



CITY OF HEALDSBURG CITY COUNCIL AGENDA STAFF REPORT

MEETING DATE: February 5, 2024

SUBJECT: Initial Financial Outlook and Rate Adjustment Requirements for the Water and Wastewater Funds

PREPARED BY: Terry Crowley, Utilities Director

STRATEGIC INITIATIVE(S):
Maintain and Improve Infrastructure and Facilities

RECOMMENDED ACTION(S):
Receive a report and provide comment and direction regarding the preliminary financial outlook for the water and wastewater cost of service update.

COMMUNITY ENGAGEMENT/OUTREACH:
At the October 16, 2023, City Council meeting a professional services agreement was approved to update the existing costs of service studies for both the Water and Wastewater funds. This meeting provides an additional opportunity for public feedback. Should the City Council approve a Proposition 218 process for adjusting rates, notices will be provided to all ratepayers.

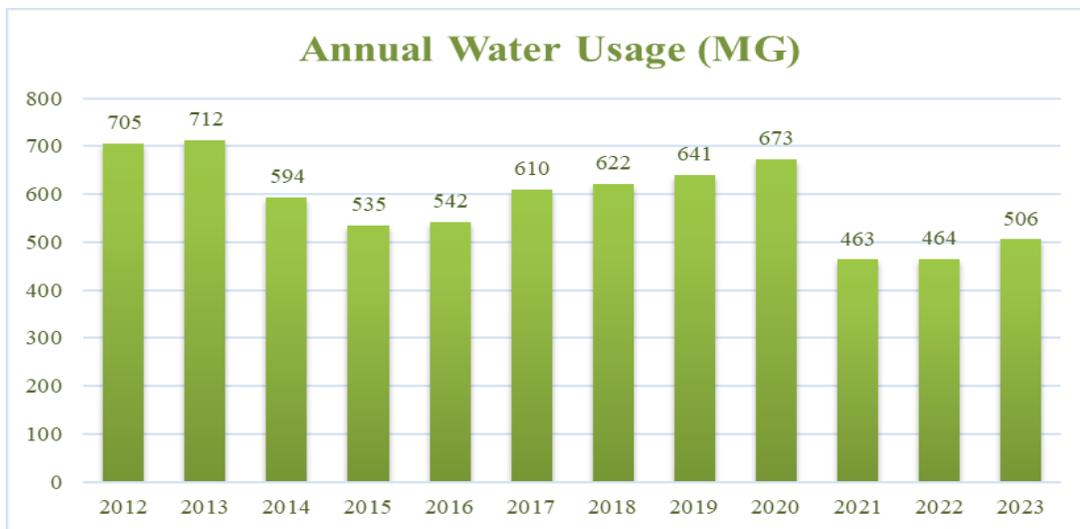
BACKGROUND:
In May of 2016 the City Council approved a series of water and wastewater rate increases starting at the beginning of Fiscal Year 2016/17 and ending at the start of Fiscal Year 2020/21. These rates include modest increases for the water department ranging between 6% and 3% per year and a 2% decrease (no increases over the five-year period) for the wastewater department. In September of 2020 City staff began work with Hildebrand Consulting to review and update the financial plans for both the water and wastewater departments. At the time, and due to ongoing financial concerns surrounding the COVID-19 pandemic, the implementation of needed rate increases was delayed. In June of 2022, following a historic multi-year drought, substantial community water conservation, and a significant reduction in water sales, the City Council approved a new series of water and wastewater increases. The current and approved increases are shown in the table below and if unchanged will continue through FY2026/27.

Implementation Date	Water Rate Increase	Wastewater Rate Increase
July 1, 2022	2.0%*	8.0%

July 1, 2023	8.0%	8.0%
July 1, 2024	8.0%	7.0%
July 1, 2025	5.0%	6.0%
July 1, 2026	5.0%	6.0%

**Due to structural changes between the fixed monthly charge and per unit charges, the effective rate increase for July 1, 2022, was closer to 8%.*

During the development of the currently adopted rates, the City and State were reacting to a multi-year drought. Due to significant reductions in natural flows within the Russian River and Dry Creek, the State water board curtailed all the City’s water rights, leaving the City with only water necessary for minimum public health and safety needs. Through the community’s collective action, Healdsburg was able to significantly reduce water usage, but that reduction also resulted in significant and prolonged declines in revenue. While water supply conditions have returned to normal, customer conservation remains high resulting water usage lower than forecasted within Hildebrand Consulting’s 2022 financial plan. The chart below indicates water usage over the past decade and shows the significant conservation from both the low water years of 2014 and 2015 as well as the 2021 drought year. The chart also indicates minimal recovery in water usage through the end of calendar year 2023.



The intent of the 2022 financial plan was to develop water and wastewater revenues that would not only cover the costs of system operations and debt payments (including the requirement to maintain a certain debt coverage ratio pursuant to bond covenants), but also fund necessary capital improvements. However, due to the ongoing and sustained levels of conservation, water and wastewater revenues have not met expectations, resulting in an inability to fund capital projects and significant budget shortfalls. Today the City is unable to meet state regulatory requirements, fund needed capital replacements, and support necessary operating costs. The table below shows revenues forecasted from the previous financial plan alongside current revenues. Annually water revenues are approximately \$800k lower than expected and \$500k lower for wastewater.

Fiscal Year	Forecasted Water Revenues	Actual Water Revenues	Forecasted Wastewater Revenues	Actual Wastewater Revenues
FY2021/22	\$5,298,000	\$4,470,868	\$7,096,522	\$7,122,365
FY2022/23	\$6,268,000	\$5,508,889	\$7,688,000	\$7,094,475
FY2023/24	\$7,113,000	\$5,946,731*	\$8,323,000	\$7,791,409*

**These are projected numbers included in the current budget and as presented during the recent FY2023/24 first quarter (Q1) financial update.*

To identify and correct these shortfalls, staff recommended and gained Council approval on October 16, 2024, to initiate an agreement with Raftelis Financial Consultants, Inc. (Raftelis). This agreement allowed staff and the Raftelis to begin the work to update financial plans and rate structures to correct shortfalls in operations and adequately fund capital improvement projects. Work to review and update the costs of service requirements began in November and initial estimates of future shortfalls are complete. While these early estimates are important to identify the magnitude of the needed correction, additional cost of service analysis remains.

DISCUSSION/ANALYSIS:

The Water and Wastewater funds are not generating sufficient revenues to cover operating costs, meet bond covenants, and fund needed capital replacements. Funding each of these obligations is necessary to maintain compliance with public health standards and provide consistent and reliable utility services. Working with City staff, Raftelis has identified the magnitude of future budget shortfalls and options to close the expected gaps. Immediate financial needs include the development of adequate funding to cover operational expenses and bond covenants along with funding of critical capital improvement projects. Near-term funding needs include the development of sufficient revenues to begin replacing aging infrastructure that is beyond expected life, along with development of new, more reliable water supplies that limit the depth of conservation required during future droughts.

Due to continued and substantially lower water sales, expected revenues for both the water and wastewater departments have not recovered as predicted in the 2022 financial plan. This has created budget shortfalls for the past two fiscal years and will continue to create shortfalls if rates are not adjusted. While short-term measures, including hiring freezes, project deferment, and not funding reserve accounts have helped lessen the impact, these measures are not sustainable and will result in deterioration of acceptable levels of utility services if continued.

Capital Improvement Projects

There is an immediate and continued need to fund capital improvement projects. The City has provided utility service for more than 100-years. The City owns, maintains, and operates an aging system in need of significant capital replacement. There are approximately 60-miles of water pipeline and 60-miles of sewer-line buried under the City’s streets. These facilities range from two to more than 100-years old. Thirty-three percent of the pipes exceed 50-years of service and are now beyond their expected life. These aging facilities create both increased frequencies of failure (watermain breaks and spills of raw sewage) and higher maintenance costs than newer systems. As an accepted best practice, water distribution and wastewater collection

systems are recommended to replace a minimum of 1% to 2% of their systems each year to avoid creating a backlog of capital replacement needs.

As there are many projects competing for the same limited pool of funding, for many years the City had been forced to make difficult decisions in prioritizing capital replacement projects. To support prioritization, capital projects are ranked and divided into three main categories: 1) public health and regulatory requirements, 2) critical infrastructure where failures will have a large or widespread impact on utility customers, and 3) projects identified as at or nearing end of life and likely to fail while in service. Below each of these categories and criteria described further.

Category 1 – Projects within this category are assigned the highest priority and are necessary to maintain safety, public health, and/or regulatory compliance. Projects in this category maintain public safety, proper treatment (e.g. water treatment) and meet existing or new water and wastewater regulatory requirements. An example is the need for new drinking water treatment to remove cryptosporidium (microscopic germs/parasites) at the Dry Creek and Fitch Well Fields.

Category 2 – Projects in this category are critical facilities that have reached or have exceeded their planned useful life and are essential to maintaining water and wastewater service for large portions of the community (e.g. impact to greater than 25% of the customer base).

Category 3 – This category represent infrastructure planned to fail while in-service requiring the initiation of contingency plans and emergency replacements. Projects are placed into this category to defer costs and lower rates due to budget limitations but recognize and plan for the risk of in-service failures. Necessary contingency plan(s) and emergency repair are likely to increase costs over an equivalent planned replacement. Examples of these projects are the Brown Street water and sewer mainline replacements as well as the Healdsburg Ave water and sewer replacements.

With both the 2016 and 2022 water and wastewater rate increases, staff deferred many capital improvement projects to support lower rate increases. While these projects were removed from previous and the current rate schedule, the work remains and is still an obligation. With the update to the financial plan and proposed rate adjustments, staff is again seeking projects that can be deferred to smooth the needed rate increase. Deferring these projects does not come without risk to service reliability, increased construction costs, and the need for future and potentially significant rate increases.

For the financial plan update, staff is recommending funding the major projects listed below as well as the deferral, beyond the three-year horizon, of several other projects. The list of projects recommended for funding and deferral provides an indication of existing deferred capital replacements and future funding obligations.

Major CIPs Include:

- Dry Creek Cryptosporidium Filtration – Water \$897,000
- Fitch Well Field Cryptosporidium Filtration – Water \$1,092,000
- Gauntlett WTP Membrane Replacements – Water \$302,000
- Healdsburg Ave Utility Replacement - Water \$398,000 Wastewater \$761,000
- Brown Street Sewer & Water Replacement – Water \$1,331,000 Wastewater \$1,331,000
- University Street Sewer & Water Rpl. – Water \$1,482,000 Wastewater \$1,482,000
- Orchard Lift Station Rehabilitation – Wastewater \$278,000
- Healdsburg Ave Sewer Replacement - Wastewater \$2,007,053
- Water Reclamation Facility Membrane Replacement – Wastewater \$282,000

Deferred Projects:

- Dry Creek Pumping & Clear Well Improvements – Water \$1,564,000
- Dry Creek Well Capacity Improvements – Water \$1,456,000
- Gauntlett Water Membrane Replacements – Water \$650,000
- Fitch Treatment Modernization – Water \$632,000
- PFAS removal – Water \$13,306,000 (TBD by 2024/25 test results)
- Gauntlett and Fitch Pipeline Rehab – Water \$1,509,000
- McDonough Watermain Replacement – Water \$2,245,000 Wastewater \$574,000
- Heron Lift Station Relocation – Wastewater \$1,706,000
- Hendricks Lift Station Conversion – Wastewater \$1,558,000
- Inflow & Infiltration Repairs – Wastewater \$1,256,000

Water Supply Security

Building on the experiences learned through the recent drought, over the next three to five years the City should consider increasing funding to support future water security. With the Potter Valley project expected to reduce available water within the Russian River watershed and climate change driving more uncertainty in rainfall from year to year, the City needs to diversify its water supply. While the City was recently awarded grant funding to construct a recycled water pipeline and a grant application for new aquifer storage and recover wells is pending, additional water supply is needed to limit the depth of water conservation required during dry and/or drought years. Being positioned between Dry Creek and the Russian River, Healdsburg has access to stored water from both Lake Sonoma and Lake Mendocino. With Lake Sonoma containing multiple years of water storage, this body of water presents a more stable water supply. However, accessing this water would come at an additional cost and require increased pumping capacity at the Dry Creek well field. While these additional costs are not proposed to be included in the next three years, the purchase of additional contracted water and construction capacity improvements at Dry Creek should be planned for in future rate analyses to improve water supply security and limit the negative financial impacts of future droughts.

Preliminary Financial Numbers

Preliminary financial planning result in the estimated operating costs and revenues shown below. The proposed revenue adjustments require the use of available fund balance to meet the proposed expenses to offset the required revenue increases. The primary driver increasing the magnitude of proposed revenue adjustments is the lower customer usage. The proposed expenses are largely consistent with the prior study with the main goal of re-establishing funding for deferred

operating costs and capital projects. Since the last study, both funds experienced inflationary increases and the wastewater fund experienced further increases in operating costs related to compliance requirements. While significant, the proposed revenue increases are fundamental to meeting the basic operating needs of the utility funds and securing safe and reliable water and sewer services.

Preliminary Water Department Financial Forecasts

Proposed Revenue Adjustment	21%	20%	12%
	FY 24-25	FY 25-26	FY 26-27
Proposed Revenue	\$ 7,065,091	\$ 8,472,497	\$ 9,485,249
Total O&M Expense	\$ 5,247,953	\$ 5,506,084	\$ 5,774,793
Total Debt & Capital	\$ 2,184,465	\$ 3,335,097	\$ 3,251,999
Net Cash Flow	\$ (367,328)	\$ (368,685)	\$ 458,457

Preliminary Wastewater Department Financial Forecasts

Proposed Revenue Adjustment	18%	18%	15%
	FY 24-25	FY 25-26	FY 26-27
Proposed Revenue	\$ 9,174,893	\$ 10,801,620	\$ 12,391,239
Total O&M Expense	\$ 6,719,022	\$ 7,045,209	\$ 7,381,809
Total Debt & Capital	\$ 2,954,844	\$ 4,124,379	\$ 5,187,123
Net Cash Flow	\$ (498,973)	\$ (367,968)	\$ (177,693)

In addition to the preliminary findings shown above, Raftelis has identified a few recommended structural changes to the City’s current water and wastewater rate structures. These include standardizing fixed monthly charges based upon meter size, consideration of tiered rate structures for residential customers, and elimination the current capital reserve policy. Standardizing fixed monthly charges will have the tendency to lower fixed monthly fees for multi-family housing where multiple residential dwellings are served by a single meter. Conversely this may have the effect of increasing fixed monthly fees overall. Additionally, Raftelis is knowledgeable and experienced with developing tiered rate structures that help recover any additional costs of large residential water users. Establishing tiered water rates may help set the foundation to fund additional water purchases and related capacity increases while providing a comparative financial benefit to households that use less water. A third recommended change is to eliminate the reserve held within the Capital Improvement Funds and use those funds as available fund balance to help stabilize the rates in the short term. While this will help lower the impact of necessary rate increases, the level of operating reserves maintained should be revisited with the next cost of service study.

Next Steps and Request for Direction

Raftelis and City staff will incorporate council direction into the financial plan and move forward with the rate design process. Specifically, staff is seeking direction on:

- The proposed rate structures (including the possible use of tiers);

- The appropriate level of capital investment to meet requirements and maintain the aging system;
- Timing of efforts to diversify the City's water supply with expanded use of contract water from Lake Sonoma, and
- Elimination of the capital reserve.

Raftelis will translate the financial plan through a cost-of-service analysis to prepare rate calculations, alternative rate designs, and complete customer impact analysis. On March 4, 2024, City staff expect to present a final financial plan and rate proposal to the City Council. To allow time to incorporate Council direction received on March 4th, on March 18th staff will request approval from Council to begin the Proposition 218 noticing process. On May 6th, after a minimum 45-day noticing period, the City would seek approval of a series of three annual increases for both the water and wastewater departments. While the timeline outlined above requires several Council meetings, each meeting will provide the Council and Community the opportunity to engage in the process and present their concerns. Should the process move forward as recommended, staff is prepared to conduct additional outreach efforts to share with the community the need and impacts of the proposed adjustments.

ENVIRONMENTAL STEWARDSHIP:

Continued adequate funding for both the water and wastewater departments allows these activities to working within existing and future environmental regulations. The proper treatment of drinking water along with the proper collection and treatment of the City's wastewater helps assure responsible use of natural water resources and that the City's waste will not pollute the local creeks and rivers.

ALTERNATIVES:

There is no action sought by Council at this time other than to provide comment and direction regarding the preliminary financials, potential rate structure changes, and estimated level of rate increases.

FISCAL IMPACT:

Due to lower-than-expected customer usage, both the Water and Wastewater departments are experiencing budget shortfalls that are not sustainable. Staff and Council have taken multiple actions to defer capital projects and necessary operating costs in order to continue operations under the current rate structure. Raftelis and staff have prepared a financial outlook that identifies the total revenue adjustments needed to correct budget shortfalls, meet bond covenants, meet required reserves, and fund necessary capital improvement projects. The proposed percentage increases presented tonight are not reflective of the individual rate increases to be implemented but rather the amount of revenue required. Staff will return on March 4th to present the proposed rate structure that details the individual rate increases.

ENVIRONMENTAL ANALYSIS:

A utility rate is not subject to the provisions of the California Environmental Quality Act (CEQA) because a rate study and/or increase is not a project, since it will not have a direct or reasonably foreseeable indirect impact on the environment.