Water Utility Financial Issues
March 11, 2010

History of the ASR Project

The Aquifer Storage and Recovery Project (ASR) is the key component of the City's adopted Integrated Local Water Supply Program (ILWSP) designed to assure the community and its wholesale customers of an adequate supply of water through the year 2050.

Since the 1950s, water levels in the Equus Beds aquifer have dropped up to 40 feet in some areas because the water pumped out for agricultural/industrial needs and municipal water supplies has exceeded the aquifer's natural recharge rate of six inches of water per year. Due to this depletion, the aquifer is also vulnerable to saltwater contamination from the Arkansas River and the saltwater left behind from oil field evaporation pits used in the 1930s.

The ASR project is broken into four phases. Phase I construction began in March 2006. It has the capacity to divert and recharge up to 10 million gallons a day of river water into the aquifer. Phase I was completed at a cost of $27 million. Through the end of 2007, Phase I had added a total of 300 million gallons of water to the Equus Beds aquifer.

In July 2008, design contracts were awarded for five Phase II projects. Completion of Phase II of the ASR project will significantly slow down the migration of the saltwater plume.

The ILWSP included a number of elements:

- 100 MGD Aquifer Storage and Recovery System (Phase II of four phases now under construction)
- Water Conservation (developed new rate structure to encourage judicious use of water)
- Bentley wellfield re-development (complete)
- Local wellfield expansion (currently in permitting stage)
- Greater use of Cheney Reservoir (complete)
- Additional raw water pipeline (partially complete)
- New 65 MGD water treatment plant (future)

The City Council adopted the ILWSP on August 31, 1993. Since that time, staff has brought various elements of the project to the City Council for review and implementation. In July 2001 a blue ribbon panel of national experts was convened to review the project and determine if other alternatives should be considered.

In May 2000, the Concept Design Study for the ASR Projects was completed and the total cost of the ILWSP was estimated at $283 million; the current estimate is $550 million.

Summary of Changes from 2009 until 2010

In June 2009, the Wichita Water Utilities (WWU) moved forward with financing the ASR Phase II project. In that month, $130 million in revenue bonds were sold with $50 million of that issue dedicated to partially pay for this phase. The total cost of ASR Phase II was estimated at $250 million.

The City Council received two presentations in July 2009 to discuss options for funding the Water Utility's capital and operating obligations including ASR Phase II. Based on financial and consumption data available at the time, staff recommended a $2 surcharge beginning on August 1, 2009 and then moderate annual rate increases thereafter. The City Council acted upon this recommendation and approved the $2 surcharge in August 2009. With the adoption of the budget, the Council also approved a 5% rate increase for water and a 5% increase for sewer service effective January 1, 2010. Staff also projected, but Council has not taken action on, future rate increases of 5% over the next three years followed by 3% increases and declining to no increase for either utility by 2018.

The rate projections also anticipated that the Water Utility's operating and capital expenditures would be reduced. To achieve this, nineteen employees were laid off in 2009 and another nineteen positions were held open indefinitely. Additionally, $8.9 million in planned operating and capital expenses were deferred.

Conditions Impacting the Utility

In December 2009, Finance staff began questioning the effectiveness of the 2009 rate increase and expense reduction. At that time, bids were being solicited for components of the ASR project and questions were raised about the Utility's ability to meet the cash flow requirements for this work. In response, Utility representatives expressed confidence in the original cash flow projections and the ability to meet the department's operating and capital needs.

In late January, Finance conducted another review of the Utility's financial position and requested an updated cash flow analysis. Concurrently, a consultant working on the 2010 bond issue (Burns and McDonald) expressed a concern that the Utility's cash position may not be sufficient to cover the debt service requirements for the issue. As a result of these concerns, a full analysis of the Utility's financial position was conducted. This analysis revealed that the Utility's cash position had eroded and that additional revenue was needed to support its budget obligations.

There were a number of factors that contributed to the Utility's change in financial condition, as noted below.

Decline in Daily Consumption: One condition contributing to the situation is the decline in average daily consumption of water since 2006. This decline is mostly attributable to the record three years of wet weather. However, at least a part of this decline, particularly since 2008, is attributable to the poor economy. Staff's presentation to the City Council in July 2009 was based on a "mid range scenario" of pumpage of 59.5 MGD. Prior years had been as high as 63 MGD (2006), so this number seemed like a reasonable assumption at the time. In actuality, 2008 and 2009 averaged 54.8 MGD and 54.6 MGD respectively. Correspondingly, projected revenues declined by $12 million over this same period of time.

The following chart shows average daily consumption by customer class.

Water Utility
Water Consumed by Customer Category (in millions representing billion gallon totals)

	Water Consumed by Customer Category						# Change 2004	% Change 2004	Average Annual
Water Customers	2004	2005	2006	2007	2008	2009	to 2009	to 2009	Change
Residential	9,355	10,367	10,705	10,238	9,003	8,938	(417)	-4.46%	-0.89%
Commercial/Industrial	7,362	7,809	8,092	8,094	6,996	6,839	(523)	-7.10%	-1.42%
Wholesale	1,373	1,401	1,435	1,416	1,365	1,299	(74)	-5.39%	-1.08%
Contract	318	407	480	352	279	235	(83)	-26.10%	-5.22%
Other	1,702	2,118	2,165	1,590	2,365	2,615	913	53.64%	10.73%
Totals	**20,110**	**22,102**	**22,877**	**21,690**	**20,008**	**19,926**	**(184)**	**-0.91%**	**-0.18%**

Financial Pro Forma: Another contributing factor to the Utility's financial situation was that the debt service schedules used by the Utility for its ASR Phase II bond issues were flawed. In order to relieve some of the burden for todays rate payer, the Utility back-loaded the debt for these issues. However, the error occurred when the Utility did not provide sufficient debt retirement in the first ten years of these issues to meet standard requirements. When this debt service calculation was reviewed by both Burns and McDonnell and Springstead Financial Services it brought to light the error and the double digit rate increases that would be needed to meet the financial obligations of the Utility in the near term. To correct this error, the Utility must add between $6-12 million annually to the debt schedules.

Sewer Main Expansion: It is common for developers to utilize special assessments to fund all of the infrastructure needs for their projects. In instances where the development is staged, it makes sense to increase the size of the utility mains to accommodate future growth. In the past, the Utility has cash funded the oversized portion of sewer mains that are associated with the utility extension. Cash funding has been possible because the costs for such projects have averaged less than $2 million per year.

However, over the last two years, this program has obligated the Utility to a cost of over $20 million for the construction of oversized sewer mains. This has significantly drained the cash available to the Utility. To properly bolster the Utility's cash position, the $20 million must be added to the 2010 bond issue, which was not originally expected. This action will require the adoption of a charter ordinance. A charter ordinance takes 60 days before it is in effect.

Compliance Issues: The bond covenants require that the rates, fees and charges of the Utility must provide sufficient revenues to cover both debt service and operational costs. Based upon current projections of usage and without increased revenues, the Utility's debt service coverage ratio (DSCR) will likely fall below its bond covenant required minimum of 1.2 prior to the end of the year. If this should occur, the Utility will not be able to issue the bonds planned for 2010. The cost associated with obtaining a DSCR of 1.2 in 2010 is estimated to be $8 million.

Issuance of Debt: The Utility's finances are also impacted by its ongoing contractual obligations. Prior to the issuance of debt for these current obligations, the Utility must be able to meet a parity test. The parity test ensures that the Utility can cover the highest principal and interest payment through the maturity of the bonds by at least 120%. Based upon current projections, the Utility will not be able to satisfy the parity requirements for its upcoming bond issue without additional revenues (rate increases). In addition to the $20 million associated with the sewer main expansion program, current outstanding obligations include $21.5 million for water projects and $2.17 million for sewer projects which are already completed. When the existing contractual obligation of $59 million for ASR Phase II is added, a bond issue of approximately $103 million is needed in 2010. Originally, it was anticipated that this bond issue would be sized at $155 million.

It should be noted that issuing bonds to cover the portion of the ASR Phase II project currently under construction will not result in an operational system. Staff has reviewed options and determined that the project may be reconfigured to perform at an 11 MGD recharge capacity. (The ASR Phase II project was originally envisioned to perform at a 30 MGD recharge capacity.) By reducing the scope of the project the Utility can save over $100 million. However, even this reduced project would require an additional $56 million in bonds.

Conclusions and Recommendations

The failure of the Water Utility staff to adequately monitor changes in the Utility's financial condition has created an urgent need for additional revenue. This revenue would be used to fund larger than anticipated debt service obligations, operating expenses and reserve requirements. To address the financial needs of the Utility, I am taking the following actions.

1. It is recommended that the City's water and sewer rates be increased by 15% on June 1, 2010. This rate increase would generate approximately $8 million in new revenue and is

needed to meet all of the debt service obligations for the 2009 bond issue. The rate payer impact of this proposed increase is shown on the attached chart. In order to cover the debt service obligations for the 2010 bond issue, another rate increase will be needed in January 2011. However, the actual size of that increase will depend on a number of factors, including water consumption for the remainder of 2010 and the future of ASR Phase II. Additionally, the City's CIP can be amended to substitute Water Utility projects for other infrastructure improvements, thereby reducing some of the burden on Water revenues. The Mayor and City Council will be provided with regular updates of the Utility's financial condition as well as a complete analysis of the debt financing options.

2. An RFP will be issued to obtain an independent review of the ASR project. The consultant will be asked to review the original documentation for the project and to identify any changes in conditions that could have altered the project's goals or design. If the ASR concept is endorsed, the consultant will be asked to review the plans for Phase II and to determine if alternative approaches are available to complete the work. Alternative financing methods will also be reviewed.

3. The management of the Water Utility will be changed. Effective this week, Mr. David Warren has retired as the Director of the Utility. On a short term basis, Mr. Chris Carrier will serve both as the Public Works Director and Utility Director. A national recruitment for a new Director will commence immediately. However, recognizing that utility experience and expertise is needed during the interim period, the consulting firms responding to the RFP will also be asked to provide a proposal for interim management services. This approach should ensure that the department's operations and the consultant's analytical work are properly aligned.

4. The financial staff of the Water Utility will be transferred to the Finance Department and will be devoted solely to financial matters involving the Utility. This action will broaden the financial oversight of the Utility while maintaining the knowledge base needed to accurately project its financial needs.

5. The Mayor and City Council will be asked to approve a charter ordinance to allow for the sale of the 2010 bond issue. Additionally, they will be asked to issue this debt.

The following chart provides the proposed time schedule for decision making.

Date	Action
April 6, 2010	City Council requested to approve contract with consultant to review ASR project and to provide interim management
April 6, 2010	City Council considers Charter Ordinance for Water and Sewer Utility
May 15, 2010	Consultant submits ASR Report
June 1, 2010	City Council requested to approve a rate adjustment for ASR and non ASR projects
June 15, 2010	Charter Ordinance approved through 2nd reading
September 14, 2010	City Council considers issuance of either temporary General Obligation Notes or Water Utility Bonds for the ASR project
October 19, 2010	City Council approves the sale of bonds/notes