenue trends and adjust the expenditure base for any on-going service level changes. Schedule A outlines the water and sewer fund results for the five-year forecast period. Updates to the 2012 Cost of Service Analysis (COSA) as well as the November 2012 Council-adopted rate proposal result in revenue that is anticipated to keep pace with expenses without a large reduction in working capital. Although the forecast shows a reduction in working capital to meet anticipated expenses, a budget balancing schedule B is not included in this forecast. The recent rate adjustments approved by Council in November 2012 allow the water and sewer fund to maintain an adequate level of working capital throughout the forecast period.

Schedule A - FY 2013-14 Five Year Water and Sewer Fund Financial Forecast							
(in millions)							
	FY 12-13	FY 12-13	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18
	Budget	Projected*	Forecast	Forecast	Forecast	Forecast	Forecast
RESOURCES							
Beginning Working Capital	\$ 33.4	\$ 37.4	\$ 38.1	\$ 34.8	\$ 34.5	\$ 34.6	\$ 34.4
Current Year Revenue	75.3	75.5	77.5	80.1	81.9	83.9	85.9
TOTAL RESOURCES	108.7	112.9	115.6	114.8	116.4	118.5	120.3
EXPENDITURES							
TOTAL EXPENDITURES	77.0	74.8	80.8	80.3	81.7	84.1	86.4
CHANGE IN FUND BALANCE							
Restricted Reserves**							
Rev Bond & DEQ	12.4	-	-	-	-	-	-
2009 FF&C & OECCD	-	8.2	8.2	8.2	8.2	8.2	8.2
Unrestricted Reserves							
Rate Stabilization/ Operating	8.1	15.7	16.3	16.8	17.4	17.9	18.5
Capital Transfers	3.2	3.2	3.2	3.2	2.7	1.2	-
Unrestricted Fund Balance	9.7	10.3	10.4	6.6	6.3	7.4	7.7
Estimated Ending Working Capital	\$ 31.7	\$ 38.1	\$ 34.8	\$ 34.5	\$ 34.6	\$ 34.4	\$ 33.9

* Projected Excludes FY 12-13 reappropriations and carryovers.
 ** Restricted Reserves declined in FY 12-13 due to bond refinancing.

Revenue Forecast

The revenue forecast is developed using conservative growth expectations for the water and sewer fund. Approximately 95 percent of water and sewer fund resources (excluding beginning working capital) come from one external source - rate revenue. New rates are adopted by Council every two years. In November 2012, Council adopted a 6 percent rate increase effective January 1, 2013, and a 6 percent rate increase effective January 1, 2014. A 3 percent rate increase is assumed for the remaining 3 years of the forecast. Table 1 summarizes the five-year revenue forecast by revenue source.

Table 1 (in millions)	Fiscal Year				
Revenue by Source	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18
Water and Sewer Rates Revenue	\$ 73.9	\$ 76.4	\$ 78.1	\$ 80.0	\$ 81.9
Permitted Development	0.6	0.6	0.7	0.7	0.7
All Other Sources	2.9	3.0	3.1	3.2	3.3
Total Current Revenue	\$ 77.5	\$ 80.1	\$ 81.9	\$ 83.9	\$ 85.9

Expenditure Forecast

The expenditure forecast is developed based on anticipated increases in the costs of labor, materials, and capital, and generally agree with assumptions used across all city funds. When available, it uses known expenditure information such as labor agreements, vendor contracts, the most recent information for the PERS rate and health care cost increases, and inflation factors. Future costs associated with higher PERS obligations for current employees are included beginning in FY 2013-14. Table 2 summarizes the five-year expenditure forecast by category for Schedule A. The assumption tables for all expenditures are included in the appendix.

Table 2 (in millions)	Fiscal Year				
Expenditure Categories	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18
Personal Services	\$ 23.8	\$ 24.9	\$ 26.3	\$ 27.1	\$ 28.7
Materials & Services	25.5	26.0	26.5	27.1	27.6
Capital Outlay	0.4	0.4	0.4	0.5	0.5
Subtotal Expenditures	49.6	51.3	53.3	54.6	56.9
Debt Service	24.2	22.0	21.0	21.0	19.5
Capital Construction Transfers	6.5	6.5	7.0	8.0	9.5
Contingency	0.5	0.5	0.5	0.5	0.5
Total Expenditures/Schedule A	\$ 80.8	\$ 80.3	\$ 81.7	\$ 84.1	\$ 86.4

Transfers are anticipated annually from the water and sewer fund to the construction fund for capital projects. During the forecast period, this investment is projected to grow from \$6.5 million to \$9.5 million. This amount represents less than a 0.2 percent annual

investment in the infrastructure. If it is assumed that on average infrastructure lasts 100 years, over \$33.8 million would be required on an annual basis to adequately maintain and replace aging pipes, reservoirs, and treatment plants. The modest increase in investment over the five-year period is a step toward more adequate funding for utility infrastructure.

Financial Forecast Risks and Rankings

Risks to Revenue Forecast

The forecast acknowledges that there are risks associated with sustaining the resources needed to fund current and future city utility services. Each identified risk is evaluated on the degree it will impact service delivery and assists in determining courses of action to be taken over the five-year period. The identified risks to the water and sewer fund's resources are summarized below:

- Rate Revenue
- Recession

Water and Sewer Rate Revenue – Water and sewer rate revenue is affected both by economic conditions and by customer behavior. Continued conservation, which is important to the sustainability of water resources, also negatively impacts revenue in systems where most costs are fixed and cannot be adjusted quickly based on demand.

Although stormwater rates will be implemented in January 2013, it is important to remember they do not represent a new or increasing revenue source. Stormwater services were previously funded through wastewater rates. As stormwater and wastewater are separated, and stormwater rates are implemented, there is a corresponding decrease in wastewater rates.

Risk Factor – MEDUIM

Decreasing water consumption is a national trend, and Salem is not unique in facing this challenge. Most of the costs to provide water to customers are fixed. A very small percentage of costs are related to the volume of water produced. When consumption declines and revenue is adversely impacted, water utilities must increase rates to maintain operations. It is unclear how far per capita consumption will decline, but it is safe to assume a decline will continue throughout the five-year period.

One way utility systems have attempted to stabilize revenue is to recover more costs through fixed rates rather than volume (consumption). The 2012 Cost of Service Analysis updated the rate structure, and an adjustment was made to shift

some costs from the variable rate to the fixed rate in an effort to stabilize revenue.

Recession – The risk of a recession is difficult to measure at this time due to the uncertainties in Congress and the continued slow economic growth that makes the US economy vulnerable to an external shock. As of November, economists estimate the risk of a recession occurring within six months at between 28-32 percent.

Risk Factor-LOW

While a recession is not a primary driver for modeling assumptions, it is considered a potential risk should slow economic growth, low job growth and unanswered federal policies continue into the out years of the five-year forecast. Continued economic challenges result in slower development activity and decreases in revenue related to permitted development. The slower the development, the fewer new customers are added to the system to cover the system's fixed costs. The December 2012 Economic Forecast by the Oregon Office of Economic Analysis states, "The good news is that the housing recovery is here to help drive economic growth. Even so, housing-related production is just now beginning to improve from its recessionary lows, and has a long way to go before the level of production approaches anything considered a normal year for housing." The state forecast projects housing starts to increase an average of 20 percent per year from 2013 to 2017. Salem currently has a supply of developed land in existing subdivisions. Development permit revenue is not anticipated to increase in Salem until existing lots are developed.

Risks to Expenditure Forecast

The following summarizes identified risks to the expenditure forecast. Each identified risk is evaluated on the degree it will impact service delivery and assists in determining courses of action to be taken over the five-year period.

- PERS employer rate increases
- Health Care Costs
- Labor Union Agreements
- Inflation

PERS employer rate increases - The city's PERS employer contribution rate for the two years beginning FY 2013-14 has increased 48 percent. Last year's forecast anticipated a 23 percent increase based on the advisory rates provided by the PERS Board. At that time, the city had planned for an additional \$400,000 in water and sewer fund PERS costs beginning in FY 2013-14, that amount is now estimated at \$800,000. The forecast also assumes a 25 percent PERS rate increase in FY 2015-16 and FY 2017-18. Table 3

details the rates by tier type for comparison. Rates are adjusted every two years to meet pension funding requirements.

Table 3	Actual FY 07/07	Actual FY 09/9	Actual FY 11/11	Actual FY 13/13	Projected FY 15/15	Projected FY 17/17
Tier 1 and 2	8.65%	6.12%	12.93%	19.06%	23.83%	29.78%
OPSRP Fire & Police	12.23%	7.08%	11.85%	17.41%	21.76%	27.20%
OPSRP General Services	8.96%	4.37%	9.14%	14.68%	18.35%	22.94%

Risk Factor Ranking – HIGH

The significantly higher rates reflect the continued low investment earnings on the Pension Fund Assets and the level of contributions needed to make benefit payments to members not paid for from these earnings. All PERS member employers are experiencing similar rate increases. PERS estimates the contribution rate increases will cost Oregon PERS employers about \$900 million more in the 2013-15 biennium, and local governments will carry about \$260 million of this cost. The PERS Board is directed to provide policy advice to the Legislature on proposed changes to PERS in the upcoming session. If additional PERS reforms are not enacted by the legislature, or if revenue forecasts are not realized, the city may be required to make cost reductions to meet the forecasted working capital target over the five-year period.

Health Care Costs – The forecast assumes that health care costs will increase by 10 percent each year of the forecast which is slightly lower than the national standard but still within industry trends. The city’s rates are developed annually based on a formal analysis with the assistance of a consultant knowledgeable in the industry. Rates are set based on a review of national and state-wide health care cost trends, legislative health care reforms and, primarily, from the city’s claims activity from previous years. The forecast includes the Patient Protection and Affordable Care Act program for transitional reinsurance. This program requires the collection of a fee from health insurance issuers for three calendar years (2014-2016) to fund a reinsurance premium stabilization fund. The fee is estimated at \$63 per “covered lives,” which equates to a cost of about \$56,000 per year for the water and sewer fund.

Risk Factor Ranking – MEDIUM

Health care costs could be higher or lower depending on a variety of difficult-to-forecast measures including increased costs in the health care industry, future illnesses affecting the amount of filed claims, or the impacts associated with the Patient Protection and Affordable Care Act due to go into effect in 2014.

Labor Agreements – Approximately 74 percent of the water and sewer fund’s workforce is represented by the AFSCME union, and approximately 30 percent of water and sewer

fund costs are personnel related, making labor agreements a significant cost driver. Wage increases associated with the most recent agreements are incorporated into the forecast. For years beyond these agreements an assumed 1 percent wage increase is used; for non-represented employees a 2 percent increase is assumed in year one with 1 percent for remaining years.

Risk Factor Ranking – MEDIUM

The AFSCME labor agreement will expire on June 30, 2013, and negotiations will begin this winter. The risks associated with increased costs from future labor negotiations are difficult to measure at this time. This will continue to be monitored, and the forecast will be modified for changes.

Inflation – The Bureau of Labor Statistic reported in August that the Consumer Price Index-All Urban Consumers (CPI-U) for the Portland-Salem, OR-WA area increased 1.2 percent in the first half of 2012, up 2.5 percent from a year ago. For purposes of forecasting, 1.6 percent was used as the inflation factor on all general goods and services in the forecast.

Risk Factor Ranking – LOW

The risk of higher inflation is regularly debated by economists as the Federal Reserve continues the use of quantitative easing monetary policies to increase economic activity. Rising gasoline prices in mid-2011 did influence cost of living indexes; however the index as of October is declining as energy prices have fallen. We expect energy prices to continue to fluctuate over the forecast period, and this risk factor may rise to a higher level in future forecasts.

Over the five-year forecast period risk factors with medium rankings will be monitored and action will be taken should they begin to move to a higher risk status. All High ranking risks are monitored closely and when possible, steps will be taken to lower the city's exposure.

Forecast Risk Revenue	Ranking	Percent Total Revenue
Water and Sewer Rate Revenue	MEDIUM	95%
Recession	LOW	-

Forecast Risk Expenditures	Ranking	Percent Total Expense
PERS Employer Rate Increases	HIGH	5%
Health Care Costs	MEDIUM	6%
Labor Agreements/Salary Costs	MEDIUM	14%
Inflation	LOW	-

APPENDIX

Expenditure Assumption Table

WAGE PROJECTIONS:	FY 13-14	FY 14-15	FY 15-16	FY 16-17	FY 17-18
	% Increase				
Market Adjustment - AFSCME	1.00%	1.00%	1.00%	1.00%	1.00%
Market Adjustment - Police (SPEU)	2.00%	1.00%	1.00%	1.00%	1.00%
Market Adjustment - Fire (IAFF)	1.00%	1.00%	1.00%	1.00%	1.00%
Market Adjustment - Non-Represented	2.00%	1.00%	1.00%	1.00%	1.00%

ANNUAL PERCENTAGE CHANGE IN BENEFIT PROJECTIONS:

Health - All Other	10.00%	10.00%	10.00%	8.80%	9.20%
Dental	7.00%	7.00%	7.00%	7.00%	7.00%
Vision	5.00%	5.00%	5.00%	5.00%	5.00%
Worker's Compensation	2.00%	2.00%	2.00%	2.00%	2.00%
Life Insurance and Disability Insurance	0.00%	0.00%	0.00%	0.00%	0.00%
Retirement - Employer Tier 1 & 2	47.00%	0.00%	25.00%	0.00%	25.00%
Retirement - Employer - OPSRP Non-Safety	60.60%	0.00%	25.00%	0.00%	25.00%
Retirement - Employer - OPSRP Police and Fire	46.90%	0.00%	25.00%	0.00%	25.00%

PERS RATE ON ELIGIBLE EARNINGS:

Retirement - Employer Tier 1 & 2	19.06%	19.06%	23.83%	23.83%	29.78%
Retirement - Employer - OPSRP Non-Safety	14.68%	14.68%	18.35%	18.35%	22.94%
Retirement - Employer - OPSRP Police and Fire	17.41%	17.41%	21.76%	21.76%	27.20%

MATERIALS AND SERVICES:

Base	1.60%	1.60%	1.60%	1.60%	1.60%
Natural Gas	-1.00%	-1.00%	0.00%	1.00%	1.00%
Electric	0.00%	0.00%	0.00%	0.00%	0.00%
Refuse Disposal	0.00%	0.00%	1.00%	1.00%	1.00%
Radio Communications	3.50%	3.50%	3.50%	3.50%	3.50%
Motor Pool (Fleet Services)	2.00%	2.00%	2.00%	2.00%	2.00%
Liability Insurance	0.00%	0.00%	0.00%	2.00%	2.00%