



**BUSINESS OF THE CITY COUNCIL
CITY OF MERCER ISLAND**

**AB 6370
November 7, 2023
Study Session**

AGENDA BILL INFORMATION

TITLE:	AB 6370: Preview of the Declaration of Intent for Seeking Reimbursement for Water Infrastructure Improvements	<input checked="" type="checkbox"/> Discussion Only <input type="checkbox"/> Action Needed: <input type="checkbox"/> Motion <input type="checkbox"/> Ordinance <input type="checkbox"/> Resolution
RECOMMENDED ACTION:	Receive report. No action necessary.	

DEPARTMENT:	Finance
STAFF:	Matthew Mornick, Finance Director Jason Kintner, Chief of Operations Patrick Yamashita, Deputy Public Works Director
COUNCIL LIAISON:	n/a
EXHIBITS:	n/a
CITY COUNCIL PRIORITY:	4. Focus efforts and actions to be an environmentally and fiscally sustainable, connected, and diverse community.

AMOUNT OF EXPENDITURE	\$ n/a
AMOUNT BUDGETED	\$ n/a
APPROPRIATION REQUIRED	\$ n/a

EXECUTIVE SUMMARY

The purpose of this agenda bill is to provide background on capital investments for the City’s water distribution system, the recommendation to use bond proceeds to help pay for these critical investments, and the steps needed to extend the timeframe in which bond proceeds can be used by declaring the intent to seek reimbursement.

- The City is in a period of significant capital reinvestment as major components of the City’s water distribution system reach the end of their useful life. Between 2023 and 2028, the water utility requires \$51.6 M in escalated capital spending.
- On November 21, the City Council will declare via resolution the City’s intention to reimburse itself for costs incurred on qualifying water capital projects prior to the date of an upcoming bond issuance. This action is referred to as a “declaration of intent.”
- Next year, the City expects to issue \$16 M of tax-exempt limited tax general obligation bonds. This declaration “starts the clock,” equipping the City to use funds from, for example, a June 2024 bond issuance to pay for costs incurred on qualifying water capital projects dating back to January 2023.

Staff will present information on the water distribution system financing strategy, answer questions related to the declaration of intent, the scheduled capital investments, and the plan to pay for these investments.

Staff will return at the November 21, 2023 City Council meeting with a resolution declaring the City's intent to seek reimbursements on costs incurred prior to a bond issuance, scheduled for Q2 2024.

BACKGROUND

WATER UTILITY CAPITAL INVESTMENTS

In December 2022, the City Council adopted a six-year Capital Improvement Program (CIP) as part of the 2023-2024 biennial budget. The [2023-2028 CIP](#) outlines the City's strategic financial plan to acquire, expand, or rehabilitate public infrastructure, including the City-owned and operated municipal water system.

Most of the Island's water distribution system was constructed 50 to 75 years ago. Though the City has made investments to effectively operate and maintain the water utility, significant system components are reaching the end of their useful life and require escalated capital spending over the next six years.

Recent use of federal funding accelerated design work for some of the 2023-2024 adopted utility capital projects. Investments related to project management, materials, and construction on major capital improvements will be funded by both current water utility charges and outside funding sources.

Historically, the Utility Board consistently seeks to balance the many infrastructure investment needs with maintaining a similar year-over-year water utility rate adjustments so not to put an undue burden on current water utility customers. For the next six years, this approach requires using outside funding for capital projects that cost more than \$2.5 M and have a useful life, at minimum, greater than 20 years.

In October of this year, the Utility Board unanimously approved a water utility rate adjustment of 8% for fiscal year 2024. Staff and the Utility Board Chairman will provide background on this recommended rate adjustment at the November 21, 2023 City Council meeting.

This rate proposal assumes a portion of the scheduled capital projects in the 2023-2028 CIP will rely on debt proceeds that amount to \$16 M in 2024 – as well as an estimated \$8.1 M in 2025 and \$6.1 M in 2027 – to offset the more than \$51.6 M in capital reinvestments for the water utility over the next six years.

Debt financing spreads costs incurred in a relatively short period over the useful life of the updated infrastructure, avoiding spikes in annual rate adjustments, and creating generational equity, whereby generations of rate payers who benefit from these investments help pay down the associated costs.

The estimated \$16 M issuance in 2024 will provide critical funding support for 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, adding a guardrail around the tank roof perimeter, and 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 \$5.6 M in the current biennium.

- **2023 Water System Improvements (WU0130)** aims to install over 6,600 linear feet of new eight-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-WU0139)** is a new ongoing program to systematically replace approximately five miles of antiquated AC water mains with ductile iron water mains from 2023-2028. 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 increased relative to prior years. Between January 2020 and October 2023, 22% of all water main breaks occurred on AC pipe. In the four years prior, there were no breaks on AC water mains.

Over the 2023-2028 CIP planning period, total project costs are estimated at \$18.7 M.

- **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. With routine maintenance, the life span of a new PRV station is typically 50 to 60 years.

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, with an additional \$4.4 M between 2025-2028.

MECHANICS OF A BOND ISSUANCE

When seeking outside funding for significant infrastructure related projects, it is common practice for public utilities to issue debt as revenue bonds. The City also has the option to issue debt as limited tax general obligations (LTGO). Staff recommends the latter option. LTGO bonds are general obligations of the City, payable from and secured by the City's full faith and credit, and other legally available sources, such as utility revenues. By issuing LTGO bonds, the City can take advantage of its LTGO credit rating which results in more competitive borrowing rates but use the revenue of the utility system to repay the debt.

The City's LTGO general obligation rating by Moody's is currently Aaa which is the highest rating category and was affirmed in May 2023. Issuing utility bonds as LTGO does impact the City's LTGO debt capacity. For cities with a considerable amount of general obligation debt, this could be an issue. This is not the case for the City of Mercer Island.

As prescribed by State statutes and the City's Financial Management Policies, 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. This includes the City's current outstanding general obligation debt of \$4.1 M related to the 2009 LGTO Sewer Lake Line and 2011 LTGO First Hill Water Improvements. The final payment on the Sewer Lake Line bond is scheduled for December 2029, with the First Hill balance scheduled to be paid in full by December 2030.

ISSUE/DISCUSSION

DECLARATION OF INTENT TO SEEK REIMBURSEMENT

At the November 21 City Council meeting, staff will seek the City Council's approval to declare via resolution the City's intention to reimburse itself for costs incurred on qualifying water capital projects prior to the date tax-exempt bonds are issued.

For rate modeling purposes, determining when to seek outside funding is based on when qualifying water infrastructure improvements are scheduled in the six-year CIP. In practice, staff closely manage cash-flow needs for capital projects against the requirement that bond proceeds be spent within three years of receipt. This three-year timeframe can prove limiting given the number and magnitude of water capital projects scheduled in the 2023-2028 CIP.

The City can reimburse itself for costs incurred prior to the date a bond is issued and proceeds are received by adopting a resolution declaring the intent to seek reimbursement. This is advantageous given large-scale capital projects are susceptible to project delays. Though work is proceeding on schedule, reasons for delay may include construction material delays, supply-chain challenges, extended permitting timelines, and limited construction windows tied to favorable weather conditions, among other factors.

Eligible Expenditures

To use tax-exempt bond proceeds to reimburse the City for hard costs (e.g., construction) paid prior to the bond issuance, the City must declare its “official intent” to repay itself. The declaration must be made no more than 60 days after the construction cost has been paid. Design, engineering, and permitting or “soft” costs are not restricted by the 60-day timeframe, so long as they do not exceed 20% of the total bond proceeds.

Once official intent is established via an adopted resolution by the City Council, the “clock starts” for purposes of the City seeking reimbursements on costs related to qualifying water capital projects.

Reimbursement Period

The reimbursement window is 18-months from when the associated bond is issued, effectively extending the timeframe to use bond proceeds from three years to four-and-a-half years as illustrated in figure 1. Should circumstances change, the declaration does not obligate the City to issue a bond.

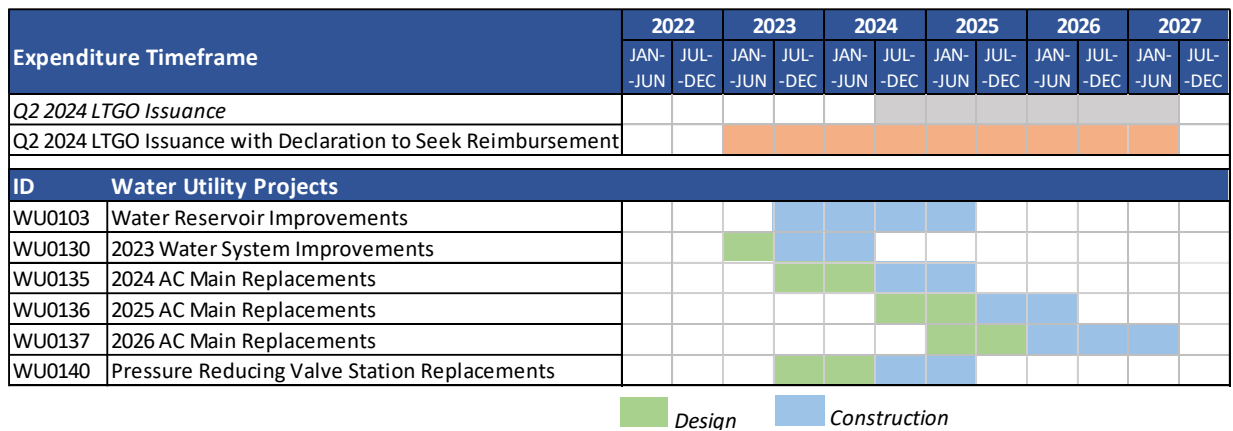


Figure 1

Staff from Public Works and Finance are closely tracking the Water Fund operating balance alongside current and upcoming capital projects that qualify for outside funding. The City began incurring construction costs for the Water Reservoir Improvements (WU0103) and the 2023 Water System Improvements (WU0130) projects this fall. Staff projects the Water Fund operating balance will remain net positive through 2023, which positions the City to conduct a \$16 M bond issuance in the first half of 2024.

NEXT STEPS

Staff will present information on the water distribution system financing strategy, answer questions related to the declaration of intent, the scheduled capital investments, and the plan to pay for these investments. Staff will return at the November 21, 2023 City Council meeting with a resolution to declare the City's intent to seek reimbursements on costs incurred prior to a bond issuance to support the water utility, scheduled in Q2 2024.

RECOMMENDED ACTION

Receive Report. No action necessary.