

## **HUMBOLDT BAY MUNICIPAL WATER DISTRICT Key Challenges Facing the District and Its Customers**

### **Increased Wholesale Costs and Retail Water Rates**

As discussed in the main body of the report, the District had long-term contracts in place with two large pulp mills on the Samoa Peninsula. In the mid-1990s, the Simpson Pulp Mill ceased operation, resulting in a significant reduction in the District water deliveries. By mid-2000 the one remaining operational pulp mill reduced its contract commitment to half of what it historically had been.

Prior to 1999, the District had long-term take-or-pay contracts with the two Industrial Customers on the Samoa Peninsula (pulp mills) and the seven wholesale Municipal Customers. These contracts specified service delivery provisions, as well as how the District's wholesale costs would be allocated among the nine wholesale customers (two Industrial and seven Municipal).

Prior to 1999, the two mills contributed to and paid approximately 75% of the District's total cost of service. These costs included all operating, maintenance and administrative costs, all capital costs, and at that time, bond repayment for the original and supplemental water systems installed in the 1960s. The seven Municipalities in aggregate contributed approximately 25% of the District's cost of service.

The loss of the Simpson Mill, who paid roughly 40% of the District's costs, triggered a significant cost shift to the District's remaining wholesale customers (the one mill and seven Municipalities). Other factors have also contributed to HBMWD's wholesale cost increases. Unfortunately, they all occurred within a few years of one another, and the cumulative impact has been quite staggering. On the Municipal side, the wholesale cost increase have contributed to retail rate increases that the Municipalities have had to pass on to their end-use customers (e.g, the residents and business they serve within our community).

Following is a brief summary of the District's wholesale cost increases over the past eight years:

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1. As already noted, contracts were formerly in place for the entire 60 MGD industrial system capacity, but today only 15 MGD (one quarter) is under contract and being used. Loss of the industrial customer base has significantly reduced the revenue contribution toward the District's cost of service.
  - Simpson alone was contributing over a \$1 million to the District's cost of service in the 1990s. About half of that amount had to be shifted to, and absorbed by, other customers when their contract terminated in 1999.
  - In 2003, Samoa Pacific Cellulose (then-current owner of the remaining operational mill) reduced their contracted volume (from 22 MGD to 15 MGD) which in-turn, triggered a reduction in their share of the District's wholesale costs. This action shifted more than \$300,000 of the District's wholesale costs from the mill to the seven wholesale Municipal Customers.
2. In the late 1990's, the Department of Health Services (DHS) – the State agency that oversees and regulates drinking water - mandated that all eight "Public Water Systems" (that is HBMWD and its seven Municipal Customers) address the occasional high wintertime turbidities in the Mad River source water. Following many years of working together, the Municipal Customers requested that HBMWD construct a regional water treatment plant to address the regulatory mandate. HBMWD constructed this new facility (called the Turbidity Reduction Facility) which was completed in 2002. Construction cost totaled \$10.5 million. This triggered another significant cost increase to the Municipalities given that it added almost \$1,000,000 to HBMWD's annual cost of service (debt service and increased O&M).
3. A significant increase in HBMWD's power costs from PG&E primarily due to the State's failed attempt at energy deregulation. All customers, but especially larger industrial customers, faced significant rate increases following the failed deregulation attempt. Power for pumping water is the District's largest single operating cost. This triggered another wholesale cost increase of over \$200,000.

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4. The District has experienced a significant increase in its regulatory compliance requirements, burdens and costs. The specific dollar impact is not readily available, but HBMWD believes it to be fairly substantial (given staffing increases and third-party consulting costs). Furthermore, the State has shifted many costs to local governments via fees and charges to fund State programs that used to be covered by the State's general fund. The District has seen significant increases in regulatory fees associated with the following State programs: dam safety, water rights, safe drinking water and clean water.
5. For many years, the State "took" (and never paid back) a significant share of property taxes that were supposed to go to local governments for local governmental services. In HBMWD's case, significant tax losses occurred in the mid-2000s, with every dollar in tax revenue loss translating to a dollar increase in wholesale water charges to the District's wholesale customers. In 2004, the voters of California passed Proposition 1A to put an end to the State's unbridled taking of local tax revenues. Unfortunately, another proposal is on the table which would again shift local tax revenues. The State's Legislative Analysts Office is recommending that property tax revenues for water and wastewater agencies state-wide, be shifted to Counties via a proposed "Public Safety Realignment Account" for what they call "parole realignment within the criminal justice system". If enacted, it is our understanding that HBMWD's share of the 1% local property taxes would be reduced by 50% (or approximately \$300,000), which in-turn would increase wholesale water costs by this same amount.
6. And finally the District itself has contributed to some of the cost increases, especially in regards to taking the first steps to address its aging infrastructure and to address employment issues (e.g. competitive compensation given attraction and retention issues).

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Cumulatively, these cost increases have resulted in staggering increases in HBMWD's total costs charged to its wholesale customers.

Table 1 presents the wholesale cost increase to three of the District's seven wholesale Municipal Customers. One small, one mid-size and one large customer were selected for illustrative purposes. The District's wholesale cost to the Municipalities increased between 200% and 300% in this short time period. Table 1 also presents the impacts to an end-use water customer over the same time period. Due to variations in water rate design among agencies, the rate increase is presented for a residential customer using a fairly typical consumption volume (1500 cf/month). As reflected, the costs to that typical residential customer increased on the low end by 31%, and on the high end by 161%. It is important to note that factors other than just HBMWD's wholesale cost increases have contributed to retail rate increases (in that the Municipalities have experienced cost increases at their level too).

Also presented in Table 1 are retail water costs (for the same standard consumption) for three communities in Sonoma County. These water bills in both Humboldt and Sonoma County are then compared to Median Household Income. As shown, residents in our communities are now seeing water bills comparable to out-of-area communities like Sonoma County, yet the Median Household Income (MHI) in Humboldt County is significantly less than the MHI in other areas like Sonoma County.

In closing, increased utility rates, and more importantly, the ability of customers within our community to pay higher rates, is a very important issue for policy makers to understand and think about. And it deserves mention that utility rates do not yet reflect increased costs that HBMWD and the Municipalities will face over the coming years to address the aging infrastructure within our Cities and Districts.

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TABLE 1						
	HUMBOLDT COUNTY				SONOMA COUNTY	
	1999	2005/06	Increase		2005/06	
			\$	%		
<b>WATER CHARGES</b>						
<b><u>Annual Wholesale Costs:</u></b>						
Fieldbrook CSD	\$14,094	\$49,915	\$35,821	Between ~ 200% - 300%		
McKinleyville CSD	\$88,140	\$357,535	\$269,395			
City of Eureka	\$338,458	\$971,008	\$632,550			
<b><u>Monthly Retail Bill (for 1500 cf):</u></b>						
Fieldbrook CSD	\$14.00	\$36.49	\$22.49	161%	Santa Rosa	\$36.86
McKinleyville CSD	\$18.38	\$24.15	\$5.77	31%	Rohnert Park	\$30.47
City of Eureka	\$23.44	\$52.84	\$29.40	125%	City of Sonoma	\$50.43
<b>INCOME</b>						
Median Household Income		\$33,281				\$53,645
MHI as % of State MHI		67%				108%
Water Rate as % of MHI		2%				1%

**HUMBOLDT BAY MUNICIPAL WATER DISTRICT  
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**Utilization of Water Rights and Maintaining Local Control**

Shortly after the District was formed in the late 1950's, the District applied to the State of California for what are called "appropriative water rights" for the District's new regional water system. The District's original applications to the State envisioned two phases of development of the regional water system. "Phase 1" proposed 50,000 acre-feet of storage at Ruth Reservoir, and a subsequent "Phase 2" expansion was proposed to increase Ruth Reservoir to 120,000 acre-feet.

Two water rights permits were issued to the District by the State for a total of 120,000 afa (acre-feet per year) of storage and 200 cubic feet per second (cfs) of direct diversion (note: 200 cfs = 129 Million Gallons per Day (MGD)). The original permits specified that construction work shall be completed by July 1967, and that "complete application" of the water shall be made by July 1970. Complete application meant that all water under permit (the 120,000 acre-feet of storage and 200 cfs diversion) was supposed to be put to what is called "full beneficial use" in California water law.

The District proceeded with and completed "Phase 1" construction. "Phase 1" of the regional water system included Ruth Reservoir at 50,000 acre-feet (later modified to 48,030 AF), and diversion and delivery works in Humboldt County capable of supplying 116 cfs (which equates to 75 MGD).

The District did not achieve "complete application" of water under permit by July 1970 as required in its original permits. The District was not alone in that most Municipalities and others did not meet the term originally specified in their water rights permits. The State understood it took time to develop projects and put water to full beneficial use, and they commonly and routinely granted 10-year time extensions to permit holders.

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Between 1970 and 2000, the District applied for three successive ten-year extensions of its water rights permits, thereby allowing additional time to put appropriated water to full beneficial use. Three ten-year extensions were granted by the State taking the permit term to December 2000.

In the late 1990s, the District began work on its fourth extension request, prior to its permits expiring in December 2000. In 1999, the District submitted an application for another 10-year extension to its original permits (which still assumed Phase 1 and Phase 2 development). That did not turn out to be a tenable position for two reasons. As discussed in the main body of this report, the Simpson Pulp mill ceased operation and the one remaining pulp mill reduced their water contract and use. This resulted in a significant reduction in total water deliveries and associated beneficial use of water under permit. The second change was that the State Division of Water Rights was beginning to evaluate extension requests more carefully and critically, especially in regards to use.

Attached is a graph showing actual water use in recent years compared to rights under the District's water rights permits. The graph clearly depicts the significant underutilization of water under permit, which staff at the Division of Water Rights began questioning.

After much work – involving legal research, projections of future water supply needs, and negotiations with senior staff at the State Division of Water Rights - the District decided to amend its extension request. The District requested a 25-year permit extension (vs. the customary 10 years) for “Phase 1” development only, thereby giving up rights associated with “Phase 2” development. In 2004, the State Water Resources Control Board approved the District's amended extension request for 25 years (to December 31, 2029) and revoked rights associated with “Phase 2” development. Therefore, the District's current permitted rights are 48,030 acre-feet of storage at Ruth Reservoir and 116 cfs diversion (75 MGD).

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Senior staff at the Division of Water Rights put the District on notice stating they expect to see significant progress toward full beneficial use upon expiration of the next permit term. Some senior staff also threatened “licensing” which is the final step in the appropriative water right process. Licensing confirms the amount of water that has been “perfected” (meaning actually used), and State law generally only allows actual use during the prior 5 years to be considered. Therefore, licensing now, or in the future if use has not increased, would be very disadvantageous to the District and the Municipalities, in that the right to use water currently under permit would be lost.

Several years ago, the District retained Bill Spruance of the Minasian et.al. law firm to conduct research in the water law area to educate the Board and staff at HBMWD as well as other interested audiences, and to begin to address strategies and tactics for HBMWD to maintain control of its water rights. The work completed by Mr. Spruance, with input from Paula Whelan of Wager & Bonsignore, is included in Appendix 4.