



Finance Committee Staff Report

From: Kiely Nose, Interim Director of Utilities

Report Type: ACTION ITEMS

Lead Department: Utilities

Meeting Date: April 1, 2025

Report #: 2412-3871

TITLE

Recommendation to the City Council to Adopt a Resolution Approving the Fiscal Year 2026 Wastewater Collection Utility Financial Forecast, and Amending Rate Schedules S-1 (Residential Wastewater Collection and Disposal), S-2 (Commercial Wastewater Collection and Disposal), S-6 (Restaurant Wastewater Collection and Disposal) and S-7 (Commercial Wastewater Collection and Disposal – Industrial Discharger), and Repealing Rate Schedules S-3 (Industrial Waste Laboratory and Analysis Charges) and S-4 (Hauled Liquid Waste Charges)

RECOMMENDATION

The Utilities Advisory Commission and Staff request that the Finance Committee recommend that the City Council adopt a resolution (Attachment A):

1. Approving the Fiscal Year 2026 Wastewater Collection Utility Financial Forecast shown in this staff report and attachments; and
2. Amending Rate Schedules (Attachment B) effective July 1, 2025 (FY 2026):
 - a. S-1 (Residential Wastewater Collection and Disposal)
 - b. S-2 (Commercial Wastewater Collection and Disposal)
 - c. S-6 (Restaurant Wastewater Collection and Disposal)
 - d. S-7 (Commercial Wastewater Collection and Disposal – Industrial Discharger); and
3. Repealing Rate Schedules effective July 1, 2025:
 - a. S-3 (Industrial Waste Laboratory and Analysis Charges)
 - b. S-4 (Hauled Liquid Waste Charges)

EXECUTIVE SUMMARY

The City of Palo Alto Utilities (CPAU) provides electricity, water, wastewater, natural gas, and fiber optic services to the Palo Alto community. The Public Works Department also provides refuse collection and processing for recycling, compost and garbage, wastewater treatment and stormwater management. The City's primary goals are to manage these services in a way that ensures continued safe, reliable, environmentally sustainable, and cost-effective operations. The City is proposing rate increases this year for electric, natural gas, wastewater and water services. Stormwater management fees will increase per the Consumer Price Index (CPI) as approved by residents in a 2017 ballot measure. The City strives to be transparent with utilities customers about the reason for rate changes, including explaining the cost

drivers, benefits to customers, what the City is doing to keep costs low for ratepayers, and the services and programs provided by the City to help customers keep utility bill costs low. Attachment E outlines CPAU’s plan for communicating rate changes to customers. Staff are presenting an overview of the financial forecast and rate change proposal for each utility service to the Utilities Advisory Commission (UAC) and Finance Committee prior to City Council review and approval in June 2025.

The Wastewater Collection Utility financial forecast proposes a 20% rate increase for FY 2026, which is equivalent to approximately \$11 per residential customer per month. With this increase, Palo Alto’s rate will remain approximately 5% below neighboring cities, conservatively assuming that neighboring cities’ rates remain at current levels. This forecast also projects rate increases of 17% annually in FY 2027, 15% in FY 2028 and 5% annually in FY 2029 and FY 2030. The additional funding generated by this rate increase is required to pay for ongoing wastewater treatment costs, wastewater utility operations, and capital improvement projects. This forecast reflects deferral of some capital costs to manage the magnitude of the rate increase.

Staff updated the utility’s cost projections for the FY 2025 to FY 2030 forecast period based on the most recent recorded costs and rates of cost increases. Relative to last year’s financial forecast, total expenses are expected to be about 14% higher over the forecast period, due to higher treatment costs and salary and benefits and inflation assumptions. To address these challenges, similar to last year’s forecast, this projection assumes deferral of the next sewer main replacement project to FY 2028. This assumption defers the more accelerated replacement cycle adopted in the FY 2024 financial plan to increase replacement from 1 miles to 2.5 miles of pipe annually starting in FY 2026. In last year’s Financial Plan, staff planned for a smaller main replacement in FY 2026 to replace 1 mile of sewer mains. This project is now deferred, and this forecast defers approximately \$0.45 million of sewer lateral/manhole rehabilitation and replacement work in FY 2025 to future years. This forecast reflects the minimal number of high priority capital projects to allow the Wastewater Collection Operations Reserve to return to within guideline range and avoid an even higher rate increase.

Table 1: Current Year (FY 2025) and Projected Rate Trajectory from FY 2026 to FY 2030

| Fiscal Year | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
|---------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Proposal | 15% | 20% | 17% | 15% | 5% | 5% |
| FY 2025 Plan | 15% | 9% | 9% | 8% | 7% | - |

In the preliminary rate meetings with the Utilities Advisory Commission (UAC) on December 4, 2024 and with the Finance Committee on December 3, 2024, staff presented a rate trajectory of 18% in FY 2026, 15% in FY 2027 and FY 2028, and 9% in FY 2029 and FY 2030. This forecast proposes higher rate increases. Key reasons for the change are that this forecast includes additional vehicle replacement costs of \$0.45 million in FY 2025, \$0.4 million in FY 2026 and \$0.1 million per year ongoing for based on staff’s latest projections. Additionally, this forecast adds

approximately \$0.35 to \$0.4 per year from FY 2027 through FY 2030 for the CCTV program to assess pipe conditions and prioritize necessary sewer replacements.

Additionally, staff recommends Council repeal rate schedules S-3 (Industrial Waste Laboratory and Analysis Charges) and S-4 (Hauled Liquid Waste Charges) as a clean-up item. These charges moved to the municipal fee schedule in 2023.

BACKGROUND

This staff report provides the Finance Committee with a financial forecast for the Wastewater Collection 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 E contains a set of Reserves Management Practices describing the reserves. This work is done annually as part of the budget and rate-setting cycle.

ANALYSIS

FY 2024 Costs and Revenues

At the end of FY 2024, the Wastewater Operations Reserve was about \$1.3 million lower than expected due to higher wastewater treatment and operating costs, partially offset by lower capital improvement project (CIP) costs. The utility's overall cash balance remained positive at \$0.34 million at the end of FY 2024, supported by the Council-approved \$3 million short-term loan from the Fiber Utility to the Wastewater Collection Utility. The loan is expected to be repaid in FY 2026.

Actual revenues in FY 2024 were approximately \$0.4 million (2%) higher than forecasted. This was driven by a net increase in retail sales revenues and connection and capacity fees, partially offset by lower interest income.

On the expense side, treatment costs were about \$1.4 million (11%) higher than forecasted, primarily due to higher operational expenses and an increase in Palo Alto's flow share relative to other treatment partner agencies, which increased Palo Alto's share of the treatment costs. Collection system operating costs were about \$0.9 million (11%) higher than expected; \$0.5 million of this was due to higher vehicle replacement costs and the remainder due to personnel cost-of-living adjustments and filled vacancies. Lastly, CIP costs were lower than anticipated due to a project deferral, by about \$0.4 million. Table 232 below summarizes key reasons for the variances from forecast.

Table 23: FY 2024 Actuals vs. Prior Year's Forecast (\$000)

| | Net Cost/ (Benefit) Variance | Type of Change |
|--|---|---------------------------|
| Higher retail sales, higher connection and capacity fees revenues, lower interest income | (555) | Revenue increase |
| Treatment expenses higher than expected | 1,372 | Cost increase |

| | | |
|---|--------------|--------------------------|
| Higher vehicle replacement and operations and maintenance salaries and benefits | 888 | Cost increase |
| Lower CIP | (395) | Cost decrease |
| Net Cost / (Benefit) of Variances | 1,310 | Net Cost Increase |

Projections

Overview

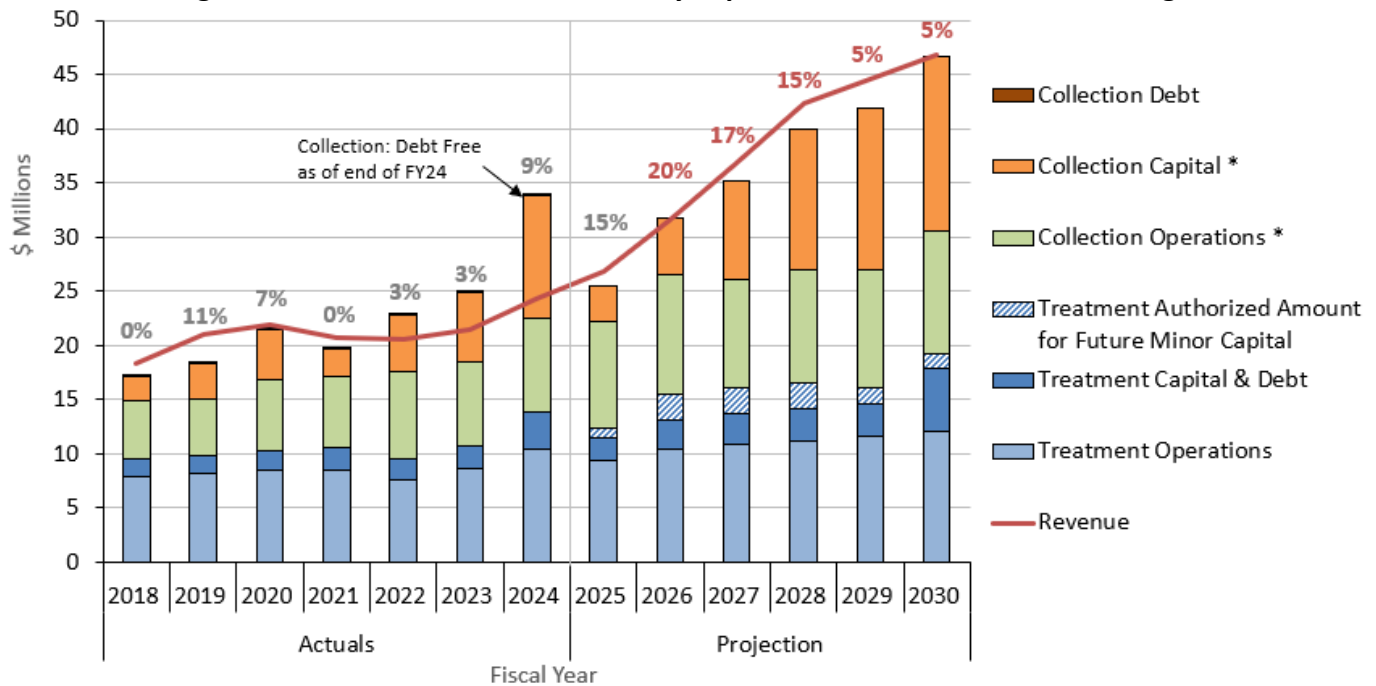
In the current year (FY 2025), staff projects sales revenues will be about \$0.6 million, or 2%, higher compared to last year's forecast, driven by a modest recovery in the commercial sector. On the expense side, staff estimates treatment costs in FY 2025 to be about \$0.9 million, or 7%, lower than last year's forecast, due to grant funding from Santa Clara Valley Water District's ["Guiding Principle 5" Program \(GP5\)](#) ¹. However, collection costs are projected to increase by about \$1 million, or 11%, in FY 2025, attributed to higher salaries and benefits, and vehicle replacement expenses. Additionally, CIP costs are expected to decrease by about \$1.2 million, or 29%, in FY 2025, reflecting the one-time deferral of a Sanitary Sewer Replacement/ Rehabilitation (SSR) project.

Looking ahead, from FY 2025 to FY 2030, the forecasting period, treatment costs are projected to rise by an average of 9% annually, while collection costs are expected to grow by 10% annually. Over the forecast period, higher sales revenues are expected primarily due to rate increases, though interest revenues are projected to be slightly lower than outlined in last year's projection due to low reserves. These rate increases are necessary to pay for rising treatment and collection system operation costs.

Figure 1 illustrates actual revenues and expenses through FY 2024, along with projections through FY 2030.

¹ GP5 <https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=c7841814-4682-4e54-b1e7-f48fe8292e5c>

Figure 1: Wastewater Collection Utility Expenses, Revenues and Rate Changes



* FY25 Commitments and Reappropriations reserves balances for Operations and Capital Investment are anticipated to be utilized in FY26 and FY27

Revenues

Staff anticipates a modest recovery in sales revenue for FY 2025, driven primarily by the rate increase implemented in July 2024 and increased sales among non-residential customers and restaurants. Other revenue sources include capacity and connection fees, which are cost-recovery fees from new customers and service expansions, as well as income from interest and transfers, which fluctuate annually. Due to higher expected expenses, staff is proposing higher rate increases compared with the prior financial forecast, which are detailed in the sections below. With the proposed rate increases, overall revenues are projected to grow by an average of 12% annually from FY 2025 through FY 2030, which will gradually bring the Operations Reserve back to within the guideline range by the end of FY 2028 and allow the CIP Reserve to also be replenished gradually by FY 2030.

Expenses

Over the five-year forecast period, total expenses are expected to increase by 9% annually from FY 2025 to FY 2030.² This increase is primarily driven by rising costs for treatment (9% annual average increase), shifting of sewer main replacements to FY 2028 (20% annual average increase), construction inflation and operating costs including salaries and benefits (operating

² Because CIP fluctuates from year to year, this calculation assumes a three-year average of CIP for FY 2025 - FY 2027 and a two-year average for FY 2030 – FY 2031 in order to provide a more accurate view of estimated CIP costs over time.

costs are forecasted to increase 3% on average over the same time period). Table 3 below shows the costs for treatment and collection expenses, which will be described in the sections below.

Table 3: Wastewater Utility Costs for FY 2024 to FY 2030 (\$,000)

| Expenses (\$000) | Actuals | Projection | | | | | |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | FY 2024 | FY 2025 | FY 2026 | FY 2027 | FY 2028 | FY 2029 | FY 2030 |
| Treatment | 13,803 | 12,317 | 15,456 | 16,071 | 16,492 | 16,048 | 19,285 |
| Treatment Operations | 10,387 | 9,362 | 10,486 | 10,853 | 11,233 | 11,626 | 12,033 |
| Treatment Capital & Debt Service/Loan repayments | 3,417 | 2,059 | 2,643 | 2,908 | 2,949 | 3,008 | 5,838 |
| Treatment Authorized Amount for Future Minor Capital | - | 896 | 2,327 | 2,310 | 2,310 | 1,414 | 1,414 |
| Collection | 20,111 | 12,980 | 15,846 | 18,714 | 23,617 | 25,790 | 27,020 |
| Collection Operations * | 8,765 | 9,963 | 11,044 | 10,081 | 10,479 | 10,890 | 11,317 |
| Collection Capital * | 11,217 | 3,221 | 5,187 | 9,000 | 13,000 | 15,000 | 16,000 |
| Collection Debt** | 129 | - | - | - | - | - | - |
| TOTAL | 33,915 | 25,501 | 31,688 | 35,152 | 39,970 | 41,938 | 46,602 |

*CIP and Operations Expenses in the projected years include changes due to commitments/reappropriations and funds transferred to the Operations and CIP Reserves

** The Wastewater Collection Utility also borrowed \$3 million from the Fiber Optics Utility through a short-term loan in FY 2024 and will be repaid in FY 2026. The Collection Operations row includes the estimated interest payment on the loan of \$90K in FY 2025 and \$90K in FY 2026.

Wastewater Treatment Costs

Treatment expenses represent the Wastewater Collection Utility's share of the costs associated with operating the Regional Water Quality Control Plant (RWQCP or Treatment Plant). These charges are determined using a formula that considers the wastewater volume as well as the organic material, ammonia levels, and total suspended solids that it contains.

Based on detailed project cost projections from RWQCP staff, overall treatment costs are expected to increase by an average of 9% annually from FY 2025 through FY 2030. The increases in Wastewater Treatment costs are driven by major plant rehabilitation, rising salary and benefit costs, and additional staffing to support capital and compliance programs. Other contributing factors include higher costs for sludge hauling services, maintenance materials, rent, and chemicals and utility rates. Additional key cost increases are described below.

In FY 2025, the Wastewater Collection Utility's flow share of the RWQCP's revenue requirement was projected to be 35%, based on FY 2023's actual flow share. However, FY 2024's actual flow share increased to 36.7%, raising treatment costs by about \$0.4 million. To account for the recent trend of Palo Alto's increasing flow share, this forecast conservatively estimates a 38% flow share annually, resulting in about an additional \$0.5 million higher in yearly costs.

Under an agreement between partner agencies, the RWQCP is permitted to charge for pay-as-you-go minor capital improvement projects (CIP) within authorized limits. Any unused amounts are carried over annually. The RWQCP does not charge the Wastewater Collection Utility for unused amounts each year. These unused amounts remain unencumbered but can be applied

towards future pay-as-you-go capital needs as necessary. These amounts are referred to as the “remaining unencumbered & authorized amount for future pay-as-you-go capital (minor capital)” or the “Treatment Authorized Amount for Future Minor Capital.” The Wastewater Collection Utility may retain these amounts but must be prepared to pay them when needed. As of FY 2025, the remaining unencumbered and authorized amount for future pay-as-you-go capital for Palo Alto is approximately \$3.5 million, up from \$2.5 million at the end of FY 2024, with an additional \$1.3 million added annually. The Wastewater Collection Utility has not been charging customers for the remaining unencumbered and authorized amounts for future pay-as-you-go capital (Minor Capital) and planned to use reserves to pay for fluctuations in these costs. The Wastewater Collection Utility’s risk assessment level for the operations reserve includes a 10% contingency for treatment costs to cover fluctuations such as these. However, due to the low operations reserve levels, the operations reserve is below risk assessment levels, and there are no reserve funds available to pay for remaining unencumbered and authorized amounts for future pay-as-you-go capital (Minor Capital).

Going forward, Wastewater Collection rates need to be designed to include both the FY 2025 remaining unencumbered and authorized amount for future pay-as-you-go capital (Minor Capital) from prior years as well as the estimated annual amount going forward. Staff recommends collecting the FY 2025 remaining unencumbered and authorized amount for future pay-as-you-go capital (Minor Capital) of \$3.5 million in rates over 4 years starting in FY 2025. To reflect this change, staff plans to include proposed revisions to the Wastewater Collection Utility’s Reserve Management Guidelines in next year’s financial forecasts for Council approval. Additionally, in the “Alternative” section below, staff presents an alternative that would achieve a lower rate increase in FY 2026 by extending the period of time over which the remaining unencumbered and authorized amount for treatment is recovered.

Lastly, starting in FY 2026, RWQCP will begin adding Section 115 Pension Trust expenses of around \$0.3 million annually to future forecasts. Personnel costs, such as salaries, benefits, pensions, and other retirement benefits, are a component of treatment costs. The pension trust expense is a personnel cost intended to cover pension obligations to City of Palo Alto employees working at the RWQCP. Palo Alto’s share of these operating expenses is estimated at about \$1.24 million at the end of FY 2025.

Capital costs for treatment are also increasing because the Treatment Plant is facing the need for major upgrades in coming years, due to aging equipment and changing environmental regulations. Rehabilitation and replacement of plant equipment that has been in use for over 40 years is necessary to ensure the city can provide wastewater treatment operation safely and in compliance with regulatory requirements for the discharge of treated wastewater 24 hours a day. The costs of the Treatment Plant are shared among member agencies. The biggest increase in Treatment costs is the addition of debt service (loan repayment) for the Secondary Treatment Upgrades in FY 2030, which is a \$193 million capital project funded through a low-interest State Revolving Fund loan. Palo Alto’s share of this loan repayment is included in this financial forecast.

Palo Alto’s share of treatment capital projects and loan repayments (debt) is increasing at an average of 20% per year from FY 2025 through FY 2030 including the offsetting GP5 grant funding and remaining unencumbered and authorized amounts for pay-as-you-go capital. The

Wastewater Collection Utility will begin to pay for debt service for major projects beginning with the Primary Sedimentation Tank in FY 2026 (financed through a low-interest State Revolving Fund loan), Outfall Line Construction in FY 2027 (bond financed), Secondary Treatment Upgrades in FY 2030 and Headworks Facility in FY 2030 - FY 2034 (financing plan is still preliminary and may be a combination of bond and State Revolving Fund loans). Palo Alto's low-interest State Revolving Fund loans for the Primary Sedimentation Tank and Secondary Treatment Upgrades are at fixed interest rates. However, for future bond financing and future State Revolving Fund loans, the rates of borrowing is uncertain and for the State Revolving Fund loans, availability of funds is also uncertain.

GP5 Grant Funding

Santa Clara Valley Water District (Valley Water) is the groundwater manager for Santa Clara County and provides water to most of the water retailers in the county. Valley Water developed the "GP5 Program" grant program for communities and/or organizations, like the City of Palo Alto, where property taxpayers pay State Water Project property taxes but receive on average 85% of their water supply from sources other than Valley Water-managed supplies. GP5 refers to Guiding Principle 5, a principle of the Valley Water Board that awards grants to each community at a dollar amount up to the State Water Project property taxes paid by property owners in their respective service areas from FY 2019 - FY 2024 plus interest. The grants must fund conservation programs, potable recycled water, non-potable recycled water (including salinity reductions), options to purchase wastewater, purified water, wastewater treatment plant environmental upgrades, Advanced Meter Infrastructure (AMI) updates, or dedicated environmental focused activities.

On June 3, 2024, the City Council approved the cost-share agreement with Santa Clara Valley Water District for GP5 funding for future projects at the RWQCP. The Wastewater Collection Utility's share of the following upcoming projects is eligible for the grant funding:

- Joint Intercepting Sewer Rehabilitation
- Outfall Line Construction
- 12kV Loop Electrical Improvements and
- Headworks

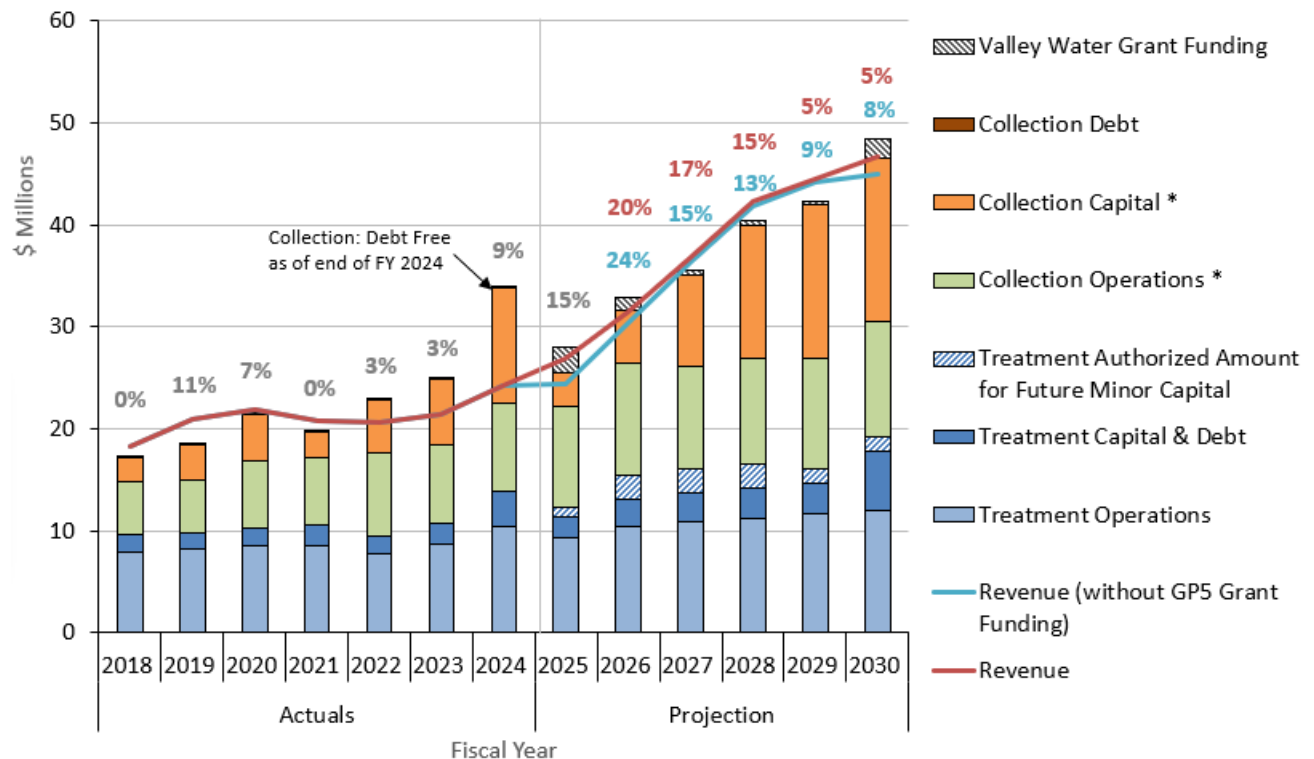
The estimated funding available to Palo Alto through this grant program is \$11.8 million and projects must be completed by June 30, 2033. This financial forecast assumes \$6.6 million of the funds offset projected costs during the 5-year planning period as shown in the following table. However, there is a possibility that some grant reimbursements may be delayed which may impact cash flow and reserve balances.

Table 4: GP5 Grant Funding Assumed to Offset Palo Alto's Treatment Costs (\$000)

| Fiscal Year | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
|-------------|-------|-------|------|------|------|-------|
| GP5 Grant | 2,453 | 1,139 | 417 | 417 | 417 | 1,810 |

The chart below illustrates a scenario without GP5 funding. Wastewater rates would need to increase by 24% in FY 2026, followed by annual increases of 8% to 15% over the next four years, as shown in blue texts in the chart below.

Figure 2: Wastewater Collection Utility Expenses, Revenues and Rate Changes
Actual Costs through FY 2024 and Projections through FY 2030 with and without GP5 Funding



* FY25 Commitments and Reappropriations reserves balances for Operations and Capital Investment are anticipated to be utilized in FY26 and FY27

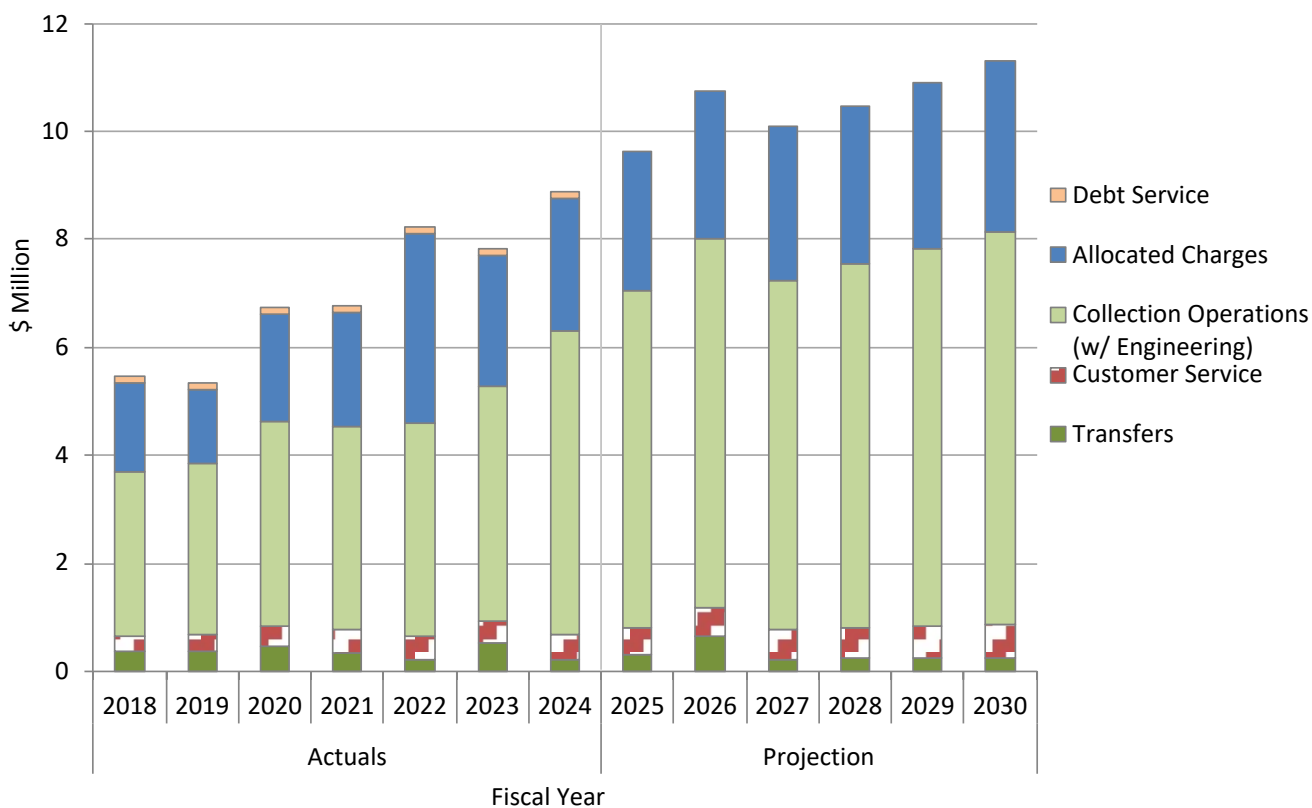
Collection Operations

Operations costs include the Customer Service, Sewer Operations, Engineering, and Allocated Charges categories. Debt service, rent, and transfers are also included in this category. The Sewer Operations category includes preventative and corrective maintenance on sewer mains and laterals, investigation of sewer overflows, regular cleaning of heavily impacted sections of the sewer system, and services shared with other utilities. Allocated Charges include the costs of accounting, human resources, information technology, purchasing, legal, and other administrative functions provided by the City's General and Internal Services Funds staff, as well

as shared communications services and Utilities Department administrative overhead and billing system maintenance costs. A portion of these costs are allocated to operations costs and a portion to capital costs.

Engineering, operations, and maintenance expenses combined are expected to increase by 3% annually over the forecast period, largely driven by higher personnel cost of living and benefits, filling of vacancies, and vehicle replacement allocations. Specifically, the salary and benefit forecast includes an assumption of 6% 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 6% per year on average. Vehicle replacement allocation costs are forecasted to be a total of \$1.4 million higher over the 6-year period from FY 2025 through FY 2030 compared with last year's financial plan, due to the need to replace aging vehicles. There is also a need to electrify vehicles in the future; however, these costs are still unknown and are not included in the forecast. Other expense increases, include cross-bore project, tools and equipment upgrades, compliance publishing, membership fees, construction materials, contract services, training, and certification.

Figure 3: Wastewater Collection Utility Operational Costs



Capital Improvement Program

The Sanitary Sewer Replacement/Rehabilitation (SSR) Program funds the replacement of deteriorating sewer mains to increase capacity or improve pipe condition in various parts of the

sewer system. The Wastewater Collection Utility completed SSR 31 in FY 2024 which replaced and rehabilitated over two miles of sanitary sewer main, sewer laterals and manholes. Most of the original clay pipes in Palo Alto were installed between 1950 and 1970. 136 miles of sewer mains remain to be replaced before the end of their useful life. Under the current replacement cycle of 2.5 miles of main replaced each year on average beginning in FY 2028, replacement of the remaining mains would take approximately 60 years and the last main would be approximately 111 years old before replacement. This rate of main replacement is based on Staff's experience, other nearby communities' experience, and the National Clay Pipe Institute Engineering Manual suggesting that clay pipe can last around 100 years in Palo Alto's underground conditions. Staff re-evaluates and prioritizes future projects based on a structural rating system, feedback from Wastewater Operations and available budget. In addition, the City is currently updating the Sewer Master Plan with anticipated completion in summer 2025. Results from this plan will assist in identifying and prioritizing future SSR projects.

As part of the FY 2024 Financial Plan, the Council approved an accelerated CIP program to increase the Sanitary Sewer Replacement (SSR) rate from 1 mile to 2.5 miles per year (from 2 miles to 5 miles per project constructed every other year) to fulfil the goal of replacing pipes near their life expectancy. Due to unforeseen reductions in revenue and increases in operating expenses, the FY 2025 Financial Plan recommended deferring the first of the 5-mile main replacement projects that had previously been scheduled for construction in FY 2026. The plan recommended a reduced main replacement project, covering 1 mile instead of 5 miles, with construction planned in FY 2026. Due to further increases in operating expenses and treatment expenses, the current forecast defers the smaller 1-mile SSR which is proposed to be included in the first 5-mile main replacement in FY 2028.

The budget for the 5-mile SSR scheduled for construction in FY 2028 increased from \$12.7 million to \$13.5 million due to adjustments for construction inflation of 5.4% annually. Additionally, the foothills lift station retrofit, originally scheduled for FY 2028 with a budget of \$2 million, has been postponed to FY 2029. Updated cost estimates and inflation adjustments increased the projected total to \$3.8 million. Lastly, staff recommends introducing a CCTV program to perform a sewer collection system condition assessment in critical sections of the system. This initiative aims to better assess pipe conditions and prioritize necessary sewer replacements. The program is estimated to cost \$0.3 to \$0.4 million annually throughout the forecast period.

Table 5 provides an overview of projected CIP spending from FY 2025 to FY 2030.

Table 5: Projected CIP Spending, FY 2025 to FY 2030 (\$,000)

| Project Category | Fiscal Year | | | | | |
|---|--------------|--------------|--------------|---------------|--------------|---------------|
| | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
| Sewer Rehab/Augmentation | 386 | 1,647 | 2,887 | 11,925 | 3,046 | 13,213 |
| One-Time Projects | - | - | - | 445 | 3,332 | - |
| Ongoing Projects | 604 | 1,250 | 1,277 | 1,305 | 1,325 | 1,383 |
| Customer Connections | 450 | 450 | 450 | 450 | 450 | 450 |
| Allocated S&B | 1,474 | 1,533 | 1,595 | 1,659 | 1,725 | 1,794 |
| Total | 2,914 | 4,881 | 6,209 | 15,783 | 9,878 | 16,840 |
| *Includes unspent funds from previous years carried forward or reappropriated | | | | | | |

Debt Service

The Wastewater Collection Utility paid the only outstanding debt for its share of the 1999 Utility Revenue Bonds, Series A, at the end of FY 2024. However, Council approved a short-term loan up to \$3 million from the Fiber Optics Fund Reserve to cover the projected shortfall of cash in the Wastewater Collection Utility, with the plan to repay the Fiber Utility in FY 2026. The Wastewater Collection Utility borrowed the full \$3 million at the end of FY 2024. The loan also included an interest payment rate equal to the City's portfolio rate each quarter plus 0.25%, or about \$90K per year, assuming a portfolio interest rate of 3%. Staff will continue to monitor the Wastewater Collection Utility's available funds and costs and will make recommendations on loan repayment timing as appropriate.

Staff is also considering debt financing some of the future SSRs. This could be beneficial for the Wastewater Collection Utility because it would allow needed construction work to move forward on sewer main replacements before FY 2028. It would also reduce the risk of further deferrals of main replacements beyond FY 2028 if operational costs, construction costs and treatment costs continue to inflate more than projected. The more that wastewater assets are operated past their useful life, the greater the likelihood of substantial pipe failures resulting in additional repair and maintenance costs, sanitary sewer overflows, sinkholes, or other catastrophic impacts. On the other hand, debt financing is most appropriate for large one-time projects and would not be able to be used as an ongoing financing method for regular main replacement projects that occur annually or every other year. Tax-exempt bonds require the funds to be spent within three years and so the funds could most likely be used to fund one large five-mile main replacement project. Additionally, Wastewater Collection Utility customers would ultimately pay interest on the funds borrowed that could add up to approximately a doubling of the total project cost compared to pay-as-you-go financing. Customers would also pay the bond issuance costs of approximately \$0.25 – \$0.28 million per bond issuance. The Wastewater Collection Utility does not have any stand-alone debt and has never been rated so staff does not know what the true interest rate would be on a bond. But the interest rate would depend on the nature of the investment, the

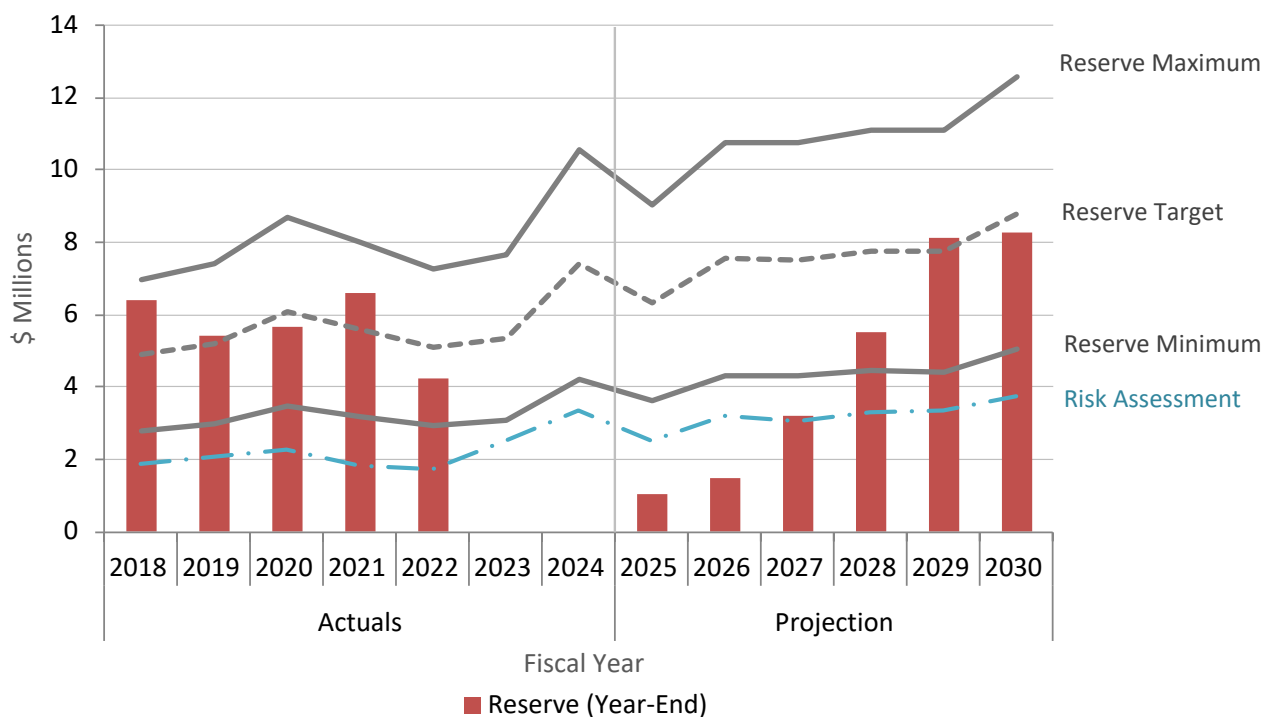
size of the bond issuance, duration of the repayment period and whether interest is capitalized during construction.

Reserves

Given the low reserves and the projected levels of revenue and expenses over the forecasting period, the Operations Reserve, which is the Wastewater Collection Utility's primary contingency reserve, is projected to be below risk assessment level in FY 2025 and FY 2026. Staff expects the Operations Reserve to return to within the guideline range by the end of FY 2028 and increase to target levels by FY 2029.

Figure 4 shows the Operations Reserve ending balances alongside the minimum, maximum, and target guidelines and risk assessment levels.

Figure 4: Operations Reserve Adequacy



Note: Operations Reserve shown with a minimum balance of \$0. The Wastewater Collection Utility borrowed \$3 million in a short-term loan from the Fiber Optics Utility in FY 2024 to cover cash needs and will repay the loan in FY 2026.

Table 6 summarizes the risk assessment calculation for the Wastewater Utility through FY 2030. The risk assessment includes the revenue shortfall that could occur due to:

1. Lower than forecasted sales revenue; and
2. An increase of 10% of treatment costs for the budget year; and
3. An increase of 10% of planned system improvement CIP expenditures for the budget year. CIP Contingency for FY 2027 and after is not needed due to resuming the use of the CIP reserve

Table 6: Wastewater Collection Risk Assessment (\$,000)

| Fiscal Year | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| Sales Revenue | 25,652 | 30,736 | 35,994 | 41,418 | 43,640 | 45,822 |
| Budget-to-Actual Risk @ 4% | 1,043 | 1,227 | 1,438 | 1,654 | 1,743 | 1,830 |
| Treatment Budget | 12,317 | 15,456 | 16,071 | 16,492 | 16,048 | 19,285 |
| Treatment Cost Contingency @10% | 1,232 | 1,546 | 1,607 | 1,649 | 1,605 | 1,928 |
| CIP Budget * | 2,464 | 4,431 | - | - | - | - |
| CIP Cost Contingency @10% * | 246 | 443 | - | - | - | - |
| Total Risk Assessment Value | 2,521 | 3,216 | 3,045 | 3,304 | 3,348 | 3,759 |
| Projected Operations Reserve Level | 1,035 | 1,502 | 3,178 | 5,494 | 8,096 | 8,250 |

**CIP budget is excluded from FY 2027 onward*

Reserve Balances

The CIP Reserve is currently depleted, and in the short term, there are insufficient funds to maintain the annual Capital Program Contribution to the CIP Reserve. Contributions will resume in FY 2027 to ensure rate stability and consistent CIP expenditures. This will gradually re-establish the CIP Reserve within the guideline range by FY 2029. The Wastewater Utility Financial Table FY26 (Attachment D) shows the amount of the rate-funded CIP Reserve contributions under “Expenses” for FY 2027 through FY 2030.

Figure 5 below shows the projected CIP Reserve balances from FY 2018 through FY 2030. The projected CIP expenditures fluctuate from year to year with the staggered main replacement schedule.

Figure 5: Projected CIP Reserve Balances, FY 2018 to FY 2030 (\$'000)

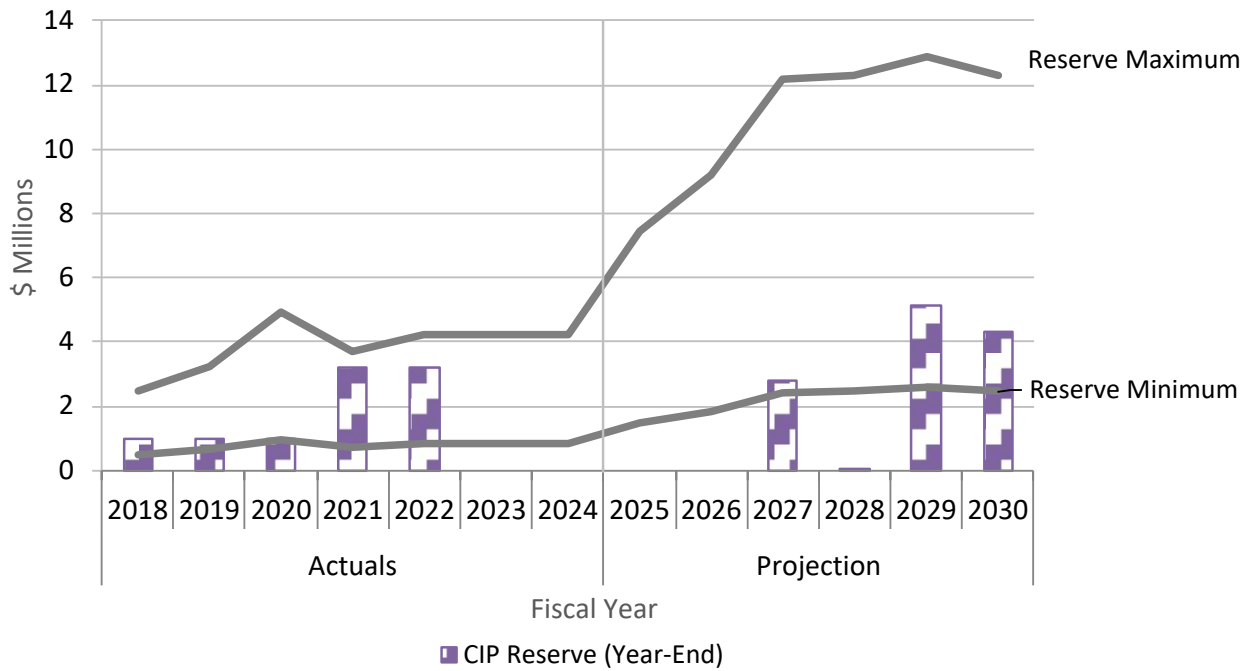
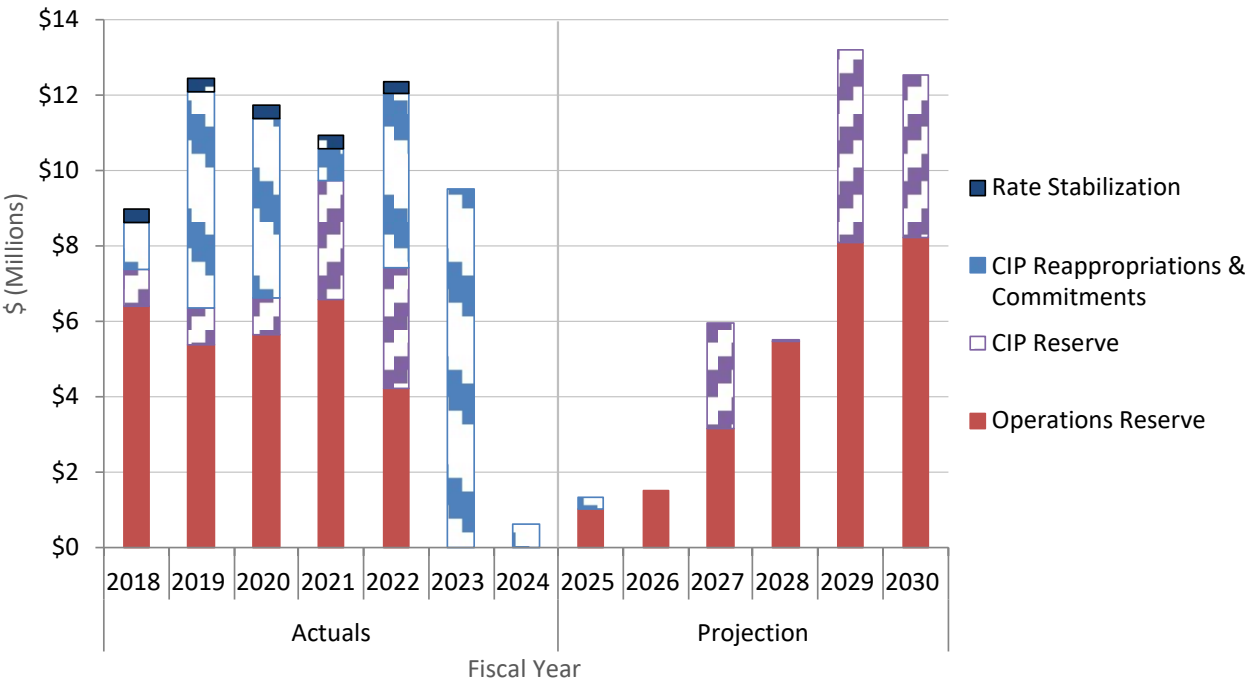


Figure 6 below shows year-end reserve balance levels for each reserve from FY 2018 through FY 2030. Table 7 shows reserve starting and ending balances, revenues, transfers expenses, capital program contribution and operations reserve guideline levels from FY 2025 to FY 2030. The Operations Reserve was depleted in FY 2023 and FY 2024 because the schedule for Sanitary Sewer Replacement 31 was accelerated to complete the replacement prior to Caltrans' street improvement project on El Camino Real, to avoid digging into the newly-paved street; additionally, costs were higher than forecasted (primarily CIP-related costs and transfers out to capital projects) and revenue was lower than forecasted (primarily capacity fee revenue).

Figure 6: Wastewater Collection Utility Year-End Reserves Levels, FY 2018 to FY 2030



Note: Operations Reserve shown with a minimum balance of \$0. The Wastewater Collection Utility borrowed \$3 million in a short-term loan from the Fiber Optics Utility in FY 2024 to cover cash needs and will repay the loan in FY 2026.

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

| | Fiscal Year | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
|--------------------------------|--|----------|----------|----------|----------|----------|----------|
| | Starting Balance | | | | | | |
| 1 | Operations | (1,012)* | 1,035 | 1,502 | 3,178 | 5,494 | 8,096 |
| 2 | Rate Stabilization | - | - | - | - | - | - |
| 3 | CIP | - | - | - | 2,791 | 8 | 5,130 |
| | Revenues | | | | | | |
| 4 | Revenue | 26,900 | 31,542 | 36,829 | 42,286 | 44,540 | 46,756 |
| | Transfers | | | | | | |
| 5 | Operations | - | - | - | - | - | - |
| 6 | Rate Stabilization | - | - | - | - | - | - |
| 7 | CIP | - | - | - | - | - | - |
| | Capital Program Contribution* | | | | | | |
| 8 | Operations | - | - | (9,000) | (13,000) | (15,000) | (16,000) |
| 9 | CIP | - | - | 9,000 | 13,000 | 15,000 | 16,000 |
| | Expenses | | | | | | |
| 10 | Total Expenses (w/o CIP, Debt, or Loan) | (21,849) | (26,104) | (26,152) | (26,970) | (26,938) | (30,602) |
| 11 | Short-Term Loan Repayment to Fiber Fund | (90) | (90) | | | | |
| 12 | Debt Service | - | - | - | - | - | - |
| 13 | Planned CIP | (2,914) | (4,881) | (6,209) | (15,783) | (9,878) | (16,840) |
| | Ending Balance | | | | | | |
| 1+4+5+8+10+11+12+13 thru FY26; | Operations | 1,035 | 1,502 | 3,178 | 5,494 | 8,096 | 8,250 |
| 1+4+5+8+10+11+12 for FY27+ | Rate Stabilization | - | - | - | - | - | - |
| 2+6 | CIP | - | - | 2,791 | 8 | 5,130 | 4,290 |
| 3+7+9+13 for FY27+ | | | | | | | |
| | Operations Reserve Guideline Levels | | | | | | |
| 14 | Minimum Guideline Level | 3,606 | 4,306 | 4,299 | 4,433 | 4,428 | 5,030 |
| 15 | Maximum Guideline Level | 9,016 | 10,765 | 10,748 | 11,084 | 11,070 | 12,576 |
| | *Capital Program Contribution to resume in FY 2027 | | | | | | |
| | Note: The \$3M loan repayment to fiber fund is accounted for as a liability and is not shown in this table | | | | | | |

* The Wastewater Collection Utility borrowed \$3 million in a short-term loan from the Fiber Optics Utility in FY 2024 and this covered the cash needs of the utility. The Wastewater Collection Utility will repay the loan in FY 2026.

Proposed Rates

The current rates were effective July 1, 2024, when the City increased sewer rates by 15%. To align revenues with costs, CPAU proposes to increase overall rates by 20% in FY 2026, followed by 17% in FY 2027, 15% in FY 2028, and 5% in both FY 2029 and FY 2030.

CPAU has three sewer rate schedules applicable to current customers: one for residential customers (S-1), one for non-residential customers (other than restaurants) (S-2), and one for restaurants (S-6). Table 8 below summarizes the current and proposed rates for all customer classes.

Raftelis Financial Consultants, Inc. completed a cost of service (COS) study for the Wastewater Collection Utility in 2021. Staff calculated the revenue increases needed for the Wastewater Collection Utility based on projected revenue and expenses to determine the proposed rates across customer classes.

Table 8: Current and Proposed Sewer Rates

| | | Current (as of 7/1/2024) | Proposed (effective 7/1/2025) | Change | |
|---|----------------|-----------------------------|----------------------------------|----------|-----|
| | | | | \$ | % |
| Monthly Service Charges (\$/Month) | | | | | |
| S-1 (Residential) | Service Charge | \$ 55.93 | \$67.11 | \$ 11.18 | 20% |
| Water Quantity Rates (\$/CCF) | | | | | |
| S-2 (Commercial) | Quantity Rates | 10.44 | 12.52 | 2.08 | 20% |
| S-6 (Restaurant) | Quantity Rates | 15.58 | 18.69 | 3.11 | 20% |

The proposed rates for the S-7 (Industrial Discharger) rate schedule are:

- 1) Collection System Operation, Maintenance, and Infiltration Inflow: \$6.21 per 100 cubic feet of metered water use.
- 2) Advanced Waste Treatment Operations and Maintenance Charge: \$2.48 per 100 cubic feet of metered water use
- 3) \$304.18 per 1000 pounds (lbs) of COD (Chemical Oxygen Demand)
- 4) \$733.40 per 1000 lbs of SS (Suspended Solids)
- 5) \$5,067.70 per 1000 lbs of NH3 (Ammonia)
- 6) \$22,233.94 per 1000 lbs of toxics (chromium, copper, cyanide, lead, nickel, silver, and zinc)

Bill Impacts

In FY 2026, residential customers will experience an 20% increase in bills. Commercial and Restaurant customers bill impacts will vary due to each customer's utilization of the system. Table 9 below shows the bill impact of the proposed FY 2026 rate changes (effective 7/1/2025) for the typical customers:

Table 9: Bill Impact of Proposed Sewer Rate Changes (\$/Month)

| | Current (as of 7/1/2024) | Proposed (effective 7/1/2025) | Change | |
|---------------------------|-----------------------------|----------------------------------|---------|-----|
| | | | \$ | % |
| S-1 (Residential) | \$ 55.93 | \$ 67.11 | \$11.18 | 20% |
| S-2 (Commercial) - 14 CCF | 146.16 | 175.28 | 29.12 | 20% |
| S-6 (Restaurant) - 38 CCF | 592.04 | 710.22 | 118.18 | 20% |

Bill Comparisons/Competitiveness

Table 10 shows the monthly sewer bills for residential customers compared to what they would be in surrounding communities. The average monthly sewer bill for a Palo Alto single family residential customer is \$55.93 at current rates, which is lower than four of the six neighboring communities. These communities are the same six that Palo Alto compares itself to in the annual

budget across Water, Wastewater, Gas, and Electric industries. In the following tables, “Menlo Park” refers to the West Bay Sanitary District.

The cities of Mountain View and Los Altos are RWQCP partners. Sewage from Menlo Park and Redwood City is treated by Silicon Valley Clean Water where some plant upgrades, have been completed and others are yet to be implemented. Santa Clara customers are served by the San Jose-Santa Clara Regional Wastewater Facility, which is still working on necessary facility upgrades. In contrast, plant upgrades at the Hayward Water Pollution Control Facility have not yet begun. Each of the plants are at different stages of rebuilding.

Table 10: Residential Monthly Equivalent Sewer Bill Comparison, Compared to Neighboring Communities at Current Rates (\$/Month)

| Palo Alto | Neighboring Community Average | Neighboring Communities | | | | | |
|-----------|-------------------------------|-------------------------|--------------|-------------|---------------|-----------|---------|
| | | Menlo Park | Redwood City | Santa Clara | Mountain View | Los Altos | Hayward |
| 55.93 | 70.40 | 114.25 | 97.74 | 52.37 | 54.60 | 59.23 | 44.19 |

Table 11 compares the sewer bills for two classes of non-residential customers to what they would be under surrounding communities’ rate schedules. Note that other communities often have specific rates for industrial customers that discharge high intensity wastewater, such as food processors or chemical or electronics manufacturers, but Palo Alto does not currently have any customers that require these special rates. The estimate of Palo Alto commercial and restaurant monthly sewer bills are competitive against the neighboring community average, assuming neighboring communities do not increase sewer rates. The monthly bill comparison assumes 14 CCF of water for general commercial customers and 38 CCF of water for restaurants.

Table 11: Non-Residential Monthly Equivalent Sewer Bill Comparison, Compared to Neighboring Communities at Current Rates (\$/Month)

| | Palo Alto | Neighboring Community Average | Neighboring Communities | | | | | |
|--------------------|-----------|-------------------------------|-------------------------|--------------|-------------|---------------|-----------|---------|
| | | | Menlo Park | Redwood City | Santa Clara | Mountain View | Los Altos | Hayward |
| General Commercial | 146.16 | 129.35 | 154.70 | 157.59 | 92.54 | 167.44 | 103.03 | 100.80 |
| Restaurant | 592.04 | 639.73 | 884.26 | 1065.51 | 608.38 | 538.08 | 279.67 | 462.46 |

Alternative

Staff developed an alternative rate trajectory of 16% annually in FY 2026 and FY 2027, 15% in FY 2028, 12% in FY 2029, and 8% in FY 2030. Under this alternative, the \$3.5 million Treatment Authorized Amount for Future Minor Capital for Palo Alto, described in detail in the Wastewater Treatment Costs section, is collected from customers over ten years instead of the originally proposed four years. This adjustment reduces the FY 2026 rate increase from 20% to 16%. The added risk of this alternative is that the RWQCP could incur the costs up to the outstanding

amount of Treatment Authorized Amount for Future Minor Capital and charge the Wastewater Collection Utility at any time. By collecting these funds from customers over ten years instead of over four years, there would be approximately \$1 million less revenue available in FY 2026 to pay for these charges. If the RWQCP charges the Wastewater Collection Utility for additional minor CIP projects, the Operations Reserve, which is currently at a very low level, would need to absorb these costs or the Wastewater Collection Utility would need to explore additional loan funding. Additionally, the Operations Reserve is projected to be below the risk assessment level in FY 2026 and projected to be restored to above the risk assessment level by FY 2028 for the alternative, one year later than the 20% proposal, thereby, carrying additional risks. To address this risk, if Council prefers the alternate rate trajectory, staff recommends Council approve an additional short-term loan in FY 2025 from the Fiber-Optics Utility of up to \$2.5 million, the projected risk assessment level (see Table 6). Staff would evaluate at the end of the fiscal year whether any loan is necessary and re-evaluate next year depending on the actual results in FY 2025 and return to Council with any new requests in for FY 2026.

Table 12, Figure 7, and Figure 8 show the rate increases, revenues and expenses, and operations reserve level for the alternative from FY 2026 to FY 2030.

Table 12: Projected Rate Increases from FY 2026 to FY 2030 (Alternative)

| Fiscal Year | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 |
|-------------|------|------|------|------|------|------|
| Alternative | 15% | 16% | 16% | 15% | 12% | 8% |
| Proposal | 15% | 20% | 17% | 15% | 5% | 5% |

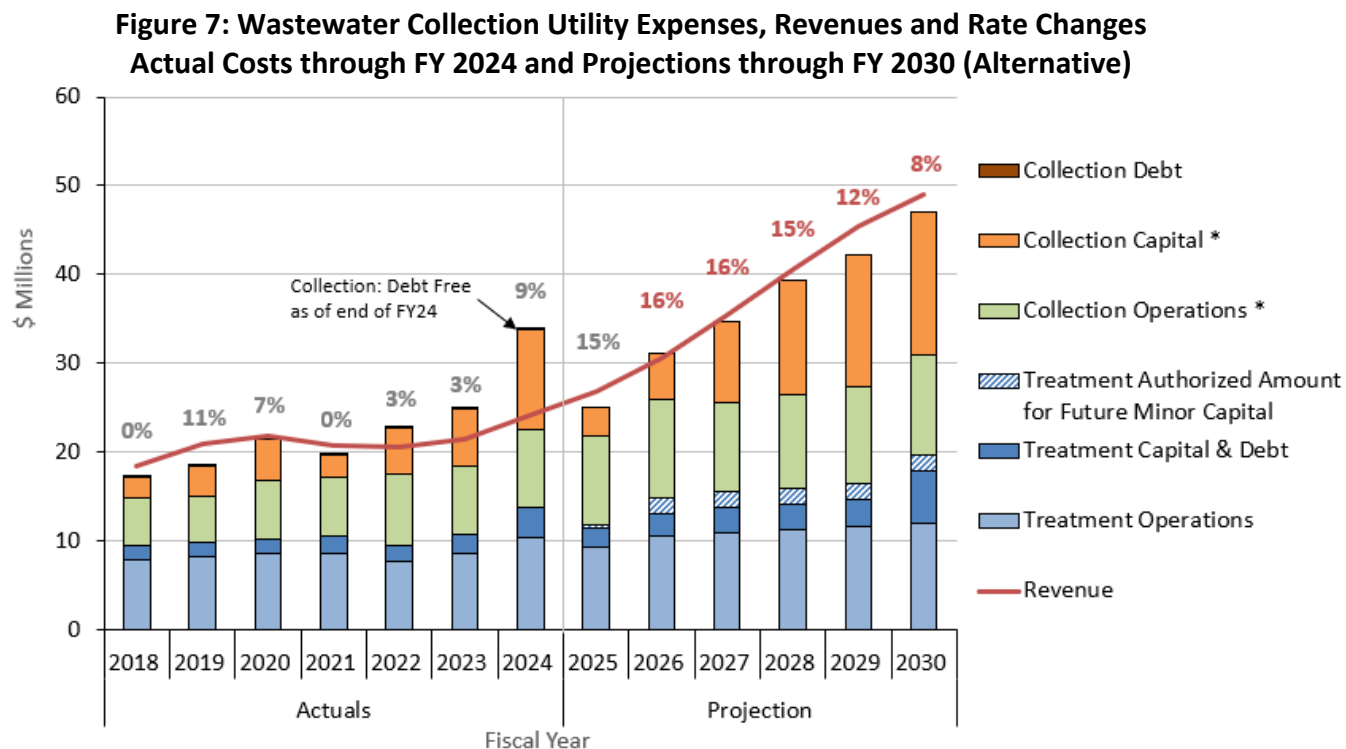
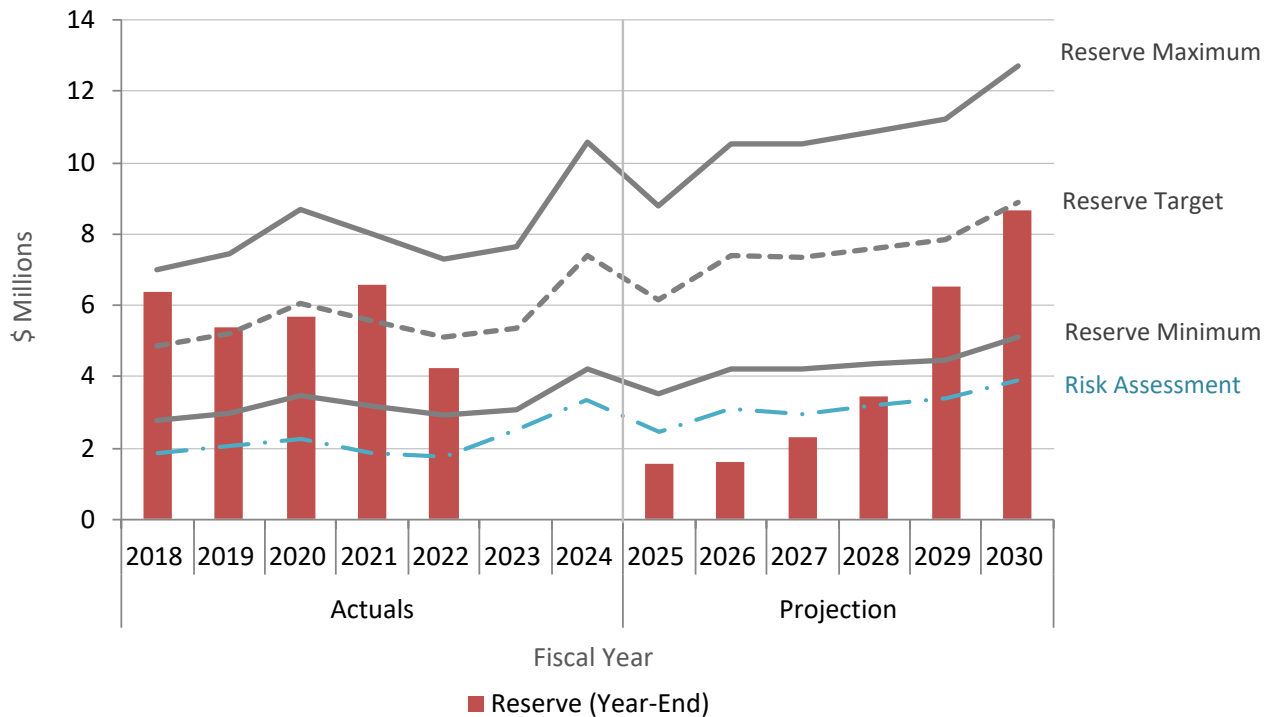


Figure 8: Operations Reserve Adequacy (Alternative)



Next Steps

Staff plans to include the Finance Committee’s recommendations for wastewater rate changes in the notification of potential rate increases to customers as required by Article XIID of the State Constitution expected in April 2025. Staff will incorporate the Finance Committee’s recommendations into the draft financial forecast and attachments and bring those to the City Council in June. The City Council will consider the proposed Financial forecasts and amended rate schedules with the FY 2026 budget, expected in June, at which time the public hearing required by Article XIID of the State Constitution will be held. If Council approves the proposed rate changes, the rates will become effective July 1, 2025.

FISCAL/RESOURCE IMPACT

Based on the proposed rate increase as shown, the estimated revenue impacts in FY 2026 would be an increase of \$4.9 million in the Wastewater Collection Fund. Utility rate increases impact the general fund because the City is a utilities customer. The impact to the general fund from the proposed rate increases is a \$0.02 million expense increase.

POLICY IMPLICATIONS

The proposed Wastewater Collection Utility rate adjustments are consistent with Council-adopted Reserve Management Practice (Attachment E) and were developed using a cost-of-service study and methodology consistent with the California constitution and industry-accepted cost of service principles. As noted in the Reserves Management Practices, if reserves fall below

the minimum guidelines, Council approval is required for a rate plan that requires more than one year to return reserves to within guideline levels. This staff report serves as the required plan.

STAKEHOLDER ENGAGEMENT

Staff presented the Wastewater Collection Utility rate proposal to the UAC during the March 5, 2025 meeting and the UAC voted unanimously to recommend that the City Council adopt a resolution approving the 20% rate increase and recommended that the Finance Committee and City Council consider potential cost saving activities (credit card separate charge, electric vehicle replacement policies as discussed by the UAC Subcommittee to control rate increases and reallocate any savings to restore reserves. Additional feedback from the Finance Committee will be incorporated in the financial forecast and included in the proposal presented to City Council in June 2025 during the budget adoption process.

On December 3, 2024³, staff discussed the preliminary rate proposals at the Finance Committee meeting. Finance Committee members expressed the importance of staff sharing information about other treatment plants and other utility rate increases and one Committee member questioned whether the reserve guideline levels are correct or whether we can have lower reserve levels.

On December 4, 2024⁴, staff discussed the preliminary rate proposals at the UAC meeting. UAC Commissioners requested more information on how other cities bill wastewater, and on the debt of the wastewater utility and the cost drivers of the rate increases, particularly in the collection system. This report includes more detail regarding debt of the wastewater utility and the cost drivers for the collection system. How other cities bill wastewater is a complex research project that is not currently in staff's workplan. UAC Commissioners requested an additional five years of historical data on the charts. If time and resources permit, that information will be included in the accompanying presentation. UAC Commissioners asked a question about the nitrogen discharge requirements other Bay Area wastewater treatment plans are facing. Karin North, Assistant Director of Public Works explained that all treatment plants have a new Nutrient Watershed Permit adopted by the State this year.

³ 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>

⁴ 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>

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, and community messaging platforms.

ENVIRONMENTAL REVIEW

The Finance Committee's review and recommendation to the City Council on the FY 2026 Wastewater Collection Utility financial forecast and rate 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: FY26 Wastewater Resolution

Attachment B: FY26 Wastewater Rate Schedules

Attachment C: FY26 Wastewater Collection Utility and CIP Financial Details

Attachment D: FY26 Wastewater Reserve Management Practices

Attachment E: FY26 Wastewater Communications Plan and Samples

APPROVED BY:

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