



CITY OF KIRKLAND
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MEMORANDUM

To: David Ramsay, City Manager

From: Erin J. Leonhart, Public Works Facilities & Administrative Manager
Daryl Grigsby, Public Works Director

Date: June 22, 2006

Subject: KING COUNTY WASTEWATER CONTRACT – 2006 UPDATE 1

Kirkland's Sewer History

Starting in the early 1940's, Kirkland's sewage was primarily discharged into Lake Washington. The Municipality of Metropolitan Seattle (METRO), a self-governing cooperative, was created by public vote in 1958 to address regional sewage and water quality problems. Four years later, METRO began conveying and treating Kirkland's wastewater. In January 1996, King County merged with METRO and is now called the King County Department of Natural Resources, Wastewater Treatment Division (King County). This eliminated the self-governing cooperative and placed wastewater treatment authority with the King County Council.

Metropolitan Water Pollution Abatement Advisory Committee

The Metropolitan Water Pollution Abatement Advisory Committee (MWPAAC) was created under RCW 35.58.210 to advise METRO (and later, King County) in matters relating to the performance of the water pollution abatement function. MWPAAC is comprised of one member from each organization contracting with King County for wastewater conveyance and treatment. Districts are required to appoint elected officials to MWPAAC while cities are not restricted and typically appoint staff. Erin Leonhart, Public Works Facilities and Administrative Manager, is Kirkland's current MWPAAC representative. MWPAAC meets monthly to discuss wastewater issues and programs.

Originally, MWPAAC had a direct advisory relationship with the METRO Council. Now, MWPAAC advises the Regional Water Quality Committee who gives input to the King County Council. The Regional Water Quality Committee is comprised of:

- Six King County Councilmembers (six votes)
- Four Elected Officials from the Suburban Cities Association (two votes)
- Two Seattle City Councilmembers (two votes)
- Two Sewer District Commissioners (two votes)

King County Wastewater Contracts

King County provides sewage disposal service to 34 local governments in King and south Snohomish counties under long-term agreements. These agreements were initially due to terminate in 2016 but most

were extended to 2036 in the late 1980's (this includes Kirkland). King County has requested amendments to the existing contracts. The three issues King County would like to address are:

1. Allowance for mid-year emergency rate increases;
2. Reduce the contract agency approval percentage for contract amendments from 100% to 90%; and
3. Extend the contract period to 2056 to allow for long-term debt.

The MWPAAC Contract Amendment Subcommittee (of which Erin Leonhart is a member) was formed to evaluate the issues and discuss the contract with County staff. Working with all members of MWPAAC, the subcommittee identified a number of issues members felt needed to be reviewed as part of the contract amendment discussions. The three priority items approved by the MWPAAC membership and submitted to the County for discussion were:

1. Institution of an operating board with a more direct advisory relationship with King County Council;
2. Restrict King County's ability to mandate agreements they make with non-contract agencies (environmental interests, etc.); and
3. Include within the contracts a method to determine amount of King County administrative costs paid by contracted entities.

All three of these were rejected by King County so MWPAAC has had additional discussions and made other recommendations. One overarching concern is that the existing contracts are still in a co-op format since they were created under METRO when members were self-governing. Another is a belief that costs are rapidly increasing and adversely impacting rates. The new Brightwater Treatment Plant, for example, was initially estimated to cost \$880 million and is now \$1.6 billion. The latest list of discussion points from the MWPAAC Membership are:

1. The contract should be a bi-lateral contract for wastewater treatment services;
2. There should be a mechanism in the contract that guarantees growth will pay for 95% of growth; and
3. The County needs to be restricted from using wastewater funds for any items other than the treatment of wastewater (an example is water re-use) and a new contract should contain cost containments.

The MWPAAC Subcommittee on Contract Amendment is continuing to meet independently as well as with King County to continue discussions about contract amendments. Each agency has an individual contract for wastewater treatment services; so, King County will approach each agency to request changes to existing contracts. The MWPAAC Subcommittee is working to ensure consistency across the contracts with member agencies.

In a letter to King County Council Chair Phillips dated April 12, 2006 (attached), King County Executive Sims expressed concern about rate impacts related to the contracts, which have only been amended by four agencies to date. The Regional Water Quality Committee (RWQC) has also discussed the contracts and the Suburban Cities Association, as an organization with members on the RWQC, has the contract as a topic for review.

Erin Leonhart will continue to participate in the MWPAAC Committee and Subcommittee meetings and report any developments. Erin is also available to answer any questions related to this contract.

Attachment: April 12, 2006 Letter to King County Council Chair Phillips



King County

Ron Sims

King County Executive

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April 12, 2006

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KING COUNTY COUNCIL

The Honorable Larry Phillips
Chair, King County Council
Room 1200
COURTHOUSE

Dear Councilmember Phillips:

Enclosed is a proposed ordinance adopting the 2007 sewer rate and setting the 2007 capacity charge. The contracts with our component sewer agencies require that King County adopt the 2007 sewer rate by June 30, 2006. Also enclosed in this transmittal package are the supporting documents required by Financial Policy 13 in K.C.C. 28.86.160.

I am pleased to transmit a proposed King County monthly sewer rate of \$28.50 per residential customer equivalent (RCE) and a capacity charge of \$34.05 for 2007, with the intention of holding the sewer rate stable through 2008. This is consistent with County Council direction in 2004 in adopting the \$34.05 capacity charge for a three-year term. The enclosed ordinance reaffirms that the 2007 capacity charge will be set at \$34.05.

The very good news is that as a result of an improved RCE picture, sound financial practices, low interest rates and continued cost savings and operating efficiencies identified by our employees, we are able to propose a two-year sewer rate that is below what we anticipated in last year's budget forecast. The following table identifies the rate savings in my 2007-2008 rate proposal forecast as compared with last year's budget forecasts.

	2007	2008	2009
2006 Adopted Budget Forecast	\$29.25	\$29.25	\$34.56
2007-2008 Rate Proposal	\$28.50	\$28.50	\$34.43

These rate proposals were developed pursuant to the county's adopted financial policies for the wastewater utility and continue the program's commitment to rate stability, predictability, and equity, while providing the revenues and debt service coverage needed to preserve the utility's credit rating and assure access to capital markets to meet its capital needs. Our continued favorable debt ratings are essential to keeping down costs of the planned borrowing needed to finance the Regional Wastewater Services Plan (RWSP). As detailed later in this letter, it may be possible to lower the proposed 2007-2008 rate below what is being proposed. Such an opportunity may occur from the bond sale now planned for May 1, 2006, by the Wastewater Treatment Division (WTD). If a lower interest rate is achieved and bonds are refinanced I will be submitting an amended rate proposal.



Key Assumptions/Financial Forecast

As required by Financial Policy 13 in K.C.C. 28.86.160, enclosed for council review is a detailed financial forecast for the wastewater utility for the period 2006-2011 (Attachment A), as well as a table outlining the key assumptions used in developing the proposed sewer rate (Attachment B). The remainder of this transmittal letter provides the discussion of critical forecasting factors and policy options that are also required by Financial Policy 13.

1. Rate Stabilization Reserve

Starting with the 2005-2006 sewer rates, a rate stabilization reserve which allows deferring the recognition of operating revenues into a future year was used to create multi-year rates. As stated in Financial Policy 12:

“King County should attempt to adopt a multi-year sewer rate to provide stable costs to sewer customers. If a multi-year rate is established and when permitted upon retirement by the county of certain outstanding sewer revenue bonds, a rate stabilization reserve account shall be created to ensure that adequate funds are available to sustain the rate through completion of the rate cycle.”

This will be used again in the 2007–2008 rate. At the end of 2005 there was \$14.5 million in the rate stabilization reserve. Based on the current forecast, it appears that only \$2.5 million will be needed in 2006. The remaining reserve of \$12 million, along with an additional deferral of \$6.9 million from 2007, will be used to create the two-year 2007-2008 rate.

The following table identifies the changes between last year’s forecast and the current 2007–2008 rate proposal for operating revenue deferrals between years.

	2005	2006	2007	2008
2006 Adopted Rate Forecast	(\$14.5 M)	\$7.25 M	\$7.25M	
2007-2008 Rate Proposal	(\$14.5 M)	\$2.5 M	(\$6.9 M)	\$18.9M

I remain committed to the principle of rate stability in setting the sewer rate. In developing this proposal, I also considered a three-year rate, but since that would require a rate increase of nearly 24 percent (from \$25.60 in 2006 to \$31.67 in 2007), I have opted for a two-year rate scenario, which results in a smaller increase of 11.3 percent in 2007 to be carried over two years.

2. Capital Program

During 2005 capital expenditures were \$21.9 million less than projected. The total difference between expected and actual capital spending in 2005 is the result of the activity in each project in which each had an assumed accomplishment rate of 85 percent. In 2005 across all projects the accomplishment rate was 78 percent. The Brightwater Treatment Plant and Conveyance

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projects accomplished 73.5 percent of planned due to lower spending on mitigation, property acquisition, and engineering. Other major contributions to the \$21.9 million difference include the delay of planned construction spending for the Juanita Bay Pump Station (permit issues), the Hidden Lake Pump Station (unqualified bidders), and the Densmore Stormwater Improvement (design modifications) projects. Additionally, actual spending was substantially less than budgeted for two major projects: Denny Way CSO and Henderson, as some of the close-out activities originally planned for 2005 shifted into 2006.

Relative to the adopted 2006 sewer rate of \$25.60, the wastewater capital program and associated debt-financing assumptions drive about 88 percent of my proposed rate increase. While I continue my commitment to capital cost containment during implementation of the Regional Wastewater Services Plan (RWSP), recent cost trends and two emergency projects have increased cost estimates for the 2006-2008 time frame which impact this rate proposal. The emergency projects are Barton Force Main and Ballard Siphon projects with costs of \$3.7 million and \$12.9 million. They require the immediate attention of the utility. The cost trend for Brightwater Treatment Plant Project indicates that overall costs have increased \$138 million compared to last year's pre-design estimate. The increase in the project cost estimate reflects increases in mitigation costs and commodity prices. My proposal incorporates these increases.

The financial forecast included in this transmittal presents capital program cash requirements of \$243.6 million in 2006, \$295.4 million in 2007, and \$418.2 million in 2008. This is an \$80.7 million increase from projections made during the 2006 rate forecast. These new estimates are equal to the projections included in the 2006 adopted WTD budget, plus the changes in Brightwater and the two emergency projects. A stringent review of capital projections, realizing cost reductions, identifying advantageous project phasing to minimize rate impacts, and continual review of planning assumptions have contained capital cost increases at this level.

The current proposal reflects WTD's ability to successfully and efficiently complete capital projects. We are assuming an accomplishment rate of 85 percent in the rate forecast in order to assure adequate revenues are available to support the capital program. From a historical perspective, as large projects move into their construction phase, accomplishment rates tend to climb. During the construction phase of the West Point Treatment Plant, the accomplishment rate climbed as high as 96 percent. If the accomplishment rate were set at 80 percent, the RCE rate would need to be \$28.18, and at 90 percent the rate would need to be \$28.84. I believe that 85 percent represents a prudent assumption in light of WTD's recent actual performance relative to capital budgets.

Other key assumptions with respect to the capital program address the cost of borrowing to support the projected capital outlays during the rate period. We assumed that interest rates for future bond issues will rise somewhat from their current level, consistent with a general consensus among bond market analysts.

For future parity bonds in 2007–2008, we assume an interest rate of 5.5 percent, or 0.76 percent higher than the rate obtained on our 2005 bond sale. To provide funding for 2006, the utility is planning a bond sale on May 1, 2006. Long-term interest on bonds has drifted higher in the last couple weeks, but is currently less than 5.0 percent. If the interest rate remains at this level, we will refinance about \$80 million in outstanding bonds at lower rates. The assumed interest rate of 5.25 percent for debt issued in 2006 and no refinancing was used to guard against possible rate climbs during the next month. A reduction of 25 basis points on this borrowing cost assumption and the bond refinancing could allow a monthly sewer rate reduction of \$0.11 for the two-year period. If the May 1, 2006, bond sale produces these lower rates, I will be submitting an amended rate proposal incorporating the difference. The staff in WTD and the Finance and Business Operations Division will work together on future bond issues to acquire the most cost-effective form of debt needed to support the capital program given market conditions at the time of issuance.

3. Capacity Charge

The proposed 2007 capacity charge rate remains at \$34.05 in accordance with our agreement to hold the rate constant from 2005 through 2007. The capacity charge is a monthly charge levied on new connections to the wastewater system in accordance with KCC 28.84.050 and KCC 28.86.160. It is set at a level to ensure that new sewer connections, over the long-term, will pay for the costs of the new capacity required to serve them (that is, “growth pays for growth”). Additionally, the revenues received from the capacity charge are included in calculating debt service coverage; therefore, the level of the capacity charge influences the level at which the monthly RCE rate must be set.

During 2005, new capacity charge equivalents grew by 9,628, compared to the forecast of 9,000. Even with this growth there was a small decline in overall capacity charge revenues from \$17.5 million in 2004 to \$17.0 million in 2005. This decline in revenues was attributable to the discount rate used to calculate connection charge payoffs being lowered from 8.0 percent to 5.5 percent at the beginning of 2005. This change induced a high number of prepayments in late 2004, followed by a correspondingly sharp decline in 2005 prepayments. The assumed number of upfront payments in future years has been changed in this forecast to recognize this shift in payment patterns. Through February of 2006, new connections are on pace to reach 8,500 for the year. The number of new connections assumed for 2006–2008 has been changed from 9,000 to 8,500 to match the most recent data.

While not under consideration in this legislation, the preliminary estimate of the capacity charge for 2008 has changed relative to last year’s projection. It should be stressed that council is, in no way, adopting a new level of the capacity charge through this current legislation. Adopting the two-year sewer rate proposal does not predetermine the capacity charge level for 2008. Based on the most recent cost trend information for the RWSP, projected 2008 capacity charge rates have increased from \$43.25 plus 3 percent per year, thereafter changing to \$50.00 plus 3 percent per year thereafter.

These estimates are preliminary and will be thoroughly analyzed and updated during the upcoming year. New information will include actual Brightwater contract bids, revised long-term RCE projections and possible adjustment to other long-term capital projects. The intended 2008 sewer rate of \$28.50 will not be changed by this update process. If there is any revenue surplus in 2008 it will be placed in the rate stabilization reserve for future rate relief. If there is any revenue deficit in 2008 it will be managed by reducing capital expenditures in 2008.

4. RCE Growth

Last year's sewer rate forecast assumed 0.6 percent growth in 2005 followed by a 2.2 percent decrease in RCEs in 2006 reflecting an anticipated drought. Actual growth in 2005 was only 0.3 percent because the drought did not occur. Based on a survey conducted of our ten largest sewer component agencies, representing approximately 85 percent of the total RCE base, we now expect annual growth of 0.5 percent through 2009. In comparison to last year's forecast, RCEs are now projected higher by 16,973 in 2006, 16,997 in 2007, and 13,684 in 2008. This would produce additional operating revenues of \$5.2 million, \$5.8 million, and \$4.7 million in 2006, 2007, and 2008, respectively. While the most recent long-term forecast shows continued customer growth and a need for increased treatment capacity, in the short term, we expect RCE growth to remain relatively flat. It should also be noted that flows experienced at the plants reached all time monthly highs during the recent rains of December and January in spite of the low RCE growth.

5. Operating Expenditures

The wastewater utility's operating program achieved very favorable expense results in 2005. Operating expenses were \$83.2 million, which is \$3.6 million below what was estimated in last year's forecast. A large portion of this savings is the result of the Productivity Initiative program to which WTD remains firmly committed. As evidence of the program's success, actual operating expenses in 2004 and 2005 increased only 0.13 percent and 0.55 percent respectively. For context, the results for 2005 were achieved in a year when chemical costs alone rose 37.7 percent or \$1.1 million, reflecting the increase in the price of petroleum-based products. WTD was able to offset these expenses through lower labor and energy costs.

In 2006 we project operating expenses to be \$92.3 million. This is an increase of 10.9 percent over 2005 expenses of \$83.2 million. While most expense increases are driven purely by inflation, there are several areas where WTD is seeing increases well above normal inflation. Some of the larger dollar expenses showing these types of increases include: salary and benefit expenses, expected to increase 11.2 percent or \$3.6 million due to benefit costs, COLAs, and new labor agreements; chemicals, 24.7 percent or \$1.0 million; and electricity increases of 8.0 percent or \$0.6 million, due to higher volumes and rate increases.

In 2007 and 2008, WTD is projecting operating expenditures of \$95.7 million and \$99.0 million, or an annual increase of 3.8 percent and 3.4 percent, respectively.

6. Investment Income

While long-term borrowing interest rates have remained near historical lows, investment interest rates have been climbing over the last couple years. In last year's rate forecast we had assumed an investment earning rate of 3.5 percent for 2006, 2007, and 2008. Rates for 2006 have already climbed to 4.0 percent and for 2007 and 2008 we are now assuming an interest-earning rate of 4.5 percent. The forecasted investment income for 2006, 2007, and 2008 is now \$1.4 million, \$3.2 million, and \$2.0 million higher, respectively.

7. Component Agency Contract Status

The 2007-2008 rates assume that term of the contracts with the component agencies has not been extended by the end of 2006, restricting the term of new bonds to 29 and 28 years respectively. If it were possible to issue 35 year bonds as they have been historically, the two year rate could have been \$.30 lower (see attachment A, bond terms). The county has been attempting to amend and extend the 34 contracts with the component sewerage agencies for the last four years with little success. To date, only the cities of Carnation and Renton, Vashon Sewer District and the Muckleshoot Indian Tribe, have extended contracts. Delays in extending the contracts prior to issuing major debt for Brightwater will negatively and significantly impact both the sewer and the capacity charge rates. It is in the best interest of all ratepayers, both new and existing, that we create the motivation for the cities and sewer districts to extend and amend the contracts as soon as possible so that King County can extend the debt repayment period and lower the sewer and capacity charge rates.

Two major issues have so far prevented these contract amendments. First for many non-Seattle agencies it is Culver expense related items. Some non-Seattle agencies have long held the position that the Culver policy and related expenditures must be eliminated before they are willing to amend and extend the contract. Yet I know these funds are very important to the council and are used every day by groups and organizations committed to improving the water quality and health of the region. I would not support elimination of the Culver fund without proposing to the council some other way to fund these excellent programs.

Second, the City of Seattle has advocated locking into the contract the current capacity charge methodology that defines how growth pays for growth. I have not accepted Seattle's proposal because for the next fifty years this would not allow the normal political process involving the Metropolitan Water Pollution Abatement Advisory Committee (MWPAAC), Regional Water Quality Committee (RWQC) and the King County Council to amend the capacity charge policies and rates in the future as necessary without having to reopen and renegotiate 50 year contracts.

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I remain committed to the fundamental principle we agreed to more than six years ago in the Robinswood Agreement (Attachment C), that growth would pay for growth, and I have been willing to include this policy in the 50 year contracts. However, I believe that how this policy is implemented through the specific methodology of what is a growth related project and how those cost are recovered should be flexible over the next 50 years, particularly since the projects post-Brightwater have not yet been designed to address either growth or existing system upgrades. I believe that these cost allocations, as well as the specific methodology for recovering growth related costs, should be left to future MWPAAC, RWQC, and council deliberations and decisions. The City of Seattle has not held this view and we have been at an impasse for four years.

8. A new Robinswood Agreement

Because of the impending serious consequence of the 4-year deadlock on extending and amending the contracts, which will cost all ratepayers if not resolved quickly, I am asking the RWQC to immediately take-up the issue of getting these contracts amended and extended by the end of the year such that the majority of Brightwater debt can be long term, with lower sewer rate and capacity charge impacts. We are informed by our financial advisor that contracts representing 75% of the rate base are necessary for us to secure long term debt. That means everyone must be at the table for a sustainable solution.

In October of 1998 the region came together and reached "the Robinswood Agreement" on many of these same issues. Robinswood did not solve all of our problems, but it allowed us to adopt the RWSP and bring Brightwater into existence. I believe we can use that model again to overcome our differences and protect both the waters of Puget Sound and the ratepayers of the region. Therefore, I will be asking members of the council and the RWQC to join me in a second regional summit at Robinswood or a similar location to resolve these issues in May.

Let me be clear. This effort is critical. If we cannot reach an agreement in a second Robinswood process, I must take the actions I deem necessary to break the stalemates and keep the wastewater system together and keep sewer rates and capacity charges as low as possible.

If the region cannot unite, I must consider proposing RWSP policy changes soon to motivate agencies to extend and amend the contracts. These policy changes could include the elimination of Culver funds, new capacity charge allocation methodologies, new definitions of "growth pays for growth", a reopening of the Combined Sewer Overflow (CSO) benefit charge issue, and reallocation of CSO costs between the rate and the capacity charge. Everything would be on the table. My goal is to avoid having to make such proposals which may create winners and losers. By working together, we can find a win-win for everyone.

My staff will be contacting you and members of the RWQC soon with details about the new Robinswood summit. I ask that you join me.

