TOWN OF
APPLE VALLEY, CALIFORNIA

AGENDA MATTER

Subject Item:

WATER RATES UPDATE

Summary Statement:

Public Water service within the Town of Apple Valley (excepting Spring Valley Lake Equestrian Estates) is provided by two privately held, for profit, public utility water companies. Apple Valley Ranchos Water Company (AVR) provides water service for approximately 20,000 customers. Golden State Water Company (GSWC), formerly Southern California Water Company, provides water service for approximately 3,000 customers. Privately held water utilities are under the jurisdiction of the California Public Utilities Commission (CPUC). Increases in water rates and service charges are consequently determined by the CPUC, and are separated from the local political structure. PUC regulated utilities are required to file general rate case applications with the CPUC on a three-year cycle. The application is reviewed and challenged, if warranted, by the Division of Rate-payer Advocates (DRA). Any final decision on the rates is determined for the next three year period upon subsequent approval by the CPUC.

Complaints that water rates in Apple Valley are excessively high are nothing new. It comes and goes as the case may be with every successive general rate case filing. In August 2005, in response to public outcry over proposed water rate increases and a lack of local control and input, Council directed Town's special legal counsel on water rights (Somach, Simmons and Dunn), to engage the financial firm of Bartle Wells Assoc. to prepare a feasibility study of probable cost for the acquisition of AVR and GSWC by the Town. The cost to complete this study ($55,000) was authorized by Council. The study was performed and results of the study were discussed and accepted at the Council meeting on April 11, 2006. The report estimated the cost of acquiring the two systems at $102.1M in 2006.

(continued)

Recommended Action:

Provide direction to staff

Proposed by: Dennis Cron, Asst. Town Manager _____ **Item Number**_____

T. M. Approval: _____ **Budgeted Item** ☐ **Yes** ☐ **No** ☒ **N/A**

Council directed staff to begin discussions with AVR and GSWC to see if a negotiated purchase would be possible. In each case, AVR and GSWC declined the Town's offer to consider a purchase. Formal notification rejecting the offer to purchase was forwarded to the Town by each agency on or around June 2006. After several months of spirited public debate at Council meetings and in the local media on both the pro and con side of the acquisition question, and subsequently, a detailed discussion at the Council goal setting workshop on February 16, 2007, Council directed staff to cease further negotiations with AVR and GSWC, and to consider the matter concluded.

Approximately three years after the previous July 2005 general rate case (July 2008) the next general rate case cycle approached. AVR and GSWC each announced proposed rate increases of approximately 25%. Council was again confronted by an angry public insisting the Town do something to provide relief from the never-ending rate increases. The Town, along with the cities of Placentia, Claremont and San Dimas, who are also served by GSWC, agreed to "intervene" in the rate making process at the CPUC. Each community paid an equal share of the cost of the legal effort to challenge the rate case on its merits as unfair, unreasonable and unjustified given the economy and the requested rate of return in 2008. Ultimately, the Town and its city partners spent $80,000 in legal expenses to intervene. The rate increase was approved by the CPUC on November 22, 2010 with only slight modification to the proposed rates originally sought.

Subsequent to the CPUC approval of the new rates, Council directed staff to work through the Town's new legal counsel, Best, Best and Krieger and the financial team at Bartle Wells Associates to update the original 2006 feasibility study and refine the financial estimates and assumptions regarding acquisition cost and funding options. In addition, Council directed staff to remain actively involved in new rate application filings and advice letters issued by AVR and GSWC to implement CPUC authorized rates. Since 2008, not including the intervention in the general rate case, the Town has officially protested GSWC advice letter filings on five (5) separate occasions. In addition, the Town attempted to intervene in the AVR rate case in September 2008 but was denied by the CPUC as untimely. Since September 2008 the Town has officially protested advice letter filings by AVR five (5) times as well. In each case the CPUC approved the rate increases requested by AVR and GSWC.

Council was briefed by legal council on the progress of the update to the April 2006 acquisition feasibility study in closed session on April 13, 2010. No action was taken by Council regarding the status report and no further direction was provided to staff to continue further with the updated data. The update was not finalized or accepted as complete. It remains a protected, incomplete and unfinished attorney/client privileged work product at this time.

In 1988 when the Town first incorporated, AVR water rates were established at $.60 per 100 cubic feet (CCF), or roughly $.60 for every 750 gallons of water delivered to the customer. The current AVR rate for the average customer using from 1 – 28 CCF is $2.10 per CCF. AVR water rates have increased on average 11.36% per year for each of the last 22 years.GSWC water rates were established at $.70 per CCF. The current

rate for water from GSWC is $2.63 per CCF delivered. GSWC water rates have increased on average 12.53% per year for each of the last 22 years. To put the AVR and GSWC rates into perspective, the current water rate in Spring Valley Lake is $.90 per CCF, Victorville is $1.47 per CCF, and Hesperia is $1.49 per CCF.

At the Council meeting on January 11, AVR provided notice to Council and the public that AVR will be seeking increased rates in the upcoming general rate case filing period with the CPUC. The application was filed with the CPUC on January 3, 2011. AVR proposes to increase rates over the next three year period by an additional 26.6%, with 20.28% occurring in the first year and smaller increases in the following two years. If approved as filed, it will result in an increase of $14.09 per average customer, per month. Over the next three years, an annual increase of $169.00 per average customer would be imposed. The Town has not been advised of a proposed rate increase having been filed by GSWC as of this date. It would be safe to assume GSWC will submit a general rate case application for something similar in size.

FINANCING OPTIONS

BWA evaluated four major financing options that are available to the Town of Apple Valley to acquire these two water systems. Each of these financing methods has been used by public agencies to acquire water systems from private owners.[4] Financing would include funding the purchase of water facilities and land and the funding of transaction costs. The four methods of financing that BWA investigated include:

- General Obligation Bonds
- Mello-Roos Community Facilities District (Special Tax) Bonds
- Assessment Bonds
- Revenue-Supported Borrowing

General Obligation Bonds

General obligation (GO) bonds are debt instruments secured by the full faith and credit of the borrower. They would be paid back through the unlimited power of the Town to levy property taxes at any rate or amount necessary to pay semi-annual debt service payments. These taxes would be levied at an equal percentage on all assessed property value within the Town of Apple Valley. Taxpayers in the Town of Apple Valley would pay higher property taxes as a result of this financing.

GO bonds require approval by 2/3 of registered voters. The principal and interest to repay GO bonds would be paid with a general tax based on the assessed value of property. The Town of Apple Valley would have to prepare a ballot measure and would have to indicate the maximum bonds authorized by the vote and an estimate of the maximum property tax.

Each year the Town would set the property tax rate per $100 of assessed value and provide the tax rate to the County, who collects the tax payments and remits them to the Town. The tax rate will more than likely decline over the life of the GO bonds assuming annual increases in assessed values of property within the town.

The most obvious advantage of a GO bond is its low cost. Since GO bonds are backed by the pledge that all necessary revenues will be raised through increased property taxes, they typically carry the lowest risk in the municipal market, which is reflected in their low interest rates. They do not require a reserve fund and they have the lowest issuance costs of the four financing methods reviewed. GO bonds are also relatively simple to administer, as they require no changes in the manner in which property taxes are collected. They are collected along with the other taxes, assessments, and special charges on the property tax bill.

Since GO bonds are dependent on property tax revenues, their impact on residents of Apple Valley would be proportional to the assessed valuation of property owned by

[4] The Montara Water and Sanitary District issued general obligation bonds; Santa Cruz County issued Mello-Roos (special tax) bonds; Yuba City issued certificates of participation; and Madera County used assessment bonds for a small acquisition.

residents. Proposition 13 limits annual increases in the assessed valuation of property to 2% per year, provided that property was not transferred in ownership during the year. When property is transferred between owners, properties are re-assessed to reflect the new market value. Newer property owners, with higher assessed values, would bear a high tax burden as a result of this financing.

Additionally, if the boundaries of the Town of Apple Valley are not co-terminus with the boundaries of the utilities being acquired, those within the Town limits would be effectively financing the acquisition for those served by the utilities but located outside the Town limits.

Mello-Roos Community Facilities District Bonds

Mello-Roos or "special tax" bonds may also be used to finance the construction or acquisition of facilities and land. Moreover, they can be used to finance certain, limited types of services and pay for limited operation and maintenance. Under the terms of the Mello-Roos Community Facilities Act of 1982, public entities, such as cities and counties, are allowed to form Community Facilities Districts (CFD), and once formed, these Districts can issue bonds upon 2/3 approval of registered voters within the District. Importantly, a CFD need not be co-terminus with the boundaries of the municipality forming the District.

Bonds issued by a CFD can be used to purchase any real property with an estimated useful life of more than five years. They are *not* secured by the unlimited power of a local government to levy property taxes. Instead, a special tax is levied on all properties within the CFD in order to pay semi-annual debt service requirements. This special tax is not an *ad valorem* tax but instead based on a special tax formula. There is considerable flexibility in its structure, with factors such as square footage developed, density of development, acreage, and zoning commonly being used to calculate the tax. Equivalent water meters can be used in the case of acquiring water facilities. Taxpayers in the proposed CFD would pay higher taxes as a result of this financing.

The special tax is fixed and does change over the life of the bonds. Increase property values would not affect the level of the special tax. Moreover, the special tax is not tied to use of the water system, such as water consumption or metered water sales.

A CFD can provide for the prepayment of special tax before bonds are issued. But after bonds are issued any prepayment of special taxes would be very difficult and would require a complex formula. Moreover, early refunding of the bonds could be difficult and would more than likely require a recalculation of the special tax and may require another vote with 2/3 voter approval of any change in the special tax.

Mello-Roos bonds have the advantage of flexibility. In this case, the Town could design the CFD boundaries to be co-terminus with the boundaries of the service areas of the two utilities. This would ensure that only those properties directly impacted by the acquisition

would be assessed the special tax. In addition, because there is no requirement that the tax be based on the "special benefit" a parcel receives, the District can tailor the rate and method of apportionment to best meet revenue requirements and the political environment, potentially improving the likelihood of voter approval.

At the same time, Mello-Roos financings are very complex. The flexibility allowed in constructing the special tax apportionment also means that these formulas can be very intricate and difficult for the property owner to understand. Engineering and financial analysis would be required to develop the special tax formula. Additionally, because Mello-Roos bonds are not secured by the full faith and credit of the issuing agency, they are considered riskier than GO bonds and carry higher interest rates. Mello-Roos bonds also typically provide for a reserve fund and bond insurance may be advisable, two factors which also increase the effective cost of this type of financing for the Town.

Assessment Bonds

The Town could possibly use assessment bonds to finance the acquisition of the water companies.[5] Assessment bonds are typically used to finance capital improvements to a relatively small distinct area where the special benefits of the public project can be readily assigned to assessed properties benefiting from the project. They may not be the best method to finance a large water system acquisition for the whole Town which could provide a general benefit to the public at large. One general benefit of a publicly owned water system is fire protection.

The most common assessment bonds used by local governments to finance public projects are issued under the Improvement Bond Act of 1915. The 1915 Act, which only involves the issuance of bonds, requires another stature to establish the assessment district, authorize public improvements, and impose the assessments. Typically the Improvement Bond Act of 1913 (or sometimes the Act of 1911) is used. The use of assessment bond financing and the establishment of an assessment district are subject to Proposition 218, which added Article XIID to the California Constitution.

An assessment bond is a financing method where bonds are secured by liens placed upon all property within a defined geographic area (the assessment district). Similar to both GO bonds and special tax bonds, owners of impacted parcels of land would fund the cost of annual debt service.

Assessments are not taxes, and their individual size is not tied to the assessed valuation of the property. Instead, assessments are calculated based on the proportional "special

[5] The Town has experience with assessment bonds. Assessment District No. 3 Improvement Bonds (1915 Act bonds) are outstanding and were originally issued by the Apple Valley Water District in 1988 to fund public improvements. Assessment District No. 2-B sold limited obligation improvement refunding bonds in 1991 to fund sanitary sewer facilities. These bonds were refunded with a 1996 assessment bond issue. The Apple Valley Water District has issued Special Assessment District 98-1, 1915 Improvement bonds to finance sewer improvements in the Jess Ranch area.

benefit" that a property receives from the improvement to be financed. Undeveloped land must be included in the assessment district. As with community facilities districts, the local government is allowed some latitude in determining the method of apportionment. In this context, the Town would likely choose some proxy for water use such as lot size or type of customer to determine the size of the assessment for each parcel.

The procedure to issue assessment bonds and to set assessments for water service is described as follows[6]. After the size of the assessment is determined, a notice is mailed to all impacted property owners along with a ballot, and a public hearing is held within 45 days to address constituent concerns and tally the vote to protest the project. Votes are weighted according to the proportional financial obligation of the affected property. A majority protest means that the district cannot be formed. If approved (i.e., not a majority protest), individual assessments are then placed as liens on property as security for any future bond issues. The property owner has the option of paying off the lien in cash, with that amount then being deducted from the total size of any bond issue, or deferring payment for a time period generally up to 30 years.

The assessment district creates a fixed dollar amount special assessment lien on each property of the district. The lien lasts for ten years or until bonds are issued, whichever happens first. If bonds are issued, the lien is for the term of the bonds, plus four years.

Special assessment bonds are secured by the unpaid amount of the fixed assessment liens on property. State law governs their payment dates so that principal is paid annually on September 2 and interest is paid semiannually on March 2 and September 2.

There are two opportunities to pay off assessment debt. The first is during the minimum 30-day cash payment period after the creation of the district. During that period, the principal amount of the assessment may be paid in whole or in part. When the bonds are sold, that person's share of any bond reserve and discount is rebated to that person. The second is after bond issuance, when a person can prepay that person's share of the total principal amount, any prepayment penalty, a share of interest to the next available bond call date, and administrative costs.

As with community facilities districts, assessment districts have the advantage of flexibility; the boundaries of the district can be created such that they are co-terminus with the boundaries of the service area of the utilities. In addition, because assessments related to water service are not considered taxes under California law, they are not subject to 2/3 voter approval. Assessments must, however, comply with Proposition 218, which outlines the legal framework for the establishment and use of assessments in raising local revenue.

[6] Procedures and requirements to set up an assessment district, voter approval, and establishment of fees are different for fees which are imposed as an incident of property ownership for a property-related service. This feasibility study assumes water services and the acquisition of water facilities would not be defined as property-related services and thus would be exempt from many of the requirements and procedures found in Proposition 218.

Assessment bonds do have a number of disadvantages over other financing options, which when taken together may make this a higher cost method to finance the acquisition. Issuance costs are higher than for GO bonds, as there are increased costs associated with the creation of the district and the need for a civil engineer to determine the special benefit for each parcel and to calculate the assessments. In addition, since debt service is only secured by the liens on property and not by the unlimited power of the Town to levy taxes, assessment bonds are considered riskier investments. To provide the bonds with appropriate security and allow for successful marketing, the property securing the lien must have value sufficient to cover the assessment. As a general guideline, the ratio of assessed value to assessment lien should be at least 3:1. In either case, assessment bonds will likely carry higher total interest costs than GO bonds and require a one year reserve fund.

Revenue-Supported Borrowing

There are two major revenue-supported borrowing options available to the Town to finance this purchase. With this type of financing, the Town does not incur any further indebtedness; instead, the Town must pledge a portion of the enterprise's future net revenues to meet the debt service. Revenue bonds take a number of different forms, to include public enterprise revenue bonds, public lease revenue bonds, and certificates of participation.

Public Enterprise Revenue Bonds

Traditional revenue bonds can be used to finance any public improvement of revenue producing nature. They are secured by a lien upon future revenues of the proposed improvement. Approval of a revenue bond is subject to provisions of the Revenue Bond Law of 1941; they can be issued upon adoption by majority vote of the governing body of the local agency. A majority vote must be obtained at an election on the proposition of issuing bonds.

Most revenue bonds are issued by means of a joint powers authority (JPA) that does not require an election or voter approval. The joint powers authority can be a financing authority created by the two public agencies, such as a city and its redevelopment agency. If a JPA is used, then the more typical financing is the use of certificates of participation, which are described below.

Effective marketing of revenue bonds requires a well-established operating history of the enterprise to ensure that future revenues will meet required debt service. The issuer may also have to covenant to establish rates and charges that are sufficient to meet debt service.

Financing Leases and Certificates of Participation

Slightly different than traditional revenue bonds, but used more frequently, is lease financing using certificates of participation (COPs).[7] COPs would allow the Town to enter into a tax-exempt lease financing arrangement in lieu of issuing bonds. In this arrangement, a third-party owner would purchase the two water companies and then lease the system back to the Town. Security for the lease is supported solely by the net revenues of the Town's water system. The lease can be structured as an installment sale/purchase agreement[8], in which the Town would assume ownership of the facilities at the closing of financing, typically two or three weeks after the COP sale.

In the context of this proposed financing, a non-profit corporation or joint powers authority (like the Apple Valley Public Financing Authority) would purchase the utility and then subsequently leased or sell it on the basis of an installment sale to the Town of Apple Valley. As with any lease or installment sale, structured payments have both principal and interest components and are tax-exempt. The lessor assigns its rights to receive future lease or installment payments to a trustee, and undivided shares of these future payments can subsequently be issued as "certificates of participation" and marketed to third-party investors. In practice, the structure, marketing, and sale of COPs is very similar to that of traditional revenue bonds, and their security is provided only through the ability of the utility to produce net revenues sufficient to meet its payments.

The use of COPs would offer Apple Valley the ability to finance this acquisition with revenues generated solely from the customers receiving service from the publicly owned water utility. There would be no obligation on the Town to raise taxes or meet debt service with resources from its general fund. Since the acquisition is paid back from water rates and service charges, the distribution of financial burden is judged equitable because it is spread proportionally among customers based on water use. In addition, COPs do not require voter approval in a general election and do not count as indebtedness under state constitutional debt limitations.

COPs may be the highest total cost method of financing the acquisition as they are viewed as riskier investments in the bond market and as such must carry higher interest rates. A reserve fund is generally required. In addition, COPs must comply with "debt service coverage requirements." This means that net revenues, after meeting all operating and

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[7] The Town has previously issued certificates of participation. In 1999, the Town sold COPs to finance the construction of the new Town Hall and new county office building. In 2001, the Town sold variable rate demand COPs to refund the 1999 COPs.

[8] The Town has experience with an installment sale/purchase agreement. In 2004, the Town entered into an installment purchase agreement with the Mojave Desert and Mountain Integrated Waste Management Authority. The agreement was established when the Authority issued revenue bonds to refund bonds that were originally issued to fund the design and construction of a materials recovery facility. The Town's installment payments come from service revenues which consist primarily of rates and charges imposed by the Town for solid waste management services.

maintenance expenses, must be 125% of the maximum annual debt service.[9] This coverage requirement means higher rates for customers, but may also allow the Town to build capital reserves.

FINANCING COSTS

For the purposes of this feasibility analysis, financing includes funding for the purchase of water facilities and all transaction costs.

Table 8 summarizes overall financing costs for the four different financing methods discussed in the previous section.[10] Each method results in a different annual debt service. The table assumes a total purchase price estimate of $97,751,000 for the two water systems and includes the high estimate (condemnation) for transaction costs of $4,290,000. Therefore, the total acquisition cost estimate is $102,041,000.

Financing methods differ in terms of interest rate, need for a debt service reserve fund, issuance cost, and underwriter's discount. GO bonds are significantly cheaper to issue, as they do not provide for underwriter's discount and have lower fees associated with the use of outside consultants and bond counsel. They also do not require a reserve fund and carry the lowest interest rate of 4.75%. Overall debt service on GO bonds is estimated to be $7.1 million per year over 25 years.

For a special tax bond, the average interest rate is 5.0% (0.25% higher than GO bonds). Issuance costs are greater because of the complexity of the special tax bonds and the need for a special tax consultant. Bond underwriters are allowed to charge a discount with special tax bonds, which is assumed to be 2.0% of the total issue. A reserve fund equal to one year's debt service would be required. The annual debt service for a special tax bond is estimated to be $8.0 million.

An assessment bond would have an even higher average interest rate, which is assumed to be 5.25%. Issuance costs and underwriter's discount would be about the same as for a special tax bond. The average annual debt service for an assessment bond is estimated to be $8.2 million.

The average interest rate for COPs would be the highest for the four financing methods and is assumed to be 5.50% for this feasibility analysis. Issuance costs would be lower than special tax and assessment bonds, but the COPs would need to be rated and would need an investment grade rating to be sold. A reserve fund equal to one year's debt service would be required. Because of market acceptance, the underwriter's discount for COPs would be lower than for special tax or assessment bonds. The average annual COP payment is estimated to be $8.3 million.

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[9] This is similar to the debt service coverage requirement applicable to the Mojave Waste Management Authority's installment purchase agreement.

[10] Appendix C shows the details of the financing costs and issue sizing.

Table 8
Feasibility Analysis of Potential Water System Purchases
Financing Options for Water Utility Acquisition Summary

	GO Bonds	Special Tax	Assessment	COPs
Total estimated acquisition cost	$102,041,000	$102,041,000	$102,041,000	$102,041,000
Issuance costs	275,000	495,000	445,000	395,000
Underwriter's discount	0	2,200,000	2,200,000	1,100,000
Bond insurance + surety	0	0	0	0
Miscellaneous	4,000	0	0	4,000
Reserve fund*	0	7,999,000	8,214,000	8,340,000
Total issue	$102,320,000	$112,735,000	$112,900,000	$111,880,000
Term (years)	25	25	25	25
Interest rate	4.75%	5.00%	5.25%	5.50%
Annual debt service	$7,079,000	$7,999,000	$8,212,000	$8,341,000

*A reserve fund equal to one year's debt service is assumed. GO bonds do not require a reserve fund.
Source: Bartle Wells Associates

Property Tax Impact of General Obligation Bonds

Table 9 shows the impact of a general obligation bond issue on the property taxes of Apple Valley. The issuance of GO bonds would increase property taxes by an estimated $293 per $100,000 assessed value. BWA estimates the average assessed value for a home in Apple Valley to be around $110,000.[11] Using this average assessed value, the additional property tax caused by the GO bonds would be $322 per year.

Table 9
Feasibility Analysis of Potential Water System Purchases
Estimated Tax Rates to Support General Obligation Bonds

Annual Debt Service	$7,079,000
Assessed value in Apple Valley*	2,412,000,000
Tax per $100 AV	0.293
Tax per $100,000 AV	$293

*Rounded to nearest $1,000,000

[11] Total assessed value $2,412,325,000 / 22,423 housing units in 2005.

Special Tax Size for Mello-Roos Bonds

Table 10 calculates the estimated special tax that would be levied on water customers should this acquisition by financed by Mello-Roos special tax bonds. The annual tax is calculated based on the estimated number of equivalent meters in the Town. With an annual debt service of $8.0 million and approximately 31,800 equivalent meters, a single family residence with one equivalent meter (5/8 x 3/4 inch) would face an annual special tax levy of $252.

Table 10
Feasibility Analysis of Potential Water System Purchases
Estimated Tax Rates to Pay Mello-Roos Bonds

Estimated number of customers	21,799
Estimated number of equivalent meters	31,800
Annual debt service (estimated)	$7,999,000
Annual cost per equivalent meter	$252

Impact of COP Issuance on Water Rates

Table 11 estimates the impact on rates of a COP issuance. With an annual debt coverage requirement of $10.4 million (125% of the estimated annual debt service of $8.3 million), the utility would have to generate an additional $3.2 million in revenue. Projected revenues for the utility in 2006 are $18.0 million (see Table 14), meaning that rates would need to increase 17.9% in order to generate sufficient net revenues to cover debt service.

Table 11
Feasibility Analysis of Potential Water System Purchases
Estimated Water Rate Increases to Pay Revenue-Supported Borrowing

Annual debt service (estimated)	$8,341,000
Net revenue requirement (125% annual debt service)	10,426,250
2005 projected net cash flow (Table 14)	7,208,000
Additional revenue needed	3,218,250
Total projected revenues (Table 14)	$17,996,000
Required 2006 rate increase to repay COPs	17.9%