



UTILITY BOARD STAFF REPORT

Item 3
October 10, 2023
Regular Business

AGENDA ITEM INFORMATION

TITLE:	2024 Water Rate and Bond Issuance Discussion/Recommendation	<input type="checkbox"/> Discussion Only
RECOMMENDED ACTION:	Accept staff's recommendation to increase the Water Utility rate for FY 2024.	<input checked="" type="checkbox"/> Action Needed: <input checked="" type="checkbox"/> Motion <input type="checkbox"/> Ordinance <input type="checkbox"/> Resolution

STAFF:	Ben Schumacher, Financial Analyst Matt Mornick, Finance Director
COUNCIL LIAISON:	Jake Jacobson
EXHIBITS:	1. Sample Schedule for LTGO Bond Issuance Draft Letter 2. Summary of Historical Interest Rates

SUMMARY

Background

As part of the 2023-2024 mid-biennial budget process, staff seeks the Utility Board's recommendation regarding the Water Utility rate adjustment for the upcoming fiscal year. The 2023-2024 operating and capital budgets presented in this memo were adopted by the City Council on December 6, 2022 and include budget amendments through May 16, 2023. Staff have also included forecasted budget figures for the operating budgets in 2023 and 2024 due to the expected issuance of debt occurring a year later than originally budgeted.

2023-2024 Operating Budget

The operating budget for the Water Utility is presented in the table below.

Operating Expenditures <i>(\$ in thousands)</i>	2021	2022	2023	2024	Percent Change	
	Actual	Actual	Forecast	Forecast	22-23	23-24
Salary & Benefits	\$1,357	\$1,868	\$2,015	\$2,133	7.9%	5.8%
Water Purchased for Resale	2,223	2,133	2,351	2,468	10.2%	5.0%
Other Services and Charges	1,446	1,755	1,674	1,773	-4.6%	5.9%
Debt Service	109	107	107	1,553	-0.6%	1356.7%
Total	\$5,134	\$5,863	\$6,146	\$7,927	4.8%	29.0%

Table 1

Highlights from the Water Utility operating budget include:

- The combined total for salary and benefit costs in 2024 are increasing 5.8% as compared to the 2023 budget. The increase is a result of the current pace of inflation which has led to atypically high cost-of-living adjustments (COLA), per the City's collective bargaining agreements. The COLA in 2023 was capped at 6.0%, per the current AFSCME bargaining contract, and is anticipated to be 6.0% again for 2024.
- The operating budget for 2024 contains no new positions when compared to 2023.

- Water Purchases from Seattle Public Utilities (SPU) are projected to increase 5.0% in 2024 when compared to the 2023 budget. Note that SPU sets a higher rate for the period of Peak usage (May 15-Sept 15) than for the period of non-peak usage (Sept 16-May 14). Staff estimates water purchase costs will make up about 31% of all Water Utility operating expenses in 2024.
- Existing debt service payments are for debt issued in 2011 on the First Hill Booster Pump Station upgrade and water system improvements projects. The Water rate model includes \$19.28 M in new outside funding in 2024 to support significant upcoming water capital improvements (e.g., island-wide meter replacements, water reservoir improvements, asbestos cement main replacements, and pressure reducing valve station replacements). Issuance of new debt would result in additional annual debt payment estimated at \$1.4 M, beginning in 2024.
- Other Services and Charges include all other costs of operations including supplies, insurance, and City administration costs. Administration costs include the Water Fund’s share of administrative support provided by the City Attorney’s Office, City Manager’s Office, Finance and Human Resources staff. An overhead cost allocation model is used to determine the Water Utility’s proportionate share of these internal services.

Summary Capital Reinvestment Projects

Planned capital reinvestments in 2023 and 2024 are outlined in the table below. Systemwide water distribution components - such as island-wide meters, water reservoirs, and pressure reducing valve stations, among others - are simultaneously reaching the end of their useful life.

Capital investment costs are the primary driver of the proposed water rate increase as the water distribution system enters a period of significant reinvestment. The numbers presented below for 2024 include projects that staff deemed necessary to accelerate and spend down bond proceeds within the three-year eligibility window for reimbursement.

Water Utility Capital Program Budget 2023-2024				
(\$ in thousands)				
Project ID	Description	2023	2024	
WU0100	Emergency Water System Repairs	\$260	\$150	
WU0101	Booster Chlorination Station	1,336		
WU0102	SCADA System Replacement (Water)	667		
WU0103	Water Reservoir Improvements	4,370	2,750	
WU0106	Water System Improvements (Madrona Crest East Addition)	1,007		
WU0109	Water System Improvements (60 Ave SE, btw SE 27 and SE 32, and 62 Ave)	291		
WU0112	Water System Components Replacement	50	50	
WU0115	Water Modeling and Fire Flow Analysis	40	50	
WU0117	Meter Replacement Implementation	7,229		
WU0119	Reservoir Generator Replacement	1,512		
WU0120	First Hill Generator Replacement	400	400	
WU0128	Reservoir Pump Replacement	540	540	
WU0130	2023 Water System Improvements (First Hill, NMW, SE 37th Pl, SE 41st-42nd Pl)	4,684		
WU0131	2024 Water System Improvements (8600 Block SE 47th & SE 59th)	373	2,082	
WU0135	2024 AC Main Replacement (Gallagher Hill Rd, Greenbrier and SE 40th)	479	2,680	
WU0136	2025 AC Main Replacement (Upper Mercerwood)		1,040	
WU0140	Pressure Reducing Valve Station Replacements	395	2,025	
WU0141	Street Related Water System Improvements	150	150	
WU0142	Emergency Well #2 Site Evaluation		50	
Water Utility CIP Total		\$23,782	\$11,967	

Table 2

Water Rate Proposal

The 2024 water rate proposal is based on the 2023-2024 operating budget, the 2023-2028 Capital Improvement Program (CIP), and the corresponding debt financing needs. Staff recommends an 8.0% increase to the water utility rates for 2024 as proposed in the smoothed rate model.

This year-over-year smoothed rate model is predicated on leveraging outside funding for investments that cost more than \$2.5 M each and have a useful life greater than 20 years. Debt financing spreads costs incurred in a relatively short period over the useful life of updated infrastructure, thereby avoiding spikes in annual rate adjustments year-over-year while generations of rate payers who benefit from these investments help pay down the associated costs.

The proposed rate adjustment for FY 2024 ensures that the Water Fund has adequate resources to complete the critical capital project work detailed below and into the future, as well as meet long-established fiscal policy guidelines. These include an operating reserve target of 90 days of operating and maintenance costs, and a capital reserve target of 1.0% of capital assets. The 8.0% rate increase in FY 2024 enables the fund to achieve its target for both established guidelines, as detailed in Tables 3 & 4 below.

Revenue Requirement	2022	2023	2024	2025	2026	2027	2028
Pre Rate Revenues							
Revenues							
Rate Revenues Under Existing Rates	\$10,215,124	\$10,215,124	\$10,215,124	\$10,215,124	\$10,215,124	\$10,215,124	\$10,215,124
Non-Rate Revenues	43,405	39,388	46,736	48,476	37,355	37,699	38,059
Total Revenues	\$10,258,529	\$10,254,511	\$10,261,860	\$10,263,600	\$10,252,479	\$10,252,822	\$10,253,182
Expenses							
Cash Operating Expenses	\$ 5,835,939	\$ 6,201,367	\$ 6,474,979	\$ 6,691,520	\$ 6,922,277	\$ 7,162,443	\$ 7,412,427
Existing Debt Service	107,250	109,531	111,631	108,550	110,150	111,550	107,750
New Debt Service	-	-	1,441,620	2,062,872	2,060,576	2,527,866	2,525,570
System Reinvestment Funding	3,000,000	3,250,000	3,500,000	3,700,000	3,900,000	3,900,000	3,900,000
Total Expenses	\$ 8,943,189	\$ 9,560,898	\$11,528,230	\$12,562,942	\$12,993,004	\$13,701,859	\$13,945,747
Net Surplus (Deficiency)	\$ 1,315,340	\$ 693,613	\$ (1,266,370)	\$ (2,299,343)	\$ (2,740,525)	\$ (3,449,037)	\$ (3,692,565)
Annual Rate Increase		8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Cumulative Rate Increase		8.00%	16.64%	25.97%	36.05%	46.93%	58.69%
Post Rate Revenues							
Revenues After Rate Increases	\$10,215,124	\$11,032,334	\$11,914,920	\$12,868,114	\$13,897,563	\$15,009,368	\$16,210,117
Additional Taxes from Rate Increase	-	41,097	85,483	133,419	185,190	241,103	301,488
Net Cash Flow After Rate Increase	\$ 1,315,340	\$ 1,469,726	\$ 347,944	\$ 220,229	\$ 756,725	\$ 1,104,105	\$ 2,000,941
Sample Residential Bill (3/4" Meter, x 14 ccf)	\$122.15	\$131.92	\$142.48	\$153.87	\$166.18	\$179.48	\$193.84
Bi-Monthly Increase (\$)		\$9.77	\$10.55	\$11.40	\$12.31	\$13.29	\$14.36

Table 3

Fund Balance	2022	2023	2024	2025	2026	2027	2028
Operating Reserve							
Beginning Balance	\$ 5,762,177	\$ 2,077,517	\$ 3,547,243	\$ 3,895,186	\$ 1,671,042	\$ 1,739,761	\$ 1,811,745
plus: Net Cash Flow after Rate Increase	1,315,340	1,469,726	347,944	220,229	756,725	1,104,105	2,000,941
less: Transfer of Surplus to Capital Fund	(5,000,000)	-	-	(2,444,373)	(688,006)	(1,032,121)	(1,925,514)
Ending Balance	\$ 2,077,517	\$ 3,547,243	\$ 3,895,186	\$ 1,671,042	\$ 1,739,761	\$ 1,811,745	\$ 1,887,172
Actual Days of O&M	130 days	209 days	218 days	90 days	90 days	90 days	90 days
Capital Reserve							
Beginning Balance	\$10,024,654	\$ 6,240,578	\$ 846,241	\$ 801,686	\$ 4,932,077	\$ 3,706,812	\$ 4,635,259
plus: System Reinvestment Funding	3,000,000	3,250,000	3,500,000	3,700,000	3,900,000	3,900,000	3,900,000
plus: Transfers from Operating Fund	5,000,000	-	-	2,444,373	688,006	1,032,121	1,925,514
plus: LTGO Proceeds	-	-	16,000,000	8,100,000	-	6,100,000	-
plus: PWTF Proceeds	-	-	3,280,000	-	-	-	-
plus: Interest Earnings	25,062	31,203	4,231	4,008	24,660	18,534	23,176
Total Funding Sources	\$18,049,716	\$ 9,521,780	\$23,630,472	\$15,050,068	\$ 9,544,743	\$14,757,466	\$10,483,949
less: Capital Expenditures	(11,809,138)	(8,675,540)	(22,828,786)	(10,117,991)	(5,837,931)	(10,122,208)	(5,749,235)
Ending Capital Fund Balance	\$ 6,240,578	\$ 846,241	\$ 801,686	\$ 4,932,077	\$ 3,706,812	\$ 4,635,259	\$ 4,734,714
Minimum Target Balance	\$ 475,035	\$ 561,790	\$ 790,078	\$ 891,258	\$ 949,637	\$ 1,050,859	\$ 1,108,352
Combined Beginning Balance	\$15,786,831	\$ 8,318,095	\$ 4,393,483	\$ 4,696,872	\$ 6,603,118	\$ 5,446,572	\$ 6,447,004
Combined Ending Balance	\$ 8,318,095	\$ 4,393,483	\$ 4,696,872	\$ 6,603,118	\$ 5,446,572	\$ 6,447,004	\$ 6,621,886

Table 4

A summary table comparing the proposed rates from the most recent rate model updates (2022-2024) as compared to the current rate recommendation is presented below.

Description	2021	2022	2023	2024	2025	2026	2027	2028
2020 Rate Update	6.50 %	6.50 %	6.50 %	6.50 %				
2021-2022 Rate Update	5.25%	5.25%	5.25%	5.25%	5.25%	5.25%		
2023-2024 Rate Proposal			8.00%	8.00%	8.00%	8.00%	8.00%	8.00%

Table 5

Scheduled Water Utility Bond Issuance

The current Water Utility rate proposal assumes a portion of the scheduled capital projects will rely on outside funding to offset the more than \$51.6 M in escalated capital spending between 2023-2028. Table 4 includes the projected limited-tax general obligation (LTGO) debt issuance that amounts to \$16 M in 2024, \$8.1 M in 2025, and \$6.1 M in 2027.

For modeling purposes, timing when to seek outside funding is based on when qualifying infrastructure improvements are scheduled in the six-year capital improvement program (CIP). In practice, staff closely manage cash-flow needs for capital projects as they unfold with the requirement to spend down bond proceeds within three years of receipt.

Staff forecast the Water Fund balance will remain net positive through the first year of the current biennium, which allows staff to push out the \$16 M bond issuance originally scheduled this year to the first half of 2024. This issuance will provide critical funding support for the water utility, including the following projects:

- **Water Reservoir Improvements (WU0103)** to the south and north tanks will protect the structural integrity and create a safer working environment. Improvements include seal welding roof plates and rafters, replacing exterior ladders with spiral staircases, and adding a guardrail around the tank roof perimeter as well as replacing interior linings and overcoating exteriors.

Work began in Q3 2023 following material procurement and permitting. Because only one reservoir can be taken out of service at a time and restricted during high water demand season, this project will take until Q2 2025 to be completed. Total project costs are estimated at \$5.56 M in the current biennium.

- **Pressure Reducing Valve (PRV) Station Replacements** (WU0140) is an ongoing program to systematically replace PRV stations throughout the island. Most stations are below the City's current operational standards. There is a total of 85 PRV stations in the City's water distribution system. In general, the life span of a new PRV station is around 50 to 60 years, with routine maintenance.

The initial design phase of the project is well underway. Design will continue through the first half of 2024. Total project costs are estimated at \$2.4 M in the current biennium.

- **Water System Improvements** (WU0130) aims to install over 6,500 linear feet of new 8-Inch ductile iron water main at six different locations on the northern portion of Mercer Island. Water services and fire hydrants in these areas will also be replaced. Construction began this September and is scheduled for completion Q1 2024. Total project costs are estimated at \$4.7 M in the current biennium.
- **Asbestos Cement (AC) Water Main Replacements** (WU0135-WU0137) is a new ongoing program to systematically replace antiquated AC water mains with ductile iron water mains. The replacement program reduces the potential for catastrophic system failure, unexpected service disruptions, and large damage claims to the City.

Staggered capital reinvestment for aging water mains is being accelerated as AC water main ruptures have notably increased relative to prior years. Over the 2023-2028 CIP planning period, total project costs are estimated at \$18.7 M.

Staff included a preliminary schedule of events (Exhibit 1) to demonstrate the timeline from initiating the bond issuance process to when the City can expect to receive revenues from said issuance.

Mechanics of a Bond Issuance

When issuing bonds for significant infrastructure related projects, it is commonplace for utility systems to issue debt as revenue bonds. The city also has the option to issue debt as limited tax general obligation (LTGO). Staff recommends the latter option. By issuing an LTGO bond, the debt would still be secured and paid for by the revenues of the utility system, but it would also have the backing of the City's full faith and LTGO credit in case of any revenue shortfalls.

Alternatively, if the debt were issued as utility system revenue bonds, it would not have the backing of the City's LTGO credit. Depending on market conditions and credit quality, and assuming both credits have the same rating, the benefit of issuing bonds as LTGO vs. utility revenue could be from zero to 10-basis points. A 10-basis point benefit on a 20-year, \$16 M bond issue would be approximately \$170,000 in debt service. Exhibit 2 contains a graph detailing municipal market data for current and prior interest rates applicable for 20-year bonds.

The City's general obligation rating by Moody's is currently at Aaa which is the highest rating category and was affirmed in May 2023. The City does not currently have a rating on its utility system and would have to apply for one if it were to issue the debt as such. Given the City's strong and structurally balanced financial position, staff anticipate the utility system would also receive an Aaa rating. Though unlikely, if the utility

system were to receive a rating of Aa1 (one notch lower than the Aaa general obligation credit rating), that could equate to five basis points higher in interest rates.

Issuing utility bonds as LTGO does impact the City's LTGO debt capacity. This could be an issue for municipalities with a considerable amount of general obligation debt outstanding, but this is not the case for Mercer Island.

As prescribed by State statutes, based on 1.5% of the City's 2023 assessed valuation of \$22.5 B, the City's remaining available debt capacity is \$332 M, taking into account the City's current outstanding general obligation debt of \$4.8 M.

Conclusion

Staff will be available at the Utility Board meeting to answer questions regarding the proposed 2024 Water Utility rate increases.

The 2024 Water Utility rate resolution is on the City Council planning schedule for review and adoption on November 21, 2023. Staff will return during the 2025-2026 biennial budget process with new information to inform potential annual rate adjustments for fiscal year 2025 and beyond.

RECOMMENDED ACTION

Accept staff's recommendation to increase the Water Utility rate for FY 2024.