



CITY OF KIRKLAND
Department of Public Works
123 Fifth Avenue, Kirkland, WA 98033 425.587.3800
www.kirklandwa.gov

MEMORANDUM

To: Kurt Triplett, City Manager

From: Rob Jammerman, Development and Environmental Services Manager
Ray Steiger, P.E., Public Works Director

Date: September 14, 2011

Subject: **Northshore Utility District Franchise Agreement**

RECOMMENDATION:

It is recommended that the City Council review the information regarding the Northshore Utility District (NUD) Franchise Fee and the request by NUD to renegotiate the Franchise Agreement and the fee and provide staff with direction. Options include:

- Accept the NUD request to reopen the Agreement and reduce the fee;
- Take no action and leave the Franchise Agreement and rate in place;
- Amend the Franchise Agreement to leave the franchise fee rate as is, but freeze any future franchise fee increase due to inflationary adjustments until the rate is roughly equivalent to the City's utility tax rate. (Staff recommendation)

BACKGROUND DISCUSSION:

Franchise fees are paid by utility districts within cities when cities elect not to absorb the service area and allow the utility district to continue providing service to the city residents. Franchise fees are also a tool that offsets the utility tax revenue that a city forgoes when it allows a utility district to provide the service. But it is important to note that although franchise fees often approximate the utility tax rates and revenues, they are distinctly different and are a fee for service negotiated between the city and the utility district. Fees and rates can vary widely depending upon the services provided and the geography covered.

NUD provides water and sewer service to about 45% of the City. The majority of this service area was just brought into Kirkland with the recent annexation. NUD pays the City an annual franchise fee that is based on a "cost per lineal foot." The fee is calculated by multiplying the cost per lineal foot times the total lineal feet in the service area right of way. Kirkland assumed the full amount of the franchise fee in the 2011/2012 budget.

The current cost per lineal foot was negotiated with the NUD Franchise Agreement in 2008 and has not changed, except through changes to the CPI. The 2008 agreement specifically contemplated the annexation. However, after applying the cost per foot to the total feet in the new neighborhoods, the franchise fee total was more than NUD had expected. NUD has asked the City to consider the opening of the Franchise Agreement so that the franchise fee can be amended. The details regarding the franchise fee are as follows:

1. Both NUD and Woodinville Water District (WWD) pay an annual franchise fee based on a cost per lineal foot (lf) of ROW in their respective service area.
2. Our recent annexation included land area that was provided water and sewer service by WWD. Prior to annexation, the City and WWD negotiated a franchise agreement and the WWD franchise fee is \$1.73/lf of right-of-way. The WWD franchise fee equates to approximately 10.5% of their annual revenue and aligns with Kirkland's current utility tax rate.
3. The current NUD franchise fee was negotiated in 2008 and became effective on January 1, 2009. The franchise fee in the agreement was set at \$3.25/lf of right-of-way within the NUD service area. Since 2009, the franchise fee has decreased to \$3.21/lf of right-of-way due to the Consumer Price Index (CPI-U) adjustments (as required per the agreement). When the fee was negotiated, it roughly equated to 7.5% of NUD's annual revenue which aligned with the 2008 City utility tax. When the City raised the utility tax rate in 2010 to 10.5%, the NUD franchise was not adjusted because the only adjustment available in the Franchise is one based on the changes to the CPI-U.
4. The NUD franchise agreement addressed future annexation and the need to pay a new franchise fee for the annexation area; see excerpt below from the 2008 NUD Franchise Agreement, Ordinance 4141, Section 11.C.

11.C In the event that any territory served by NUD is annexed to the City after the effective date of this Franchise, this franchise agreement shall be deemed to be the new agreement required to be granted to a franchisee in annexed territory by RCW 35A.14.900 for whatever period of time is then required under that statute or the remaining time left under this franchise agreement for the Franchise Area, whichever is longer. Such territory shall then be governed by the terms and conditions contained herein upon the effective date of such annexation. The first franchise fee for any annexed area shall be calculated pro rata from the effective date of the annexation to the end of the next calendar quarter and paid to the City at the same time as the fee for the Franchise Area is paid for that quarter.

5. In March of this year, a letter was sent to NUD to formally notify them that the right-of-way way subject to the franchise fee would be increasing to 531,752 ft on June 1, 2011 due to the annexation.
6. In approximately June of this year, NUD contacted City staff to inform us that the increase in ROW length within the annexation area had caused their resulting franchise fee of \$2.11 million per year to increase from 7.5% to approximately 12.84% of their annual revenue. Although both the City and NUD had known what the calculated franchise fee was going to be for quite some time, the City was not made aware of this percentage increase in relation to their annual revenue until NUD contacted us about the issue.
7. NUD contends that they hadn't anticipated this large of an increase in the fee (as a percentage of their annual revenue) and is now asking the City to amend the Franchise Agreement so that the fee is roughly equivalent to 10.5% of their annual revenue and

more in line with the City's existing utility tax and the WWD Franchise Agreement. If the City is willing to make this adjustment, the franchise fee would be reduced from \$2.11 million to \$1.77 million per year resulting in approximately \$340,000 in lost general fund revenue per year beginning in 2012 (this revenue was included in the 2011/2012 budget). The loss of this revenue would have to be accounted for through reductions in the general fund or other means.

8. A secondary issue that NUD has raised is related to the Lane v. Seattle decision. In that case, the Washington State Supreme Court ruled that the general fund of an agency was responsible for the costs associated with fire protection. Kirkland responded to that ruling within the Kirkland water service area in 2010 by modifying the utility rate charged on water rates. The ruling has yet to be extended to special purpose districts such as NUD. However, NUD's assertion is that the City may have to reimburse NUD for fire protection costs (hydrants) in the future (depending on how the case law on this matter evolves). In exchange for opening the agreement and adjusting the franchise fee, NUD has offered that specific language regarding the fire protection charge could be negotiated now, which would limit the City's exposure in the future if we are required to start paying for future fire protection.

Although having some certainty on this pending issue could be good for the City, the unknowns about if and when it will become effective must be weighed against the known annual loss of franchise fee revenue if the franchise fee is renegotiated.

9. As an attempt to compromise, Kirkland staff offered to NUD to adjust the Franchise Agreement to freeze any further inflationary increases until the franchise fee is roughly equivalent to the City's utility tax rate (the agreement calls for inflationary adjustments based on the June-June CPI-U index). As an example, the current fee is \$3.21/l.f. of right-of-way and the current CPI-U is 3.71%. In January of 2012, the fee is scheduled to be adjusted to \$3.33/l.f. of right-of-way (resulting in approximately \$79,000 in additional franchise fee revenue). By freezing the inflationary increases, the percentage of the franchise fee in relation to the annual NUD revenue should decrease over time (assuming NUD revenue increases over time).
10. NUD staff presented this issue to the NUD Commissioners on September 12, 2011, and the Commissioners directed staff to prepare a rate increase to account for the franchise fee and to prepare a letter to all Kirkland NUD customers explaining the reason for the rate increase.

NUD Commissioners and staff are waiting to see what action (if any) that Kirkland takes prior to sending the letter. Some of them may attend the September 20 Council meeting and testify under public comment. In summary, it is recommended that Council provide staff direction on next steps. The staff recommendation is to offer a limited opening of the Franchise Agreement to add language that freezes any future franchise fee increase due to inflation, but not open the agreement to adjust the franchise fee.

cc: Tracey Dunlap, Director of Finance and Administration
Marilynne Beard, Assistant City Manager
William Evans, Assistant City Manager