
**REVIEW OF
WATER AND WASTEWATER UTILITY FUNDS
PROPOSED RATE INCREASES
EFFECTIVE JULY 2013**



**City of Baltimore
Department of Audits**

CITY OF BALTIMORE

STEPHANIE RAWLINGS-BLAKE, Mayor



DEPARTMENT OF AUDITS

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Honorable Joan M. Pratt, Comptroller
And Other Members of the Board of Estimates
City of Baltimore

We have reviewed the methodology and procedures used to determine the proposed Water and Wastewater rate increases submitted for the Board of Estimates' approval by the Department of Public Works (DPW) and the Director of Finance for fiscal years 2014, 2015, and 2016. The proposed rate increases for both Water and Wastewater are 15% for fiscal year 2014, and 11% for fiscal years 2015 and 2016. The effective dates of the proposed rate increases are anticipated to be July 1, 2013, July 1, 2014, and July 1, 2015, respectively. The purpose of our review was to determine whether the methodology and procedures used by DPW to determine the rate increases were reasonable and whether the applicable computations were accurate.

As required by the December 1978 Charter Amendment, the City Council adopted Ordinance 941 which established, among other things, a mechanism for the determination of rates and charges for water and wastewater services. Ordinance 941 requires that the City's Water and Wastewater Utility Funds (Utilities) establish rates or adjust rates to make the Utilities self-supporting. Ordinance 941 also requires that the rates be established at a level sufficient to recover any accumulated deficit from prior years. Additionally, the Utilities must comply with revenue bond covenants and operating reserve requirements that cover the utility rates.

The City entered into a Consent Decree with the U.S. Environmental Protection Agency and Justice Department and the Maryland Department of the Environment in 2002 to address past and periodic discharges and wet overflows from the City's Wastewater collection system. As part of the Consent Decree, the City must significantly increase and accelerate its existing Capital Improvement Program (CIP) for the Wastewater System.

In order to determine the need for the proposed rate increases, Utilities' personnel prepared a comprehensive financial model that projects revenues, expenditures, cash balances and reserves for fiscal years 2014 through 2019. The projected revenue requirements and proposed rate increases are based upon expected operating expenses, CIP projects, sources of funds, and legal covenant requirements. The proposed rate increases provide more reserve funds than required to meet expected legal covenants and required revenue bond coverage through fiscal year 2016. According to the Utilities' comprehensive financial model, annual rate increases for fiscal years 2017, 2018, and 2019 are expected to be 16%, 12%, and 12% for Water, respectively; and, for Wastewater, 8% for both fiscal years 2017 and 2018, and 7% for fiscal year 2019.

Based on our review of the methodology and procedures used to calculate the proposed rate increases and our review of DPW's projections of revenues, expenditures, and cash and reserve balances, we believe that the proposed Water and Wastewater rate increases of 15% for fiscal year 2014, and 11% for fiscal years 2015 and 2016 are higher than necessary for the Utilities to be self-sustaining and to meet the reserve and debt service requirements.

BACKGROUND

Significant Requirements, Revenue Bond Covenants and Utility Goals

The significant Operating Reserve Requirements, Revenue Bond Covenants, and the Department of Public Works, Bureau of Water and Wastewater's (W&WW's) established goals are summarized below. The information presented below in bold italics represents W&WW's targeted minimum goals that exceed the requirements or covenants.

Operating Reserve Requirements

The covenants require operating reserves to be established in an amount determined by the City to be adequate operating reserves for each Utility, but in any event no less than 8% of the operating expenses of each Utility for the period of the calculation, exclusive of depreciation. *(W&WW has established a targeted minimum reserve of 25% of the budgeted operating and maintenance expenses, exclusive of depreciation, for each of the Utilities.)*

Revenue Bond Covenants

The Utilities must comply with Revenue Bond Covenants relating to Debt Service Coverage. Those covenants require that the City ensure that the rates and charges of the Utilities be assessed, established and collected so that, for each fiscal year,

- a) Net Revenues will be at all times at least equal to 1.15 times the Debt Service Requirements on Senior Revenue Obligations *(W&WW's targeted minimum is 1.40.)* of each Utility for such fiscal year, and
- b) Net Revenues after payment of debt service on Senior Revenue Obligations will be at all times equal to at least 1.10 times the Debt Service Requirements on outstanding Subordinate Revenue Obligations for such fiscal year *(W&WW's minimum target is that Net Revenue will be at all times equal to at least 1.10 times the combined debt service on outstanding Senior and Subordinate Revenue Obligations.)*; provided that,

Net Revenues of each Utility will be at all times at least equal to 100% of the Debt Service Requirements (Senior Revenue Obligations, Subordinate Revenue Obligations and General Obligation Bonds) for such fiscal year.

ANALYSES AND COMMENTS

Finding #1

As previously stated, the targeted amounts established by the W&WW exceed the minimum Operating Reserve Requirements and Revenue Bond Covenants. According to Utilities' personnel, the proposed rate increases provide more reserve funds than required to meet expected legal covenants and required revenue bond coverage so that Utilities' revenue bonds are more attractive to investors, resulting in favorable interest rates when bonds are sold. Also, according to Utilities' personnel, the additional reserve funds could be utilized in subsequent years to provide moderate, predictable rate increases rather than large one-time rate increases.

As part of our analyses of the Utilities' comprehensive financial models, we calculated the rate increases needed for fiscal years 2014, 2015, and 2016 using the minimum Operating Reserve Requirements and Revenue Bond Covenants. We did not adjust any other revenue or expense amounts included in the Utilities' comprehensive financial model. Based on our analyses, we determined that Water rate increases of 13%, 11%, and 11% would meet those minimum requirements and covenants for fiscal years 2014, 2015, and 2016, respectively, compared to the Utilities' proposed rates of 15%, 11%, and 11%.

We also determined that Wastewater rate increases of 12%, 9%, and 10% would meet the minimum requirements and covenants for fiscal years 2014, 2015, and 2016, respectively, compared to the Utilities' proposed rates of 15%, 11%, and 11%.

Finding #2

In order to determine the proposed rate increases, the Utilities used the fiscal year 2014 budgeted amount for Water's Operating and Maintenance (O&M) expenses, reduced that amount by \$1.6 million for anticipated savings such as salary turnover and deferral of vehicle replacements, and increased the budgeted amount, including the unbudgeted expected savings, by an average of 3.4% for the next five fiscal years (FY 2015 – FY 2019). The amount for anticipated savings for fiscal years 2014 – 2019 totaled \$8.5 million.

For the projected Wastewater O&M expenses, the Utilities used the fiscal year 2014 budgeted amount, added an additional \$3.3 million for Asset Management Division projects, which is not included in the budget, and increased the budgeted amount plus the unbudgeted amount for the Asset Management Division projects by an average of 4.2% for the next five fiscal years (FY 2015 – FY 2019). According to information provided to us, the unbudgeted fiscal year 2014 Asset Management Division projects included anticipated costs for such items as \$500,000 for cleaning large sewer pipes and siphons, \$757,000 for a root control program, \$257,698 for City Staff Augmentation, and \$1.8 million for Consultant Staff Augmentation. The amount for anticipated extra costs of the Asset Management Division projects for fiscal years 2014 – 2019 totaled \$31.0 million, including Consultant Staff Augmentation costs totaling \$4.2 million. We were told that W&WW might request a supplemental appropriation (additional budgeted funds) for the fiscal year 2014 anticipated projects in December 2013, if needed. Therefore, we are not

sure whether those additional appropriations will be requested and approved; however, those additional anticipated costs are included as part of the Utilities' proposed rate increases.

Finding #3

Increased efforts to collect outstanding delinquent water and wastewater bills could reduce the need to increase water and wastewater rates. According to a report we obtained from the Mayor's Office of Information Technology (MOIT), there were 15,063 delinquent accounts (more than 260 days overdue) with outstanding balances as of June 17, 2013, totaling \$24.5 million. After excluding four commercial accounts with outstanding balances, totaling \$7.3 million, the outstanding balances would be reduced to \$17.2 million because it is our understanding that those accounts are part of ongoing bankruptcy proceedings. The majority of the delinquent accounts (11,073) represent City customers with aggregate outstanding delinquent balances totaling \$13.6 million (10,883 residential accounts, totaling \$9.5 million and 190 commercial accounts, totaling \$4.1 million). The delinquent amounts for Baltimore City customers include both water and wastewater charges.

The delinquent report also included 3,986 Baltimore County customers with outstanding delinquent balances totaling \$3.6 million, excluding the four accounts in bankruptcy proceedings referred to above (3,922 residential accounts, totaling \$3.1 million and 64 commercial accounts, totaling \$524,000). The accounts for Baltimore County include water charges only. Baltimore County customers pay their wastewater and related charges as part of their annual real property tax bills.

It is our understanding that water services for both Baltimore City and Baltimore County customers are subject to being shut off for not paying the bills. However, we are not aware of any procedures to sell Baltimore County properties at tax sale when County customers fail to pay their water bills to the City.

RECOMMENDATIONS

Based on our analyses above, we recommend that the Department of Public Works and the Department of Finance consider reducing the proposed rate increases.

Because uncertainties can inherently affect various estimates of revenue and expense amounts projected two or more years in advance, we recommend that the Board of Estimates consider limiting its decision to the rate increases that are proposed for fiscal year 2014.

If the rate increases are approved for three years as proposed, we recommend that the Utilities compare actual results of operations with the projected amounts for subsequent years to determine whether the rates approved for those subsequent years can be reduced, especially since the Utilities' included amounts in the wastewater rate calculations that are not part of the budget requested or approved. These subsequent comparisons should be

subject to the review of the Department of Audits and the results presented to the Board of Estimates.

We recommend that the City develop procedures to improve the collection of unpaid water bills. We also recommend that the City explore the possibility of Baltimore County placing liens on county customers' properties when delinquent water bills are greater than an established amount or if those bills are not paid within a designated time period. Additionally, we recommend that the City consider modifying the water settlement agreement with Baltimore County to adjust for the delinquent water bills of Baltimore County accounts. Adjusting the water settlement to reflect actual collections rather than amounts billed would make Baltimore County responsible for the unpaid water bills of Baltimore County accounts.

Lastly, the Utilities should continue to seek other cost-savings measures to reduce future rate increases, since the comprehensive financial model indicates that annual rate increases for fiscal years 2017, 2018, and 2019 are expected to be 16%, 12%, and 12% for Water, respectively; and, for Wastewater, 8% for both fiscal years 2017 and 2018, and 7% for fiscal year 2019.

Respectfully submitted,


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