CITY OF KIRKLAND
City Manager's Office
123 Fifth Avenue, Kirkland, WA 98033 425.587.3001
www.kirklandwa.gov

MEMORANDUM

To: Kurt Triplett, City Manager

From: Marilynne Beard, Assistant City Manager

Date: December 1, 2011

Subject: NORTHSHORE UTILITY FRANCHISE FEE INFLATIONARY DEFERRAL

RECOMMENDATION:

City Council authorizes the City Manager to execute a Memorandum of Understanding (MOU) with the Northshore Utility District to delay implementation of the 2012 franchise fee inflationary adjustment until March 1, 2012 to coincide with the District's annual rate adjustment.

BACKGROUND DISCUSSION:

At the September 20, 2011 meeting the City Council considered a request from the Northshore Utility District to reduce the franchise fee to more closely approximate a 10.5% effective rate. As noted in the staff memo, franchise fees are not calculated as percentage of revenue but are based on a cost per lineal foot of right of way in the District's service area. The District had already implemented a 10.5% franchise fee assessment for its customers in May 2011, but later determined that a 12.84% rate was needed to collect enough revenue to pay the franchise fee due in 2011. A copy of the staff memo is included as Attachment A. The City Council declined to reduce the franchise fee due to the estimated $350,000 budgetary impact to the City. Council did authorize the City Manager to negotiate with the District to temporarily freeze the annual inflationary adjustment until the effective rate is closer to 10.5%.

Subsequently, the City Manager sent a letter to the District's manager, Fanny Yee, advising her of the City Council's direction, offering to discuss the inflationary deferral and requesting clarification about the District's plans for hydrant charges should legal action require municipalities to pay hydrant charges to utility districts (see Attachment B). City and District staff met in November to discuss both of these issues. At that meeting, District staff indicated that the City's outreach explaining the franchise fee adjustment had been effective in responding to customers' concerns and that a deferral of the inflationary adjustment would not be necessary (sees Attachment C "Annexation Update – Impact of Utility Taxes and Franchise Fees on New Residents"). However, District staff did suggest that if the City would agree to delay the inflationary adjustment until March when the District's annual rate adjustment normally occurs, it would prevent having to send another rate adjustment notice out at the beginning of 2012 (the third such rate adjustment notice in six months). If the implementation

were delayed, the City would also experience a one-time franchise revenue loss of approximately $13,000.

The implementation delay would have three benefits for Kirkland franchise fee rate payers. As noted above, the delay will avoid the need for an interim franchise rate adjustment close on the heels of the previous two adjustments. Second, it potentially mitigates the percentage rate change needed for the inflationary adjustment for Kirkland residents. The Consumer Price Index adjustment for 2012 is 3.7%. If the District's rates increase by 3.7% or more, the franchise fee rate will stay the same or decrease. District staff is currently estimating a 4% utility rate increase. Finally, by March, annexation area residents will have received their reduced property tax assessment for 2012, which is the primary financial offset to the utility tax and franchise fees implemented with the effective date of annexation in June 2011.

With regard to hydrant costs, the City and the District still remain at odds with regard to their respective legal counsels' opinions about municipalities' obligation to pay hydrant fees to utility districts. The District's legal counsel believes that the 2008 Washington Supreme Court ruling in Lane v. Seattle requires the District to invoice cities for hydrant costs retroactively for three years. For the Kirkland annexation area, NUD would only seek retroactive charges from the date that area became part of Kirkland. The Kirkland City Attorney's Office does not believe that the obligation extends beyond the requirement for a City-owned utility to reimburse itself for hydrants from its General Fund. Staff is not aware of any utility district in Washington currently assessing hydrant charges to a city. Nonetheless, the District has advised us that they believe they are obliged to send invoices in order to "comply with that decision." The City has advised the District that, if an invoice is received, there would be no remittance until there is further legal action that clearly calls for payment. City staff also advised the District that the hydrant issue is included on the City's legislative agenda for 2012 (see Attachment D). If cities are successful in securing a legislative clarification that hydrants are considered part of a water system, then this issue would become moot. The District saw no reason to oppose the clarifying legislation.

The City does have an interest in how the District handles the hydrant charges. The cost of hydrants and related fire suppression infrastructure is already contained within the District's rates. There is no marginal cost to the District for a service it already provides. Therefore, any additional taxes or franchise fees assessed to customers should be offset by reduced utility rates (similarly to the action taken by the Kirkland City Council and other cities to adjust utility rates and utility taxes to essentially eliminate any net impact on utility bills). The District had earlier discussed with the City the possibility of increasing the franchise fee to provide additional revenue to the City to pay the hydrant charges. In exchange, the District would reduce utility charges a like amount so that the net effect on District ratepayers would be zero. Once the franchise revenue was received, the City would remit the hydrant amount back to the District. This is the type of arrangement that the City had hoped to reach and incorporate into the franchise agreement. However, this method would not necessarily provide for retroactive charges as proposed by the District.

Incorporating this element into the franchise agreement would require that both the City and District agree to reopen the agreement. The City's position would be that the fire suppression element of the agreement would only spell out how the transaction would be handled if legal or legislative action required the City to pay hydrant charges to water utility districts. Recent communications with District staff indicate that they are still willing to adopt this methodology but believe that the requirement to pay hydrant costs exists now.

The delay in implementing the inflationary adjustment for 2012 can be accomplished by a memorandum of understanding between NUD and Kirkland with the Council's concurrence. Staff will continue to work with the on the hydrant issue through the legislative advocacy process and recommends that further discussion with the District on this issue take place after more is known about potential legislative remedies.

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

October 3, 2011

Ms. Fanny Yee, Manager
Northshore Utility District
6830 NE 185th Street
Kenmore, WA 98028-2684

Re: Franchise Fee

Dear Ms. Yee:

I understand that you and Rob Jammerman, Development and Environmental Services Manager, have discussed the direction that we received from our City Council on September 20th, 2011 regarding the Northshore Utility District (NUD) Franchise Fee. I am sending you this letter to formalize the direction given to us by Council and outline the steps that we'd like to take between now and the end of the year.

First, the Council recommended that the current franchise fee of $3.21 per lineal foot of right-of-way which was negotiated in 2008 remain in place. Reducing the fee as requested by NUD would require a reduction in services to the new neighborhoods, most likely in police or fire response. But as a potential compromise, the Council also concurred with the staff recommendation that Kirkland consider re-opening the Agreement to evaluate a freeze of the annual inflationary adjustment until the fee is roughly equivalent with the City's utility tax rate.

Second, in conjunction with the amendment to the Franchise Agreement, Kirkland would also like to discuss the potential fire suppression reimbursement issue, and outline in the Agreement how this will be handled if municipalities are required to reimburse Water Utility Districts for fire suppression costs.

I have asked Rob Jammerman; Marilynne Beard, Assistant City Manager Bill Evans, Assistant City Attorney; and Tracey Dunlap, Director of Finance and Administration to begin working with you and your team on these issues, with the goal of having them resolved by the end of this year.

Should you have any questions, please feel free to e-mail me at ktriplett@kirklandwa.gov or call me at 425-587-3020.

Sincerely,

Kurt Triplett
City Manager

cc: Marilynne Beard, Assistant City Manager
Tracey Dunlap, Director of Finance and Administration
William Evans, Assistant City Attorney
Rob Jammerman, Public Works Development and Environmental Services Manager

ATTACHMENT C

ANNEXATION UPDATE
IMPACT OF UTILITY TAXES AND FRANCHISE FEES ON NEW RESIDENTS

The City has received a number of inquiries about franchise fees as a result of a recent letter mailed to Northshore Utility customers that live within the Kirkland city limits. The following questions and answers provide information about franchise fees and on the overall tax and fee impact of annexation.

What are franchise fees and how do they compare to the City's utility tax?

Franchise agreements between the City and utilities provide for payments to the City for utilities' right to use the public right-of-way for their pipes, conduits, etc. For a utility, the franchise fee is the charge they pay for occupying property they don't own (similar to the rent a resident might pay to a landlord). The franchise fee is a cost of doing business for the utility which is passed along to its customers.

The most recent franchise agreement with Northshore Utility District was approved by the Northshore Utility District Commissioners and the City Council in 2008 and included a provision for the potential annexation. A part of that agreement is payment of a franchise fee.

Utility taxes are imposed by the City on private and City-owned utilities. Utility taxes are imposed as a percentage of electric, natural gas, telephone, cable TV, garbage and, when provided by a city, water and sewer charges. Cities are not allowed to impose a utility tax on water and sewer utility districts within the city limits.

Both franchise fees and utility tax revenue are considered General Fund revenue and are used for general governmental expenses such as road maintenance, police, fire and parks. Residents served by the City's water and sewer utility do not pay a franchise fee and those served by the Northshore Utility District do not pay utility tax on water and sewer services.

What is the difference between the franchise fee paid by Northshore Utility District customers and the utility tax paid by Kirkland Utility customers?

Franchise fees are not considered a tax and therefore are not calculated or imposed like a tax. While Northshore's franchise fee was originally calculated in 2008 to be roughly equivalent to the City's utility tax rate at the time (7.5%), the franchise fee is actually a charge per lineal foot of right-of-way the district uses or could use to place their utility infrastructure ($3.21 in 2011). The amount of the franchise fee is a negotiated amount and not tied to changes in the City's utility tax rate as demonstrated by the fact that the Northshore franchise fee rate did not change when the City increased its utility tax rate from 7.5% to 10.5% in 2009 or increased the tax on the water utility to 13.38% to reflect the costs of fire protection charges to the General Fund.

Since the franchise fee is part of a district's cost of operating the utility, the fee is recouped through the district's utility bills. The district determines the amount it needs to add on to utility bills to recover the amount needed to make the franchise fee payment – usually calculated by the district as a percentage amount. The percentage applied to utility bills is a function of the individual district's utility rates and will change as the district's rates change.

Because Northshore Utility District's utility rates are lower than the City's rates in 2011, a higher percentage recovers roughly the same amount of general government revenue as the City's utility tax. The following chart compares the average monthly water and sewer charges and the utility tax or franchise fee amount for a City of Kirkland utility customer compared to a Northshore Utility District customer.

Utility Provider	Average Monthly Water and Sewer Charges	Utility Tax or Franchise Fee Percentage	Utility Tax or Franchise Fee*	Total Monthly Water/Sewer Utility Bill
City of Kirkland Utilities	$96.21	Water 13.38% Sewer 10.50%	$11.14	$107.35
Northshore Utility District	$80.85	12.86%	$10.38	$91.23

The percentage that the franchise fee equates to in terms of a District's revenue from customers in the City limits will vary over time depending on changes in the District's rates and other conditions – it can be lower than the utility tax rate, as it was for 2009-2010, or higher than the utility tax rate, as is currently the case. The City is in discussions with the District to forego the inflationary increase called for in the franchise agreement until the rate comes more in line with the City's utility tax rate.

Why did Northshore Utility District have to raise their rate twice this year for the franchise fee?

Per the Franchise Agreement, Northshore Utility District (NUD) agreed to pay a franchise fee of $3.21 per lineal foot of public right-of-way in their respective service area. When annexation occurred, 531,752 ft of right-of-way was added to the City within Northshore Utility District service area. This new right-of-way, coupled with the right-of-way that the District already had their utilities in prior to annexation, resulted in an annual franchise fee of approximately $2.1 million per year. In order for Northshore Utility District to generate this fee from their rate payers in the City, they needed to impose a fee equivalent to 12.86%. In June of this year, the District raised their rates by 10.5%, which was insufficient to cover the franchise fee. The City is not consulted as part of the District's rate-setting process and does not have access to their revenue data to evaluate the percentage, so the City is not in a position to speak to why the Northshore Utility District did not raise the rates to 12.86% in June.

Why does the Northshore Utility franchise fee revenue shown in the City's budget double between 2011 and 2012?

The annexation took effect on June 1, 2011, so the Northshore Utility District will only be paying the franchise fee for the annexation area for approximately half the year in 2011. The franchise fee budgeted in 2012 reflects a full year of the franchise fee, roughly double the 2011 amount. The fee of $3.21 per lineal foot is the basis for the City's budget in both years.

Woodinville Water District (WWD) pays only $1.73 per lineal foot of right of way while Northshore Water District pays $3.21 per lineal foot. Why is there a difference?

Franchise fees are negotiated amounts. The Woodinville Water franchise fee is less than the $3.21 per foot Northshore Utility District charged due to several factors:

(1) Differing development patterns – the NUD area is more densely developed and therefore the use of the right of way is greater,
(2) Scope of Services – WWD has a less intensive use of the right-of-way since most of the facilities provide water service only

How does the increase in Northshore's franchise fee rate change the overall impact on fees and taxes paid before and after annexation?

The utility tax and franchise fees are part of the City's overall tax base along with property tax and sales tax and are used to fund such services as public safety (police and fire) and street maintenance. The current utility tax rates were set in 2009 to help sustain the City's level of service. For the majority of residents of Juanita, Finn Hill, and Kingsgate, the overall taxes paid for the municipal services provided by the City will be lower than what was paid to King County for a lower level of service. The table below was provided to annexation area residents at various times prior to annexation and illustrates the estimated impacts on a homeowner with an assessed valuation of $495,000 reflecting the 2011 public utility rates and the 12.86% rate applied by NUD (the full detail of the comparison is provided as an attachment). The table shown below is an updated version based on the most current information.

Overall taxes and fees for an average single family residence are still lower than what was previously paid when the new area was part of King County. The full impact of the new rates and taxes will not take effect until 2012 when the annexation revenue transition is fully implemented. The estimated tax and fee impact will vary by individual households, the assessed value of their property and their utility usage.

Tax or Fee	King County	City of Kirkland	Annual Increase or (Decrease)
Property Tax*	$5,788	$4,763	($1,025)
Utility Tax/Franchise Fee**	$0	$455	$455
Surface Water Fees	$122	$178	$56
King County Surface Water Debt	$11	$11	$0
Total	**$5,921**	**$5,406**	**($515)**

*Figures based on average home value of $495,000 and excludes debt service on City's voted debt since residents in the annexation area did not assume Kirkland's outstanding voted debt. Actual property tax rates vary within different areas of the annexation area. King County property taxes will continue to apply in 2011. City of Kirkland property taxes will apply in 2012.
**Utility taxes apply to all residents for electric, natural gas, cable TV, garbage and telephone. Utility taxes on water and sewer only apply for Kirkland water and sewer utility customers and franchise fees only apply to Northshore Utility District and Woodinville Water District Customers. Actual utility taxes or franchise fees will vary for individual customers based on utility usage.

The most recent version of this table estimated annual tax and fee savings of $539 compared to an updated savings of $515. Overall taxes and fees for an average single family residence are still lower, however, it is important to note that total taxes and fees will be different for each resident based differences in assessed valuation and utility usage.

2011 Tax Comparison Illustration [1]

King County (Area served by FD #41) vs. Kirkland

Property Tax Comparison

Rate per $1,000 of Assessed Valuation

King County			City of Kirkland		
County Road Levy (Levy Code 7337)	$	2.20	Regular Levy	$	1.30
Fire District #41		1.15	Debt*		-
Consolidated (State, Port, County)		3.84	Consolidated (State, Port, County)		3.84
Finn Hill Park District**		0.06	Finn Hill Park District**		0.06
EMS		0.30	EMS		0.30
Lake Washington School		2.98	Lake Washington School		2.98
Hospital District		0.48	Hospital District		0.48
Library District		0.57	Library District		0.55
Flood Control Zone District		0.11	Flood Control Zone District		0.11
Ferry District***		0.00	Ferry District***		0.00
Total Levy	**$**	**11.69**	**Total Levy**	**$**	**9.62**
Property Tax on $495,000 Home	**$**	**5,788**	**Property Tax on $495,000 Home**	**$**	**4,763**
			Difference City to County	$	(1,025)
			Rate Difference	$	(2.07)

* Excludes debt service on City's voted debt ($0.09/1,000 A.V.) which does not apply to the annexation area. A portion of Fire District 41 debt service will remain until debt is retired (estimated at $0.13/1,000 A.V.)

** Finn Hill Park District levy only applies to residents within the Finn Hill Park District boundary.

*** Ferry District rate is $0.00360/$1,000 A.V.

Total Tax Comparison

Rate per $1,000 of Assessed Valuation

	King County	City of Kirkland	Annual Increase or (Decrease)
Average Property Tax Paid^	$5,788	$4,763	($1,025)
Utility Tax/Franchise Fee^^	$0	$455	$455
Surface Water Fees	$122	$178	$56
King County Surface Water Debt Service^^^	$11	$11	$0
Total	**$5,921**	**$ 5,406**	**($515)**

^ These figures are based on an average home value of $495,000 and excludes debt service on City's voted debt since residents in the annexation area did not assume Kirkland's outstanding voted debt; actual property tax rates vary within different areas of the annexation area.

^^ Actual utility taxes for annexation area residents may be more or less depending on their utility usage.

^^^ King County surface water-related debt service continues until debt is retired in 2021.

Note (1): King County property taxes continue to apply in 2011. The annexation area will be subject to City of Kirkland property taxes in 2012.

ATTACHMENT D

CITY OF KIRKLAND
City Manager's Office
123 Fifth Avenue, Kirkland, WA 98033 425.587.3001
www.kirklandwa.gov

October 3, 2011

WORKING TITLE: Addressing the need to clarify that fire hydrant/protection costs are an integral part of providing water service and thus appropriate in rates.

ISSUE BACKGROUND:
In October 2008, the Washington State Supreme Court ruled that fire hydrant costs are a general government function and should be paid out of general tax revenues (Lane v. City of Seattle – Attachment 1). The City of Seattle began to pay Seattle Public Utilities for fire hydrants from their general fund and raised utility taxes on SPU to cover for the general funds expended for the hydrants. This ruling has far-reaching consequences for all water providers throughout Washington in that water rate-making standards (as defined in the American Water Works Association M1 Manual) specifically include fire protection costs as part of water rates. Currently, the only direction that exists on how this ruling should be implemented is found in court documents related to Lane v. City of Seattle. Water utilities across Washington are grappling with how to comply with this ruling, especially given the limitations on general fund resources due to economic conditions and the absence of clear guidance on the specifics of how to apply the ruling to a wide variety of rate-setting approaches.

Under the ruling, providing fire protection is a general government service that must be paid for out of general fund revenue and not through water-use rates and charges. The ruling pertains not only to cost of fire hydrant maintenance and operations but also to a proportion of the capital costs for providing fire protection -- the infrastructure necessary to deliver water to hydrants and to insure there is adequate water supply in the water mains. Consistent with actions taken by several cities (including Seattle and Bellevue), Kirkland increased its water utility tax rate from 10.50% to 13.38% to generate sufficient general purpose revenue to absorb the costs of fire protection charged to the General Fund. While this action was revenue neutral to the utility (and ultimately to the ratepayers) because the utility received the same amount in additional revenue from the General Fund as the General Fund received from the water utility tax increase, the issue adds complications to the rate-setting and accounting process and is confusing to customers.

DIFFICULTIES ARISING FROM THE RULING:
While the solution described above addresses the impact of the ruling on the City's own utility, a number of inter-jurisdictional issues are pending that further illustrate the complications arising from the ruling. For example, the City of Bellevue has spent the last two years negotiating an interlocal agreement with the cities in which Bellevue owns fire hydrants. There are 8 Bellevue owned hydrants within Kirkland, so this is not a large cost to Kirkland, but it is a substantial cost to the other cities served by Bellevue, such as Medina. Further, water special purpose districts are contemplating how the ruling impacts their relationships with the cities in which they serve. Northshore Utility District, which serves a large portion of the northern part of Kirkland, has approached the City to establish a method for charging their fire protection costs to the City (which would also apply to the other cities and unincorporated areas in which they provide

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service). The proposal is to increase the franchise fee the district pays to the City in the same amount as the City will pay the district for fire protection costs, creating another paper transaction with no real impact except to increase administrative costs. The issue is further complicated when unincorporated areas and fire districts are added to the mix. There is no clarity on whether or how this ruling should be applied by special purpose districts and the discussion is creating increasing tension between the agencies.

BENEFITS TO CITIES AND RATE-PAYERS BY CLARIFYING FIRE PROTECTION COSTS:
Ideally, the request is to clarify that fire protection costs are considered an integral part of providing water service and thus appropriate in rates. The main benefits to the City of Kirkland would be simplifying its water rate and tax structure (for clarity to the customer) and eliminating the administrative burden that produces no real change to what customers pay (what they paid for in rates before is now being paid as a tax). It would also return water rate-making in Washington to the industry standard that is applied in the rest of the United States. If that cannot be accomplished, limiting the application of the ruling to city-owned utilities would reduce the inter-jurisdictional disputes and the attendant administrative burden and customer confusion.

CITY OF KIRKLAND CONTACTS:
Tracey Dunlap, Director of Finance & Administration, 425-587-3101
Lorrie McKay, Intergovernmental Relations Manager, 425-587-3009