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Financial Study and Rate Analysis

FCS GROUP
Solutions-Oriented Consulting

| Memorandum

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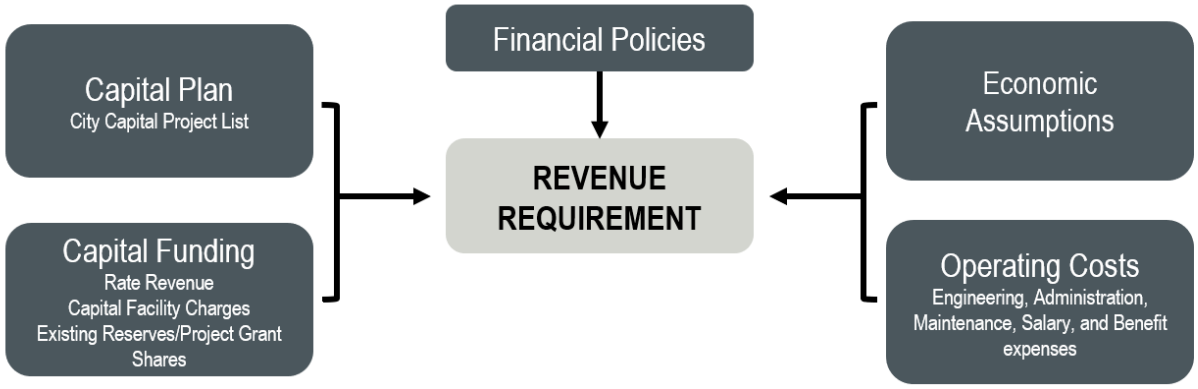
RE 2023 Surface Water Utility Financial Plan

INTRODUCTION

The City of Kirkland (City) is in the process of updating its Surface Water Management Plan (SWMP), which details a course of action for the City to take in order to comply with the conditions of its National Pollutant Discharge Elimination System (NPDES) Permit. In addition to meeting minimum regulatory requirements, the SWMP also outlines the operating and capital investments needed in order for the City's surface water utility to attain several distinct levels of service.

FCS GROUP has been asked to develop a financial plan for the City's surface water utility through 2030, building on the rate study that was completed in the fall of 2022 for the 2023 – 2024 biennium. The financial plan identifies the revenue requirement, which is the total revenue needed to fully fund the utility's operating and maintenance expenditures, debt service (if any debt is outstanding), any necessary capital funding contributions, and any other amounts needed to comply with established fiscal policies. **Exhibit 1** describes the general methodology of the revenue requirement analysis.

Exhibit 1: Revenue Requirement Overview



Study Results

All rates are assumed to be implemented at the beginning of the year (January 1) and in effect for twelve months. **Exhibit 2** shows the annual across-the-board rate adjustment needs for the study period for the surface water utility. The rate increases for 2023-2024 were adopted on October 18th, 2022.

Exhibit 2: Surface Water Utility Annual Rate Increases

	2023*	2024*	2025	2026	2027	2028	2029	2030
Annual Surface Water Rate Increase	5.00%	5.00%	5.00%	5.00%	5.00%	2.50%	2.50%	2.50%

*Rates were adopted on October 18th, 2022, in *Ordinance O-4820*

FISCAL POLICIES

The financial plan incorporates a framework of fiscal policies, which are described in further detail below.

Utility Reserves

The City maintains the following structure of reserves for its surface water utility.

- ***Operating Fund (Fund 421):*** This fund accounts for the resources associated with the maintenance, operation, and minor construction components of the City's surface water system, protecting the utility from the risk of short-term variation in the timing of revenue collection or payment of expenses. City policy establishes a minimum working capital reserve (WCR) balance equal to 100 days of annual operating expenses for this fund, which equates to $2.9 million based on the 2023-2024 Budget.

- ***Capital Projects Fund (Fund 423):*** This fund tracks costs and funding resources associated with the City's surface water capital improvement program (CIP). City policy establishes a minimum capital contingency reserve (CCR) balance equal to 10% of the rolling six-year capital plan for this fund, which equates to $2.1 million based on the current six-year CIP. This 10% reserve target does not include any adjustments for anticipated external funding.

Debt Management

Adopted by Resolution R-5458 in November 2020, the City's Debt Management Policy outlines terms for using debt financing. Although the financial plan for the surface water utility does not anticipate the need for debt financing, it incorporates these debt standards because of the anticipated issuance of revenue bonds by the City's sewer utility. As revenue bonds are typically secured jointly by all utility revenues, we have assumed that this target would apply to all of the City's utilities. Terms specifically relevant to the surface water utility include:

- In the City of Kirkland, debt is used to equalize capital costs between present and future community members and requires City Council approval.

- The total general obligation debt for the City's utilities must not exceed a total of 2.5% of assessed valuation with voter approval.

- Debt Structure

  - The issuance of a bond should not be longer than the asset's useful life, and bonds should be issued with maturities of 30 years or less.

- All debt should be structured on a level or declining payment basis, unless otherwise deemed necessary.
- All debt should be structured to minimize interest payments and maximize the City's ability to refund or retire debt early.

The City's surface water utility does not currently have any outstanding debt.

Rate-Funded System Reinvestment (Rate-Funded Capital)

Rate-funded system reinvestment is the funding of long-term infrastructure replacement needs through a regular (annual) and predictable rate provision. The financial plan assumes that the surface water utility funds system reinvestment based on annual depreciation expense (estimated to be $2.3 million for 2023) plus an additional $500,000 per year for transportation improvement projects.

SURFACE WATER UTILITY REVENUE REQUIREMENT

Economic & Inflation Factors

The forecast of operating and maintenance expenditures largely relies on the City's 2023 – 2024 budget projections. The line items in the budget are then adjusted each year thereafter by utilizing one of the following applicable factors:

- ***General Cost Inflation:*** Assumed to be 3.0% per year based on budgeting assumptions provided by City staff. Though recent inflation has significantly exceeded historical averages, the financial plan assumes that economic conditions will return to normal (as defined by longer-term historical averages) by 2025. This is consistent with and slightly higher than the projections of inflation in the Seattle Consumer Price Index released by the Washington State Economic and Revenue Forecast Council in November 2022.
- ***Labor Cost Inflation:*** Based on budgeting assumptions provided by City staff, salary and benefit costs are assumed to increase by 6.3% in 2023 and by 3.5% per year thereafter.
- ***Interfund/Other Services:*** Assumed to be 2.0% per year based on budgeting assumptions provided by City staff.
- ***Professional Services:*** Assumed to be 2.4% per year based on budgeting assumptions provided by City staff.
- ***Construction Costs:*** The surface water CIP provided by City staff reflected adjustments for construction cost inflation at 15.0% for 2023 and 5.0% per year for 2024 – 2028. Beyond 2028, the forecast assumes inflation at a long-term average rate of 3.0% per year.
- ***Customer Account Growth:*** Assumed to be 0.50% per year based on planning assumptions provided by City staff. This equates to roughly 235 additional equivalent service units (ESUs) per year.

- ***Taxes:*** Calculated on projected revenues, including both the State Business and Occupation Tax rate of 1.75% and the City's utility tax rate of 6.98%.

- ***Fund Earnings:*** Assumed to be 1.50 % per year based on recent earnings reports from the State's Local Government Investment Pool (LGIP), and discussions with City staff.

Fund Balances

The surface water utility began 2023 with roughly $9.6 million in cash and investments (including both capital and operating cash balances). For forecasting purposes, operating resources and uses are tracked separately from capital resources and uses. **Exhibit 3** shows that of the $9.6 million in beginning cash, nearly $4.6 million is available for future capital projects after accounting for 2023's minimum reserve balance targets.

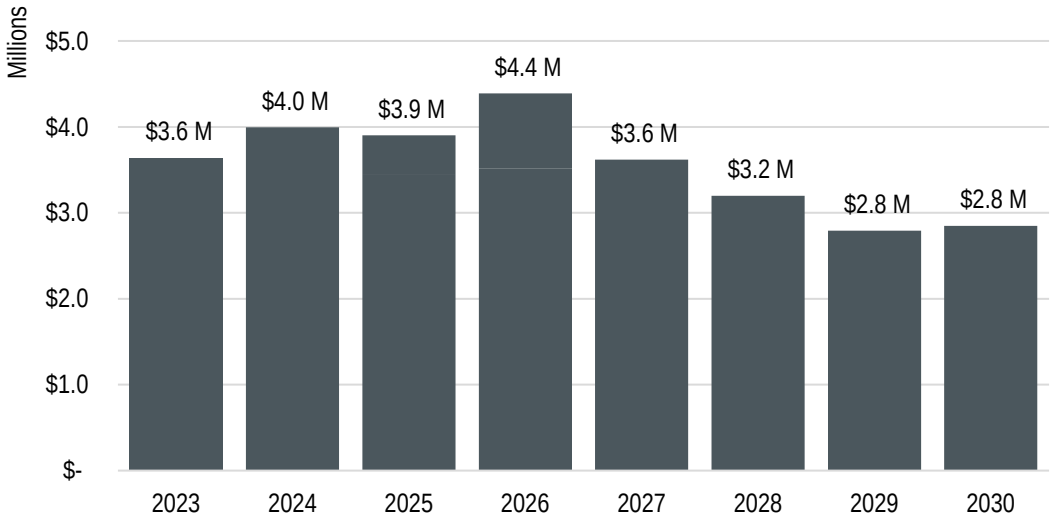
Exhibit 3: Summary of Estimated Cash Balances (2023)

Description	Amount
Total Beginning Cash for 2023	$9.6 million
Less: Minimum Operating & Capital Reserve Balance Targets	$5.0 million
Available for Future Capital Projects	$4.6 million

Capital Expenditure Forecast

The City's 2023 – 2028 surface water CIP includes $22.7 million in project costs. Beyond 2028, the forecast assumes a "placeholder" expense equal to the surface water utility's projected annual depreciation expense (based on the premise that the utility would spend money generated for system reinvestment on projects). **Exhibit 4** shows the projected capital expenditures by year, which add up to a cumulative total of $28.4 million from 2023 – 2030.

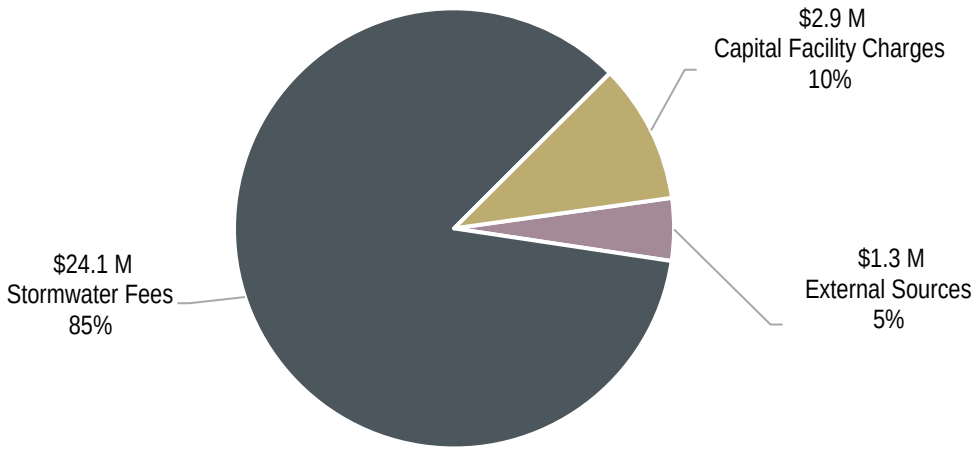
Exhibit 4: Projected Capital Expenditures



Capital Funding Strategy

Of the total $28.4 million in costs shown in **Exhibit 4**, $1.3 million is expected to be funded through external sources, $24.1 million is expected to be funded through annual surface water operating revenues, and $2.9 million is expected to be funded through capital facility charges (CFCs). The anticipated funding from CFCs reflects an increase in the surface water CFC from $508 to $1,556 per equivalent service unit (ESU) that the City Council adopted with the passing of Ordinance O-4808. This increase was recommended based on a review of the surface water CFC that was completed as part of the 2022 rate study. We recommend that the City review its surface water CFCs every two years and update them as needed to keep them consistent with system costs. The capital funding strategy is summarized in **Exhibit 5**.

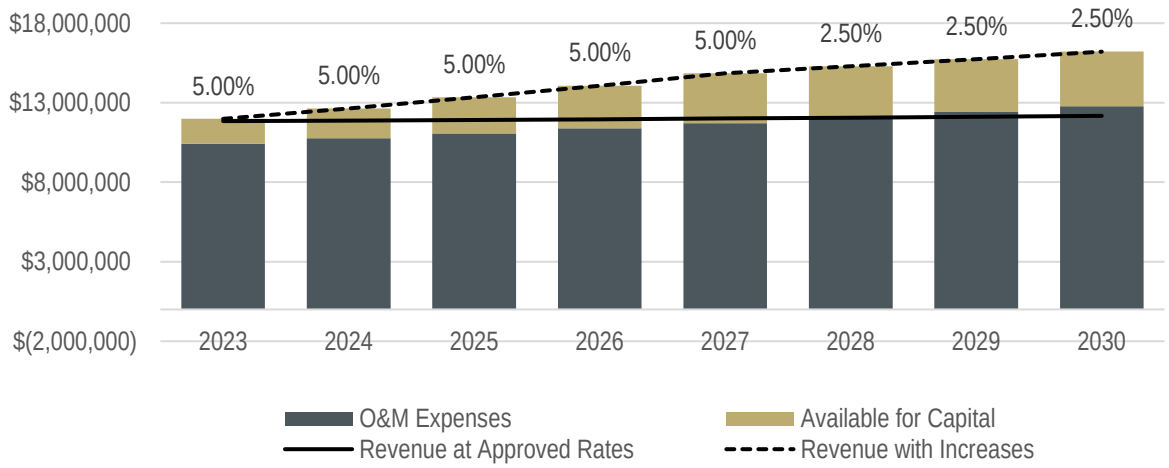
Exhibit 5: Capital Funding Strategy (2023 – 2030)



SURFACE WATER REVENUE REQUIREMENT RESULTS

Exhibit 6 presents the "baseline" revenue requirement forecast through 2030 based on the adopted 2023 – 2024 Budget and rate plan adopted by the City Council.

Exhibit 6: Surface Water Financial Plan Summary



	2023*	2024*	2025	2026	2027	2028	2029	2030
Annual Rate Increase	5.00%	5.00%	5.00%	5.00%	5.00%	2.50%	2.50%	2.50%
Monthly Surface Water Rate	$19.75	$20.74	$21.77	$22.86	$24.01	$24.61	$25.22	$25.85

*Rates were adopted on October 18th, 2022, in *Ordinance O-4820*

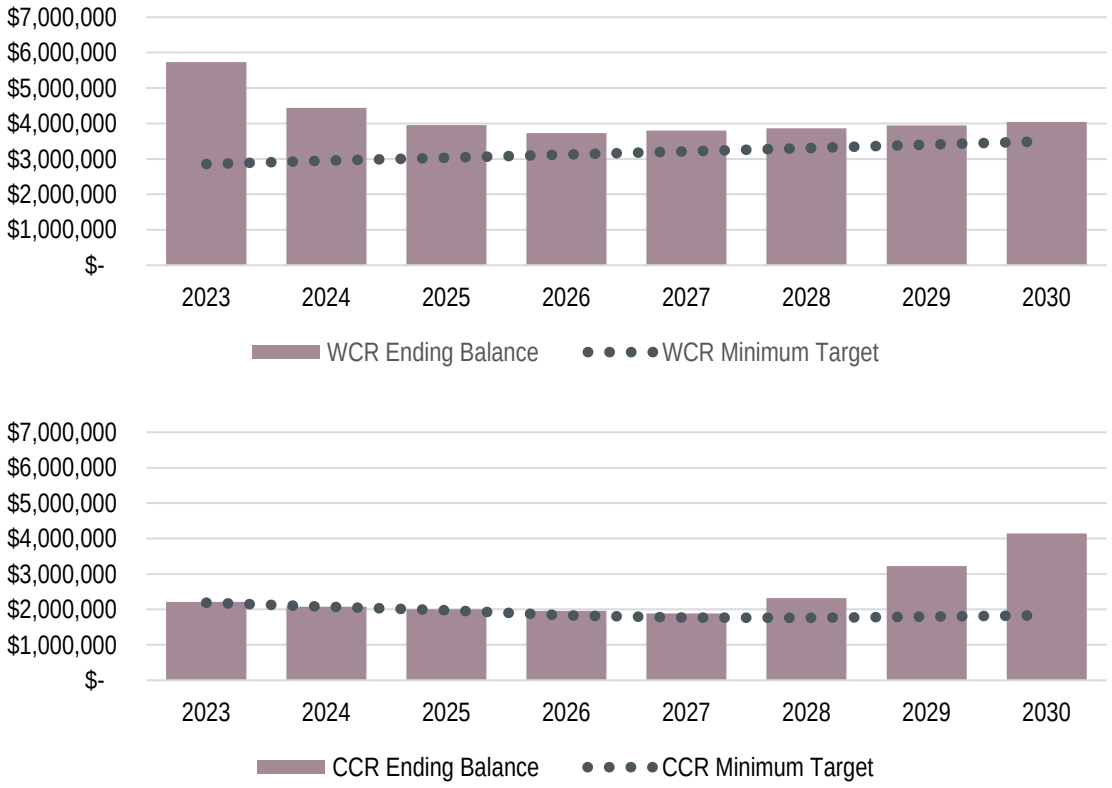
Exhibit 6 shows that at existing rates, the utility is able to cover all operating expenses through the year 2028. However, starting in 2023 the utility will need rate increases to cover anticipated capital. In this analysis, capital costs are the main driver for the utility's rate increases.

Note that the rate increases shown in **Exhibit 6** reflect an additional policy target with respect to reserve funding. In addition to meeting the operating and capital reserve targets, the surface water rates are set to meet a combined operating/capital reserve target of 180 days of operating and maintenance expenses. The bond rating agencies have recommended this target for utilities aspiring to achieve the highest possible bond ratings.

Although this target is not explicitly stated in the City's formal fiscal policies, it is consistent with the intent expressed in Section 5.3 of the City's Debt Management Policy ("The City will continually strive to maintain its bond rating by improving financial policies…so its borrowing costs are minimized and its access to credit is preserved."). Though the capital funding plan presented in **Exhibit 5** does not show any future bond issuance, the surface water financial plan incorporates this standard because of the anticipated issuance of revenue bonds by the City's sewer utility. As revenue bonds are typically secured jointly by all utility revenues, we have assumed that this target would apply to all of the City's utilities.

Exhibit 7 shows that in each year of the forecast, the surface water utility is expected to meet both the WCR and the CCR target balances.

Exhibit 7: Reserve Forecast



LEVEL-OF-SERVICE (LOS) SCENARIOS

The SWMP outlines three levels of service for the operations of the surface water utility:

- ***Minimum LOS:*** Includes operating investments needed to fulfill regulatory requirements, meet Council priorities, and provide sufficient staff and resources to meet the current level of service more efficiently.
- ***Moderate LOS:*** Includes projects that are strongly recommended to advance the surface water utility's priorities and prepare it for the future, proactively enhancing existing work programs to deliver projects more efficiently.
- ***Enhanced LOS:*** Includes additional projects that would be beneficial but are not requirements, also providing additional capital funding that would allow another high-priority project to be constructed every year.

The financial plan presented in **Exhibit 6** constitutes the "Minimum LOS" scenario, representing the strategy of rate increases needed to support the completion of planned capital projects while funding ongoing operations (with the service packages approved by the City Council for the 2023 – 2024

Budget). City staff provided estimates of the one-time and ongoing operating costs associated with the other LOS scenarios.

- Adjusting for inflation, the "Moderate LOS" scenario would increase the surface water utility's annual operating costs by $1.5 – $1.9 million from 2025 through 2030, also requiring a total of $2.8 million in one-time investments during that period.

- Relative to the "Moderate LOS" scenario, the "Enhanced LOS" scenario would increase annual operating costs by an additional $0.2 million from 2025 through 2030 and require an additional $0.9 million in one-time investments.

The evaluation also considers three levels of capital investment:

- Minimum: The capital plan summarized in **Exhibit 4**.

- Moderate: $500,000 per year in capital investment above the minimum scenario, which would allow another high-priority project to be completed every two years.

- Enhanced: $1 million per year in capital investment above the minimum scenario, which would allow another high-priority project to be constructed every year.

Exhibit 8 summarizes the cumulative rate impact of each scenario by 2030.

Exhibit 8: Summary of LOS Scenarios

LOS Scenarios	Minimum LOS	Moderate LOS (Operations)			Enhanced LOS (Operations)		
		+$0 CIP	+$500K CIP	+1.0 M CIP	+$0 CIP	+$500K CIP	+1.0 M CIP
Projected Monthly Rate (in 2030)	$25.85	$30.69	$31.73	$32.77	$30.69	$31.73	$32.77
Incremental Impact vs. Minimum	-	*+$4.84*	*+$5.88*	*+$6.91*	*+$4.84*	*+$5.88*	*+$6.91*
Average Annual Rate Increases (2023-2030)	4.6%	7.6%	8.2%	8.8%	7.6%	8.2%	8.8%
Incremental Impact vs. Minimum	-	*+3.0%*	*+3.6%*	*+4.2%*	*+3.0%*	*+3.6%*	*+4.2%*

The average annual surface water rate increase in the "Minimum LOS" scenario is 4.6%. The incremental operating costs associated with the "Moderate LOS" scenario would require an additional average annual rate increase of 3.0%, resulting in a cumulative increase of $4.84 per month in the surface water bill by 2030. **Exhibit 8** suggests that the incremental operating costs in the "Enhanced LOS" scenario do not materially impact the rate forecast (relative to the rate increases needed to support the additional operating costs in the "Moderate LOS" scenario) because the ongoing operating costs in the "Enhanced LOS" scenario are minimal compared to those in the "Moderate LOS" scenario.

The alternate levels of capital investment appear to impact the rate forecast more significantly, requiring an incremental average annual rate increase on the order of 0.6% (an increase of $1.04 to the monthly surface water rate) per $500,000 of additional annual capital investment.