

***CITY OF SALEM, OREGON***  
***WATER AND SEWER FUND***  
***FIVE-YEAR FINANCIAL FORECAST***  
FISCAL YEARS 2014-15 THROUGH 2018-19

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## **EXECUTIVE SUMMARY**

The City manages its utility services in a fiscally responsible manner to ensure ongoing day-to-day operations and provide capital funding for infrastructure. The Water and Sewer Fund is the financial structure supporting:

- Treatment, storage, and delivery of the highest quality drinking water to homes and businesses;
- Collection, conveyance, and treatment of wastewater before its return to the Willamette River; and
- Collection and conveyance of runoff from streets, buildings, and other hard surfaces through the stormwater system to prevent flooding.

The forecast presented this year continues to demonstrate conservative, but adequate spending resulting in the maintenance of an ending working capital balance sufficient to meet reserve requirements. In the Water and Sewer Fund 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 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, a new economic development project or unanticipated system failure may require several million dollars in capital investment.

Highlights of this forecast include:

- Rate revenue growth over the forecast period adequately funds operations and allows for a slight increase in capital construction transfers over the forecast period.
- The modest increase in capital improvement funding over the five-year period is a step toward more adequate funding for utility infrastructure.
- Water consumption has been declining; this trend is anticipated to continue.
- Stormwater services, previously funded through wastewater rates, have a separate rate which began in January 2013. The implementation of the stormwater rates corresponds with a decrease in wastewater rates.

## **FORECAST RESULTS**

The Water and Sewer Fund forecast provides a view into the financial impact on the City's utilities services, priorities, and policies in relation to projected economic activity through 2019. This view is influenced by federal 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 86 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 revenue and expenditure assumptions are included in the appendix section of this report.

Developing a forecast for water, wastewater, and stormwater utilities requires establishing 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 December 2013 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.

## **Budget Balancing Scenario–Schedule B**

The Water and Sewer Fund forecast is presented as Schedule B–Budget Balancing Scenario, which includes PERS savings as total resources adequately fund expenditures and no additional reductions are required over the five-year forecast period. The values in the forecast are in millions of dollars and have been rounded to the nearest hundred thousand. The schedule builds out the forecasted years using the FY 2013-2014 Projected column 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. The November 2012, City Council-adopted rate adjustments maintain an adequate level of working capital throughout the forecast period.

<b>SCHEDULE B–FY 2014-15 Five-Year Water and Sewer Fund Financial Forecast</b>							
<i>(Values in Millions)</i>	<b>FY 13-14 Budget</b>	<b>FY 13-14 Projected</b>	<b>FY 14-15 Forecast</b>	<b>FY 15-16 Forecast</b>	<b>FY 16-17 Forecast</b>	<b>FY 17-18 Forecast</b>	<b>FY 18-19 Forecast</b>
<b>RESOURCES</b>							
Beginning Working Capital	\$ 38.0	\$ 39.6	\$ 34.4	\$ 33.3	\$ 32.3	\$ 30.8	\$ 30.7
Current Year Revenues	82.4	81.8	85.8	87.9	90.3	92.7	95.1
<b>TOTAL RESOURCES</b>	<b>120.4</b>	<b>121.4</b>	<b>120.2</b>	<b>121.3</b>	<b>122.6</b>	<b>123.5</b>	<b>125.8</b>
<b>EXPENDITURES</b>							
Base Expenditures	94.1	87.0	93.0	95.3	98.2	99.8	100.3
Less:							
Unspent Contingency			(3.5)	(3.5)	(3.5)	(3.5)	(3.5)
Anticipated Expense Savings			(1.8)	(1.9)	(1.9)	(2.0)	(2.0)
Anticipated PERS Savings			(0.8)	(0.9)	(1.0)	(1.5)	(1.6)
<b>TOTAL NET EXPENDITURES</b>	<b>94.1</b>	<b>87.0</b>	<b>86.9</b>	<b>89.0</b>	<b>91.8</b>	<b>92.7</b>	<b>93.2</b>
<b>Estimated Ending Working Capital</b>	<b>\$ 26.3</b>	<b>\$ 34.4</b>	<b>\$ 33.3</b>	<b>\$ 32.3</b>	<b>\$ 30.8</b>	<b>\$ 30.7</b>	<b>\$ 32.6</b>

## REVENUE FORECAST

The revenue forecast is developed using conservative growth expectations for the Water and Sewer Fund. Approximately 86 percent of Water and Sewer Fund resources (excluding beginning working capital) come from one external source—rate revenue. New rates are adopted by City Council every two years. In November 2012, City Council adopted a 6 percent revenue slope effective January 1, 2013, and a 6 percent revenue slope effective January 1, 2014; a 3 percent revenue slope is assumed for the remaining years of the forecast. Table 1 summarizes the five-year revenue forecast by revenue source.

<b>Table 1 (in millions)</b>	<b>Fiscal Year</b>				
<b>Revenue By Source</b>	<b>2014-15</b>	<b>2015-16</b>	<b>2016-17</b>	<b>2017-18</b>	<b>2018-19</b>
Water and Sewer Rate Revenue	\$ 73.8	\$ 75.5	\$ 77.5	\$ 79.5	\$ 81.6
Franchise Fees	3.0	3.1	3.2	3.3	3.4
Permitted Development	1.1	1.1	1.1	1.2	1.2
Internal Charges	6.0	6.2	6.3	6.5	6.7
All Other Sources	2.0	2.1	2.1	2.2	2.3
<b>Total Current Revenue</b>	<b>\$ 85.8</b>	<b>\$ 87.9</b>	<b>\$ 90.3</b>	<b>\$ 92.7</b>	<b>\$ 95.1</b>

## 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 PERS rates and health care cost increases, and inflation factors. Future costs associated with higher PERS obligations for current employees are included. Table 2 summarizes the five-year expenditure forecast by category for Schedule B. The assumption tables for all expenditures are included in the Appendix.

Table 2–Schedule B Expenditures	Fiscal Year				
	2014-15	2015-16	2016-17	2017-18	2018-19
<b>Expenditure Categories</b>					
Personal Services	\$ 32.2	\$ 34.0	\$ 34.8	\$ 36.8	\$ 37.6
Materials and Services	27.6	28.2	28.8	29.4	30.0
Capital Outlay	0.6	0.6	0.6	0.6	0.7
<b>Subtotal Operating Expenditures</b>	<b>60.5</b>	<b>62.8</b>	<b>64.2</b>	<b>66.8</b>	<b>68.2</b>
Debt Service	22.0	21.0	21.0	19.5	18.1
Contingency	3.5	3.5	3.5	3.5	3.5
Capital Construction Transfers	7.0	8.0	9.5	10.0	10.5
<b>Total Base Expenditures</b>	<b>93.0</b>	<b>95.3</b>	<b>98.2</b>	<b>99.8</b>	<b>100.3</b>
<b>Less:</b>					
<i>Unspent Contingency</i>	<i>(3.5)</i>	<i>(3.5)</i>	<i>(3.5)</i>	<i>(3.5)</i>	<i>(3.5)</i>
<i>Anticipated Savings</i>	<i>(1.8)</i>	<i>(1.9)</i>	<i>(1.9)</i>	<i>(2.0)</i>	<i>(2.0)</i>
<i>Anticipated PERS Savings</i>	<i>(0.8)</i>	<i>(0.9)</i>	<i>(1.0)</i>	<i>(1.5)</i>	<i>(1.6)</i>
<b>Total Net Expenditures</b>	<b>\$ 86.9</b>	<b>\$ 89.0</b>	<b>\$ 91.8</b>	<b>\$ 92.7</b>	<b>\$ 93.2</b>

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 \$7.0 million to \$10.5 million. This amount represents a 0.2 to 0.3 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.

***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.

Water consumption has been declining over the past 10 years nationally, and this trend is anticipated to continue in Salem throughout the forecast period with reduced consumption of about two percent annually. The restrictive impact on revenues from declining consumption is partially offset by a very small (less than .25% annually) anticipated growth in the number of customer accounts.

Although stormwater rates were 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 – MEDIUM

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.

## Risks to Expenditure Forecast

This summary presents risks to the expenditure forecast by evaluating the degree by which service delivery may be impacted. This assessment assists in determining actions to be taken over the five-year period.

**PERS Employer Rate Increases**—A great deal of change has occurred in the investment market and through state legislation in the past year that may influence future PERS employer rates. The advisory PERS rates for the 2015-2017 rating period have declined from 2013 projections. This is due to the legislative reforms now in effect and the higher than expected investment returns on the PERS portfolio for 2013. While both of these factors are favorable for employers, the legislative reforms are not without challenges. In addition, Governor Kitzhaber has made it clear that with the passage of the 2013 reform bills further PERS legislative changes are now “off the table” for the remainder of his term.

Lawsuits have been filed on SB 822 and SB 861 and a decision by the Oregon Supreme Court may not be known until summer. The decision could possibly impact the current rate relief of 4.4 percentage points now in effect as well as rates going forward should these bills be ruled unconstitutional. Because of this uncertainty, the forecast assumes a 22 percent PERS rate increase in FY 2015-16 and FY 2017-18 for all three tiers based on the current year base rates, which do not include the 4.4 percentage point rate relief.

Below is a table of the rates by tier for comparison, rates are adjusted every two years to meet pension funding requirements. See Appendix for a complete table of PERS related expenses.

PERS Employer Contribution Rates					Projected Rate	
Table 3	FY 07-08	FY 09-10	FY 11-12	FY 13-14	FY 15-16	FY 17-18
Tier 1 and 2	8.65%	6.12%	12.93%	19.06%	23.25%	28.37%
OPSRP General Service	8.96%	4.37%	9.14%	14.68%	17.91%	21.85%
OPSRP Fire and Police	12.23%	7.08%	11.85%	17.41%	21.24%	25.91%

### Risk Factor Ranking—HIGH

The lawsuit outcomes will have an immediate impact on employer rates. Should the legislation be declared unconstitutional, it is anticipated that the PERS Board will recover the needed contributions by increasing future rates. The forecast assumes a higher increase in rates than the PERS advisory rates for this reason

**Health Care Costs**—Health care rates are developed annually with the assistance of a consultant knowledgeable in the industry. The rate analysis is based on a review of national and statewide health care cost trends, legislated health care reforms, the

required cash reserves to meet obligations year-over-year and the City's claims activity from previous years. The rate of increase for health benefits premium costs is assumed to decline over the five-year period; see Appendix for the detailed assumption table. The Patient Protection and Affordable Care Act program for transitional reinsurance premium charged on employer plans is included in the calculated rates.

Risk Factor Ranking—MEDIUM

Health care costs could be higher or lower depending on a variety of factors, which are difficult to predict, including increased costs in the health care industry, the amount of filed claims, and future impacts associated with the Patient Protection and Affordable Care Act.

**Labor Agreements**—Approximately 72 percent of the workforce supported by the Water and Sewer Fund is represented by AFSCME. Approximately 53 percent of the Water and Sewer Fund's operating costs (excludes debt service, contingencies, and transfers) are personnel related, making labor agreements a significant cost driver. The wage increase associated with the most recent agreement is incorporated into the forecast. For the years beyond the term of these agreements an assumed 1 percent wage increase is used. A 2 percent increase is assumed in the first year of the forecast for non-represented employees with 1 percent used in the remaining four years. The increased rate is intended to project the impact of correcting potential inequities in pay relationships between supervisors and the represented staff they supervise, as well as align compensation for some non-represented classifications with the average salary for comparable jobs.

Risk Factor Ranking—MEDIUM

The AFSCME labor agreement has been ratified and will expire on June 30, 2015. The risks associated with increased costs from future labor negotiations beyond FY 2014-15 are difficult to measure at this time.

**Inflation**—The Bureau of Labor Statistics reported in August that the Consumer Price Index-All Urban Consumers (CPI-U) for the Portland-Salem, OR-WA area (not seasonally adjusted) increased 1.3 percent in the first half of 2013 for an annual change of 2.2 percent. The increase was influenced primarily by higher prices for shelter (1.8 percent) and food (1.7 percent). Energy prices declined 1.1 percent since the second half of 2012; natural gas (-4.2 percent), followed by electricity (-1.6 percent) and gasoline (-0.4 percent). For purposes of this forecast, 1.2 percent was used as the inflation factor on general goods and services.

Risk Factor Ranking—LOW

Inflation is expected to remain relatively low over the forecast period for the goods and services that the City purchases. Energy price fluctuations will be monitored but are not anticipated to be significant risks at this time.

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.

<b>Forecast Risk–Revenue</b>	<b>Ranking</b>	<b>Percent Total Revenue</b>
Water and Sewer Rate Revenue	MEDIUM	86%

<b>Forecast Risk–Expenditures</b>	<b>Ranking</b>	<b>Percent Total Expense*</b>
PERS Employer Rate Increases	HIGH	5%
Health Care Costs	MEDIUM	8%
Labor Agreements/Salary Costs	MEDIUM	30%
Inflation	LOW	

\*Percentages in the expenditures table are based upon comparison with the total operations budget, which includes personal services, materials and services, and capital outlay. Debt service, contingencies, and transfers are not included in this comparison.

**APPENDIX**

**EXPENDITURE ASSUMPTION TABLE**

	FY 14-15 % Increase	FY 15-16 % Increase	FY 16-17 % Increase	FY 17-18 % Increase	FY 18-19 % Increase
<b>WAGE PROJECTIONS</b>					
Market adjustment-AFSCME	1.50%	1.00%	1.00%	1.00%	1.00%
Market adjustment-Police (SPEU)	1.00%	1.00%	1.00%	1.00%	1.00%
Market adjustment-Fire (IAFF)	0.00%	1.50%	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%	8.00%	5.00%	5.00%	5.00%
Dental	7.00%	5.80%	3.80%	3.00%	3.00%
Vision	16.00%	10.00%	5.00%	3.00%	3.00%
Worker's compensation	4.30%	5.00%	5.00%	5.00%	5.00%
Life insurance	8.70%	1.00%	1.00%	1.00%	1.00%
Disability insurance	28.00%	2.00%	2.00%	2.00%	2.00%
Retirement-Employer Tier 1 and 2	0.00%	22.00%	0.00%	22.00%	0.00%
Retirement-Employer-OPSRP General	0.00%	22.00%	0.00%	22.00%	0.00%
Retirement-Employer-OPSRP Police and Fire	0.00%	22.00%	0.00%	22.00%	0.00%

**PERS RATE ON ELIGIBLE EARNINGS**

Retirement-Employer Tier 1 and 2	19.06%	23.25%	23.25%	28.37%	28.37%
Retirement-Employer-OPSRP General	14.68%	17.91%	17.91%	21.85%	21.85%
Retirement-Employer-OPSRP Police and Fire	17.41%	21.24%	21.24%	25.91%	25.91%

**MATERIALS AND SERVICES**

Base	1.20%	1.20%	1.20%	1.20%	1.20%
Postage	4.00%	1.20%	1.20%	1.20%	1.20%
Natural gas	1.00%	1.00%	1.00%	1.00%	1.00%
Electricity	2.20%	2.00%	2.00%	2.00%	2.00%
Radio Communications	0.00%	0.00%	0.00%	0.00%	0.00%
Motor Pool (Fleet Services)	2.80%	1.20%	1.20%	1.20%	1.20%
Liability Insurance	0.00%	0.00%	0.00%	0.00%	0.00%