

## **Water and Sewer Rates for the year beginning July 1, 2010**

As you may be aware, the City of Sault Ste. Marie has been under a federal mandate to eliminate the overflow of sewers into the St. Mary's River since the early 1990's. This coincidentally followed another mandate to construct a new Water Filtration Plant that opened in 1992. These mandates have led to a significant increase in Water and Sewer rates over the past two decades for the City of Sault Ste. Marie to cover the debt for these improvements. It has also led to the renewal of an aged water and sewer system that had many problems resulting in regular sewer back-ups in basements throughout certain areas of the city, regular water main breaks and minimal fire flows throughout the community since we were relying on a system that had components that were 75, 100 or more years in service. Even without the mandate, the City needed to address an aging and, in some cases, failing infrastructure. The City was successful in negotiating a five-phase plan with the MDEQ so that the debt for the construction of new utilities could be phased in at the time debt for a number of earlier improvements such as the Wastewater Plant and the Water Plant would be retired. As a result the MDEQ allowed the City to come into compliance with the Combined Sewer Overflow (CSO) regulations in five separate phases over a twenty-five year period in 1994. The final phase of this effort is to be completed by 2018 under our current order. Since the cost for building and replacing underground utilities is significant, since it requires that the City tear up the streets to accomplish this work, the City has also prepared a master plan identifying the water mains and streets that need to be replaced and have tied these plans together with the CSO five-phase plan. We want to minimize the necessity to tear up streets at different times because we didn't deal with water main and other underground issues at the time we build a new sanitary and or storm sewer.

Throughout this time the City has taken advantage of the State Revolving fund (SRF) and Drinking Water Revolving Fund (DWRP) when we have qualified to lower borrowing cost for this work. Both of these programs have had rates of around 2.5% to fund this type of work. These funds are available on a competitive basis statewide, so the Commission has accelerated several phases to take advantage of these rates (which were even more impressive compared to market municipal bond rates a decade ago!) when it appeared unlikely that the City would have this opportunity if we waited for the scheduled phase to occur.

The decision that the Commission made last year to accelerate the fourth phase of this work was for two specific reasons. Under the American Reinvestment Recovery Act (ARRA) there was a unique opportunity for the City to receive "principal forgiveness" on a portion of the SRF project. This amounts to a grant for work to bring the City in compliance with the MDEQ order. The City has not been eligible for grants in the past for this work. This amounted to 2.7 million dollar grant for the SRF eligible portions of the project. Furthermore, the City was also eligible for lower interest rates through Build America Bonds on the non CSO portion of this project that wasn't eligible for SRF funding. The City Commission made the decision to accelerate this phase of the project that would have been required to be done in 2012-13 because of the unique grant opportunity through the ARRA. This required a significant commitment of time and energy in order to fit this project into the narrow time frame allowed for ARRA projects, but we were able to do this. The net effect reduces the principal by 2.7 million dollars (along with the interest that would otherwise have been paid on the principal over a twenty year period). Furthermore the Build America Bonds will reduce the interest on the non-eligible SRF cost for the system. For the rate payers, it means that both the principal

and the interest paid back for this work will be reduced. With this project being accelerated by two years, we are paying slightly higher water and sewer rates for 2010-11 and 2011-12 fiscal years, but over the 20 year life of the bond the rate payers will not have to pay the \$2.7 million debt that will be forgiven by the ARRA program and the ratepayers are able to take advantage of the Build America Bonds with a lower interest rate as well. This results in lower rates than what would have been paid in years 3 through 20 for the bonding if we waited and didn't have the unique financing opportunity that occurred in 2009-10 due to the Federal economic crisis.

Several questions are often raised in regards to water rates. They are as follows:

- 1) **What is the schedule for debt payment in the water and sewer fund?** - The debt schedule is structured to level out the payments for the various bond issues so that the impact to the ratepayers is relatively constant throughout the five phases of the CSO work. In 2018 and 2019, the debt payments begin dropping off. This will be the time that the final phase of the CSO work will be completed and added to this schedule. The debt schedule for this phase will correspond with the retirement of other debt issues in the water and sewer fund.
- 2) **What are the next phases of work to address the CSO work?** - The last phase of the CSO control program will be constructed in 2016-17.
- 3) **When will ratepayers see reductions?** – The rates will continue to support the debt load for the CSO and associated work for 20 years after the final phase of the CSO work is completed. The bonds for these projects were structured to stabilize the impact on ratepayers by timing work when other debts are retired. In the next two years we are anticipating rate increases equal to a couple of percentage points above inflation. The bonding for final phase of CSO work will be timed to take advantage of the reduction in debt service in future years in order to level out the impact to ratepayers. A significant drop off of debt occurs in 2024. This would begin the process of Sault Ste. Marie's rates being reduced due to debt considerations. While this is a number of years out, the impact on the rates will be significant. The other item that cannot be determined is what the rate of inflation will be in future years. Inflation will affect the cost and rates in out years. For example, if the cost to provide water and sewer services is \$7 million per year and inflation is at a rate of 3% per year, \$7 million would escalate to \$10.6 million by 2024. However, inflation does not affect the debt schedule. Assuming that 50% of the cost of the water and sewer system is paying principal and interest on the previous projects so that \$3.5 million is for operations and \$3.5 million is for debt retirement, and if debt service levels are maintained at current levels, the actual affect of a 3% annual inflation rate on the cost of water and sewer would be \$5.3 million for operations, with the debt being fixed at \$3.5 million a year, with the total cost of the system being 8.8 million per year by 2024. Based on these assumptions, the ratepayers would be paying less than the rate of inflation for water and sewer at that time by a total of \$1.8 million per year (\$10.6 M – 8.8M) even before the drop off of debt requirements after 2024. To understand the long-term impacts of debt on the water and sewer system, it is important to understand the impact that inflation may have on the system over time. The remaining factor affecting water and sewer rates is the

estimated usage of water and sewer services for the next fiscal year. A number of factors affect usage include the installation of high efficient washing machines, toilets and dishwashers by homeowners, economic conditions (fewer tourist for example), conservation by businesses and homeowners due to the cost of water and sewer, and weather. There has been a national trend of people using less water. While variable cost factors are reduced (energy use, chemicals for treatment, etc.) it is necessary to allocate the fixed cost (primarily debt service) on fewer cubic feet of water sold. As a result, the sale of fewer units of water and sewer services increases the cost per unit for these fixed costs. This has an impact on future rates for water and sewer.

- 4) **How do the increases compare to inflation?** – For a family using 700 cubic feet of water and sewer services, the cost for water and sewer services in 2010-11 will be \$80.83 a month. This compares to \$70.56 a month for the 2005-06 fiscal year. This is an annual increase that averages 2.89% per year over this five year period. The Consumers Price Index over the past 5 years (including 2009's -0.4% adjustment) has averaged 2.56% per year over the past five years. (Please note that the five year period for the CPI runs 18 months ahead of the water and sewer rates since the annual CPI will not be known for 2010 until 2011.
- 5) **How do wage and benefits affect rates?** – Of the proposed budget of \$6,699,547 for the 2010-11 budget for the water and sewer fund, 20.7% of the cost are direct wages and benefits for employees paid through the water and sewer fund. The largest component of this fund is for satisfying debt requirements which amounts to 51.3% of the budgeted expenditures. The City Commission has taken a number of steps to control employee cost. Most significant is that the Commission has negotiated a fixed contribution to the cost of healthcare beginning with the 2004-08 DPW contract. This provision is now in all labor agreements. The City's obligation for healthcare cost is fixed at \$1175 for a family per month, \$867 for a two person plan, \$460 for a single plan. The employees have the right to select a high deductible plan, or a more comprehensive plan. The employees pay 100% of the cost above these thresholds. Furthermore, the wage increases in the 2008-11 contract were 0%, 2.5%, and 2.5%. I believe that employee costs in the City are being contained.
- 6) **How do the Water and Sewer rates in Sault Ste. Marie compare to other communities?** – Annually we do a rate survey for the Commission to see how the city rates compare to other water and sewer systems in the U.P. In April 2010, rates for 700 cubic feet of water and sewer services ranged from a low of \$37.01 a month in Escanaba to a high of \$146.72 in Ontonagon. Sault Ste. Marie's rates were \$76.28 per month. Of the communities surveyed, Norway (\$83.67), Munising (\$91.81), Manistique (\$105.04), Ironwood (\$93.14) and Ontonagon (\$146.72) had higher rates, and Escanaba (\$37.01), Iron Mountain (\$41.95), Gladstone (\$66.13), Marquette (\$66.38), Menominee (\$41.81) and St. Ignace (\$74.99) had lower rates. I am not aware of any statewide database that shows rates for water and sewer for all systems. While our rates are higher than many locations, I do know there are many other systems that have higher rates than Sault Ste. Marie. **On a side**

**note, the MDEQ was threatening to require the City to finish its CSO work five years ahead of the original schedule because the City's water and sewer rates as compared to personal income for Sault Ste. Marie were below thresholds to justify the additional five years of time to come into compliance.** In effect, they said our ratepayers have the capacity to pay substantially higher rates than what we are charging! We challenged the DEQ's decision to reduce the schedule by 5 years and the administrative law judge, in a consent order, reduced the schedule by two years which we accepted.

- 7) **Should an outside audit be done to review how our expenditures for water and sewer compare to other communities?** – Since the City has participated in the SRF and DWRP programs, we are required to construct water and sewer rates to cover the system expenses in accordance with state and federal requirements. This includes a review of our expenses and rates every time we finance a CSO project with SRF or DWRP funding. Also, in 2006, we did an extensive review of rates, expenses and debt load of a number of water and sewer systems. In addition, the financial records of the water and sewer fund are audited annually as well. There are a number of factors that affect rates in these systems. The single largest issue is that CSO communities and communities that have had to do substantial rebuilds of their system have substantially higher rates. At the time we did the analysis, the City of Escanaba had virtually no debt in their system. They didn't have to deal with combined sewers since the system was built as separate storm and sanitary systems over the years. Their water and sewer plants were built long enough ago that the debt has been paid in full. Knowing that over 50% of the rates for Sault Ste. Marie cover debt, if we were in Escanaba's great situation, we would be paying about half of the rates that we currently pay. For 700 cubic feet of water the cost would be \$38.14 per month, very similar to Escanaba's rate of \$37.01 per month. When we deducted debt service from each of these other systems and compared what the rates would be, Sault Ste. Marie would have one of the lowest rates in the U.P! Other issues that impact costs are types of systems. For example, the cost of operating a well system for municipal water is substantially cheaper than treating surface water. These communities with a good source of ground water can save their customers a substantial amount of operating costs over a filtration plant. The same is true for those communities that have the proper soils for a lagoon type sewage treatment facility. These are cheaper to operate than a rotating biological contact plant that the City is required to operate. The fact that Sault Ste. Marie has to build its water mains and sewer mains at a minimal depth of 7 feet adds a tremendous expense to construction due to the frost depths experienced along the south shore of Lake Superior. I am always envious that all Edison Sault has to do is to string wires on utility poles to provide electricity to homeowners. Those in the water and sewer utility business have to construct pipelines 7 – 25 feet underground (since sewer runs downhill, sewer depths are significantly deeper than the 7 foot waterline depths) and not only do we have to pump raw water from the St. Mary's River, but we have add chemicals, run all that water through a series of filters, build water storage tanks to store treated water and deliver this water to every building in the City through a pipeline system constructed 7 feet under every street in the City. Our job is not done here, however. Once the resident or business "uses"

the water, it is then necessary for the City to construct a second pipeline 7-25 feet below the surface of the ground and then clean the water through a wastewater treatment plant so the water can be returned to the St. Mary's River. When I consider all of these facts, I think it is amazing that we can provide water for drinking, then treating that sewage for an amount that is not that different than an electric bill, cable bill or telephone bill! (I didn't mean to rant, but it occasionally feels good to share my thoughts with someone who may care!!!)

- 8) **Does the City have plans to manage without a tax increase if the city faces another downturn?** – The City Commission and administrative team are very mindful of these concerns. We do financial modeling to try to project what our expenditure trends and revenue trends will be in the future. While the Commission is obligate to adjust the police and fire pension rate to meet actuary requirements, and the City Commission is proposing a small adjustment of 0.0966 to keep the refuse and composting programs intact. The overall millage rate for the City is still below the 1980 millage rate of 24.3800 mills with this year's millage being proposed at 21.9584. The City has never requested voters to approve a Headlee Tax override vote to return the operating rate to the Charter Authorized 20.0000 mills. The general operating millage is now at 16.8139. I do not anticipate the Commission seeking any general fund millage increase in the future. In 2004, the City Commission approved a downsizing of about 10% of the funded positions at that time. The Commission has requested that we develop another plan to take necessary steps to reduce the budget during the 2010-11 fiscal year in the event that State Revenue Sharing is cut below anticipated levels for the next year. This will most likely be accomplished through reduction of staffing and expenses.

Please contact City Manager Spencer Nebel if you have any questions regarding this information.

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