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MEMORANDUM

DATE: December 20, 2022

TO: Financial Commission

FROM: NBS and June Du, Finance Director

SUBJECT: SEWER RATE STUDY

NBS attended the Finance Commission meeting on November 21, 2022, to inform the committee on the draft sewer rate results. As a result of this meeting, several questions were asked from the Financial Commission and a subcommittee was formed to review a second time. Questions from the Commission included the following:

- 1) The operating fund target is 180 days of O&M costs. Although you included a slide showing that having a reserve is consistent with policy, why is the amount so high?

Answer: The industry standard for O&M reserves is 90-180 days of O&M costs. The City currently uses 180-days as target policy. Since the City receives the tax revenues in two payments, 180 days is recommended for cash flow purposes. It is also a governmental accounting principle that the enterprise fund has to stand on its own.

- 2) The O&M reserve is 50% of operating costs whereas the overall Los Altos budget only uses a 20% guideline. Further can you please confirm that the total Los Altos accounting process does not include the sewer costs? Otherwise, we would be creating two levels of reserves.

*Answer: *NBS defers to June Du for this question Reserves are set on the basis that the Sewer Enterprise Fund will be self-sufficient and not depend on General Fund assistance.*

- 3) The capital reserve fund target is 12 months of average capital expenditures. This also seems excessively conservative.

Answer: Using the annual average capital expenditures over the rate study period is a common industry practice that is consistent with the last rate study. Using the 5-year annual average would result in a \$3.9M annual capital reserve target. However, we are using the FY 23/24 capital expenditures estimate of \$3.08M for our targeted reserve level. Given future higher expected expenditures and bids from Palo Alto that are coming in higher than originally planned, it is better to have reserves available for any variance in costs.

4) The current revenue forecast at prevailing rates shows no actual change in sewer usage. This seems inconsistent with the city's residential building targets. It also seems to contradict the level of sewer capital expenditures. Do any of these capital projects increase capacity?

Answer: We are using a conservative approach of assuming no growth in the City for rates. This protects the City from potentially under collecting revenues should no growth happen. NBS looked at the growth since 2017 as a reference point. The data shows a cumulative growth total of about 0.32% from 2017.

5) Could you please show us how the minimum reserve targets are calculated (showing the specific calculations).

Answer:

- *Operating reserve: Budget of \$6.4M in FY22/23 divided by 2 and rounded to the nearest 100th.*
- *Capital Reserve: Annual CIP budget of \$3.084M in FY22/23 and inflated by CPI (~3%) annually.*

6) Regarding the large capital and operating reserves, the consultants said it is up to the city to decide the level of operating and capital reserves for this fund. It seems we may be double counting operating funds reserves for sewer in the general fund if we don't have totally dedicated staffing and facilities for it; and highly unlikely that the city would deny the sewer fund capital improvement monies if and when needed. In general, we think increasing rates to raise reserves may not be necessary. Since it is discretionary, we suggest you look at it and set the right level.

Answer: *Reserves are set on the basis that the Sewer Enterprise Fund will be self-sufficient and not depend on General Fund assistance. The City set the operating reserve at 180 days and the Capital Reserve at one year of expenditures because of cash flow concerns. The City receives the sewer tax revenue twice a year, one in late January and another one in late August (accrues back to June to make one fiscal year). Meanwhile, the City does not control the progress of the majority of sewer CIP projects; the City of Palo Alto does. Due to the above two factors, the City will need to have the O&M reserve for six months and CIP reserve for twelve months to make sure the cash flow won't run short.*

7) Why does receiving sewer revenue bi-annually mean we need to reserve costs in advance? Los Altos receives property tax asymmetrically but doesn't reserve capital. Plus, the City is already reserving 20% of costs through the city's operations reserve.

Answer: *The CIP projects and payment dates are largely outside of the control of the City. Should a bill be received prior to the collection of funds the Sewer fund may not be able to make the payment for the project. It's primarily a cashflow issue. The 20% GF reserve will not be used for enterprise funds. In this scenario, the saying "property taxpayers don't subsidize rate payers" is appropriate. Reserves are set on the basis that the Sewer Enterprise Fund will be self-sufficient and not depend on General Fund assistance.*