THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: September 26, 2025 **IBA Report Number:** 25-31

City Council Docket Date: September 30, 2025

Item Number: 331

Additional IBA Review of the Public Utilities Department FY 2026-2029 Water and Wastewater Cost of Service and Rate Increases

OVERVIEW

On September 30th, the City Council will be holding a public hearing to consider rate increases for both the Water and Wastewater system. The Public Utilities Department (PUD) recently conducted Cost-of-Service (COS) studies for each system, which recommended the proposed rate increases that are being brought forward by PUD.

In response to concerns over the impact of the proposed rates on the City's customers, our Office has done additional analysis of the financial plans prepared by PUD. *As we have maintained previously, the COS studies prepared by PUD demonstrate the need for increased revenues for both systems in order to maintain operations.* In the current environment of declining water sales and wastewater flows which generate revenue for the systems, **this inevitably means increasing rates.** Without additional revenues to support the system, PUD will need to cut expenses, either through decreased operating costs or lower spending on the Capital Improvements Program (CIP). Both of these options come with significant risks and tradeoffs that the Council should be aware of prior to making their final decision.

This report discusses the anticipated revenue impact that the rate proposal will have for each system, as well as the potential impacts should either lower rates or no rate increase be approved.

BACKGROUND

Our Office has conducted numerous reviews over the last couple of years on PUD's Five-Year Financial Outlooks for both systems. This section will provide a brief synopsis of the major takeaways and recommendations from each of the IBA reports. We would also encourage Council and the public to read these reports as well, as they outline how the Water and Wastewater systems got to their current financial situation, and the steps that have been taken to avoid steeper rate increases.

- IBA Report 22-34 *IBA Review of the Public Utilities Department FY 2024-2028 Five-Year Financial Outlook* – This Outlook was prepared just prior to the last water rate case in 2023. Our analysis noted that the largest reason for increasing rates was due to decreasing water demands and limited rate increases in the prior years for the water system. Wastewater during this Outlook was in the middle of a previously approved four-year rate case and had strong metrics.

- IBA Report 23-07REV *Independent Review of the Public Utilities Department's Water Cost of Service Study and Request for Rate Increase for FY 2024-2025* – This was an independent review of the 2023 Water COS study conducted by Stantec on behalf of the IBA. The report found that the Financial Plan was sound, and that revenue and expenditure projections tracked with historical trends.

- IBA Report 23-38 *IBA Review of the Public Utilities Department FY 2025-2029 Five-Year Financial Outlook* – This report in particular noted that the need to increase rates was being driven by two factors: for both systems, increased operating costs tied to personnel, energy, and supply costs, and for Water, increased water purchase costs. This was the first report to make specific recommendations in regard to changes that the City's appointed representatives (City-10) should seek to achieve at the San Diego County Water Authority (CWA), the City's wholesale water provider. The report also offered alternatives that could potentially lower rate impacts, almost all of which have been incorporated by PUD into the current COS studies for both systems.[1]

- IBA Report 25-02 *IBA Review of the Public Utilities Department FY 2026-2030 Five-Year Financial Outlook* – This report covered how continuing declines in water sales to PUD's customers, combined with increased costs for operating expenses and water purchases from the CWA, continued to drive rates higher than previous Outlooks. This was despite planned CIP deferrals as well as significant use of cash that lowered key financial metrics to try and limit rate impacts. This report also continued to focus on specific recommendations to the City-10 in regard to upcoming budget and rate setting processes at the CWA.

- IBA Report 25-23 & IBA Report 25-24 – *Independent Review of the Public Utilities Department's Water (Wastewater) Cost of Service Study and Request for Rate Increase for FY 2026-2029* – These two reports are independent reviews of the current COS studies conducted by Stantec on behalf of the IBA. Once again, Stantec found that the Financial Plans were sound for both systems, tracked with historical trends, and used reasonable sales assumptions.

FISCAL/POLICY DISUSSION

[1] These options were to 1) smooth out rates so that they were not high in the first year and then lower in subsequent years; 2) increase local water usage assumptions; 3) smooth out the issuance of debt to support the CIP in order to maintain steadier financial metrics; and 4) reduce or defer CIP projects.

This report focuses both on the status of important financial metrics that have been highlighted in previous IBA reports as well as revenue impacts for the proposed rate increases for each system. For more detail on the importance of the various financial metrics, we recommend referring to one of the IBA reports reviewing the PUD Five-Year Financial Outlook that were referenced in the previous section.

Water System

The Water System has the largest proposed rate increases and has the most impact on a customer's bill. The rates for the water system are larger than the wastewater system due to the fact that the revenue generated from these rates has to cover the costs of both the City's water operations as well as water purchases from the CWA. As shown in the table below, the impact of increasing costs for water purchases makes up a significant portion of the rate increase for the water fund, especially in the first two years.

Proposed Water Rate Increases				
	1/1/2026	1/1/2027	1/1/2028	1/1/2029
CWA Purchase Costs	13.6%	11.4%	3.5%	5.6%
Water System Costs	1.1%	3.1%	8.0%	5.4%
Total Rate Increase	14.7%	14.5%	11.5%	11.0%

It is important to note the overall impact of CWA's rate increases on the City's proposed rates. The proportion of the rate increase attributed to CWA's cost is tied to the proportion of the total revenue increase needed to cover the increase in total water purchase expenditures. For FY 2026, the expected increase in the CWA's water purchase costs ($48.6 million) makes up 92.6% of the expected revenue increase for that year from the proposed 14.7% rate adjustment ($52.5 million). Hence, 92.6% of the total rate increase is attributed to water purchase costs. The reason that CWA water purchase costs are going up so dramatically is driven by a combination of factors, including changes to water purchase assumptions, as well as increases for both fixed and volumetric charges.

In preparing this report, our Office was provided an updated model that included the actual rates that were approved by the CWA Board of Directors for 2026. Even though the percentage increase in the rates as published by CWA was lower than initially anticipated, the new fixed costs, volumetric charges, and updated water purchase volumes did not result in a significant change in the overall financial metrics for the Water System.

Financial Metrics and Cash Availability

PUD's financial metrics—such as debt service coverage ratios, Rate Stabilization Fund (RSF) levels, and days of cash on hand—are essential tools for ensuring the utility's financial health, guiding rate-setting decisions, and maintaining strong credit ratings to secure low-cost financing. As presented in the Water COS study, PUD has already done what it can with its cash reserves and RSF to lessen the impact on the rates in the near term and spread out the rate increase over the four-year period. The table below shows the projected use of the RSF, as well as other important metrics.

Financial Metrics in Water Cost-of-Service				
Water System	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**
Debt Service Coverage Ratio	1.25 x	1.22 x	1.40 x	1.69 x
Rate Stabilization Fund Balance	$ 15.4	$ 5.4	$ 12.4	$ 57.4
Above/(Below) Rate Stabilization Target	$ (22.0)	$ (36.1)	$ (35.2)	$ 3.5
Days of Cash on Hand	89	59	89	149

While the RSF balance as projected in the Water COS study is slightly better than what was included in the most recent PUD Five-Year Financial Outlook, the remaining metrics are below the Outlook projection, and in particular show the cash crunch that the Water System is anticipated to experience in both FY 2026 and FY 2027. Whereas previous projections did not have the debt service coverage ratio going below a 1.30x, with a 1.50x being the policy target, the Water COS proposes to lower this metric down to 1.22x in FY 2027, with recovery thereafter. This is done in conjunction with using significant fund balances from the RSF, taking the fund from a projected fund balance at the end of FY 2025 of $40 million down to $5 million in FY 2027 before recovery happens over the last two years.

For illustrative purposes, our Office reran the model using a different rate scenario, where each year's rate increase was lowered to 10% per year, without changing any other assumptions as far as expenditures or current rate revenue. Those financial metrics are presented in the table below. Note that the RSF metric would remain the same since no further use of the fund is assumed.

Alternative Rate Scenario: Financial Metrics for Water				
Water System	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**
Updated Rates	*10.0%*	*10.0%*	*10.0%*	*10.0%*
Debt Service Coverage Ratio	1.13 x	0.86 x	0.93 x	1.10 x
Rate Stabilization Fund Balance	$ 15.4	$ 5.4	$ 12.4	$ 57.4
Above/(Below) Rate Stabilization Target	$ (22.0)	$ (36.1)	$ (35.2)	$ 3.5
Days of Cash on Hand	80	24	15	27

Without expenditure decreases, the debt service coverage ratios would fall dramatically down to 1.13x in FY 2026, and then below 1.00x in FY 2027 and FY 2028. Falling below a debt service coverage ratio of 1.10x would violate the City's bond covenants on the debt, and further falling below 1.00x indicates that the City would not have enough cash to make debt service payments in those years. Additionally, the days of cash on hand, which has a policy target of 160 days, would fall down to 15 days, or rather two weeks. This also means that other reserves, such as the Emergency Operating Reserve, would be well below target. **Because the financial metrics under the proposed rate structure are already at the lowest advisable point, there are no financial levers that PUD can use to absorb rate reductions below the proposed rates, particularly in FY 2026 and FY 2027, without resorting to lowering expenditures.** At this point, any decrease in revenue due to either approvals of a lower rate increase, delays in the rate increase, or not approving the rate increase at all, will require significant reductions to the operating expenses of the Water System.

Potential Impacts from Lower or Delayed Rate Increases

The table below provides an overview of the expected revenue and cash expenditures anticipated in the Water COS study. This provides an overview of how PUD is anticipating to generate revenue as well as what is driving their cash needs for each of the years covered in the study. As shown in the table, cash revenues are anticipated to be close to cash expenditures in FY 2026 and FY 2027 (with the RSF or other cash reserves assumed to bridge any gaps), with the trend reversing in FY 2028 and FY 2029. Since things like debt service and water purchases are fixed costs in FY 2026, expenditure reductions required to match revenue reductions will inevitably have to come from operations.

Water Expenditures, Revenues, and Rates				
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**
Existing Rate Revenue	$ 714.4	$ 716.1	$ 717.9	$ 719.6
Revenue from Rate Increases	52.5	164.8	279.1	392.1
Other Revenue	90.1	98.2	99.0	107.1
Total Cash Revenue	***$ 857.0***	***$ 979.1***	***$ 1,096.0***	***$ 1,218.8***
Water Purchases	$ 346.5	$ 393.3	$ 409.9	$ 439.4
Operating Expenditures	359.6	409.0	417.4	410.4
Debt Service	151.4	163.6	196.7	199.9
Total Cash Expenditures	***$ 857.5***	***$ 965.9***	***$ 1,024.0***	***$ 1,049.7***
Rate Increase	**14.7%**	**14.5%**	**11.5%**	**11.0%**

Not approving any rate increase at all, or a lower amount, would require ongoing reductions to the Department's operating expenditures. Operating expenditures for the Water System in FY 2026, absent debt service and water purchase payments, is approximately $359.6 million. If additional rate revenue is not realized, this would require a reduction from the operating budget of PUD beginning in FY 2026, which is the fiscal year currently underway and therefore could not be spread over the full fiscal year. In order to meet revenue shortfalls, PUD would have to make ongoing cuts in line with the ongoing revenue reductions. Based on current projections, rate revenue in FY 2026 and moving forward is approximately $8.8 million per month. That annualizes to a total of $105.6 million, which is approximately what PUD would need to cut from its operating expenditures, representing close to 29.4%.

While there is the potential that some of the revenue reduction could be made up from changes to water purchases, or lowering debt service assumptions due to delayed CIPs, PUD would still need to shrink its operations at a level beyond what is likely feasible without significant impacts in FY 2026. PUD would mostly likely start with reducing things like building maintenance or IT projects. While this would not directly impact customers immediately, these are expenditures that would 1) likely need to be restored at a later date, and 2) will not be enough to meet the reductions required. Thus, reductions at this proportion will most likely result in reductions to staff. These reductions will be felt by customers in potential longer call times to customer service and greater levels of service disruption. PUD would also likely see unavoidable increased costs in the future due to greater emergency repair needs as well as regulatory fines.

Reductions at this level could potentially impact other operating costs, including expenditures that PUD incurs to pay for General Fund services such as the Department of Finance, City Attorney's

Office, Transportation, and others. Other areas of impact could also include funds that support Engineering & Capital Projects as well as the Department of General Services since PUD is a heavy user of those departments' services, and therefore contributes a significant amount of revenue to these funds and departments.

Delaying the implementation of a FY 2026 rate increase will also require PUD to make significant adjustments to their operating expenditures, although these would possibly be one-time reductions. For illustrative purposes, the amount of revenue generated by the rate increase in FY 2026 is $52.5 million, which will be generated over a six-month period. Without approval on September 30th, it would be a minimum of a three-month delay in the implementation of a rate increase. This would result in a one-time loss of approximately $26.2 million based on the COS financial model. As noted previously, there is no longer this amount available in the RSF to absorb this one-time loss, and as such cuts will need to be made to PUD's operating expenditures.

FY 2027 is also anticipated to be a year with limited cash availability and requires both the FY 2026 rate increase and the FY 2027 rate increase to be approved in order to prevent financial metrics from dipping lower. As noted in the previous table, expenditures in FY 2027 are anticipated to be even higher than FY 2026, and the revenue from the rate increases from both years totals $164.8 million. As shown in the previous table with financial metrics for an alternative scenario assuming lower rate approvals, the most profound impacts are in FY 2027. This makes sense as FY 2027 is the nadir as far as financial metrics for the system and includes the last significant CWA cost increase. **At a minimum, approving the FY 2026 and FY 2027 rate increases at or near the proposed rates in the COS study is crucial to maintaining the operations of the water system.**

Due to lower rate increases anticipated for CWA costs in outyears, as well as stabilized water purchase assumptions, there is more room to lower revenue increases in FY 2028 and FY 2029. However, doing so comes with two potential downsides. First, per the financial plan in the COS study, these are the years when PUD is anticipating to replenish the reserves, particularly the RSF, that will have been heavily relied upon over the prior few years. These years are also when many of the CIP projects that were previously delayed due to the cash crunch in FY 2026 and FY 2027 are anticipated to come back into the CIP. Without additional revenue, this will limit options during the next rate period to either smooth out rates or withstand major changes in water sales due to rain events. This will also potentially make the next round of rate increases higher than they other would need to be.

Second, the assumptions for increased costs passed through from the CWA are relatively modest in these years. The model currently assumes that CWA rates will increase at about 8.0% per year in FY 2027, 2028, and 2029. If the CWA increases their rates higher than these assumptions, it will require PUD to either come back and ask Council for additional rate authority to cover these passthrough charges, or otherwise absorb these costs through their operations. Given the financial issues that are anticipated for CWA in these years due to various Pure Water projects coming online, creating a significant local water supply, and without significant headway on them selling excess water, it is unknown if these assumptions will hold.

Wastewater System

The City's Wastewater System also shows the need for rate increases, although not as substantial as those proposed for the Water System, as shown in the table below. This is due to that fact that wastewater historically does not have the same customer sales volatility as the Water System, is not similarly impacted by increased water purchase costs from CWA, and the Wastewater System is coming to the end of a four-year period where steady rate increases were previously approved for the system in 2021. Prior to that, it had been numerous years without a rate increase for Wastewater.

Proposed Wastewater Rate Increases				
	1/1/2026	1/1/2027	1/1/2028	1/1/2029
Wastewater System	6.0%	6.0%	8.0%	8.0%

Financial Metrics and Cash Availability

Even with these steady increases, the Wastewater System still shows a need for additional rate revenue. The table below provides the same financial metrics that were previously provided for the Water System, but now for the Wastewater System. As shown in the table, the Wastewater System does maintain a higher debt service coverage ratio, although it is still below the policy target of 1.50x. The days of cash on hand are also all above the target of 160 days, with the exception of FY 2028 – off by one day.

Financial Metrics in Wastewater Cost-of-Service				
Wastewater System	FY 2026	FY 2027	FY 2028	FY 2029
Debt Service Coverage Ratio	1.40 x	1.33 x	1.41 x	1.37 x
Rate Stabilization Fund Balance	$ 79.3	$ 38.3	$ 28.3	$ 5.3
Above/(Below) Rate Stabilization Target	$ 56.8	$ 15.2	$ 4.6	$ (19.8)
Days of Cash on Hand	314	456	159	245

For the Wastewater System, however, the concerning metric is the continued use of the RSF even with the rate increases. While the fund is currently projected to have a sizeable balance in FY 2026, this balance is almost depleted by FY 2029, even with the additional rate revenue. As will be discussed more below, this is due to the total cash revenue each year closely matching the total amount of cash outflows to the system.

Our Office did run a scenario with different rate implications where we removed the rate increase for FY 2026, and then lowered the other increases to 5.0% in each subsequent year. The results of the impact of these rate changes on the financial metrics are shown in the table below. As with the water alternative scenario, no additional RSF balance was assumed.

Alternative Rate Scenario: Financial Metrics for Wastewater				
Wastewater System	FY 2026	FY 2027	FY 2028	FY 2029
Updated Rates	*0.0%*	*5.0%*	*5.0%*	*5.0%*
Debt Service Coverage Ratio	1.30 x	1.16 x	1.15 x	1.06 x
Rate Stabilization Fund Balance	$ 79.3	$ 38.3	$ 28.3	$ 5.3
Above/(Below) Rate Stabilization Target	$ 56.8	$ 15.2	$ 4.6	$ (19.8)
Days of Cash on Hand	304	425	99	146

While FY 2026 metrics show an ability to withstand a rate decline, the implication is that subsequent years show serious deterioration, particularly for the debt service coverage ratio. The ratio would dip below 1.20x in FY 2027 and would fall to as low as 1.06x in FY 2029, which would violate bond covenants. This demonstrates that while the Wastewater System could potentially withstand rate decreases in early years, ongoing reductions would need to be made up in the later years in order to maintain the system's financial metrics.

Potential Impacts from Lower Rate Increases

Due to the better fiscal health of the Wastewater System overall, there is the potential that rate changes could be accommodated. However, while the consequences would not be as dire as for the Water System, there would be potential consequences in later years. We note that consistently approving modest rate increases is a more fiscally prudent approach to managing the system and mitigating future impacts to customers.

First, it is important to note that the revenues for the Wastewater System basically match the cash expenditures required for both operations and debt service. This is why the RSF is being used to maintain the debt service coverage ratio for this system. If lower rates are approved in the earlier years, that would inevitably require higher rates in subsequent years unless expenditures are decreased.

Wastewater Expenditures, Revenues, and Rates				
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**
Existing Rate Revenue	$ 341.1	$ 329.4	$ 330.0	$ 330.7
Revenue from Rate Increases	10.2	30.2	55.6	86.7
Other Revenue	135.6	142.1	143.0	143.1
Total Cash Revenue	***$ 486.9***	***$ 501.7***	***$ 528.6***	***$ 560.5***
Operating Expenditures	$ 368.7	$ 389.3	$ 399.9	$ 410.4
Debt Service	101.6	124.4	121.5	150.6
Total Cash Expenditures	***$ 470.3***	***$ 513.7***	***$ 521.4***	***$ 561.0***
Rate Increase	**6.0%**	**6.0%**	**8.0%**	**8.0%**

Working along a similar logic as was discussed for the Water System, PUD would most likely need to make reductions in line with monthly revenue reductions. At the rates proposed, the Wastewater System would be forecasted to generate an additional $1.7 million per month. This annualizes to $20.4 million, which would represent an approximately 4.9% reduction to the Wastewater System's operating budget. However, due to the better financial health of the Wastewater System, these cuts might not have to be implemented in FY 2026. Additionally, a reduction of this size would most likely be to items such as IT upgrades and deferred maintenance, which would mostly likely need to be made up in later years. However, if the Water System is having to remove positions related to customer support or administration, many of these positions are cost shared between the two systems. Therefore, some of the operating reductions required without a rate increase to the Water System might inevitably impact the Wastewater System as well.

CONCLUSION

PUD is being forward a proposal to increase rates substantially for the Water System, and increase rates for the Wastewater System, in order to maintain operations and meet the financial needs of each system. This report adds to our Office's previous analysis of PUD's financial plans. As previously stated, and has been confirmed by our independent consultant, the financial plans for both systems are sound, and the rates reflect the needs for each system. The need to increase rates is driven by a combination of increasing costs to both systems, combined with stagnant sales and flows that require increased costs to be supported by rate increases. The Wastewater System is in a healthier position due to regular rate increases over the past four years, while the Water System is in the most need of financial assistance due to increasing water purchase costs and lower financial buffers due to the lack of regular rate increases prior to 2023.

Based on Council feedback, our Office conducted this additional analysis in order to independently verify and stress test the financial models to provide the Council with clear information on what the impacts would be if the rate increase proposals are either modified or not approved. As discussed in this report, lower rate revenues will require reductions to operating expenditures, with the most acute impacts occurring within the Water System during FY 2026 and 2027.

We would like to thank PUD staff for providing us extended access to their models and expeditiously answering all of our questions. We are prepared to assist the Council further on this topic as they consider the rate proposals.

Jordan More
Principal Fiscal and Policy Analyst

APPROVED: Jillian Andolina
Deputy Director