

## **WATER UTILITY OPERATING BUDGET ADJUSTMENT FOR 2017 AND 2018**

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### **EXECUTIVE SUMMARY**

A net-zero Water Utility operating budget adjustment for 2017 and 2018 is included in the 2017 Capital Budget Recast and other Capital and Operating Revisions Report (PFC2017-0354). This report provides additional information on the net-zero budget adjustment.

The Water Utility is experiencing a shortfall in revenue due to significantly less development taking place in 2016 than anticipated, resulting in lower off-site levies being paid to the utility. It is now also expected that development will be considerably less than previously forecast for an extended period of time. This creates a revenue shortfall for the Water Utility in 2017 and into the future.

The Water Utility's budget was reduced at Mid-Cycle Adjustments (MCA) based on lower annual rate increases and the land development forecast that was current at the time. It is now being further reduced for 2017 and 2018, primarily to reflect the lower off-site levy revenue. The Water Utility is undertaking work to manage the shortfall while maintaining commitment to Calgarians' health and safety, the provision of safe, clean drinking water, and the long-term sustainability of the utility. The operating budget adjustment presented in this report and PFC2017-0354 is a net-zero adjustment to align expenditures with the reduced revenue.

Although the Water Utility's focus on cost control, budget accountability and operating adjustments has resulted in mitigation of a significant amount of the anticipated revenue shortfall, the magnitude of the shortfall will still put pressure on the rate increases in the 2019-2022 business cycle. At this time, the utilities rate increases forecast for 2019-2022 have increased from in the range of 2.5 to 3.5 per cent per year, as indicated at the time of MCA, to a range of 4.0 to 5.0 per cent per year. Although not being done at this time, there may be an opportunity to reduce these projected increases by compromising compliance with financial policy at the time of preparing the indicative rates for the next Action Plan cycle. An important implication of absorbing any shortfall within utility and drainage rates is that less than 100 per cent of the cost associated with growth is recovered from the development industry.

The work being completed to identify operating budget reductions for 2017 and 2018 is complementary to the work Water Resources is conducting to develop an implementation plan for the recommendations from the 2016 Zero-Based Review (ZBR) (PFC2016-0660). To maximize benefit, efforts will be coordinated, extending finalization of the ZBR implementation plan beyond Q3 2017. A request to defer reporting the Water Resources ZBR implementation plan to Council will be brought forward as part of the ZBR Program Update – May 2017 report (PFC2017-0431) to the Priorities and Finance Committee on 2017 May 16.

### **ADMINISTRATION RECOMMENDATION**

That the Priorities and Finance Committee receive this report for information.

### **PREVIOUS COUNCIL DIRECTION / POLICY**

On 2014 November 24, Council approved Action Plan 2015-2018 Proposed Business Plans and Budgets, including utility rates and operating and capital budgets.

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On 2016 January 11, Council approved the Off-Site Levy Bylaw (C2016-0023) and directed Administration to implement the 2016 work plan to address issues that arose through the process of developing the bylaw.

On 2016 September 19, Council directed Administration to present an operating budget adjustment for 2017 and 2018 based on reduced utility and drainage rate increases as part of Mid Cycle Adjustments (C2016-0688 and C2016-0689).

On 2016 September 26, the Water Resources Zero-Based Review and Administration's Response (PFC2016-0660) were presented to Council, and Council directed Administration to report back by September 2017 with a detailed implementation plan.

On 2016 November 21, Council approved Mid-Cycle Adjustments (C2016-0863) that included amending The Wastewater Bylaw (14M2012), The Water Utility Bylaw (40M2006), and The Drainage Bylaw (37M2005) to reduce the utility and drainage rate increases for 2017 and 2018, and an operating budget adjustment for 2017 and 2018 based on the reduced rate increases.

### **BACKGROUND**

#### ***Water Utility revenue***

The Water Utility provides water, wastewater and drainage services for customers in Calgary. These services operate under a self-supported model, meaning that revenues must cover all the costs to provide services. Revenue consists primarily of rate revenue, which is based on the utility rates for water and wastewater, and the drainage charge. Additionally, an off-site levy is collected on development in new and existing areas. The off-site levy revenue is used to fund the infrastructure investments required to support new growth.

The off-site levy rates in 2016-2020 are intended to recover 100 per cent of growth-related infrastructure costs (Off-Site Levy Bylaw, C2016-0023). Previously, the levy rates were only intended to recover 50 per cent of growth-related infrastructure costs, and the remainder of the costs were captured in utility rates. The new 100 per cent recovery model increases the overall financial risk because a larger proportion of revenue is tied to land development. This creates risk because investments in utility and drainage systems to support growth have already been made, requiring payments to be made on the related debt. However, the levy revenue to make the payments may not be available due to slower than expected growth.

In Q3 2016, as part of The City's response to ongoing challenging economic times, the rate increases for water, wastewater, and drainage services that had previously been approved in Action Plan were reduced for 2017 and 2018. The lower rate increases in 2017 and 2018 were anticipated to have a moderate impact on rate increases for the 2019-2022 timeframe, increasing them slightly from the 2019-2022 rate increases that were projected previously.

The keys to being able to reduce the rate increases in water, wastewater and drainage were:

- The capital budget recast in 2016.
- A 2 per cent reduction in operating expenditure.
- Modifying the target of achieving the 10 per cent of revenues sustainment reserve balance by 2018, which was deferred to 2022.

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### ***Revenue shortfall 2017 and 2018***

When the approved off-site levy rates for 2016-2020 were calculated, the corporate land forecast was 400 hectares (ha) of development per year. This is equal to the 20-year average of development in Calgary. During 2016, the land development forecast was revised downward from 400 ha per year to 225 ha per year for 2016 and 2017. Operating budgets in 2017-2018 were adjusted to reflect the lower development forecast as part of Mid-Cycle Adjustments in November 2016. In 2016, the actual area of new development was 78 hectares. This is the lowest total since 1984.

Based on this result in 2016, Corporate Economics has preliminarily revised the forecast for future growth to an extended downturn forecast that would see lower development activity than was previously forecast, over the next four years. This results in a shortfall in 2017 and 2018 from the total revenue budgeted for at the time of Mid-Cycle Adjustments (Attachment 1).

### **INVESTIGATION: ALTERNATIVES AND ANALYSIS**

#### ***Reducing the Water Utility operating budget to match lower revenue***

The Water Utility is working to mitigate the impact of this change in the pace of growth and is taking immediate steps to reduce costs, considering both risk and impact to customers, and positioning the Water Utility to be a more efficient and effective public service. The Water Utility is able to build on strengths established through past financial management practices, leverage the historical commitment to making investments in assets that reduce operating costs, and accelerate process and business improvements that had already been identified. Facing this revenue shortfall has reinforced across the Water Utility that every expenditure, no matter how small, is important and needs to contribute to outcomes for customers.

In response to changing growth projections for Calgary, some infrastructure and growth plans have been reprioritized. Growth forecasts will continue to be revisited to ensure that we are responding appropriately to Calgary's needs. As the Water Utility focuses on efficiency in the delivery of core services, there may be some changes in service to customers, but those reductions will not be significantly felt at this time.

A great deal of work has been done to manage vacant positions and ensure hiring and refilling vacancies is only done when essential. In addition, the majority of seasonal staff were not rehired for this summer, achieving significant savings. While the shortfall gap in 2017 requires adjustments to the salary and wage budget, anticipated staff reductions will be limited.

These efforts, and the focus on cost control, budget accountability and operating adjustments, have resulted in the Water Utility being able to mitigate a significant amount of the anticipated revenue shortfall.

However, the magnitude of the shortfall will still put pressure on the rate increases in the 2019-2022 business cycle. At this time, the Utilities rate increases forecast for 2019-2022 have increased from in the range of 2.5 to 3.5 per cent per year, as indicated at the time of Mid-Cycle Adjustments, to a range of 4.0 to 5.0 per cent per cent per year. Drainage will not require incrementally higher rate increases in 2019-2022. Drainage increases are still projected at 7.4 per cent per year for the next business cycle, provided all else remains the same.

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With these projected annual rate increases, compliance with current financial policies can be maintained. The opportunity to further reduce the projected rate increases in the Utilities by compromising compliance with financial policy was not exercised at this time. This is an opportunity that may be employed at the time of preparing the indicative rates for the next Action Plan cycle, and if required, the Water Utility financial plan policies and targets would be aligned to this approach.

An important implication of absorbing any shortfall within utilities and drainage rates is that less than 100 per cent of the cost associated with growth is recovered from the development industry.

Further details on the approach to managing the revenue shortfall within the Water Utility, as shared with Leadership in the Water Utility, are provided in Attachment 2.

### ***Water Resources zero-based review***

On 2016 September 26, the Water Resources Zero-Based Review and Administration's Response (PFC2016-0660) were presented to Council, and Council directed Administration to report back by September 2017 with a detailed implementation plan. As this work is complementary to that being completed to identify operating budget reductions for 2017 and 2018, efforts will be coordinated, extending finalization of the ZBR implementation plan beyond Q3 2017. A request to defer reporting the Water Resources ZBR implementation plan to Council will be brought forward as part of the ZBR Program Update – May 2017 report (PFC2017-0431) to the Priorities and Finance Committee on 2017 May 16.

### **Stakeholder Engagement, Research and Communication**

Operational, financial and strategic staff have monitored off-site levy revenue relative to budgets and forecasts, and collectively initiated plans to manage the variances and shortfalls that results. These plans include engaging with the development industry.

The Water Utility continues to engage customers to understand customer needs and service impacts, so that operating reductions can be selected that ensure continued high quality service to Calgarians.

### **Strategic Alignment**

The Water Utility has a goal of maintaining alignment with corporate forecasts of growth, while providing high quality services for Calgarians and managing financial and strategic risk in the business.

Ongoing focus on the financial capacity and sustainability enables the utility to deliver its commitment on three Council Priorities:

- To support a city of inspiring neighbourhoods, the Water Utility provides the infrastructure needs of a growing city, enhances The City's ability to prepare/respond to natural disasters, and builds resiliency to flooding.
- Contributing to a healthy and green city, the Water Utility leads by example to protect public health and the environment, and ensure regulatory compliance.

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- The financial discipline demonstrated through the Water Utility's performance within its financial plan is an example of commitment to a well-run city.

### **Social, Environmental, Economic (External)**

The current economic downturn has affected the Calgary community. The City has consistently responded to difficult economic times, including through reduced utilities and drainage rate increases for 2017 and 2018. Administration will ensure that social, environmental and economic priorities are maintained and pressure on future rate increases is mitigated to the greatest degree possible. Investment in utility systems to maintain Calgary's readiness to service growth is also a priority.

As the Water Utility focuses on efficiency in the delivery of core services, there may be some changes in service to customers, but those reductions will not be significantly felt at this time.

### **Financial Capacity**

#### **Current and Future Operating Budget:**

The net-zero adjustment to the Water Utility operating budget absorbs the revenue shortfall through reducing operating expenditures. The reductions identified balance savings, risk, and the impact to services and customers.

#### **Current and Future Capital Budget:**

Administration is currently reviewing the capital budget for the water, wastewater and drainage services, including flood mitigation and resiliency projects. This is being done in alignment with Infrastructure Calgary's corporate-wide capital budget recast for 2017 and 2018. The recast process will result in a capital budget more closely aligned with the anticipated capital spend and the highest priority projects. The capital budget needs to maintain capacity to deliver on the major projects underway that support future growth, as well as what is needed to meet regulatory and environmental requirements, maintaining the existing utility systems and where possible capacity to support other Council priority areas (Infrastructure Calgary).

### **Risk Assessment**

Administration will balance savings, risk, and the impact to services and customers. The Water Utility will not compromise its focus on public health and the environment and will continue to make decisions to ensure long term sustainability.

### **REASONS FOR RECOMMENDATIONS:**

This report provides additional information on the net-zero utilities operating budget adjustment as included in the 2017 Capital Budget Recast and other Capital and Operating Revisions (PFC2017-0354).

### **ATTACHMENTS**

1. Water Utility Operating Budget Adjustment for 2017 and 2018
2. Overview: Addressing the Water Utility Revenue Shortfall