



Utilities Advisory Commission Staff Report

From: Kiely Nose, Interim Director of Utilities
Lead Department: Utilities

Meeting Date: March 5, 2025
Report #: 2502-4193

TITLE

Staff Recommends the Utilities Advisory Commission Recommend that the City Council Adopt a Resolution Approving the Fiscal Year 2026 Water Utility Financial Forecast including Reserve Transfers, and Amending Rate Schedules W-1 (General Residential Water Service), W-2 (Water Service From Fire Hydrants), W-3 (Fire Service Connections), W-4 (Residential Master-Metered and General Non-Residential Water Service), and W-7 (Non-Residential Irrigation Water Service)

RECOMMENDATION

Staff recommends the Utilities Advisory Commission recommend that the City Council adopt a resolution (Attachment A):

1. Approving the Fiscal Year 2026 Water Utility Financial Forecast shown in this staff report and attachments and approving a reserve transfer of up to \$3,000,000 from the Rate Stabilization Reserve to the Operations Reserve in FY 2025; and
2. Amending Rate Schedules (Attachment B) effective July 1, 2025 (FY 2026):
 - a. W-1 (General Residential Water service)
 - b. W-2 (Water Service from Fire Hydrants)
 - c. W-3 (Fire Service Connections)
 - d. W-4 (Residential Master-Metered and General Non-Residential Water Service)
 - e. W-7 (Non-Residential Irrigation Water Service)

EXECUTIVE SUMMARY

The Water Utility has two main costs: water supply costs (primarily the cost of water delivered to Palo Alto from the Regional Water System) and the costs of operating the distribution system (the system of pipes, pumps, reservoirs, and other infrastructure that carries water to Palo Alto customers). Both cost components have been increasing and are expected to continue to increase. The FY 2025 Financial Plan projected a distribution rate increase in FY 2026 of 17%, which is equivalent to a 9% overall system average increase when combined with the supply cost increases. However, given lower reserves and higher expected ongoing costs going forward, this

FY 2026 forecast reflects a 19% increase to the distribution rates, equivalent to a 10% overall system average increase on customer's water rates. This rate increase is necessary to pay for inflationary cost increases and continued lower water sales, while funding performance of the necessary infrastructure maintenance and replacement activities that contribute to the safe and reliable provision of high-quality water to Palo Alto residents and businesses.

In December 2024, staff discussed a preliminary FY 2026 rate proposal of 14% with the Utilities Advisory Commission and Finance Committee. Members from both committees expressed concerns and asked staff to reassess the FY 2026 rate increase and reduce to 10% if feasible. Staff took this feedback into consideration and made modifications to the rate proposals reflected in this report.

At the end of FY 2024, the operations reserve was approximately \$2 million below projected levels with a balance of \$7.1 million, which is below the minimum guideline level of \$8.4 million. Revenues were \$2.3 million higher than forecasted last year in the FY 2025 Financial Plan (sales revenue, capacity and connection fees). This is because water purchases were higher than forecasted in the FY 2025 Financial Plan while purchases were still lower than in each of the pre-drought years (FY 2018 through FY 2022). Additionally, operating and capital expenses were \$4.4 million higher than forecasted. Many of the cost increases are ongoing annual expenses, as discussed further in the Analysis section below. The rate stabilization reserve at the end of FY 2024 had a \$4 million balance, and this financial forecast proposes to use all of that remaining funding to cover the unexpected additional costs for FY 2025 and 2026.

The Water Utility needs to plan for large capital projects in the five-year budget, including two reservoir replacements or rehabilitations and a large main replacement every other year. This revised proposal defers the reservoir work by two years from FY 2027 and FY 2028 to FY 2029 and FY 2030, defers \$4 million of main replacement work planned in FY 2026 and \$3 million of main replacement work planned in FY 2028 to beyond the 5-year forecast horizon. The Water Utility has utilized or plans to use all available reserve funds to help offset higher costs and keep rates below the utility's actual expenses during both the pandemic and the drought, up through the current drought recovery period. However, the reserves have now reached a point where rate increases are needed to pay for distribution system costs. Staff is developing an alternative financial model assuming debt financing (instead of pay-as-you-go) for the two reservoir capital projects, summarized in the Alternative section below.

This forecast assumes no rate increase for the wholesale water rate in July 2025 from its current level of \$5.67/CCF (consistent with the April 12, 2024 rate notice from the City's water supplier, the San Francisco Public Utilities Commission (SFPUC)). This forecast also relies on the April 12, 2024 SFPUC wholesale rate increase projection of 3.4% in FY 2027, 7.5% in FY 2028, and 5.4% in FY 2029. Staff assumed a 4% inflationary wholesale rate increase in FY 2030. However, SFPUC's

latest estimate is for a rate increase in July 2025 between 0.9% and 5.6%.¹ SFPUC's wholesale rate projection is subject to change with high uncertainty. SFPUC typically decides on the final wholesale rate increase in May. Staff plans to hold the proposed rate increase at 10% irrespective of the final wholesale rate increase by deferring additional distribution system capital work to be consistent with the Finance Committee and UAC Commissioner's preference for a water rate increase of no more than 10%. With a wholesale water rate increase of 0.9% to 5.6% this July, additional capital deferrals of approximately \$0.5 million to \$1.5 million would be necessary to maintain the overall water rate increase at 10%. Deferring capital work increases the cost to complete the same capital work because of construction inflation, and deferring the work may increase maintenance costs and emergency repairs as a result of older water mains. Table 1 shows the projected overall average system rate increase is 10% per year from FY 2026 through FY 2030. As shown in Table 1, the Water Utility requires distribution rate increases between 12% and 19% per year through FY 2030 to provide sufficient revenues to fund annual expenses for the distribution system and capital improvements.

Table 1: Projected Water Rate Trajectory from FY 2026 to FY 2030

| Fiscal Year | 2026 | 2027 | 2028 | 2029 | 2030 |
|-------------------------|--------------------|-------------|-------------|-------------|-------------|
| Current Projection | 10% | 10% | 10% | 10% | 10% |
| SFPUC Projection | Range: 0.9% - 5.6% | 3% | 8% | 5% | - |
| Distribution Projection | 19% | 15% | 12% | 12% | 13% |

Table 2 shows the Water Utility rate trajectories with debt financing for the two tank replacements/rehabilitations.

Table 2: Alternate Water Rate Trajectory from FY 2026 to FY 2030

| Fiscal Year | 2026 | 2027 | 2028 | 2029 | 2030 |
|-------------------------|--------------------|-------------|-------------|-------------|-------------|
| Current Projection | 10% | 10% | 10% | 8% | 7% |
| SFPUC Projection | Range: 0.9% - 5.6% | 3% | 8% | 5% | - |
| Distribution Projection | 19% | 15% | 12% | 9% | 9% |

BACKGROUND

This staff report provides the UAC with a financial forecast for the Water Utility and provides an overview of the utility's operating costs, capital costs, and debt and includes recommended rate adjustments required to maintain the utility's financial health. Attachment D contains a set of Reserves Management Practices describing the reserves. This work is done annually as part of the budget and rate-setting cycle.

Water usage and revenues declined in FY 2022 and FY 2023 as customers successfully conserved

¹ January 21, 2025 Estimated Fiscal Year 2025-26 Wholesale Water Rate Range

water in accordance with local, regional and state calls for water conservation. When the drought ended in FY 2024, water usage and sales revenue began to increase gradually. Some of the water conservation achieved during the drought will be permanent, and staff expects water sales will continue to gradually rebound before resuming a long-term decline. The lower revenue has been managed using \$5 million from the water rate stabilization reserve in FY 2023 and FY 2024 and approximately \$7 million from the water operations reserve from FY 2022 through FY 2024 to cover the utility's costs. By drawing down reserves, the City has been able to keep the overall water bill increase lower than 4% annually on average while wholesale supply rates increased 16% in FY 2023, 10% in FY 2024 and an additional 9% in FY 2025. The Finance Committee reaffirmed its support for this approach on April 23, 2024 when it voted unanimously to limit the overall system average water rate increase to 9.5% in FY 2025 while reducing reserve funds available in FY 2026 and future years.²

Between FY 2019 and FY 2024, the Water Utility implemented average annual rate increases of 3.7% (bringing the average monthly bill for a residential customer using 9 CCF per month from \$86.59 in FY 2019 to \$103.68 in FY 2024). However, sales revenue grew at an average rate of only 1.3% annually due to the drought, drought recovery period and other factors that contribute to variability in customer water consumption such as weather, and water conservation programs. The Water Utility's operating costs during this time period grew by 8.2% annually while capital costs fluctuated from year to year. This FY 2026 forecast projects increases in capital and operational costs that average approximately 5% - 6% per year over the next five years. Water Utility revenues are currently below costs and rate increases are necessary to increase the utility's revenues over time to bring revenues in line with costs as well as to recover costs that are increasing over time.

ANALYSIS

Past Trends

Attachment C: Water Utility Financial Forecast Detail shows how costs have changed during the last five years as well as how staff projects they will change over the next five years. Expenses for the Water Utility rose by 3.8% annually on average between FY 2019 and FY 2024. The increases were primarily related to operations costs. SFPUC held its wholesale water rate at \$4.10 from July 2016 to June 2022 and then increased the rate to \$4.75 on July 1, 2022, to \$5.21 on July 1, 2023, and to \$5.67 on July 1, 2024. Operations costs other than purchased water and CIP increased by about 10.4% annually from FY 2019 to FY 2024, due to increases across all categories of operations cost including administration, resource management, engineering, operations and maintenance, and customer service. CIP costs have generally risen, though they have decreased in some years. At the end of FY 2024 there was \$12.2 million of CIP Reappropriations and

² Finance Committee April 23, 2024, Action Minutes

<https://cityofpaloalto.primegov.com/Public/CompiledDocument?meetingTemplateId=15050&compileOutputType=1>

Commitments budgeted in previous years and carried over to FY 2025 due to multi-year engineering design and construction projects.

Water system losses in FY 2024 were estimated to be 272,753 CCF or 6.2%. At \$5.21 per CCF, this is \$1.4 million that is not passed through to customers through the commodity charge and is paid for by distribution rates. Each year CPAU completes a water audit, validated through an external auditor specialist, and submits this to the California Department of Water Resources. Palo Alto's baseline real water loss rate is 24.6 gallons per capita per day (based on the years 2017 – 2020), which ranks within the top half of California's urban water suppliers. Nevertheless, deferring main replacement over time could increase Palo Alto's water loss.

Table 3 shows the FY 2024 actual costs and revenues compared to the FY 2025 Financial Plan forecast. Sales revenue was 1.7% (\$0.85 million) higher than forecasted in last year's financial plan. Similarly, water purchase costs were 2.2% (or \$0.26 million) higher than forecast. Other revenues were nearly \$0.9 million higher than forecasted in the FY 2025 Financial Plan due to higher interest income (\$0.17 million), higher service connection fees (\$0.65 million), and higher capacity fees (\$0.12 million).

Operating expenses other than water purchases were higher than expected due to increased allocated charges (general fund charges were \$0.17 million higher than forecasted, utilities admin fund charges were \$0.59 million higher). Additionally, operations and maintenance costs were \$1.16 million higher, engineering (operating) costs were \$0.1 million higher, and customer service costs were \$0.13 million higher than forecasted in the FY 2025 Financial Plan. The increase in operations and maintenance costs is in part due to Lead and Copper Rule implementation work that required additional staffing in FY 2024 on a temporary basis as well as equipment vehicle purchase increases of \$0.45 million. Additionally, the increases across operation cost categories are a result of a lower number of vacancies in FY 2024 compared to FY 2023. As of June 30, 2024, the Utilities Department filled 12 positions compared to FY 2023, which brought vacancies down from 49 to 37.

Projected CIP costs for FY 2024, including CIP reappropriations and commitments, totaled \$22.1 million in the FY 2025 Financial Plan. Actual spending in FY 24 was \$11.13 million with \$12.25 million in CIP reappropriations and commitments at year end, which totals \$23.38 million, or an increase of approximately \$1.3 million or 5.7%.

Table 3 summarizes the variances from forecast.

Table 3: FY 2024 Actual Results vs. Prior Year's Forecast

| | Net Cost/ (Benefit) (\$000) | Type of change |
|--|--|---------------------------|
| Higher sales revenues | \$(853) | Higher revenues |
| Higher other revenue | \$(863) | Higher revenues |
| Capital-related costs including CIP reappropriations/commitments | \$1,272 | Cost increase |
| Water purchases higher than expected | \$268 | Cost increase |
| Operating expense higher than expected | \$2,811 | Cost increase |
| Net Cost / (Benefit) of Variances | \$2,635 | Net cost increase |

Projections

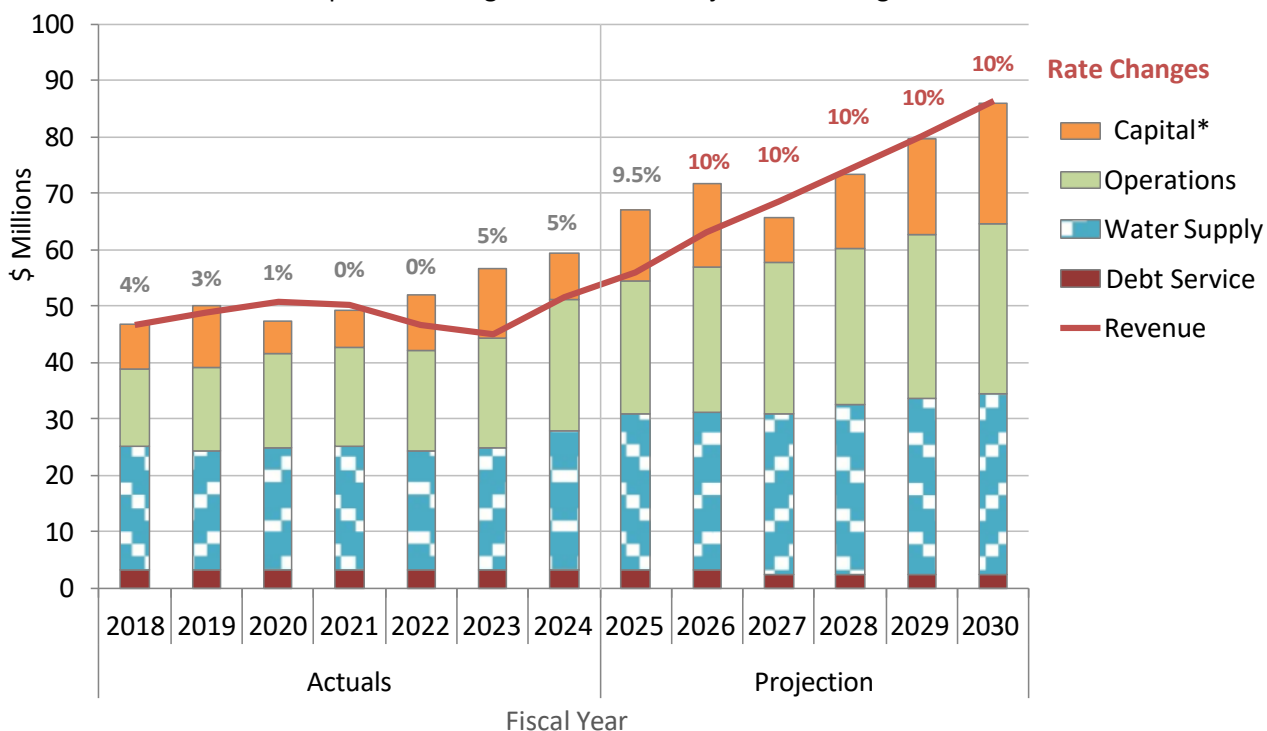
Overview

This forecast anticipates that water supply costs will increase 3% annually on average over the forecast period FY 2025 – FY 2030. Staff projects operations costs other than debt service to increase by 4% annually on average and capital contributions to the CIP Reserve to increase 17.1% on average each year. This increase is calculated based on an average of FY 2025 and FY 2026 compared to an average of FY 2030 and FY 2031. The increase in the capital contributions to the CIP Reserve appear high because of the capital deferrals in the near term, together with deferring the tank replacements to FY 2029 and FY 2030, making the capital costs high in those years. While staff has revised future CIP costs upwards to reflect the higher construction costs seen in recent projects, there is still uncertainty with regard to the utility's future costs for water main replacements. Debt service costs are declining during the FY 2025 – FY 2030 time period because the 2011 Utility Revenue Refunding Bond, Series A, is scheduled to be retired in 2026.

The FY 2025 Financial Plan estimated a 5-year capital project budget for FY 2025 through FY 2029 of \$54.2 million (not including carry-forward budgets from prior years). Staff currently projects a higher capital project budget of \$58.7 million is needed (an increase of \$4.5 million or 8%) for those same years. However, to maintain no more than a 10% rate increase in each year, this forecast reduces the size of the next two upcoming main replacement projects in FY 2026 and FY 2028 by \$4 million and \$3 million, respectively. Additionally, this forecast defers the two reservoir replacement/rehabilitations from FY 2027 and FY 2028 to FY 2029 and FY 2030 which increases the total cost by \$1.6 million or 10.4% due to construction inflation, but also lengthens the time available to build reserves to pay for these replacements. Staff developed an Alternative section in this staff report which describes an alternative funding model where the tank projects are debt-financed rather than pay-as-you-go which would allow for the full main replacement budget in FY 2028 as well as reducing the impact on customer rates during FY 2029 and FY 2030.

This forecast utilizes the full \$4 million remaining in the Rate Stabilization Reserve at year-end FY 2024 by the end of FY 2026 to stabilize rates and cover operational and capital costs.

Figure 1: Water Utility Expenses, Revenues, and Rate Changes:
Actual Expenses through FY 2024 and Projections through FY 2030



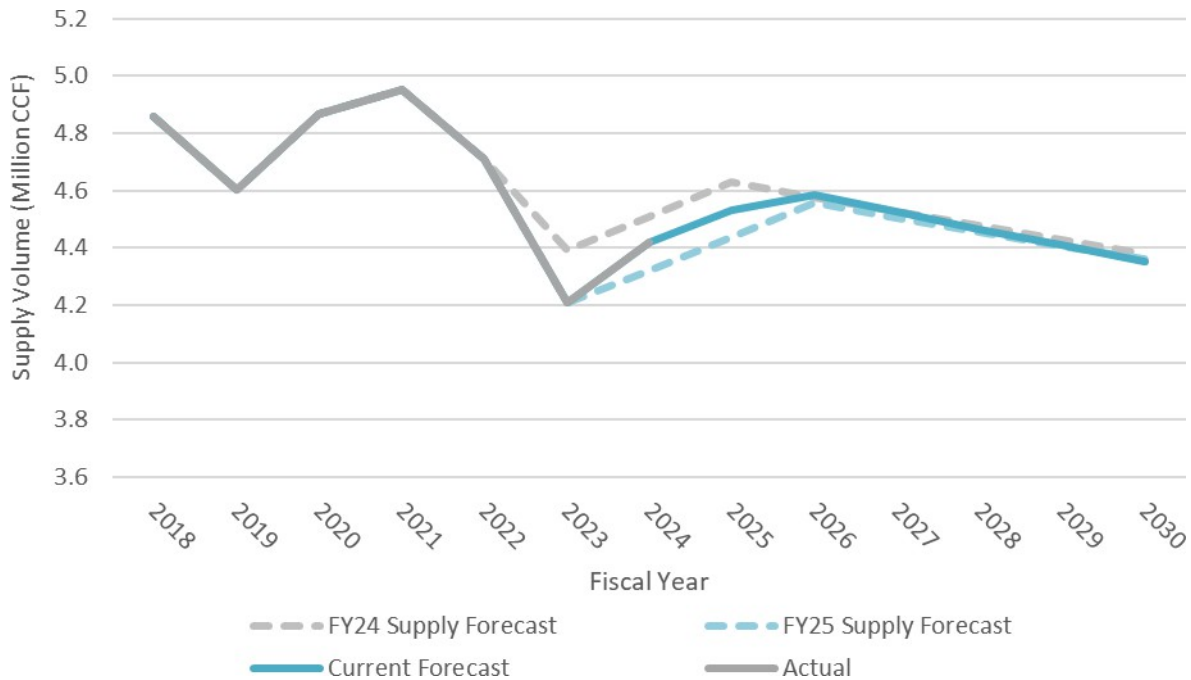
* Note: in Figure 1, Capital in the projected years reflects one-time transfers from the Operations Reserve to the CIP Reserve, the annual capital program contribution to the CIP Reserve, as well as increases in the CIP Reappropriations and Commitments Reserve.

Load Forecast

Actual water sales in FY 2024 were 1.8% higher than forecasted in the FY 2025 Financial Plan. Similarly, actual sales revenues for FY 2024 were approximately \$0.8 million (1.8% higher) than projected (\$48 million vs. \$47.2 million). The plan assumed an end to the drought by the end of FY 2023 with water sales recovery from FY 2024 to FY 2026. The drought recovery in FY 2024 was better than expected, and system losses slightly improved from 8.2% in FY 2023 to 6.2% in FY 2024.

The current forecast begins with the most recent water purchases from FY 2024 (a year with close to average precipitation) and assumes a drought recovery over three years from FY 2024 to FY 2026, followed by a return to the pre-drought long-term decline trend of 1.3% annually based on the average decline from FY 2005 to FY 2024. This forecast assumes a 3-year average water loss for FY 2022 through FY 2024.

Figure 2: Water Purchases Forecast



Revenues

Staff based the sales revenue projections on the load forecast and the projected rate changes shown in Figure 2. Precipitation can vary substantially, and this can affect revenues substantially. In dry, non-drought years customers use more water, increasing revenues, and in wet years they use less. It is difficult to predict customer usage recovery from drought together with impacts from weather from year to year. Staff will continue to monitor these patterns and adjust projections accordingly in subsequent forecasts.

The Water Utility receives most of its revenues from sales of water. In FY 2024 the Water Utility also received approximately 7% of total revenue from a combination of other sources including service connection fee and capacity fee revenue, interest income, and grants (interest subsidy on Build America Bonds). Other sources of revenue are projected to remain stable during the forecast period.

Expenses

Water Purchase Costs

CPAU purchases all of its potable water supplies from the SFPUC, which owns and operates the Hetch Hetchy Regional Water System (RWS). The RWS begins with a system of reservoirs and tunnels in the high Sierra in Tuolumne County and water is transported by a gravity-fed pipeline to the Bay Area. CPAU is one of 26 agencies that purchase water from the SFPUC, all of whom are members of the Bay Area Water Supply and Conservation Agency (BAWSCA). These agencies, including the City, are frequently referred to as the “wholesale customers” (as compared to the

SFPUC's "retail customers" in San Francisco). Palo Alto uses roughly 7% of the water delivered by the SFPUC to BAWSCA member agencies.

For many years, the largest cost increases have been on the water supply side. This is due primarily to major capital investments the SFPUC has made since 2010, which were undertaken partly due to pressure from wholesale customers. The Water System Improvement Program (WSIP) is a \$4.8 billion capital improvement program, one of the largest in the country, to rehabilitate and seismically strengthen the lower portions of the RWS. One of the goals is to achieve the capability to return to service within 24 hours after a major earthquake. Although much of the work is complete, some of the projects are still under construction and bond financing of WSIP projects over the next several years will continue to drive wholesale rates up. Parts of SFPUC's system not included in the WSIP will also need rehabilitation as part of SFPUC's CIP program. Some of these projects are already included in the SFPUC's rate projections, such as additional Transmission, Supply, Storage and Treatment system upgrade projects, and dam safety work.

SFPUC provides 30 days' written notice to Palo Alto before its Commission meeting to increase wholesale rates, which typically occurs in May. SFPUC also provides a wholesale rate increase estimate in February. SFPUC's latest rate forecast from January 2025 is for a rate increase in January 2025 between 0.9% and 5.6%.

Operations

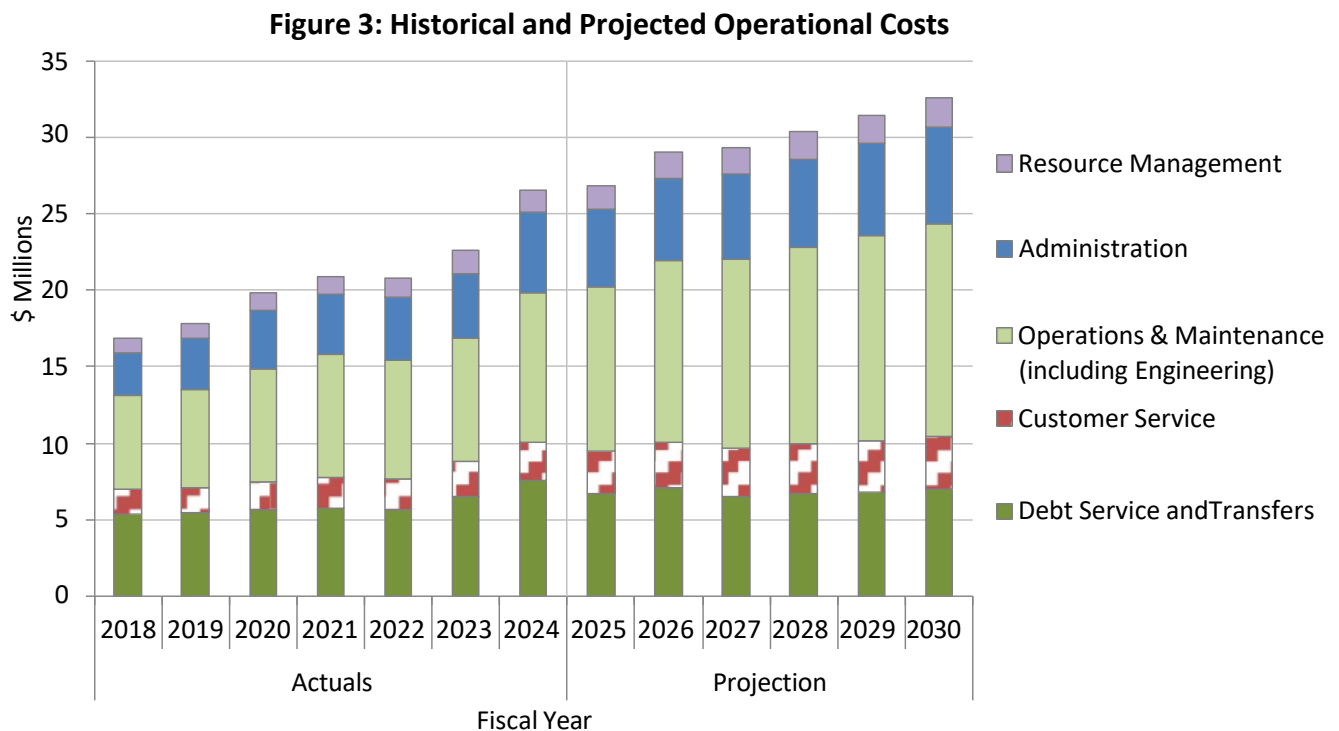
CPAU's Water Utility operations include the following activities:

- Administration, a category that includes charges allocated to the Water Utility for administrative services provided by the General Fund and for Utilities Department administration, as well as debt service and other potential transfers.
- Customer Service
- Engineering work for maintenance activities (as opposed to capital activities)
- Operations and Maintenance of the distribution system; and
- Resource Management

From FY 2019 to FY 2024, overall operations costs increased 8.2% per year on average. Resource Management costs increased 8.2% per year on average while customer service increased by 9.4% and administration increased 7.5%. Operations and Maintenance increased 8.9% annually on average while Engineering (Operating) increased by 10.7% per year on average. Some of these increases are due to one-time costs in FY 2024 including increased salaries and benefits to staff lead and copper rule testing as well as a one-time transfer out true-up that occurred in FY 2024.

Staff anticipates inflationary increases for operations costs of 4% per year, on average, over the forecast period. For salary and benefit assumptions, this forecast uses an assumption of 5% annual average increase from FY 2024 actuals to FY 2030, which is consistent with the 3-year average increase in salaries and benefits from FY 2021 to FY 2024 of 5% per year on average. Additionally, the forecast includes an adjustment for new staff for cross-connection control from

the FY 2025 budget. This forecast improves the method for allocated charges projections (shown in the Administration category in Figure 3) by using adopted FY 2025 budgets and Long-Range Financial Forecasts where possible. This forecast adjusts adopted numbers if there is a pattern of under or over-spending by category.



Capital Improvement Program

The Water Utility's CIP consists of the following types of projects.

- Non-recurring construction projects (One Time Projects) of large system assets, such as the seismic retrofit projects, and the emergency water storage project. Currently there are no alternative water supply projects included in the budget but if Council decides to move forward with any such project in the future, it would fall within this project type.
- The Water Main Replacement Program, which represents the ongoing replacement of aging water mains and main appurtenances.
- Ongoing projects:
 - Water distribution system improvements are projects improving the reliability and operations of the water distribution system. The projects include but are not limited to engineering studies, hydraulic modeling, leak survey, hydrant maintenance, and pipe strength sampling.
 - Water supply improvements are projects maintaining and improving the water supply within the City's distribution network and to individual pressure zones. The projects include but are not limited to emergency diesel generators, power supply projects, communications and controls, water quality engineering, site security, and engineering studies.

- Water metering improvements are projects replacing water meters, testing, and improving accuracy of the City's water metering.
- New Development Improvements (customer connections) are projects funded or constructed by private developers and property owners. The projects may include new services, hydrants, and other water system improvements necessary to support new development and new water demand.

Table 4 shows the FY 2025 projected current year budget and the five-year CIP spending plan, although these figures are preliminary pending ongoing budget discussions.

Table 4: Budgeted Water Utility CIP Spending (\$000)

| Project Category | Current Budget* | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 |
|--------------------------|-----------------|--------------|--------------|---------------|---------------|---------------|
| One Time Projects | 1,864 | - | - | - | 8,776 | 7,776 |
| Water Main Replacement** | 7,491 | 5,407 | 472 | 7,438 | 682 | 11,886 |
| Ongoing Projects | 7,314 | 2,040 | 2,154 | 2,213 | 2,289 | 2,348 |
| Customer Connections | 973 | 989 | 1,019 | 1,100 | 1,100 | 1,100 |
| TOTAL | 17,642 | 8,436 | 3,645 | 10,751 | 12,847 | 23,110 |

*Includes unspent funds from previous years carried forward or reappropriated into the current fiscal year

** Reflects \$4 million deferral in FY 2026 and \$3 million deferral in FY 2028

The Ongoing Projects budget is larger in FY 2025 than in the other years because the budget includes \$0.7 million for a generator purchase and a 3-year maintenance plan as well as \$2.8 million for security cameras. Of the \$7.3 million current budget for ongoing projects, \$4.9 million is already reflected in the reappropriations or commitments reserves. The CIP budget additionally includes allocated overhead, estimated to be approximately \$1.1 million in FY 2025 and escalating at 4% - 6% annually thereafter as shown in the Table 5. Table 5 also shows the forecast for unallocated CIP-related salaries and benefits, estimated to be \$0.9 million in FY 2025. Allocated overhead and unallocated salaries and benefits are added to the capital budget.

Table 5: Allocated Overhead and Unallocated CIP Salaries and Benefits (\$000)

| | FY 2025 | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 |
|---------------------------------------|---------|---------|---------|---------|---------|---------|
| Allocated Overhead | 1,062 | 1,266 | 1,317 | 1,370 | 1,424 | 1,481 |
| Unallocated CIP Salaries and Benefits | 894 | 1,066 | 1,108 | 1,153 | 1,199 | 1,247 |

The water system consists of over 231 miles of mains, approximately 2,000 fire hydrants, and over 20,000 metered service connections spanning 9 pressure zones over a 26 square mile service area. Since the Water Main Replacement Program began in 1990, CPAU has replaced 61 miles or 26% of the most leak-prone and deteriorated water mains. CPAU continues to pursue a pipe replacement program of mains nearing the end of their useful life.

The water main replacement schedule in this forecast will require CPAU to defer \$7 million in main replacement work to beyond the 5-year planning period which will mean extending the timeline for replacing water mains. Deferring capital work increases the cost to complete the same capital work

because of construction inflation, and deferring the work may increase maintenance costs and emergency repairs as a result of older water mains.

Additionally, costs for the water main replacement program are increasing for a variety of reasons:

- Construction costs in the San Francisco Bay Area have increased substantially, outpacing the consumer price index for all urban consumers. Additionally, material, fuel, and labor costs have escalated due to inflation, leading to higher bids.
- More stringent traffic control requirements have driven cost increases: requirements for engineered traffic control plans, restricted working hours, maintaining pedestrian right of ways, bike lanes during construction, and special street plating requirements.
- Street cut fees.
- Code changes to fire flow requirements requiring larger diameter mains.
- CPAU has switched to high-density polyethylene (HDPE) for its water mains for leak reduction and seismic performance.

These factors have created some uncertainty in future water main replacement costs. As bids for recent projects have consistently come in higher over the past decade, the scope of main replacement has been reduced. In the 1990s, the City replaced on average two miles of pipe per year. The pipe replacement rate in recent years has dropped to less than one mile per year. Future main replacement project budgets have been increased to reflect cost inflation. Budgets will need to be revised further to replace the water system's pipes before the end of their useful life. From 1990 to 2000, the long-term water main replacement program focused on replacing all 4" cast iron pipes, the smallest and most susceptible pipe to corrosion, leakage, and failure. In 2000 the program was expanded to include other pipe materials. In 2015, CPAU completed a pipe replacement master planning process identifying and prioritizing seismically vulnerable pipe. Preparing for the future, CPAU is preparing an RFP for a comprehensive capital improvement plan and a new prioritization for the water main replacement program.

To maintain its current main replacement scope, CPAU needs approximately \$8.5 million every other year for water main replacement construction, assuming inflation of 5.4% annually on the main replacement budget, which is derived from a linear trend of historical CIP cost increases. However, due to the need to limit the overall water rate increase for FY 2026, this forecast reduces the next two main replacement budgets by \$4 million and \$3 million, respectively. In the longer-term, CPAU will need to restore the main replacement budgets and catch up on the main replacement projects in order to meet the main replacement needs of the water system.

Included in the one-time project budget are seismic water system upgrades and/or replacement for the Park and Dahl Tanks, two water distribution storage reservoirs located in the Palo Alto Foothills. This work will improve protection from water loss and damage to these storage tanks during seismic events. Significant earthquake damage could lead to a loss of water for firefighting, sanitation, and domestic and commercial drinking water uses. A rupture and failure of the storage tanks during an earthquake could cause property damage, mudslides, and environmental damage. Staff contracted with an engineering specialist and investigated and analyzed the structural integrity and condition of the Park Tank Reservoir. The engineering specialist recommended a full roof replacement of the Park Tank Reservoir in addition to a seismic retrofit of the tank. Staff solicited proposals for an engineering firm to prepare plans and cost estimates for the seismic retrofit and roof replacement of Park Tank and to perform a condition assessment of Dahl Tank. If full tank replacement is needed for either Dahl or Park Tank, the estimated cost for design and construction of Dahl and Park reservoirs is approximately \$7 million each. This forecast

defers this work from FY 2027 and FY 2028 to FY 2029 and FY 2030. The cost to replace tank roofs and seismically retrofit the tanks is approximately \$4 million per tank. Staff is evaluating the replacement or rehabilitation needs of these two tanks. These tanks are part of Palo Alto's water distribution system located in the high fire threat area in the California Public Utilities Commission (CPUC) State Fire Map west of Highway 280 in the foothills.

Ongoing projects are expected to cost approximately \$2.0 and \$2.3 million annually through the end of the forecast period. Actual expenses vary each year based on operational needs. Customer connection expenses vary each year based on the level of development and redevelopment, which drives the need for water service replacements or upgrades. Property owners pay a fee for water distribution system replacement or expansion during redevelopment, so when the number of projects go up (meaning higher costs for this activity), so does fee revenue.

Aside from customer connections, the CIP plan for FY 2025 to FY 2030 is funded by revenue from utility rates and capacity fees. Attachment C: Water Utility CIP Financial Table shows the details of the plan.

Figure 4 shows the projected CIP Reserve balances from FY 2025 through FY 2030. Figure 5 shows the projected CIP expenditure fluctuating from year to year with the staggered main replacement schedule and one-time reservoir replacements/rehabilitations, relative to the steadier capital program contributions to the CIP Reserve. Additional one-time transfers from the operations reserve will fund the tank rehabilitations/replacements. This forecast defers the tank rehabilitation/replacements from FY 2027 and FY 2028 to FY 2029 and FY 2030. The Water Utility may refine the timing of the tank projects to space them out by at least one year to ensure one is fully operational before the second is decommissioned and eliminate the spike in CIP spending shown below in Figure 5. Attachment C: Water Utility Financial Table shows the amount of the capital program contributions under "Expenses" for FY 2025 through FY 2030.

Figure 4: Projected CIP Reserve Balances FY 2025 to FY 2030

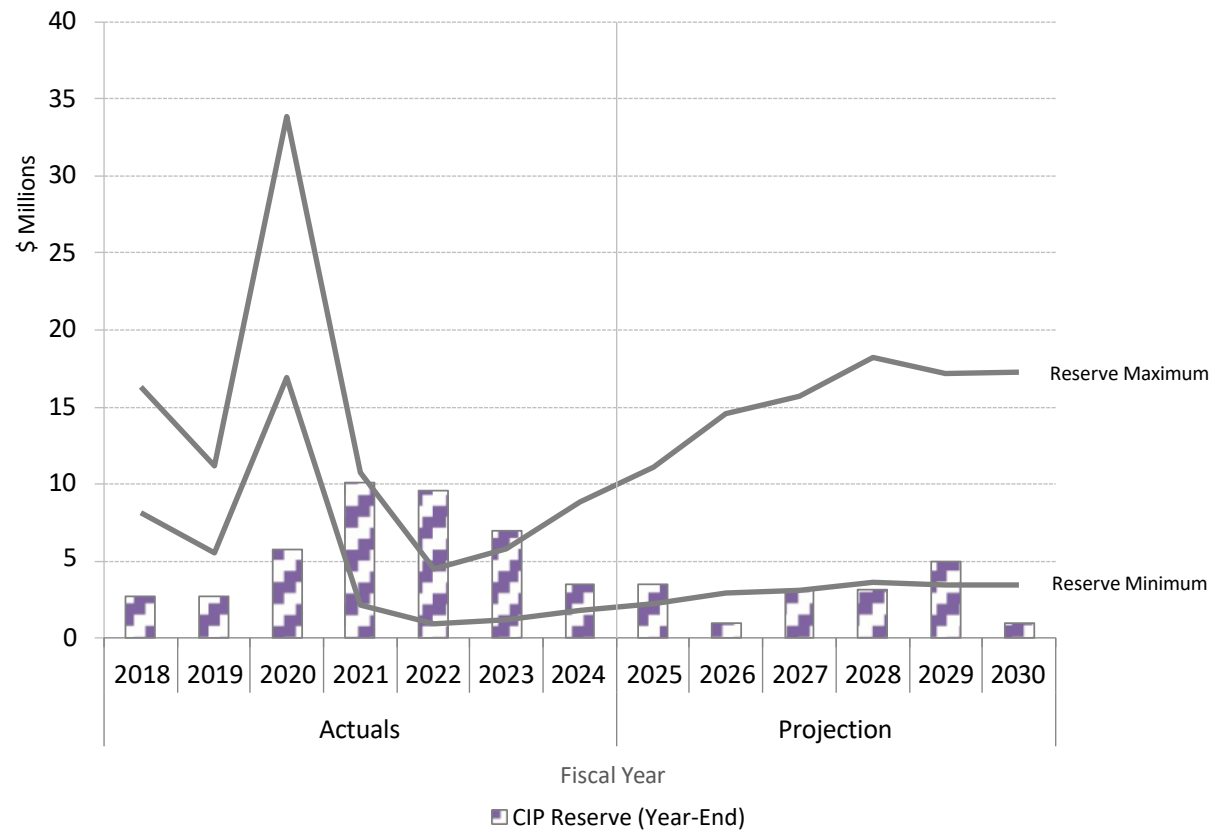
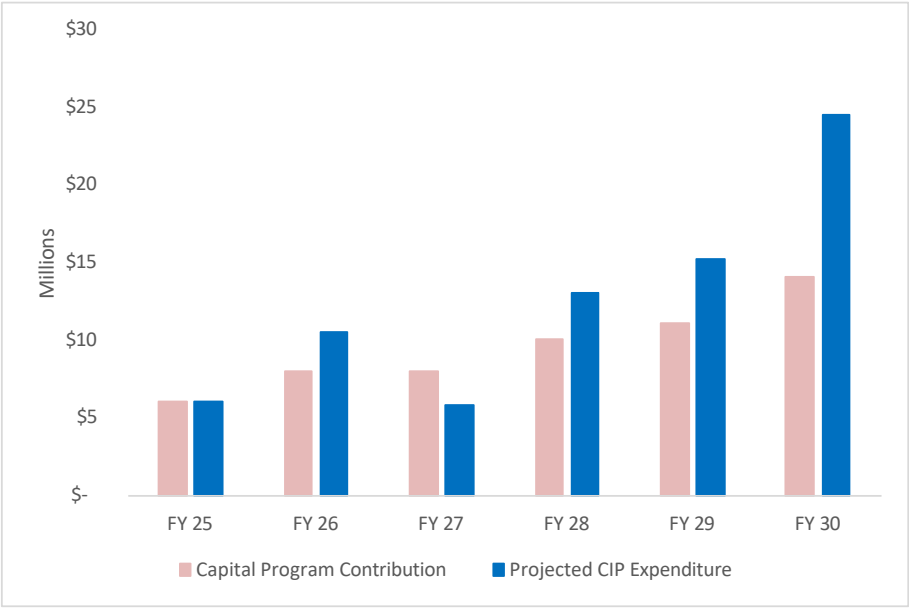


Figure 5: Projected CIP Expenditure, and Projected Capital Program Contribution, FY 2025 to FY 2030



Debt Service

The Water Utility's annual debt service is roughly \$3.2 million per year, which is offset by a federal subsidy of approximately \$300K to \$430K annually. The debt service is associated with two bond issuances, one requiring payments through 2026, the other through 2035. CPAU is in compliance with all covenants on both bonds.

The first bond is the 2009 Water Revenue Bond, Series A, issued for \$35 million to finance construction of the Emergency Water Supply and Storage project (the El Camino Reservoir, new wells, and rehabilitation of existing wells and tanks) which will be retired by 2035. As part of the 'Build America' bond program, there is an interest payment subsidy from the Federal Government of 33 to 35%.

The second bond issuance is the 2011 Utility Revenue Refunding Bond, Series A, which is to be retired in 2026. This \$17.2 million issuance refinanced an earlier Water and Gas Utility bond issuance, the 2002 Utility Revenue Bonds, Series A, which was issued to finance various capital improvements for both systems. The Water Utility's share of the issuance was roughly \$7.8 million.

Table 6 shows the cost of debt service for the Water Utility's share of these bond issuances for the financial forecast period:

Table 6: Water Utility Debt Service (\$000)

| | FY 2025 | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 |
|--|---------|---------|---------|---------|---------|---------|
| 2009 Water Revenue Bond, Series A (net of subsidy) | 2,181 | 2,201 | 2,225 | 2,251 | 2,280 | 2,316 |
| 2011 Utility Revenue Refunding Bond, Series A | 654 | 656 | 0 | 0 | 0 | 0 |
| Total | 2,835 | 2,857 | 2,225 | 2,251 | 2,280 | 2,316 |

Both the 2009 and 2011 Bonds include the following covenants: 1) net revenues plus Available Reserves shall at least equal 125% of the maximum annual debt service, and 2) Available Reserves shall be at least 5 times the maximum annual debt service. Note that "Available Reserves," as defined for both bonds, include the reserves for the Gas and Electric systems, not just the Water system. This forecast maintains compliance with these covenants throughout the forecast period, as shown in Attachment C: Water Utility Financial Forecast Detail.

Reserves

Staff expects the Water Operations Reserve, the main contingency reserve for the water utility, to continue to fall further below the minimum guideline range in FY 2025 and FY 2026 and then return to within the guideline range in FY 2028 and going forward (Figure 6). Staff projects the Operations Reserve to exceed the short-term risk assessment level throughout the forecast period (Figure 6). If additional funding is needed to address all identified risks discussed in the risk assessment discussion, the water utility could investigate financing options, as described later in this report, or explore other measures to address the funding needs. Figure 7 shows the

Water Utility's year-end reserve balances from FY 2024 through FY 2030 and Table 7 summarizes the Water Utility's reserve balances and transfers from FY 2025 through FY 2030.

Figure 6: Operations Reserve Adequacy

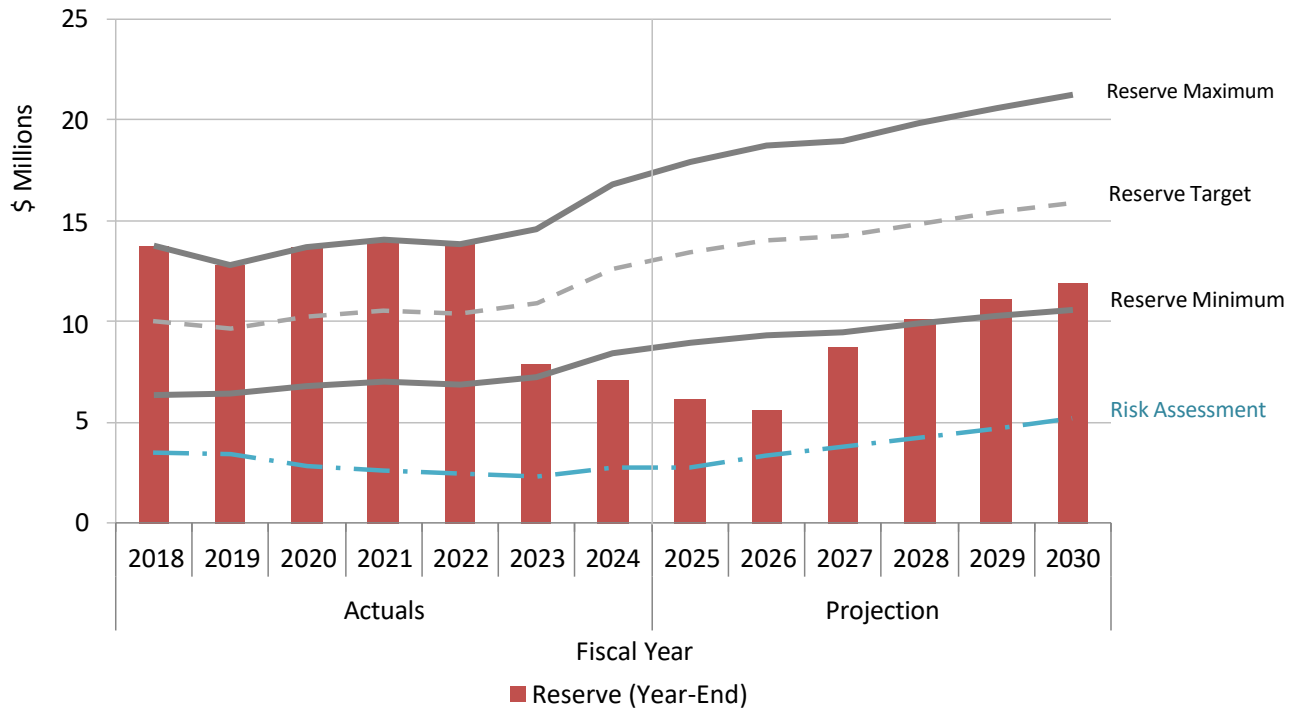


Figure 7: Water Utility Reserves
Actual Year End Reserve Levels through FY 2024 and Projections through FY 2030

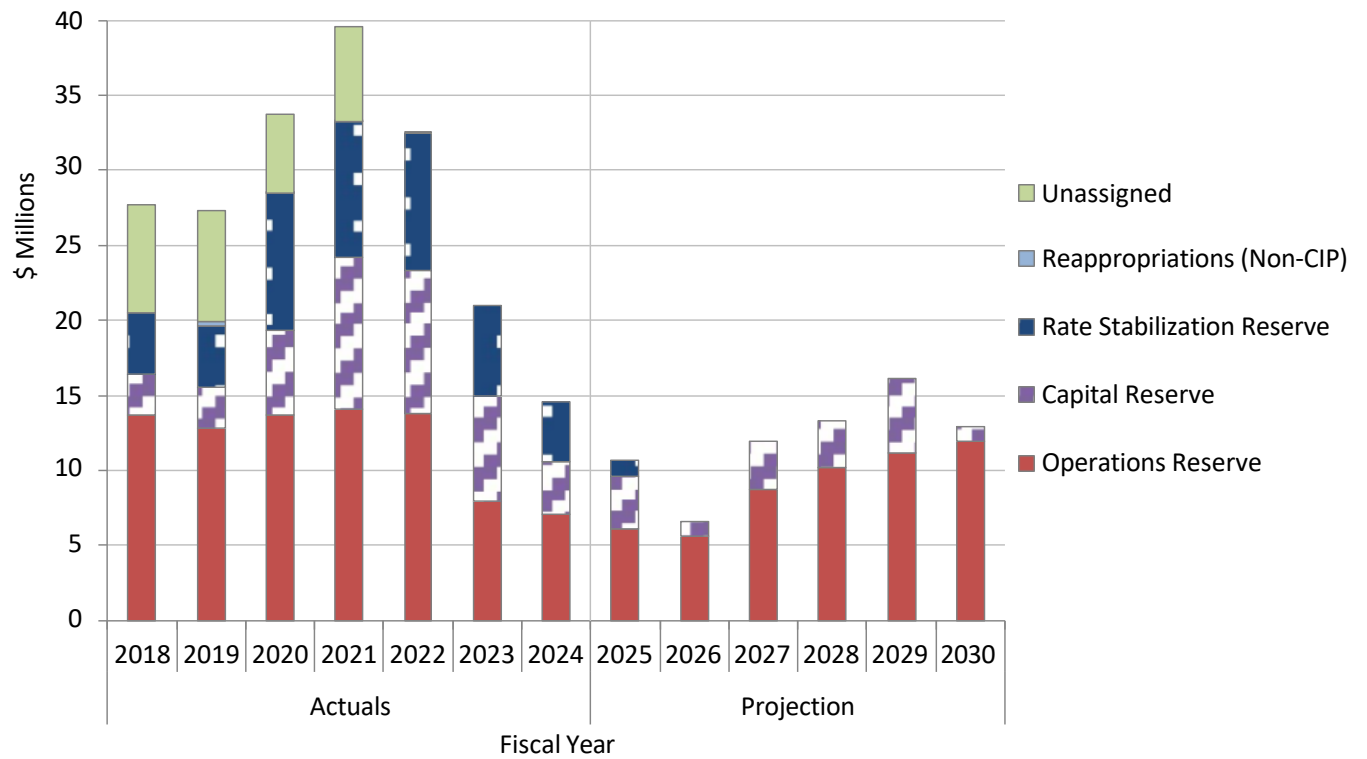


Table 7: Operations & Unassigned, Rate Stabilization and CIP Reserves Starting and Ending Balances, Revenues, Transfers To/(From) Reserves and Capital Program Contribution To/(From) Reserves Projected for FY 2025 to FY 2030 (\$000)

| | Fiscal Year | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
|------------------|--|----------|----------|----------|----------|----------|----------|
| | Starting Balance | | | | | | |
| 1 | Operations/Unassigned | 7,076 | 6,154 | 5,619 | 8,752 | 10,176 | 11,127 |
| 2 | Rate Stabilization | 4,000 | 1,000 | - | - | - | - |
| 3 | CIP | 3,500 | 3,481 | 972 | 3,171 | 3,178 | 4,998 |
| | Revenues | | | | | | |
| 4 | Total Revenue | 56,134 | 63,026 | 68,482 | 74,375 | 80,148 | 86,402 |
| 5 | Transfers In | 363 | 373 | 389 | 400 | 400 | 410 |
| | Transfers | | | | | | |
| 6 | Operations/Unassigned | 3,000 | 1,000 | - | (3,000) | (6,000) | (7,500) |
| 7 | Operating Commitments | - | - | - | - | - | - |
| 8 | Rate Stabilization | (3,000) | (1,000) | - | - | - | - |
| 9 | CIP | - | - | - | 3,000 | 6,000 | 7,500 |
| | Capital Program Contribution | | | | | | |
| 10 | Operations/Unassigned | (6,000) | (8,000) | (8,000) | (10,000) | (11,000) | (14,000) |
| 11 | CIP | 6,000 | 8,000 | 8,000 | 10,000 | 11,000 | 14,000 |
| | Expenses | | | | | | |
| 12 | Total Expenses other than CIP | (53,597) | (55,823) | (56,614) | (59,215) | (61,447) | (63,362) |
| 13 | Planned CIP | (6,019) | (10,509) | (5,801) | (12,993) | (15,179) | (25,535) |
| 14 | Transfers Out | (823) | (1,111) | (1,124) | (1,137) | (1,150) | (1,163) |
| | Ending Balance | | | | | | |
| 1+4+5+6+10+12+14 | Operations/Unassigned | 6,154 | 5,619 | 8,752 | 10,176 | 11,127 | 11,913 |
| 2+8 | Rate Stabilization | 1,000 | - | - | - | - | - |
| 3+9+11+13 | CIP | 3,481 | 972 | 3,171 | 3,178 | 4,998 | 963 |
| | Operations Reserve Guideline Levels | | | | | | |
| 15 | Minimum Guideline Level | 8,946 | 9,359 | 9,491 | 9,921 | 10,290 | 10,607 |
| 16 | Maximum Guideline Level | 17,891 | 18,718 | 18,982 | 19,842 | 20,580 | 21,214 |

* Planned CIP (item 13) is reflected as an expense in the CIP Reserve and does not include CIP funded through Reappropriations or Commitments reserves. This will be funded with the \$6 million Capital Program Contribution (item 11).

Table 8 summarizes the risk assessment calculation for the Water Utility through FY 2030. The risk assessment includes the revenue shortfall of 14% that could occur due to lower than forecasted sales revenue.

Table 8: Water Risk Assessment (\$000)

| | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 |
|---|----------------|----------------|----------------|----------------|----------------|
| Total Non-Commodity Revenue | \$35,221 | \$40,131 | \$44,449 | \$49,108 | \$54,581 |
| Max. Revenue Variance, Previous Ten Years | 14% | 14% | 14% | 14% | 14% |
| Risk of Revenue Loss | \$3,374 | \$3,844 | \$4,258 | \$4,704 | \$5,228 |
| Total Risk Assessment Value | \$3,374 | \$3,844 | \$4,258 | \$4,704 | \$5,228 |

Proposed Rates

The Water Utility's rates are evaluated and implemented in compliance with the cost-of-service requirements and procedural rules set forth in Article XIII D of the California Constitution (Proposition 218) and applicable statutory law. The City structured current rates based on staff's assessment of the financial position of the Water Utility, and updated current rates using the methodology and rate structures developed by Raftelis Financial Consultants, Inc. (RFC).³ The Water Utility's rates are based on RFC's 2019 update to the 2015 cost of service study, which reviewed the City's most recent cost of service methodologies and rate structures and declared both fundamentally sound. Before conducting any new cost of service study, staff will review current water rates and the scope of the study with the Utilities Advisory Commission (UAC) and Council to determine the City's policy priorities.

The current rates and surcharges became effective on July 1, 2024. CPAU has five water rate schedules: separately metered residential customers (W-1), commercial and master-metered multi-family residential customers (W-4), irrigation-only services (W-7), services to fire sprinkler systems in buildings and private hydrants (W-3), and service to fire hydrant rental meters used for construction (W-2). All customers pay a monthly service charge based on the size of their inlet meter. This charge represents metering, billing, and other customer service costs, and also the cost of maintaining the capability to deliver a peak flow for that customer based on their meter size.

All customers are also charged for each CCF (one hundred cubic feet) of water used. Separately metered residential customers are charged on a tiered basis, with the first 0.2 CCF per day (6 CCF for a 30-day billing period) charged at the first-tier price per CCF, and all additional units charged a higher tier price per CCF. Commercial customers, including most multi-family customers, pay a uniform price for each CCF used. A separate rate per CCF exists for separately metered irrigation service.

Water rates are composed of two general types of costs: commodity and distribution. For July 1, 2025, staff proposes to pass through any increase in the SFPUC wholesale water rate and to increase distribution rates by 19%.

Customers have a separate commodity rate for purchased water from SFPUC relative to the rest of the distribution-related portion of the volumetric rates. California Government Code Section 53756 (established by AB-3030) became effective January 1, 2009. This section of the Code authorizes public agencies providing water, sewer, and garbage services to adopt automatic pass-through rate adjustments to account for increases in wholesale water charges or wastewater treatment charges, as well as inflation. Pass-throughs must be adopted via the Proposition 218

³ RFC has developed 3 cost studies for the City: a 2019 Memorandum analyzing the 2015 methodology and rate structure, titled *Proposed FY 2020 Water Rates* <https://www.cityofpaloalto.org/civicax/filebank/documents/71892>; a 2015 study reviewing the 2012 methodology and analyzing drought rates entitled, *Memorandum: Proposed Water Rates*, <https://www.cityofpaloalto.org/civicax/filebank/documents/48398> and a March 2012 *Palo Alto Water Cost of Service & Rate Study* <https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2012/id-2676-04-18-12-1.pdf>

process and can be effective for up to five years without additional Prop 218 authorization. In 2024, Palo Alto used the Prop 218 process and the Council adopted the pass-through process effective July 1, 2024 through June 30, 2029 pursuant to Resolution [10176⁴](#). The separate commodity charge passed-through SFPUC rate increases to customers. All customers pay this separate commodity rate, currently \$5.67 per CCF, for each unit of water in addition to the volumetric rate that is applicable for their customer class. The rates shown below are in addition to the pass-through commodity rate charged to Palo Alto's customers based on SFPUC supply charges. For further information and details about the proposed commodity rate, see Water Purchase Cost section above.

Distribution rates cover all the costs to deliver water within the City, such as operations, maintenance, billing, and capital improvements. Through annual Council approvals, the water utility provides steady funding to the CIP Reserve, which reflects actual fluctuations in CIP expenditures (money spent on actual projects in a given year). Previously, CIP expenditures were reflected in the Operations Reserve. In this way, although CIP expenditures fluctuate from year to year, staff anticipates the capital program contribution to the CIP reserve to remain steady over the next five years. However, due to the deferrals of CIP reflected in this forecast, the capital program contributions are lower in FY 2025, FY 2026 and FY 2027. Additionally, the one-time reservoir replacement costs will be partly funded through one-time transfers from the Operations Reserve to the CIP Reserve. Once these reservoirs are replaced or rehabilitated, these costs will no longer be included in the ongoing CIP budget needs for the water utility.

Table 9 shows the current and proposed consumption charges, which are distribution rates.

Table 9: Current and Proposed Water Distribution Charges

| | Current (7/1/2024) | Proposed (7/1/2025) | Change (\$/CCF) | Change (%) |
|---|-----------------------|------------------------|--------------------|------------|
| W-1 (Residential) Volumetric Rates (\$/CCF) | | | | |
| Tier 1 Rates | 2.99 | 3.55 | 0.56 | 19% |
| Tier 2 Rates | 6.96 | 8.28 | 1.32 | 19% |
| W-2 (Construction) Volumetric Rates (\$/CCF) | | | | |
| Uniform Rate | 4.21 | 5.00 | 0.79 | 19% |
| W-4 (Commercial) Volumetric Rates (\$/CCF) | | | | |
| Uniform Rate | 4.21 | 5.00 | 0.79 | 19% |
| W-7 (Irrigation) Volumetric Rates (\$/CCF) | | | | |
| Uniform Rate | 6.41 | 7.62 | 1.21 | 19% |

⁴ Resolution 10176 <https://portal.laserfiche.com/Portal/DocView.aspx?id=83860&repo=r-704298fc>

Table 10 and Table 11 show the current monthly service charges for rate schedules W-1, W-4 and W-7. These monthly service charges are also considered distribution rates.

Table 10: Current and Proposed Monthly Service Charges for Residential W-1

| Meter Size | Monthly Service Charge (\$/month based on meter size) | | Change | |
|------------|---|---------------------|--------|-----|
| | Current (7/1/2024) | Proposed (7/1/2025) | \$ | % |
| 5/8" | 23.62 | 28.10 | 4.48 | 19% |
| 3/4" | 23.62 | 28.10 | 4.48 | 19% |
| 1" | 23.62 | 28.10 | 4.48 | 19% |
| 1 ½" | 76.31 | 90.80 | 14.49 | 19% |
| 2" | 118.05 | 140.47 | 22.42 | 19% |
| 3" | 250.22 | 297.76 | 47.54 | 19% |
| 4" | 445.01 | 529.56 | 84.55 | 19% |
| 6" | 911.09 | 1,084.19 | 173.10 | 19% |
| 8" | 1,676.31 | 1,994.80 | 318.49 | 19% |
| 10" | 2,650.21 | 3,153.74 | 503.53 | 19% |
| 12" | 3,485.00 | 4,147.15 | 662.15 | 19% |

Table 11: Current and Proposed Monthly Service Charges for W-4 and W-7

| Meter Size | Monthly Service Charge (\$/month based on meter size) | | Change | |
|------------|---|---------------------|--------|-----|
| | Current (7/1/2024) | Proposed (7/1/2025) | \$ | % |
| 5/8" | 20.65 | 24.57 | 3.92 | 19% |
| 3/4" | 27.62 | 32.86 | 5.24 | 19% |
| 1" | 41.53 | 49.42 | 7.89 | 19% |
| 1 ½" | 76.31 | 90.80 | 14.49 | 19% |
| 2" | 118.05 | 140.47 | 22.42 | 19% |
| 3" | 250.22 | 297.76 | 47.54 | 19% |
| 4" | 445.01 | 529.56 | 84.55 | 19% |
| 6" | 911.09 | 1,084.19 | 173.10 | 19% |
| 8" | 1,676.31 | 1,994.80 | 318.49 | 19% |
| 10" | 2,650.21 | 3,153.74 | 503.53 | 19% |
| 12" | 3,485.00 | 4,147.15 | 662.15 | 19% |

Table 12 shows the current and proposed monthly service charges for rate schedule W-3.

Table 12: Current and Proposed Monthly Service Charges for Fire Services (W-3)

| Meter Size | Monthly Service Charge (\$/month based on meter size) | | Change | |
|------------|---|---------------------|--------|-----|
| | Current (7/1/2024) | Proposed (7/1/2025) | \$ | % |
| 2" | \$4.86 | 5.78 | 0.92 | 19% |
| 4" | \$30.11 | 35.83 | 5.72 | 19% |
| 6" | \$87.46 | 104.07 | 16.61 | 19% |
| 8" | \$186.39 | 221.80 | 35.41 | 19% |
| 10" | \$335.21 | 398.89 | 63.68 | 19% |
| 12" | \$541.46 | 644.33 | 102.87 | 19% |

Bill Impact

Table 13 **Table 1** shows the impact of the proposed July 1, 2025 rate changes on the median residential bill. The system average increase is projected to be 10%, but some customers will see higher or lower increases due to changes in the composition of the customer's utilization of the system over time.

Table 13: Impact of Proposed Water Rate Changes on Residential Bills

| Usage (CCF/mo.) | Bill under Current Rates (7/1/2024) | Bill under Proposed Rates (7/1/2025) | Change | |
|--------------------|-------------------------------------|--------------------------------------|---------|-----|
| | | | \$/mo. | % |
| 4 | \$58.26 | \$64.98 | \$6.72 | 12% |
| (Winter median) 7 | \$88.21 | \$97.37 | \$9.16 | 10% |
| (Annual median) 9 | \$113.47 | \$125.27 | \$11.80 | 10% |
| (Summer median) 14 | \$176.62 | \$195.02 | \$18.40 | 10% |
| 25 | \$315.55 | \$348.47 | \$32.92 | 10% |

Table 14 shows the impact of the proposed July 1, 2025 rate changes on the median commercial bill.

Table 14: Impact of Proposed Water Rate Changes on Commercial Bills

| Usage (CCF/mo.) | Bill under Current Rates (7/1/2024) | Bill under Proposed Rates (7/1/2025) | Change | |
|--------------------------------|-------------------------------------|--------------------------------------|----------|-----|
| | | | \$/mo. | % |
| Commercial (W-4) (5/8" meters) | | | | |
| (Annual median) 12 | \$139.21 | \$152.61 | \$13.40 | 10% |
| (Annual average) 64 | \$652.97 | \$707.45 | \$54.48 | 8% |
| Irrigation (W-7) (1 ½" meters) | | | | |
| (Winter median) 9 | \$185.03 | \$210.41 | \$25.38 | 14% |
| (Summer median) 37 | \$523.27 | \$582.53 | \$59.26 | 11% |
| (Winter average) 56 | \$752.79 | \$835.04 | \$82.25 | 11% |
| (Summer average) 199 | \$2,480.23 | \$2,735.51 | \$255.28 | 10% |

Bill Comparisons/Competitiveness

Table 15 compares the current water bills for single-family residential customers in Palo Alto with those of neighboring communities. While Palo Alto is among the highest monthly bills across these communities, the difference between Palo Alto's bills and those of the surrounding cities has decreased in recent years as other agencies have increased their capital investments. Additionally, bills for smaller water users in Palo Alto are lower than in some neighboring communities. Palo Alto uses these comparison cities for benchmarking in its annual budget across all utilities.

Table 15: Single-Family Residential Monthly Water Bill Comparison, Compared to Neighboring Communities at Current Rates (\$/Month), as of January 2025

| Usage (CCF/Month) | Palo Alto | Neighboring Community Average | Neighboring Communities | | | | | |
|----------------------|-----------|-------------------------------|-------------------------|---------------|----------|--------------|-------------|-----------|
| | | | Menlo Park | Mountain View | Hayward | Redwood City | Santa Clara | Los Altos |
| 4 | \$ 58.26 | \$ 51.41 | \$ 54.34 | \$ 52.06 | \$ 49.70 | \$ 64.16 | \$ 35.60 | \$ 52.61 |
| (Winter median) 7 | 88.21 | 74.26 | 73.09 | 78.61 | 76.58 | 86.27 | 62.30 | 68.68 |
| (Annual median) 9 | 113.47 | 94.75 | 95.29 | 96.31 | 94.50 | 112.31 | 80.10 | 89.99 |
| (Summer median) 14 | 176.62 | 148.16 | 150.79 | 140.56 | 149.50 | 180.22 | 124.60 | 143.27 |
| 25 | 315.55 | 279.69 | 283.17 | 287.41 | 270.50 | 340.49 | 222.50 | 274.06 |
| % Supplied by SFPUC* | 100% | | 95% | 87% | 100% | 100% | 10% | 0% |

* Based on the FY 2013 BAWSCA survey, the percentage of SFPUC as the source of potable water supply

Alternative

Staff developed an alternative assuming debt financing (instead of pay-as-you-go) to pay for the two tank rehabilitations/replacements. This scenario still requires the deferral of \$4 million

from the Water Main Replacement project in FY 2026 but no further deferrals of necessary capital work during the five-year forecast period. Table 2 in the Executive Summary shows the Alternate water rate trajectory from FY 2026 through FY 2030.

Table 16 shows the existing debt service together with the additional assumed revenue bond for financing the two tank replacements/rehabilitations. In order to minimize costs due to construction inflation, this alternative model keeps the tank replacement construction in FY 2027 and FY 2028 with a total estimated cost of \$15 million with bond repayment beginning in FY 2028. Assuming a bond interest rate of 4.6% over 30 years, the annual debt service payment would be approximately \$0.9 million.

Table 16: Water Utility Debt Service (\$000) (Alternative)

| | FY 2025 | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 |
|---|---------|---------|---------|---------|---------|---------|
| 2009 Water Revenue Bond, Series A (net of subsidy) | 2,181 | 2,201 | 2,225 | 2,251 | 2,280 | 2,316 |
| 2011 Utility Revenue Refunding Bond, Series A | 654 | 656 | 0 | 0 | 0 | 0 |
| Hypothetical New Bond for Tank Replacement Costs | | | | 932 | 932 | 932 |
| Total | 2,835 | 2,857 | 2,225 | 3,183 | 3,212 | 3,248 |

Figure 8 shows the Water Utility's expenses, revenues, and rate changes throughout the most recent seven years and six projected years for the alternative. Note that the Operations Reserve returns to target levels by FY 2030 under the alternative (see Figure 9) and this is different than the main scenario where the Operations Reserve remains close to the reserve minimum by FY 2030. This is because rate increases in the main scenario are limited to 10% per year and tank replacements are not debt financed. The Alternative could assume lower rate increases in the outer years if the Council selects to keep reserves at similar levels as the main scenario, below target levels or below guideline levels.

Figure 8: Water Utility Expenses, Revenues and Rate Changes, Actual Costs through FY 2024 and Projections through FY 2030 (Alternative)

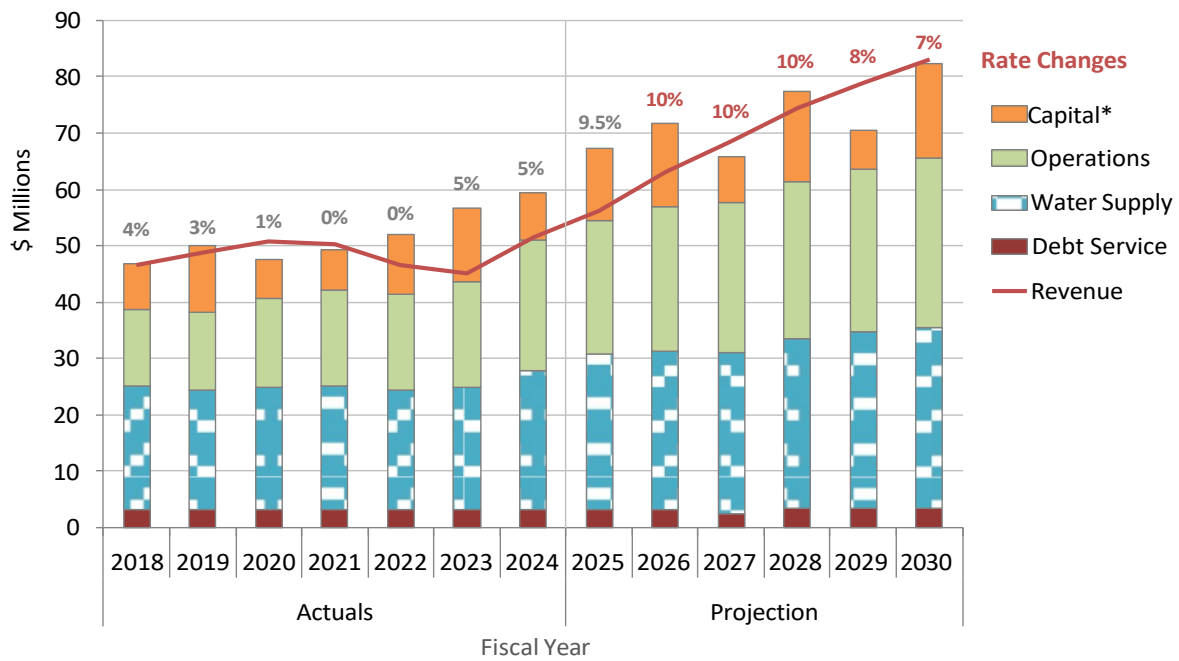
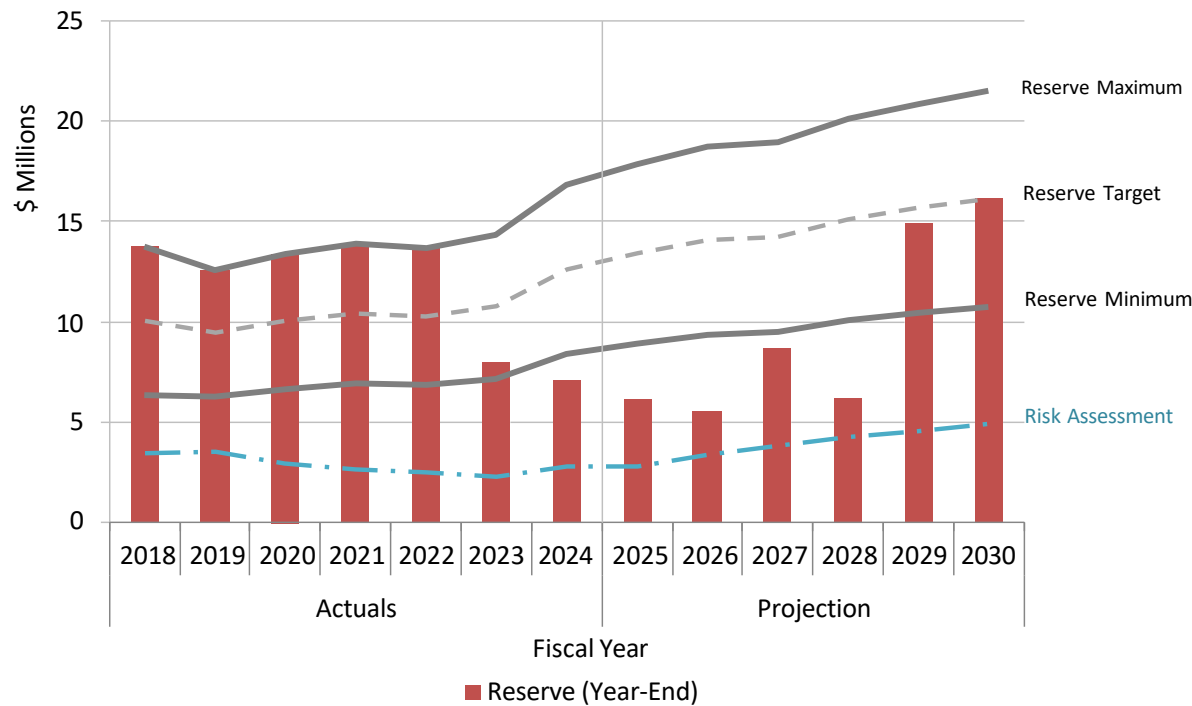


Figure 9: Operations Reserve Adequacy (Alternative)



Next Steps

The City Council will consider adopting the Financial Forecast and rate adjustments as part of the FY 2026 budget review and adoption process in June 2025. If Council approves the proposed rate changes, the rates will become effective July 1, 2025.

FISCAL/RESOURCE IMPACT

Based on the rate increases as shown, the estimated revenue impacts in FY 2026 would be an increase of \$5.6 million in the Water Fund. Utility rate increases impact the general fund because the City is a utilities customer. The impact to the general fund of these rate increases is a \$0.2 million expense increase.

POLICY IMPLICATIONS

The proposed water rate adjustments are consistent with Council-adopted Reserve Management Practices that are part of the Financial Forecast and were developed using a cost-of-service study and methodology consistent with the California Constitution and industry-accepted cost-of-service principles.

STAKEHOLDER ENGAGEMENT

On December 3, 2024⁵, staff discussed preliminary rate proposals at the Finance Committee meeting. Finance Committee members asked questions including whether the reserve guidelines levels are correct or whether we can have lower reserve levels and cautioned that messaging around the water increase will be very important. A reserve study is not currently in staff's work plan. One Committee member requested a bill comparison to Bay Area agencies that rely 100% on the Regional Water System for potable water, and staff has included that information in the presentation for this item. One Committee member suggested making it clear that Palo Alto customers benefit both from Regional Water System water reliability during droughts as well as from the pristine water quality. Committee members cautioned that deferring water capital work to a later year could cause more costs from price inflation. One Committee member expressed concern that a 14% water rate increase (the cost recovery rate increase without deferring maintenance or seismic rehabilitation projects) would not be palatable to the community.

On December 4, 2024⁶, staff discussed the preliminary rate proposals at the UAC meeting. UAC commissioners asked for the drivers behind the distribution rate increase as well as more detailed information about cost categories (including allocated costs, vehicle replacement, salaries and benefits, non-revenue water, electricity costs, and costs to comply with new regulations). In response, staff has presented additional detail regarding the cost drivers in this report. One

⁵ December 3, 2024 Finance Committee Meeting, Staff Report

<https://portal.laserfiche.com/Portal/DocView.aspx?id=111748&repo=r-704298fc>, Minutes

<https://portal.laserfiche.com/Portal/DocView.aspx?id=117363&repo=r-704298fc>, Video

<https://www.youtube.com/watch?v=-tshOdaDA3A%3Ffeature%3Dshare>

⁶ December 4, 2024 Utilities Advisory Commission, Staff Report

<https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=d7cd6030-1d05-412e-a96b-cabd33557bc1>,

Minutes <https://portal.laserfiche.com/Portal/DocView.aspx?id=123724&repo=r-704298fc>, Video

<https://www.youtube.com/watch?v=tfznidSYXiU%3Ffeature%3Dshare>

Commissioner requested a plan to limit the rate increase to 10% and Commissioners also asked for information about SFPUC's planned wholesale rate increase. Staff took this feedback into consideration and made modifications to the preliminary rate proposals reflected in this report. Additional feedback from the UAC and Finance Committee meetings in 2025 will be incorporated in the financial forecast and included in the proposal presented to City Council in June 2025 during the budget adoption process.

Attachment E contains examples of CPAU's communication and outreach methods including the use of the utilities website, utility bill inserts, messaging on utility bills and MyCPAU online account management platform, email newsletters, print and digital ads in local publications, social media, community messaging platforms, and through direct mailings of the Home Water Reports and online WaterSmart portal.

ENVIRONMENTAL REVIEW

The UAC's review and recommendation to Council on the FY 2026 Water Utility financial forecast and rate schedule adjustments does not meet the California Environmental Quality Act's definition of a project, pursuant to Public Resources Code Section 21065, thus no environmental review is required.

ATTACHMENTS:

Attachment A: Water Resolution FY26

Attachment B: Water Utility Rate Schedules FY26

Attachment C: Water Utility Financial and CIP Tables FY26

Attachment D: Water Reserves Management Practices

Attachment E: Water Utility Communications Plan and Samples

APPROVED BY:

Kiely Nose, Interim Director of Utilities

Staff: Lisa Bilir, Senior Resource Planner