

Ask the right question part 2 – What is the financial impact of lower (option 2) water rates?

KEY POINTS

- **The analysis below shows that lower water rates, proposed as Option 2, without corresponding cuts to expenses, result in continued annual deficits each year for the five-year planning period.**
- **It appears that the lower option 2 water rate increases will produce an accumulated deficit over five years of \$1.75 MM. Presumably, the deficit would have to be funded by further loans from the General Fund.**
- **Would operating deficits and negative reserve balances disqualify the city from obtaining a loan to pay for the well 4 replacement?**
- **Expense reductions over five years of approximately \$2.5MM would be required to restore annual operating surpluses. Cuts would need to be made in direct operating expenses and/or capital improvement projects. Input from city staff suggests these expenses are already at minimum acceptable levels.**
- **The higher option 1 rates produce annual operating surpluses and restore the reserve to policy levels. Presumably the higher rates will improve the dependability and the safety of our water supply.**

ANALYSIS

At the last meeting, Council expressed concerns about the impact of very high proposed water rates on consumers. You did not discuss what impact selecting (option 2) lower rates/revenue would have on the health of the water enterprise fund. You postponed the decision pending actual rate information. You did not ask for the financial impact of lower rates. Understanding the financial impact rate payers is one consideration. Ensuring the viability of the enterprise operations is your fiduciary responsibility.

The fiscal impact of the two revenue increase options in the staff report for this meeting is limited to the change in revenue (See “Fiscal Impact” below). For fear you will not see how that impacts the financial health of the Water operations, I have attempted to reconstruct the financials from the Raftelis rate study and apply the option 2 revenue assumptions.

The financial analysis in the Rate Study is reconstructed recognizing there are many inconsistencies between the numbers and the textual descriptions. It would be preferable that Raftelis prepared this analysis, given they have the model.

Presumably lower rates are going to produce lower revenues and ultimately require some cuts to expenses to increase the reserve balance.

Excerpt from June 4 Staff Report:

FISCAL IMPACT:

At the May 21, 2024 meeting, Council decided that selection of Option 2 may be a better option for both Water and Wastewater, pending the information of the Water Option 2 rates provided in this report. Below is a summary of the percent increases in revenue requirements for Water Rate Option 1 (4/23/24 decision) versus Water Rate Option 2 (5/21/24 pending decision):

Table: Water Revenue Increase Requirements

	Option 1	Option 2
FY 2024-25	50%	37%
FY 2025-26	16%	4%
FY 2026-27	1.5%	4%
FY 2027-28	1.5%	3.5%
FY 2028-29	1.5%	3.5%

To orient the reader to the source of data and analysis, Table 4-10 Below is copied from the 2024 Raftelis Rate study and shows the financial impact of the water revenue increases proposed for the higher rates proposed as option 1:

Table 4-10: Water Operating Cashflow

No.	Line Item	FY2023-24	FY2024-25	FY2025-26	FY2026-27	FY2027-28	FY2028-29
1	Revenue Under Existing Rates	\$2,317,972	\$2,328,248	\$2,336,404	\$2,344,600	\$2,352,838	\$2,361,117
2	Additional Rate-Revenue	\$0	\$1,164,124	\$1,728,939	\$1,796,198	\$1,864,840	\$1,934,889
	Other Revenue						
3	Interest	\$35,000	\$4,516	\$15,484	\$39,222	\$44,521	\$38,219
4	Miscellaneous	\$65,000	\$65,254	\$65,509	\$65,765	\$66,023	\$66,282
5	Total Revenue	\$2,417,972	\$3,562,141	\$4,146,335	\$4,245,786	\$4,328,221	\$4,400,507
	O&M Expenses						
6	Operating Expenditure	\$1,356,903	\$1,349,844	\$1,417,902	\$1,518,125	\$1,582,653	\$1,740,203
7	G&A Allocation	\$1,363,097	\$852,863	\$823,801	\$882,031	\$919,522	\$1,011,058
8	Total O&M Expenses	\$2,720,000	\$2,202,707	\$2,241,703	\$2,400,156	\$2,502,175	\$2,751,261
9	Net Revenue	-\$302,028	\$1,359,434	\$1,904,632	\$1,845,630	\$1,826,046	\$1,649,246
	Debt Service						
10	Existing	\$380,704	\$318,656	\$318,656	\$252,547	\$252,547	\$252,547
11	Proposed	\$0	\$0	\$0	\$246,964	\$246,964	\$246,964
12	Total Debt Service	\$380,704	\$318,656	\$318,656	\$499,510	\$499,511	\$499,511
13	Cash Funded Capital	\$530,000	\$808,992	\$1,191,016	\$384,603	\$1,985,258	\$851,111
14	Annual Surplus/Deficit	-\$1,212,732	\$231,786	\$394,960	\$961,516	-\$658,722	\$298,623
15	Beginning Balance	\$1,225,855	\$13,123	\$244,909	\$639,869	\$1,601,385	\$942,663
16	Ending Balance	\$13,123	\$244,909	\$639,869	\$1,601,385	\$942,663	\$1,241,286
17	Minimum Reserve Level	\$764,557	\$621,706	\$631,321	\$714,986	\$740,142	\$801,560

Option 1 results in annual surpluses beginning in FY 24-25 (Line 14). Support for the numbers chosen for operating expenses, debt service and cash funded capital expenses are explained in the report.

There is not a similar analysis produced in the Raftelis report showing the financial impact of lower revenue increases described as option 2.

Below is a table produced using data from table 4.10 above with the exception of the “Additional rate revenue line 2”. Line 2 below is calculated based on the option 2 revenue proposal.

Not surprising, the lower water revenue expected from option 2, keeping all other expenses unchanged results in very poor financial results.

No.		23-24	24-25	25-26	26-7	27-28	28-29
	Option 2 Revenue change		37.0%	4.0%	4.0%	3.5%	3.5%
1	Revenue (existing rates)	\$ 2,317,972	\$ 2,328,248	\$ 2,336,404	\$ 2,344,600	\$ 2,352,838	\$ 2,361,117
2	Additional rate revenues	\$ -	\$ 861,452	\$ 980,884	\$ 1,105,379	\$ 1,217,891	\$ 1,334,587
	Total Revenue	\$ 2,317,972	\$ 3,189,700	\$ 3,317,288	\$ 3,449,979	\$ 3,570,729	\$ 3,695,704
3	Interest	\$ 35,000	\$ 4,516	\$ 15,484	\$ 39,222	\$ 44,521	\$ 38,219
4	Miscellaneous	\$ 65,000	\$ 65,254	\$ 65,509	\$ 65,765	\$ 66,023	\$ 66,282
	Option 2 Total Revenue	\$ 2,417,972	\$ 3,259,470	\$ 3,398,281	\$ 3,554,966	\$ 3,681,273	\$ 3,800,205
8	O&M Expenses	\$ 2,720,000	\$ 2,202,707	\$ 2,241,703	\$ 2,400,156	\$ 2,502,175	\$ 2,751,261
9	Net Revenue Option 2	\$ (302,028)	\$ 1,056,763	\$ 1,156,578	\$ 1,154,810	\$ 1,179,098	\$ 1,048,944
10	Existing debt	\$ 380,704	\$ 318,656	\$ 318,656	\$ 252,547	\$ 252,547	\$ 252,547
11	proposed debt				\$ 246,964	\$ 246,964	\$ 246,964
12	Total Debt	\$ 380,704	\$ 318,656	\$ 318,656	\$ 499,511	\$ 499,511	\$ 499,511
13	Cash Funded Capital	\$ 530,000	\$ 808,992	\$ 1,191,016	\$ 384,603	\$ 1,985,258	\$ 851,111
	Option 2 Balances						
14	Annual Surplus/Deficit	\$ (1,212,732)	\$ (70,885)	\$ (353,094)	\$ 270,696	\$ (1,305,671)	\$ (301,678)
15	Beginning Balance	\$ 1,225,855	\$ 13,123	\$ (57,762)	\$ (410,856)	\$ (140,160)	\$ (1,445,832)
16	Ending Balance	\$ 13,123	\$ (57,762)	\$ (410,856)	\$ (140,160)	\$ (1,445,832)	\$ (1,747,510)
17	Minimum Reserve Level	\$ 764,557	\$ 621,706	\$ 631,321	\$ 714,986	\$ 740,142	\$ 801,560

- The annual operating deficits (Line 14) continue during four of the next five years.
- The reserve balance (line 16) goes negative in FY24-25 and continues to grow more negative ending FY28-29 (\$1,747,510).
- At no time does the reserve meet the minimum required by policy (line 17).
- One assumes that we would not get a loan for the “critical” well 4 replacements.

Achieving the \$801,560 minimum reserve level in FY 28-29 would require cutting \$2,549,070 in expenses over the five-year period. The council has not looked at direct operating expenses for water in the past two years. Is there is an option to cut operating (O&M) expenses by an average of \$500,000 per year?

Debt payments (line 12) are not negotiable. Cash funded capital (line 13) looks like the only other expense you can cut. The projects making up cash funded capital actually described (table 4.2.2) are a small part of the total over five years. The \$600,000 per year “replacement program set-aside makes up much of the spending.

4.2.2. Capital Improvement Plan

Table 4-5 shows the City’s plan for water capital improvements over the rate-setting period. The CIP is inflated by 6 percent per year to reflect projected inflationary increases from an uninflated base of FY 2022-23 except for the current year, which is in FY 2023-24 dollars.

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Table 4-5: Projected Capital Improvement Projects

Project	FY2023-24	FY2024-25	FY2025-26	FY2026-27	FY2027-28	FY2028-29
Parquet Street Water Line Replacement	\$530,000	\$0	\$0	\$0	\$0	\$0
Well 4 Replacement	\$0	\$0	\$400,000	\$2,600,000	\$0	\$0
Water System Master Plan Update	\$0	\$120,000	\$0	\$0	\$0	\$0
Florence: Water Line Replace South	\$0	\$0	\$0	\$26,000	\$181,500	\$0
Florence: Water Line Replace North	\$0	\$0	\$0	\$56,000	\$402,000	\$0
Pleasant Hill Rd. Water Line: Mitchell Ct. to Lynch Rd.	\$0	\$0	\$0	\$0	\$300,000	\$0
Replacement program-set aside	\$0	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000
Total Uninflated	\$530,000	\$720,000	\$1,000,000	\$3,282,000	\$1,483,500	\$600,000
Total Inflated	\$530,000	\$808,992	\$1,191,016	\$4,143,449	\$1,985,258	\$851,111

Lowering the “replacement program set aside” from \$600,000 per year to \$100,000 per year (before inflation adjustment) would restore annual balances to a positive state in most years and restore the reserve fund over time. (See below).

The table below uses the lower Option 2 revenue increase assumptions (Line 2). Line 13 “cash funded capital” is reduced by the lowering the Replacement program set aside from \$600,000 to \$100,000 per year plus the 6% annual inflation assumption used in the rate study. All other capital projects shown in table 4-5 (shown above) are left in the cash funded capital budget line 13.

No.		23-24	24-25	25-26	26-7	27-28	28-29
	Option 2 Revenue change		37.0%	4.0%	4.0%	3.5%	3.5%
1	Revenue (existing rates)	\$ 2,317,972	\$ 2,328,248	\$ 2,336,404	\$ 2,344,600	\$ 2,352,838	\$ 2,361,117
2	Additional rate revenues	\$ -	\$ 861,452	\$ 980,884	\$ 1,105,379	\$ 1,217,891	\$ 1,334,587
	Total Revenue	\$ 2,317,972	\$ 3,189,700	\$ 3,317,288	\$ 3,449,979	\$ 3,570,729	\$ 3,695,704
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4	Miscellaneous	\$ 65,000	\$ 65,254	\$ 65,509	\$ 65,765	\$ 66,023	\$ 66,282
	Option 2 Total Revenue	\$ 2,417,972	\$ 3,259,470	\$ 3,398,281	\$ 3,554,966	\$ 3,681,273	\$ 3,800,205
8	O&M Expenses	\$ 2,720,000	\$ 2,202,707	\$ 2,241,703	\$ 2,400,156	\$ 2,502,175	\$ 2,751,261
9	Net Revenue Option 2	\$ (302,028)	\$ 1,056,763	\$ 1,156,578	\$ 1,154,810	\$ 1,179,098	\$ 1,048,944
10	Existing debt	\$ 380,704	\$ 318,656	\$ 318,656	\$ 252,547	\$ 252,547	\$ 252,547
11	proposed debt				\$ 246,964	\$ 246,964	\$ 246,964
12	Total Debt	\$ 380,704	\$ 318,656	\$ 318,656	\$ 499,511	\$ 499,511	\$ 499,511
13	Cash Funded Capital	\$ 530,000	\$ 247,192	\$ 595,508	\$ 229,771	\$ 1,316,145	\$ 141,852
	Option 2 Balances					\$ -	
14	Annual Surplus/Deficit	\$ (1,212,732)	\$ 490,915	\$ 242,414	\$ 425,528	\$ (636,558)	\$ 407,581
15	Beginning Balance	\$ 1,225,855	\$ 13,123	\$ 504,038	\$ 746,452	\$ 1,171,980	\$ 535,422
16	Ending Balance	\$ 13,123	\$ 504,038	\$ 746,452	\$ 1,171,980	\$ 535,422	\$ 943,003
17	Minimum Reserve Level	\$ 764,557	\$ 621,706	\$ 631,321	\$ 714,986	\$ 740,142	\$ 801,560

Now the Annual Surplus/Deficit becomes positive each year of the analysis until it goes negative in FY27-28. The 27-28 deficit is driven by the Florence Street and Pleasant Hill Road water main replacement projects both planned for FY 27-28.

- The reserve values drop below policy levels in that year but recover in FY 28-29.
- Not sure how that impacts the qualifications for the Well 4 loan to fund that project.
- Not sure why two major projects are planned in the same year or if it is even realistic to complete them in that time period?

Attempting to fund highly variable capital expenses from rates set every five years is difficult. Increasing the policy reserve levels would make sense. Raftelis made such a recommendation which failed to get discussed by the Council.

- **Can the water operation be operated safely after cutting \$2.5MM in capital expenditures?**
- **If the infrastructure study when completed says you need the additional \$2.5 MM, where will you get the money?**
- **Do reserves have to be above policy level every year after taking out the loan to replace well 4?**

- **The last-minute nature of this decision makes exploring other options impossible before the June public meeting.**

CONCLUSION - Water Rate Analysis

The proposed rate increases are, as expected, substantial.

- The unnecessary step of adding tiers makes the impact even greater on larger families that use more water.
- Past councils prioritized low rates for consumers and neglected investments to maintain the quality and dependability of the system, making it inevitable that the time would come to pay the piper.
- The original proposal (option 1) for water revenue increases and the resulting rates prioritizes restoring the financial health of the water enterprise fund and creating funding for anticipated capital improvements on our “aging infrastructure”.
- There is no explanation for why Sebastopol pays more to produce water than our neighbors.
- There are no real insights into the nature of our infrastructure, the needs, and the cost to maintain or improve it going forward.

Given the information you have, option 1 rates appear necessary to restore the enterprise funds.

Option 2 lowers rates but also means there is less revenue available to pay rapidly rising expenses and fund capital projects that may be needed in the future.

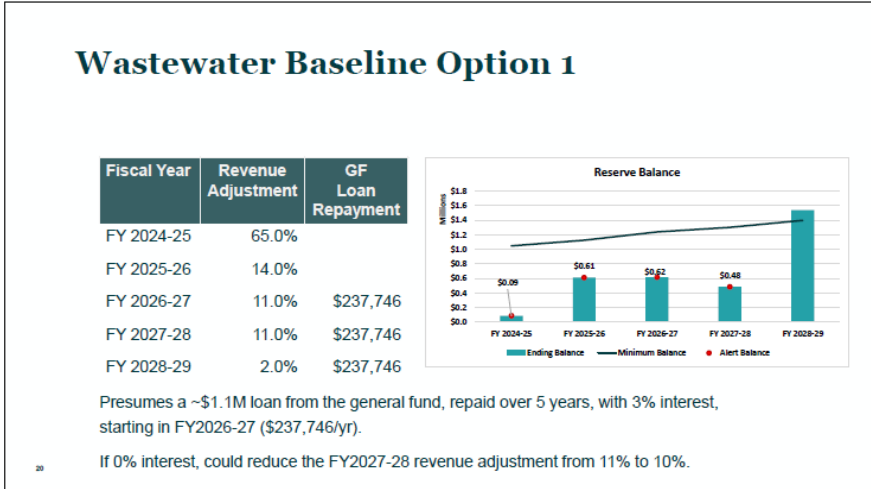
If the council prioritizes lower rates, then you need to step up and specify what cuts in expenses are responsible. Operating expenses can be cut, or cash-funded capital projects can be reduced. Five-year savings of \$2.5MM are needed.

Wastewater rate analysis – Change of topic.

The charts below are taken from the staff report for the April 23 meeting. At that meeting, the **City Council voted to accept the lower option 2 Wastewater rate.** Two slides were shown with proposed rate options and the impact on reserve levels over five years. (See below)

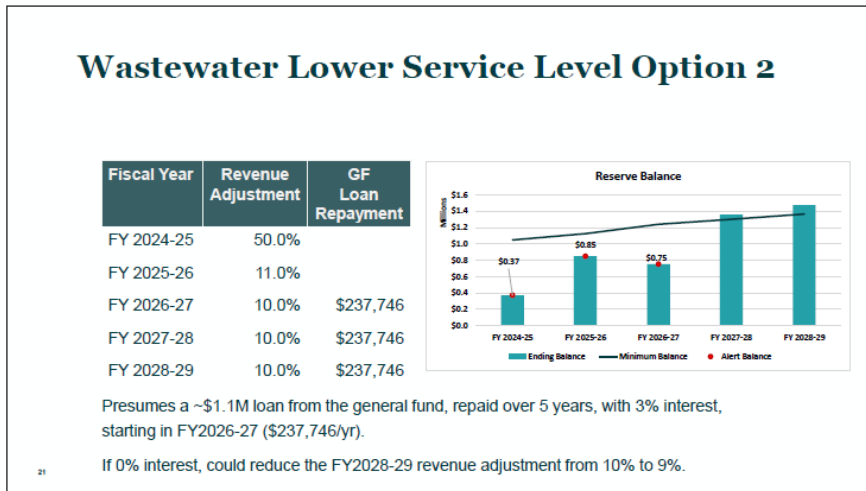
My concern is that the inset graph showing Reserve Balance for Option 2 (lower rates) shows substantially higher reserve balances than Option1 (higher rates). On the surface this makes Option 2 look like the best choice, but it is counterintuitive.

Why would higher revenues not generate higher reserve balances? Did option 2 come with substantial cuts in operating expenses or capital improvements? Are the inset graphs reversed? If so, would the council still have supported Option 2 given that it takes five years to get to the required reserve level?



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