THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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IBA Review of the Public Utilities Department FY 2027-2031 Five-Year Financial Outlook

OVERVIEW

The *Public Utilities Department Fiscal Year 2027-2031 Five-Year Financial Outlook* (PUD Outlook) was released on December 4, 2025. Similar to the Five-Year Financial Outlook for the General Fund, *Council Policy 000-02: Budget Policies* states that the PUD Outlook is intended "to guide long-range planning and serve as the framework for the development of the next year's Proposed Budget for the Water and Sewer Enterprise Funds." While the General Fund Outlook has been an annual report since 2006, this is the seventh PUD Outlook. In addition to projecting what may be included in future proposed budgets, the PUD Outlook also serves as the basis for projecting costs as well as potential future revenue needs for the next set of proposed water and wastewater rates. This PUD Outlook includes both already approved rate increases as well as anticipated rate increases for both systems. **The rate increases included in this Outlook are anticipated to be the rates that the Council will be asked to approve in the next Cost-of-Service (COS) study if expenditure and revenue assumptions do not change significantly.**

The Office of the Independent Budget Analyst (IBA) is charged with providing the City Council with review and analysis of all major budget reports including the PUD Outlook. While the City Council cannot change this PUD Outlook, City Council is the ultimate budget authority and can make changes to the Proposed Budget for the Public Utilities Department (PUD) during its review of the FY 2027 Proposed Budget following its release in April 2026. City Council will also review any proposed water and wastewater rate cases brought forth following the Proposition 218 process and has the ultimate authority to approve rates.

For this review of the PUD Outlook, our Office provides an analysis of the various factors that are driving increased costs, and consequently a need for increased revenue and rates. This analysis also covers the major financial indicators and metrics used to ensure the enterprise funds are sound, and how those indicators are impacted by spending and rate decisions. We also examine changes to revenue and expenditure assumptions, increases in water purchase costs, and increases to the

overall CIP program. Finally, we conclude with a discussion on policy matters that the City's representatives on the San Diego County Water Authority (CWA) should consider over the next year.

FISCAL/POLICY DISUSSION

Overview

PUD operates two major utility systems, the City's water system and the City's wastewater system. Each function is accounted for and budgeted in separate funds. Water rate revenues must be used to support the activities of providing water to customers, while wastewater rate revenues can only be used to support the collection, treatment, and disposal of wastewater.[1] Across both water and wastewater functions, the PUD Outlook projects expenditures of approximately $2.3 billion in FY 2027 for operations, baseline (or more routine) capital projects as well as Pure Water capital expenditures, debt service, and reserve requirements, as summarized in the table below. Expenditure projections are highest in FY 2030, mostly due to declining CIP costs for both systems in FY 2031. Otherwise, most expenditure categories are projected to steadily rise throughout the Outlook period for both systems.

Summary of Public Utilites FY 2027-2031 Five-Year Financial Outlook Expenditures *(in millions)*						
	FY 2026 Adopted	**FY 2027 Projection**	**FY 2028 Projection**	**FY 2029 Projection**	**FY 2030 Projection**	**FY 2031 Projection**
Water Fund	$ 1,312.4	$ 1,406.5	$ 1,409.2	$ 1,595.2	$ 1,620.0	$ 1,576.6
Wastewater Funds	898.1	855.7	969.1	881.9	899.7	884.7
COMBINED	**$ 2,210.5**	**$ 2,262.2**	**$ 2,378.3**	**$ 2,477.1**	**$ 2,519.7**	**$ 2,461.3**

In contrast to the City's General Fund Outlook, PUD's Outlook does not reflect a gap (deficit or surplus) between revenues and expenditures. While the City's General Fund is constrained by available tax revenues to support expenditures, the water and wastewater systems are supported primarily by rates paid by customers using the systems. Historically, the PUD Outlook would first focus on projecting the costs of maintaining and operating the water and wastewater systems, and then estimate any revenue increases needed to fund those expenditures. However, this Outlook, particularly for the water system, includes various changes to expenditure assumptions to match the rates and revenue projections that were previously approved by the City Council or proposed in the prior COS study.

In addition to revenue and expenditure projections also covered by the previously approved rate cases, the Outlook serves as a preview of expenditure projections and revenue needs for the *next* set of water and wastewater rates. While the PUD Outlook identifies the overall system needs, COS analyses further allocate the cost of those needs to different user classes.[2]

[1] Note that the Wastewater System is broken down into separate funds for the (1) collection of wastewater from municipal customers in the City of San Diego (the Muni Fund) and (2) treatment and disposal of wastewater, which is provided for City of San Diego customers as well as other agencies in the region that utilize the City's wastewater treatment system (the Metro Fund). For the purposes of the PUD Outlook, these two funds have been combined.

[2] User classes for the Public Utilities system include Single-Family Domestic Customers, Multi-Family/Other Domestic Customers, Commercial and Industrial Customers, Temporary Construction, and Irrigation Customers.

Rate Increases

Water and wastewater rates are determined through a process prescribed by state law under Proposition 218, which requires a COS analysis, the opportunity for a majority protest by impacted parcels/customers, and approval of the legislative body (the City Council) of rate adjustments at a public hearing.[3] COS studies provide detail on projected expenditures, determine the total revenue required to cover those expenditures, and allocate those revenue needs based on system functions and the demands each customer class places on the water and wastewater systems.

As summarized in the table below, the PUD Outlook shows the need for rate increases to support the water and wastewater systems over the next five years. These percentages are at the aggregate, summary level for each system and do not reflect how costs would be allocated to customer classes. That level of detail is included in the rate design portion of the respective COS study. It is important to note that rates detailed in COS studies may reflect higher percentage increases for some customer classes and lower increases – or even decreases – for others.

Summary of PUD Outlook Water and Wastewater Rate Increases FY 2026-2030						
	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031
Water[a]	14.7%	14.5%	11.5%	11.0%	11.0%	5.0%
Wastewater[b]	6.0%	6.0%	8.0%	8.0%	8.0%	7.0%

[a] *FY 2026 and FY 2027 rates represent up-to rate increase approved by Council in October 2025.*

[b] *FY 2026 - FY 2029 rates represent up-to rate increase approved by Council in October 2025.*

Over the Outlook period (FY 2027-2031), total rate increases are 65.2% for water and 42.9% for wastewater. As noted in the footnotes to the table, rate increases have already been approved through FY 2027 for the water system, and through FY 2029 for the wastewater system. Absent significant changes to either expenditures or revenue sources, **the rate increases included in the table above, for those years that do not already have a previously approved rate increase, are the rate increases for which PUD will seek Council approval in the future.**

Wastewater – For the wastewater system, rate increases are projected to be between 6.0% and 8.0% each year for the duration of the PUD Outlook. These rates are consistent with both the recently approved COS study as well as the previous PUD Outlook. As will be discussed, the PUD Outlook shows increased costs in the wastewater system – particularly for capital and debt service costs – requiring higher revenues, which when combined with static wastewater flows entering the system require increasing rates.

Water – For the water system, the PUD Outlook includes rate adjustments to support projected expenditures, reserves, and targeted financial metrics; rate adjustments range from 5.0% to 14.5% a year over the five-year period. These rate increases are consistent with what was proposed in the previous COS study as well as the previous PUD Outlook.

We raise two key points regarding water rates:

[3] Among other requirements, Proposition 218 requires a majority protest vote and public hearing before approval of proposed rates (Article XIII D, Section 6), and stipulates that rates charged to customers "must not exceed the proportional cost of the service attributable to the parcel or customer." (Article XIII D, Section 6, Subdivision (b))

- The current PUD Outlook continues to assume substantial increases in water rates, especially through FY 2030. As will be discussed, increases are tied both to increased operating expenditures and flat water demand assumptions, which are already lower than historical averages due to conservation.

- Since the City buys most of its water from CWA, expenditure projections for the water system are heavily impacted by increases in CWA's rates. Over the PUD Outlook period (FY 2027-2031), the majority of proposed water rate increases are associated with increased CWA water rates. However, because the City is adding new local water supplies through the Pure Water system, the share of the overall rate impact is smaller than in the past. Uncertainties related to CWA's rate increases are discussed in more detail at the end of this report.

Financial Metrics are a Factor for Rate Increases and also Reveal Financial Strain on Water System

The need for additional rate increases is in part driven by financial metrics targeted by each of the enterprise funds. These metrics ensure there is sufficient cash to fund operations, debt payments, and reserves. The main metrics PUD uses to ensure the enterprise funds have sufficient cash to meet the systems' needs are: Debt Service Coverage Ratios (DSCR), the Rate Stabilization Fund, and days of Cash on Hand. It is important to note that metrics provided in the Outlook assume the rate increases previously discussed will be approved. Any potential change in the assumed rates would result in a change in these metrics.

The water and wastewater system are experiencing vastly different performance when it comes to these financial metrics. For the water system, in the early years these metrics demonstrate the financial strain the system is under due to increasing costs for water purchases and operations. In the near term, all the financial metrics are below targets, in some cases significantly so. There is dramatic improvement in FY 2030 as both the DSCR and Rate Stabilization funds return to being above targets. Conversely, the wastewater system shows relatively healthy financials in each year, though the DSCR in FY 2029 is particularly low (though still positive). While the DSCR mostly remains below target, it is still relatively healthy, especially given that the Rate Stabilization Fund remains above targets in every year.

Debt Service Coverage Levels

PUD uses a combination of cash funding and debt financing to support the water and wastewater capital improvement program (CIP). DSCRs[4] are an important factor in the Outlook, because they impact the utility's credit rating, and a high credit rating is required to receive low-interest rate financing. Existing PUD bond covenants require a minimum DSCR of 1.2x for senior debt and 1.1x for aggregate debt. PUD indicates that it generally targets a DSCR of 1.5x for both the water and wastewater systems to maintain a high credit rating and receive low-cost borrowing. As shown in the table below, the Outlook includes a DSCR ranging from 1.18x to 2.18x for the water system and 1.25x to 1.52x for the wastewater system.

[4] The DSCR is a fund's revenues net of operating expenses divided by the total debt service owed. A DSCR less than 1.0 would indicate that the organization does not have enough revenues to support its debt payments through annual cash flows and would need to draw from fund balance or reserves or borrow additional funds in order to make debt payments. A DSCR of 1.2x means the utility has 20% more revenue than its payments, providing a safety margin for lenders.

Utility System Projected Debt Service Coverage Ratio *(in millions)*						
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**
Water						
Net Systems Revenue	$ 177.6	$ 202.7	$ 245.5	$ 291.0	$ 399.5	$ 492.3
Debt Service	$ 140.1	$ 172.0	$ 190.0	$ 196.6	$ 211.6	$ 226.2
Debt service Ratio	1.27 x	1.18 x	1.29 x	1.48 x	1.89 x	2.18 x
Wastewater						
Net Systems Revenue	$ 149.8	$ 195.1	$ 185.0	$ 205.2	$ 208.9	$ 252.1
Debt Service	$ 102.1	$ 138.2	$ 121.6	$ 163.9	$ 152.0	$ 172.0
Debt service Ratio	1.47 x	1.41 x	1.52 x	1.25 x	1.37 x	1.47 x

Each utility has different DSCR metrics during the Outlook period, with the water system moving above the 1.5x target in FY 2030, while the wastewater system remains below the target throughout the Outlook period, with the exception of FY 2028. For both systems, overall debt service throughout the Outlook period increases, with debt service for the water system increasing by 61.5% and the wastewater system by 68.5%. These increases in debt service are attributed to assumptions regarding how much the City will spend on capital projects and how much of that spending will be financed through borrowing rather than paid upfront with cash.

As the debt service increases, net system revenue is also projected to increase to maintain coverage ratios in the wastewater system while dramatically improving the coverage ratio of the water system, reaching over 2.0x in FY 2031. While this could typically be an indicator that rate increases might not be needed at the magnitudes included in the Outlook, there are some large CIP projects that are projected to begin construction in FY 2032 that will require significant debt proceeds to finance over the following years. *Our Office will monitor the DSCR and related CIP spending over the next year and prior to the next Outlook to determine the appropriateness of these metrics in line with the proposed rate increases.*

Rate Stabilization and Reserve Requirements

Reserve balances and targets are important factors in the PUD Outlook: reserves help ensure stable, reliable operations and are required to meet debt financing requirements. The Department maintains reserve funds in accordance with the City's Reserves Policy (*Council Policy 100-20: Reserve Policy*). There are three reserves for both the Water and Wastewater Utility Funds: an Emergency Operating Fund, an Emergency Capital Reserve Fund, and a Rate Stabilization Reserve Fund. The Water Utility Fund also has a Secondary Purchase Reserve fund intended to mitigate risks associated with rainfall variability and unforeseen emergencies impacting supply. At the end of FY 2026 the Water and Wastewater Utility Funds are estimated to have total reserves of approximately $116.9 million and $183.6 million, respectively. Reserves

Council Policy 100-20: Reserve Policy

- Emergency Operating Reserves equivalent to 70 days of operations (for water, this is 70 days of operations less water purchase costs).
- Emergency Capital Reserves of $5 million each (total $10 million for Public Utilities) budgeted in the CIP each year.
- Rate Stabilization Fund Reserves equivalent to 5% of prior year's operating revenue.
- Secondary Purchase Reserve (water only) equivalent to 6% of the annual water purchase budget.

are all projected to be funded at targeted levels throughout the Outlook, *with the exception of the Rate Stabilization Funds (RSFs).*

The RSF for the water utility fell below the target in FY 2025 and is projected to remain below target until FY 2030, while the RSF for the wastewater utility, which is currently carrying a balance roughly five times its targeted level, is anticipated to remain above targeted levels throughout the Outlook period.

Rate Stabilization Fund Reserves in PUD Outlook *(in millions)*						
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**
Water						
Reserve Target	$ 35.9	$ 42.0	$ 48.1	$ 54.5	$ 60.6	$ 67.1
Estimated Funding Level	21.7	0.7	7.7	52.7	89.7	89.7
Amount Above Target	***$ (14.2)***	***$ (41.3)***	***$ (40.4)***	***$ (1.8)***	***$ 29.1***	***$ 22.6***
Wastewater						
Reserve Target	21.3	23.6	22.4	27.5	26.6	29.4
Estimated Funding Level	104.3	35.3	63.3	40.3	60.3	60.3
Amount Above Target	***$ 83.0***	***$ 11.7***	***$ 40.9***	***$ 12.8***	***$ 33.7***	***$ 30.9***

For the water system, nearly all remaining fund balance of its RSF is projected to be used in FY 2027, which is consistent with both previous Outlooks and the recent COS study. The water RSF will then be slowly brought back to above targeted levels by FY 2030. *Because nearly depleting the RSF in FY 2027 leaves very little room for financial relief if revenues do not obtain targeted levels due to less demand from conservation or a wetter year than normal, this was a major factor in our Office recommending that the Council approve the rates proposed by PUD in the last rate case through at least FY 2027.*

For the wastewater system, there is also anticipated to be a significant draw on the RSF in FY 2027, reducing the funding level to its lowest point in the Outlook, but still remaining above target. Funding is then replaced in FY 2028, drawn down in FY 2029, and replaced in FY 2030. The draw downs in FY 2027 and FY 2029 are being done to improve the DSCR in those years, when there are large increases in debt service payments due to anticipated bond issuances. More on the anticipated bond schedule is discussed below.

Days of Cash on Hand

The final metric that PUD uses to judge the financial health of its enterprise funds is the number of days of Cash on Hand (CoH). This metric is derived from dividing the estimated ending fund balance of each fund (including reserve balances) by the total costs for operations and maintenance expenditures for that year, and then multiplying that by the number of days in a year. The Department strives to maintain 160 days of CoH for each system.

Cash on Hand in PUD Outlook *(days of cash)*						
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**
Target	160	160	160	160	160	160
Water						
Days of Cash On Hand	59	50	66	61	83	122
Amount Above Target	***(101)***	***(110)***	***(94)***	***(99)***	***(77)***	***(38)***
Wastewater						
Days of Cash On Hand	365	353	67	272	74	161
Amount Above Target	***205***	***193***	***(93)***	***112***	***(86)***	***1***

For the Water Utility Fund, the days of CoH fell below the 160-day target in FY 2024 and reaches a low of 50 days in FY 2027 before slowly increasing over the remainder of the Outlook period. However, the days of CoH never goes back over 160 days. For the Wastewater Utility Funds, days of CoH fall below the 160-day target in both FY 2028 and FY 2030 but remain above the targets in the other years. This swing is mostly due to assumptions regarding when cash or debt is being used to finance the wastewater CIP, which has significant volatility due to the lack of a short-term borrowing Commercial Paper program for that utility. We discuss this volatility and its potential impact on rates in the discussion regarding CIP expenditures.

Outlook Comparisons: Higher Expenditures and Revenues Across both Systems

The PUD Outlook continues to reflect the need for increased rates in each of its five years. Rate increase assumptions remain at the same levels as projected in the previous Outlook and COS study for FY 2027-2030, with a notable decline in FY 2031 for water and a slight decline in wastewater. While expenditure assumptions are increasing for both systems when compared to the prior Outlook, revenues are also anticipated to increase beyond prior projections even with the same rate increase assumptions. The following tables show the total cash expenditures projected in the prior PUD Outlook and the current PUD Outlook across both water and wastewater systems, as well as revenue projections and rate assumptions.

For the water system, total cash expenditures in the current PUD Outlook are larger than in the previous Outlook, with the exception of FY 2027. As will be explained in more detail below, this is due to both increased assumptions on water purchases costs as well as some operating expenditure increases. However, in the near-term operating expenditures are projected to be lower than previous projections due to PUD proactively delaying certain expenditures to remain within current revenue constraints.

Total cash revenue for the water system is higher in each year of the Outlook as compared to last year's Outlook, mainly due to increased water sales assumptions. More on total water sales and other revenue changes is discussed below.

Water Expenditures, Revenues, and Rates							
	FY 2025	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**
FY 2026-2030 Outlook							
Water Purchases	$ 272.6	$ 311.5	$ 329.8	$ 357.3	$ 383.1	$ 418.5	
Operating Expenditures	312.7	365.1	414.7	423.2	416.4	427.6	
Debt Service	121.8	145.0	176.4	187.1	214.0	219.9	
Cash-Funded CIP	(46.1)	85.7	51.0	148.3	61.9	171.2	
Total Cash Expenditures	***$ 661.0***	***$ 907.3***	***$ 971.9***	***$ 1,115.9***	***$ 1,075.4***	***$ 1,237.2***	
Water Sales Rate Revenue	$ 694.9	$ 789.7	$ 910.5	$ 1,031.0	$ 1,146.5	$ 1,272.7	
Other Revenue	27.7	44.2	43.5	33.0	34.3	37.9	
Total Cash Revenue	***$ 722.6***	***$ 833.9***	***$ 954.0***	***$ 1,064.0***	***$ 1,180.8***	***$ 1,310.6***	
Rate Increase	**14.2%**	**13.7%**	**14.5%**	**11.5%**	**11.0%**	**11.0%**	
FY 2027-2031 Outlook							
Water Purchases	$ 289.4	$ 337.7	$ 398.0	$ 401.6	$ 430.7	$ 450.4	$ 485.1
Operating Expenditures	357.8	346.0	407.4	465.4	473.6	487.0	499.8
Debt Service	112.9	140.1	171.9	190.0	196.5	211.5	226.1
Cash-Funded CIP	61.1	95.6	-	-	133.5	147.8	136.9
Total Cash Expenditures	***$ 821.2***	***$ 919.4***	***$ 977.3***	***$ 1,057.0***	***$ 1,234.3***	***$ 1,296.7***	***$ 1,347.9***
Water Sales Rate Revenue	$ 701.3	$ 821.7	$ 944.9	$ 1,072.7	$ 1,193.9	$ 1,325.2	$ 1,428.9
Other Revenue	49.6	39.8	30.8	32.1	33.2	35.0	35.4
Total Cash Revenue	***$ 750.9***	***$ 861.5***	***$ 975.7***	***$ 1,104.8***	***$ 1,227.1***	***$ 1,360.2***	***$ 1,464.3***
Rate Increase	**14.2%**	**14.7%**	**14.5%**	**11.5%**	**11.0%**	**11.0%**	**5.0%**

Wastewater Expenditures, Revenues, and Rates							
	FY 2025	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**
FY 2026-2030 Outlook							
Operating Expenditures	$ 340.5	$ 358.4	$ 378.7	$ 389.0	$ 399.3	$ 406.8	
Debt Service	113.2	93.8	106.4	101.0	101.1	89.2	
Cash-Funded CIP	(69.4)	(58.8)	(123.1)	340.2	(116.3)	168.7	
Total Cash Expenditures	***$ 384.3***	***$ 393.4***	***$ 362.0***	***$ 830.2***	***$ 384.1***	***$ 664.7***	
Wastewater Rate Revenue	$ 322.9	$ 335.9	$ 358.8	$ 385.5	$ 418.0	$ 452.6	
Other Revenue	141.0	136.8	141.0	140.8	140.7	143.9	
Total Cash Revenue	***$ 463.9***	***$ 472.7***	***$ 499.8***	***$ 526.3***	***$ 558.7***	***$ 596.5***	
Rate Increase	**3.0%**	**7.0%**	**6.0%**	**8.0%**	**8.0%**	**8.0%**	
FY 2027-2031 Outlook							
Operating Expenditures	$ 354.8	$ 361.7	$ 384.6	$ 397.9	$ 409.6	$ 421.4	$ 432.3
Debt Service	113.5	102.0	124.4	121.5	163.9	152.0	172.0
Cash-Funded CIP	(112.5)	9.5	(38.3)	358.6	(248.1)	262.2	(60.1)
Total Cash Expenditures	***$ 355.8***	***$ 473.2***	***$ 470.7***	***$ 878.0***	***$ 325.4***	***$ 835.6***	***$ 544.2***
Wastewater Rate Revenue	$ 311.3	$ 351.3	$ 359.7	$ 385.6	$ 417.3	$ 451.8	$ 486.8
Other Revenue	147.1	153.4	121.3	192.8	140.7	163.5	162.6
Total Cash Revenue	***$ 458.4***	***$ 504.7***	***$ 481.0***	***$ 578.4***	***$ 558.0***	***$ 615.3***	***$ 649.4***
Rate Increase	**3.0%**	**6.0%**	**6.0%**	**8.0%**	**8.0%**	**8.0%**	**7.0%**

For the wastewater system, total cash needs are higher than previous projections mostly due to increases in debt service projections. Total rate revenue is in line with previous projections, while

other revenues have increased. As will be further discussed below, the increase in other revenues is tied to expected increases in payments made by participating agencies from the Metropolitan Joint Powers Authority (Metro JPA), consistent with expectations that these agencies contribute proportionally under the CIP financing plan.

Revenues: Key Drivers Across Systems

Revenue assumptions are a critical part of the PUD Outlook as they consider both rate revenues and other revenue sources. Revenues for each utility are heavily dependent on units of sale, with water demand determining both water sales revenue as well as estimated wastewater flows which are used to calculate sewer charges resulting in revenues from City customers. Water demand is volatile, subject to large swings due to changing weather conditions and water conservation. Wastewater sales are less volatile as they are based on primarily indoor water usage (such as showers, toilets, washing machines, etc.), although there can be variance in other wastewater revenues.

Changes to revenues in this Outlook are primarily driven either by updated water demand forecasts, or changes in payments from Metro JPA members based on wastewater expenditure assumptions. Notably, PUD has not made any new assumptions regarding non-rate revenues within the water or wastewater system that have not been presented in other Outlooks.

Water Demand Assumptions Stabilize Below Historical Averages

Water demand assumptions impact both projected rate revenues and water purchase costs from CWA. Projected water demand is influenced by several factors, including rainfall, population growth, and regional demand. The Outlook states PUD is currently averaging approximately 161,000 acre-feet (AF) of potable water deliveries to its customers every year. This average has recently plateaued following declines from previous averages which were around 200,000 AF from FY 2014-2018.

The last several Outlooks have reflected decreasing demand for water. Previously, water demand assumptions were based on the City's Urban Water Management Plan (updated 2021), which estimated that total water use would be approximately 172,073 AF in FY 2025 and 179,065 AF in FY 2030. However, since 2021 water use has continued to decline, which PUD attributes to the conservation messaging related to droughts in northern California and the Colorado River Basin. PUD expects the current level of conservation to continue. The table below compares the water demand forecasts in the Urban Water Management Plan and the PUD Outlook.

Water Demand Assumptions (AF)			
	FY 2020	**FY 2025**	**FY 2030**
Urban Water Management Plan	154,473	172,073	179,065
FY 2027-2031 Outlook	156,261	164,255	161,195
Difference	**1,788**	**(7,818)**	**(17,870)**

While water conservation efforts reduce PUD's need to purchase water from outside sources, a significant portion of operating expenditures for the water system are fixed costs, which are not directly impacted by actual water demand. For example, personnel, information technology, administrative, and debt service costs do not vary based on the level of water usage. This presents

challenges, as the majority of water rate revenues are collected based on the volume of water delivered, and decreases in demand have disproportionately large impacts on revenues relative to expenditures. In other words, when water demand drops, revenue falls but fixed costs remain, creating a financial gap.

Additionally, water sales dropped to 149,533 AF in FY 2024 (after only 150,327 AF in sales in FY 2023) due to significantly above-average rainfall during the winters of 2022-2023 and 2023-2024. With a dry winter during this past fiscal year, sales rebounded up to 164,255 AF in FY 2025. Over the years covered in this Outlook, sales are projected to remain between 160,000 AF and 162,500 AF, which as noted, is roughly the historical average over the past few years. These estimates are marginally higher than what was included in the previous COS study, mostly to account for the additional sales experienced in FY 2025, which led to the increased rate revenue assumptions in this Outlook.

Monitoring sales and weather conditions over the next several years will be critical to determining the future financial health of the water system. PUD is updating the Urban Water Management Plan this upcoming year, which should provide greater clarity on what should be expected as the "new normal" going forward. Having a good grasp on water sales will be important for the next COS study and rate case as water sales are a major driver for determining rate increase needs. **If water demand does not increase, additional revenue needed to sustain rising operating costs must come from rate increases.**

Metro JPA Payments Pose Revenue Volatility for Wastewater System

The City's wastewater system has two components: the *Metropolitan Wastewater System* which is the major wastewater conveyance and treatment system that transports and treats wastewater for more than 2.3 million people in San Diego County, including both City residents and participating municipalities that border the City, and the *Municipal Wastewater System* which represents the smaller pipes and conveyance infrastructure that transports wastewater out of City neighborhoods and into the Metropolitan System. The Municipal System is funded largely by City residents through their sewer bills, but the Metropolitan System is funded by both City residents and the other regional participating agencies to cover their proportional costs of the system. These payments from participating agencies make up the majority of the revenue captured in the Other Revenue category in the preceding tables.

In this Outlook, the Metro JPA contributions range from $80.0 to $155.8 million across the Outlook period. The volatility in payments is directly related to the volatility in cash-funded CIP assumptions, as the participating agencies are paying their proportionate share during the years when cash is needed, and then receiving credit when the cash is then reimbursed by debt.

These payments will need to be closely monitored in the coming years, however, as development of the East County Water Purification Project is likely to reduce the amount of wastewater flowing into the Metropolitan Wastewater System. If that project does significantly reduce the amount of wastewater coming into the system, payments from agencies that are part of the East County Joint Powers Authority (JPA) may be lower than projected. Currently, the Outlook does not make any adjustments for the East County JPA project.

Expenditures: Key Drivers Across Systems

Water Purchase Assumptions: Declining Purchases but Increasing Costs

The City provides water from two sources: (1) local supplies from rainfall and runoff that flow into reservoirs, which historically have provided on average 10 – 15% of water needs, and (2) water purchased from its wholesaler, the CWA, which historically has provided 85 – 90% of water needs. Because the City currently imports a significant percentage of its water supply – PUD's water purchase costs represent $337.7 million or 35.8% of the Water Utility Fund expenditures in FY 2026 – water purchase assumptions are the most critical single component of the PUD Outlook.

The PUD Outlook projects expenditures for imported water purchases will increase from $398.0 million to $485.1 million over the next five years. These amounts are higher than those seen in previous Outlooks due to 1) increases in the assumed rates charged for imported water based on recent projections provided by CWA, and 2) dramatically increased purchasing needs due to a combination of higher water requirements (due to previously noted increases in water demand assumptions for City customers) and assumed lower use of local water supplies. In the prior Outlook, supplies from rainfall and runoff were projected at around 55,000 AF for FY 2026, falling to 43,000 AF in FY 2027 and then 30,000 AF thereafter. The aggressive use of these supplies in the near-term was designed to offset high imported water costs by using stored capacity from recent wet years, as well as to maintain capacity at reservoirs in the event of additional major rain since many of the City's largest reservoirs, such as El Capitan and Lake Hodges, are currently under height restrictions.

Water Purchases Estimated in PUD Outlook						
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**
Water Requirement (AF)	177,786	175,133	175,542	175,951	176,362	176,774
Local Water Supply (AF)	46,000	21,900	40,800	43,600	48,600	48,600
Reservoirs/Storage	*46,000*	*10,000*	*10,000*	*10,000*	*15,000*	*15,000*
Pure Water Production	*-*	*11,900*	*30,800*	*33,600*	*33,600*	*33,600*
Purchased Supply (AF)	131,786	153,233	134,742	132,351	127,762	128,174
Estimated Cost *(in Millions)*	$ 337.7	$ 398.0	$ 401.6	$ 430.7	$ 450.4	$ 485.1
Cost Per AF	*$ 2,562*	*$ 2,598*	*$ 2,981*	*$ 3,254*	*$ 3,526*	*$ 3,785*

This strategy is reflected in the current Outlook, but it is now in a more diminished state, with only 46,000 AF projected for FY 2026, and then only 10,000 AF for FY 2027 through FY 2029, and 15,000 AF thereafter. These new projections reflect updated modeling by PUD's water production division which looked at historical rainfall amounts and how they correlated to runoff received by the reservoirs and the impacts of evaporation. Based on PUD's recent experiences with aggressively using local water, having more modest projections for local reservoir use is prudent for the time being.

In addition to captured rainfall and runoff, the Outlook assumes Pure Water Phase 1 is delivering water beginning in FY 2027, with full capacity being reached sometime in FY 2028. Unlike local sources from reservoirs, the amount of water generated by Pure Water is anticipated to be more consistent and reliable once the system is fully operational. These projections are relatively similar to the prior Outlook.

Considering the use of local water and Pure Water production, PUD estimates the total purchases that will be needed to meet demand for the system within each year. As shown in the table, purchases will be highest in FY 2027 when local supplies run low and the Pure Water project has yet to fully turn on. However, once Pure Water does turn on, total water purchases decline in FY 2028, and then plateau over the remainder of the Outlook period.

Despite lower water purchases beginning in FY 2028, the total estimated costs to purchase that water rise in each year of the Outlook period. This is due to assumed rate increases in the cost to purchase water from CWA. CWA rate increases have been high over the last several years, including a 14.0% increase for calendar year 2025 and an 8.0% increase for calendar year 2026. The Outlook projects CWA's water rates will increase by 11.0% in CY 2027, 9.0% in CY 2028, 8.0% in FY 2029, 6.0% in FY 2030, and 9.0% in FY 2031. All of these rate increases are based on the CWA's own Long Range Financial Plan, initially presented to the CWA Board of Directors in November. Overall, the cost per AF of water increases by 47.7% over the PUD Outlook period. More information is provided below on these rate increases from CWA.

Lower amounts of local water usage from the City's reservoirs are having a large impact on the rate increases needed to cover purchases from CWA. While the amount of local water available is directly tied to local rainfall, which is out of the control of the City, it is disappointing that only 10,000 AF can be drawn from the City's existing ten reservoirs. Additionally, many of the City's reservoirs need extensive rehabilitation, and in some cases complete dam replacement. Notably, the amount of water generated from each reservoir is not uniform as well, indicating that some reservoirs are more financially beneficial to maintain than others. **As part of the update of the Urban Water Management Plan, PUD should also perform a comprehensive cost benefit analysis on each of the City's reservoirs and develop a plan for what improvements need to be made in order to maximize the City's ability to use its local water resources.**

Operating Expenditures: Water System Mitigations

Similar to the General Fund Outlook, the PUD Outlook uses operations and maintenance (O&M costs) in the FY 2026 Adopted Budget as a baseline and then applies a series of inflation factors and other discrete adjustments to develop the Outlook's projections. Many of the inflation factors used in the General Fund Outlook were also applied to the PUD Outlook, including factors for personnel costs, fringe benefits, energy and utilities, and other categories.

O&M costs for the water system are more volatile than the wastewater system, with expenditures projected to be lower than prior Outlooks in FY 2026 and FY 2027, but then well above prior projections in FY 2028 and beyond. The majority of this variance is within the Contracts and Services category, where PUD has planned for reductions of approximately $15 million in the current year (FY 2026) and next year (FY 2027) in order to stay within revenue constraints of approved rates. Then, beginning in FY 2028, those expenditures return to normal levels, resulting in an increase. Additionally, while the Outlook notes that there are no Critical Strategic Expenditures included, there are additional expenditures included in the Outlook that go beyond baseline services: primarily Pure Water Phase 1 operational costs and the Dam Safety Program. Most of the Dam Safety Program expenses have been delayed until FY 2028 due to revenue constraints.

For the wastewater system, O&M expenditures are projected only slightly higher than the prior Outlook. The variance occurs across multiple spending categories and is related to updating the current Outlook to align with the Adopted Budget.

Similar to the General Fund's Five-Year Financial Outlook, the Council's ability to influence the expenditure projections within the Outlook are largely within O&M costs. As noted in the Outlook, PUD also used similar anticipated salary increase assumptions, although the PUD Outlook has higher assumptions than the General Fund to account for potential special salary and certification increases. There were also assumptions made for fringe benefits and other non-personnel expenditures that could be changed if the City Council were to make different decisions regarding the PUD budget during the annual budget process. Notably, many of PUD's operations are driven by external regulatory requirements and safety considerations, which may hinder the ability to constrain certain expenditures. **If the Council wishes to limit future rate increases, it should request the Mayor and PUD to develop budget mitigation options ahead of the FY 2027 Proposed Budget.**

Capital Improvement Program (CIP): Additional Water System Mitigations

Capital investments are a key driver of costs and revenue needs in the PUD Outlook for both the water and wastewater systems and include two key categories of projects: (1) Pure Water (including final Phase 1 construction costs and Phase 2 planning costs), and (2) Baseline CIP (ongoing investments in infrastructure repairs, replacements, and improvements). As shown in the following table, Pure Water expenditures significantly decrease following FY 2026 as Phase 1 construction ends and the facilities go into the testing and production phases.

Total CIP *(in millions)*							
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**	**Total**
Pure Water							
Water	$ 164.9	$ 65.4	$ 28.2	$ 32.5	$ 33.2	$ 35.8	$ 195.1
Wastewater	$ 105.6	$ 42.1	$ 15.4	$ 17.5	$ 15.1	$ 16.2	$ 106.3
Total Pure Water	**$ 270.5**	**$ 107.5**	**$ 43.6**	**$ 50.0**	**$ 48.3**	**$ 52.0**	**$ 301.4**
Baseline CIP							
Water	$ 314.7	$ 372.9	$ 305.5	$ 433.6	$ 397.1	$ 325.2	$ 1,834.3
Wastewater	$ 301.2	$ 354.3	$ 402.7	$ 310.3	$ 287.6	$ 260.9	$ 1,615.8
Total Baseline CIP	**$ 615.9**	**$ 727.2**	**$ 708.2**	**$ 743.9**	**$ 684.7**	**$ 586.1**	**$3,450.1**
Total CIP	***$ 886.4***	***$ 834.7***	***$ 751.8***	***$ 793.9***	***$ 733.0***	***$ 638.1***	***$ 3,751.5***

In order to mitigate near term rate needs, particularly for the water system, PUD implemented a three-year CIP delay for certain projects. This results in lower projections for both FY 2027 and FY 2028 in the current Outlook. Overall, water CIP costs over the comparable five-year period are down almost $197 million because delays in the Baseline CIP, which lead to additional time being needed for projects to become construction-ready again. Conversely, wastewater CIP costs are up $185 million, with the majority of this increase happening in FY 2029 and 2030. Other years for the wastewater CIP remain relatively consistent.

Baseline CIP Comparison *(in millions)*						
	FY 2026	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**Total**
Water System						
FY 26-30 Outlook	$ 271.9	$ 445.2	$ 446.7	$ 415.9	$ 440.8	$ 2,020.5
FY 27-31 Outlook	$ 314.7	$ 372.9	$ 305.5	$ 433.6	$ 397.1	$ 1,823.8
Difference	**$ 42.8**	**$ (72.3)**	**$ (141.2)**	**$ 17.7**	**$ (43.7)**	**$ (196.7)**
Wastewater System						
FY 26-30 Outlook	$ 285.6	$ 350.0	$ 398.4	$ 241.4	$ 195.7	$ 1,471.1
FY 27-31 Outlook	$ 301.2	$ 354.3	$ 402.7	$ 310.3	$ 287.6	$ 1,656.1
Total Baseline CIP	**$ 15.6**	**$ 4.3**	**$ 4.3**	**$ 68.9**	**$ 91.9**	**$ 185.0**

While costs might be down for water and up for wastewater, it is important to note that there are still significant investments in PUD infrastructure shown in the Outlook. Total CIP spending is $3.7 billion between the two systems over the Outlook period, with significant investments proposed for pipelines for both systems (62.0% of the water CIP and 56.9% of the wastewater CIP are proposed for either pipelines or transmission pipelines/trunk sewers).

Additionally, there are known large capital projects that the City will need to undertake in the coming years, including Pure Water Phase 2, the potential replacement of Lake Hodges Dam, and the rehabilitation or replacement of other reservoir dams, many of which are scheduled to begin construction in the years immediately following this Outlook period. While deferring some projects now may help maintain rate stability, additional deferrals of currently planned projects into the years beyond the Outlook would eventually either require higher rate increases to cover increased project costs or continued deferred maintenance on critical assets, which could lead to significantly larger costs if those assets eventually fail or require emergency repairs.

Revenues and Sources for CIP Funding: Growing Wastewater CIP and Use of Debt

The financing plan for the Baseline CIP is a major driver of cash needs for each of the utility enterprise funds, and impacts important financial metrics including the DSCR and days of CoH. The table below provides an overview of baseline CIP expenditures and funding sources for the Outlook period. For each system, proposed financing includes a mixture of debt, cash, and capacity fees[5], with the water system's CIP funded with 83.0% debt financing and the wastewater system's with 76.1% debt financing. The mechanisms used to fund needed capital improvements – such as commercial paper/bonds, loans, or cash – should align with the anticipated useful life and expected benefit of each improvement project; debt financing of one-time system upgrades and improvements promotes intergenerational equity by distributing project costs over the life of the new asset. The optimal combination of debt and cash funding can help balance the near- and long-term impacts to ratepayers while meeting PUD's financial targets and ratings agencies' benchmarks.

[5] Capacity fees are charges collected from developers or property owners for new or expanded water or wastewater connections.

Baseline CIP Expenditures and Revenues *(in millions)*								
	FY 2025	**FY 2026**	**FY 2027**	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**	**Outlook Total**
Water System								
Expenditures	**$ 187.6**	**$ 314.7**	**$ 372.9**	**$ 305.5**	**$ 433.6**	**$ 397.1**	**$ 325.2**	**$ 1,834.3**
Revenue Souces								
Commercial Paper/Bonds	$ 127.3	$ 240.0	$ 400.0	$ 170.0	$ 125.0	$ 150.0	$ 120.0	$ 965.0
SRF Loans	$ 8.9	$ 59.9	$ 100.9	$ 148.7	$ 101.8	$ 117.4	$ 89.1	$ 557.9
Capacity Fees	$ 16.1	$ 15.0	$ 15.0	$ 15.0	$ 15.0	$ 15.0	$ 15.0	$ 75.0
Capacity Fees/Cash	$ 35.3	$ (0.2)	$ (143.0)	$ (28.3)	$ 191.8	$ 114.7	$ 101.1	$ 236.3
Total Revenue	**$ 187.6**	**$ 314.7**	**$ 372.9**	**$ 305.4**	**$ 433.6**	**$ 397.1**	**$ 325.2**	**$1,834.2**
Wastewater System								
Expenditures	**$ 190.9**	**$ 301.2**	**$ 354.3**	**$ 402.8**	**$ 310.2**	**$ 287.7**	**$ 261.0**	**$ 1,616.0**
Revenue Souces								
Revenue Bonds	$ 278.2	$ 240.0	$ 360.0	$ -	$ 520.0	$ -	$ 300.0	$ 1,180.0
SRF Loans	$ -	$ -	$ 15.3	$ 16.0	$ 16.0	$ 2.7	$ -	$ 50.0
Capacity Fees	$ 28.4	$ 33.0	$ 34.0	$ 35.0	$ 36.1	$ 37.1	$ 37.1	$ 179.3
Capacity Fees/Cash	$ (115.7)	$ 28.2	$ (55.0)	$ 351.7	$ (261.8)	$ 247.8	$ (76.2)	$ 206.5
Total Revenue	**$ 190.9**	**$ 301.2**	**$ 354.3**	**$ 402.7**	**$ 310.3**	**$ 287.6**	**$ 260.9**	**$1,615.8**

Compared to the previous Outlook, overall debt financing decreased for the water system, but increased for the wastewater system. In both instances, the change is in alignment with total anticipated CIP spending trends. However, the proportion of debt used to cover the costs for the CIP has increased for both systems (water previously was projected to be funded with 74.6% debt and wastewater with 66.7%).

The debt issuance schedules for both systems remain the same as the prior Outlook, with a large issuance of water debt assumed in FY 2027 followed by smaller issuances in the remaining years for the water system, while the wastewater system anticipates having issuances in alternating years, with a particularly large issuance assumed in FY 2029. The larger size of the debt issuances is directly tied to the larger overall CIP need for the wastewater system. These larger issuances, combined with higher anticipated interest rates, are the main drivers increasing debt service payments higher within the wastewater system, and thereby necessitating higher rates and revenue requirements, particularly in FY 2029 and beyond.

In reviews of previous PUD Outlooks, our Office noted that more regular debt issuances could mitigate cash needs for the various systems. In our review of this Outlook, PUD indicated that the large swings required for CIP cash and debt in the wastewater system is due to no short-term financing Commercial Paper program being available for wastewater. The water system does maintain a Commercia Paper program, which helps smooth projections for debt spending, debt service, and CIP cash. Since the wastewater system does not include water purchases, which are the most volatile component of the water system, it has historically had more regular revenues and expenditures. However, given the increasing size of the wastewater CIP, and the larger swings in cash and debt needs, it could worth evaluating whether a Commercial Paper program should be established for wastewater. *Our Office will work with PUD and the Department of Finance to see how a Commercial Paper program, or other debt smoothing options, could mitigate the need for additional rate increases within the wastewater system.*

Potential Mitigating Actions

The drivers of rate increases shown in the PUD Outlook are mainly increased debt service costs, water purchase assumptions, and CIP cash needs, combined with revenues that are not anticipated to grow without increasing rates. Our Office provided mitigation options in previous reports reviewing the PUD Outlook, and many of these mitigation measures were incorporated in the most recent COS study for the water and wastewater systems.[6]

Moving forward, there are fewer mitigation options available to avoid the need for increasing rates at the magnitudes included in the Outlook. Throughout this report, we identify some areas where more limited mitigations may be possible, including operating expenditure reductions, lowering water purchase costs by driving down rate increases from CWA (more on that in the next section), and improving the local reservoir and water collection system to generate additional local water. Over the next year, our Office will continue to work with PUD on mitigations that we think are feasible, or that the Council identifies, such as non-rate revenue generation. Identifying mitigation actions early will be key to maintaining flexibility on rates during future rate cases.

San Diego County Water Authority (CWA) Rates

The largest single expenditure for PUD – and the largest non-personnel expense for the City – is the purchase of water from CWA. The City's reliance on imported water leaves it susceptible to rate increases beyond its control. The City is also the largest user of CWA water, accounting for about 40% of CWA's water deliveries. Pure Water Phase 1 entering production will have a significant impact on lowering the total regional demand for CWA water.

CWA sets its rates on a calendar year basis, with rate hearings normally taking place in the summer. Applicable rate and charge categories for the City include four fixed categories (Storage, Customer Service, Supply Reliability, and Infrastructure Access) and a variable volumetric rate based on the volume of water purchased by the City. As previously mentioned, the PUD Outlook assumes that CWA rates will increase by between 6.0% and 11.0% in each year of the Outlook period. As shown in the table below, over the Outlook period rates to cover the increasing costs for water purchases make up more than half of the total rate increase need, although the amount varies significantly from one year to the next depending on both the rate increases assumed from CWA as well as the assumptions on how much water the City is projecting to purchase. Years where the Water System Costs rate is negative indicate that the total additional revenue generated by the rate increase is less than the increase in anticipated water purchase expenditures.

Projected Water Rate Increases by CWA Pass-through Costs and Water System Costs						
	1/1/2027	1/1/2028	1/1/2029	1/1/2030	1/1/2031	Total Increase (Compounded)
CWA Pass-through Costs	14.6%	0.8%	5.5%	3.3%	5.3%	32.6%
Water System Costs	-0.1%	10.7%	5.5%	7.7%	-0.3%	25.3%
Total Rate Increase	14.5%	11.5%	11.0%	11.0%	5.0%	65.2%

During the hearings on the previous water rate COS study and rate case, there was confusion about how the rates published by PUD staff related to the rate increases adopted by CWA. In the COS study, PUD used a new methodology for determining the impact of CWA pass-through costs on

[6] See IBA Report 23-38 for more information on these mitigation measures.

the overall rate need. What is displayed in the table *above*, and what was included in the COS study, combines the increase from CWA rates and additional water purchases, and then shows what proportion of the City's rate increase is needed to cover those costs. The table *below* provides greater detail on these calculations, which includes both the total new revenue derived from rates as well as the total new expenditures required for water purchases in each year. As the water purchases vary, both due to price increases and total water volumes purchased, the impact of water purchases on rates varies as well. This is why, even though there is a projected 8.0% rate increase from CWA in FY 2028, the total passthrough from CWA is only listed as 0.8% since this is the year that the City will be purchasing substantially less water than in the prior year.

Allocation of Rate Increases to Water Purchases					
	FY 2027	**FY 2028**	**FY 2029**	**FY 2030**	**FY 2031**
Increased Revenue from Rates	$ 60.2	$ 54.8	$ 58.5	$ 65.1	$ 32.9
Increased Water Purchase Costs	$ 60.4	$ 3.6	$ 29.1	$ 19.7	$ 34.7
Percentage of Revenue for Water Purchases	100.4%	6.6%	49.6%	30.3%	105.3%
Projected Water Rate Increase	14.5%	11.5%	11.0%	11.0%	5.0%
Rate Increase Attributed to Water Purchases	14.6%	0.8%	5.5%	3.3%	5.3%
Rate Increase Attributed to Water System	-0.1%	10.7%	5.5%	7.7%	-0.3%

While we understand PUD's methodology, and acknowledge that it is transparent, we note that the pass-through itself and how it is determined can be confusing because it is not solely tied to the increase in rates from CWA. For example, even if the CWA rate increases were projected at 0.0% in each year, there would be years with positive and negative rates attributed to the CWA pass-through costs due to changes in the City's water purchase volumes. *Prior to the next rate case for water, our Office will work with PUD to simplify the water rate model, and present in future Outlooks and COS studies rate attributions that make it clearer what portion of any rate increase in a given year is directly tied to the rate increases being implemented by CWA in that given year.*

Similar to the City, CWA's revenues are also tied to the amount of water it sells, while many of its expenses remain fixed. Recent discussions of the CWA Board of Directors have included an evaluation of CWA's current rate structure, and in particular have focused on the need for the CWA to increase the proportion of revenues that it recovers from fixed charges. This is in response to projected decreases in demand associated with the City's Pure Water program, and efforts by the East County JPA and the City of Oceanside to complete similar projects. Starting in 2025, a portion of CWA's Transportation Rate (30%) has been moved to a fixed basis. It is important to note that **if CWA's fixed charges are increased to recover a greater share of CWA's revenue needs, the City will be impacted substantially more than if CWA instead increased its volumetric rates.** The structural change being contemplated by CWA to recover more of its revenues from fixed costs would *reduce* the City's cost savings associated with shifting a portion its water supply from CWA to Pure Water. This could potentially be even more acute in FY 2035 when the development of Pure Water Phase 2 is contemplated to be completed.

The City, and more directly the ten members of the CWA Board of Directors who represent the City (the City-10), can have a major impact on these potential rate changes. If fixed charges are to be increased, the City's directors should seek to identify ways to bring down the CWA's total operating and capital costs and overall revenue needs. Last year, our Office

recommended that City-10 members focus on two specific goals: 1) ensuring that CWA expenditures were directly tied to the delivery of water to the region and requesting that CWA prepare an updated business plan to address its long-term financial issues, and 2) focus on right-sizing the CWA's water supplies, particularly by selling excess supplies. We remain encouraged that some members of the City-10, as well as other directors from other regional water agencies, appeared to understand the need for this right-sizing.

CWA City-10 Recommendations

In the remainder of this report, we provide recommendations to the City-10 as they sit on the CWA Board that approves the CWA's rates, and therefore can have a significant impact on PUD's water system costs. Once decisions on rates are made by the Board of Directors, the City has no choice but to pay CWA the costs charged for water purchased. While the Council can work to influence the CWA's decisions on rates, the most direct control that Council has over the costs passed down by CWA are through controlling who represents the City on the CWA Board of Directors. **While our Office can make recommendations, the Mayor and the Council should ensure the City-10 adequately represents the City's interests, and it is the Council's responsibility to ensure that the City-10 does so in a way that satisfies the Council.**

We continue to advocate that the CWA Board focus on limiting new capital projects, reducing operating expenditures, and right-sizing water supplies. Since CWA operates on a two-year budget process, there will be less opportunity for the Board to focus on capital and operating expenditures over the next twelve months. However, our analysis and recommendations this year focus on two areas: the pressing need for a new business plan and making continued progress on selling excess water supplies and water transfers to entities outside of the CWA service area to offset some costs.

Requiring a New Business Plan

CWA is currently in the process of adopting a new Long Range Financial Plan (LRFP), which as noted in the Outlook, is the basis for the rate increase assumptions used in the PUD Outlook. The LRFP covers fiscal years 2026 through 2035 and depending on different scenarios and growth needs, rates are projected to almost double during the next ten-years and could potentially increase by 150%. This is based on assumptions contained in the plan around both CWA's operating and capital needs, as well as water sales projections that fall below the amount of water that CWA is contractually obligated to purchase. Notably, the LRFP does not assume any water sales or transfers to outside entities, nor does it make any assumptions about dramatic changes to CWA's current operation that would reduce its costs. While the LRFP has not been officially adopted yet by the Board of Directors, it paints a disturbing picture of where rates will need to go for the region without a significant change in the CWA's direction.

Based on the data in the LRFP, it is clear that given rapidly declining water sales to its member agencies, many of CWA's past and current practices are not sustainable. Notably, PUD is having to delay City projects in order to afford water purchase costs; CWA should also be doing this with its own assets. Although progress has begun, more rapid and wholistic changes are needed quickly to have a lasting and dramatic impact on rates. While water purchases are the largest component of CWA's budget, there are other initiatives that CWA and its board should consider when it comes to helping increase regional affordability. A Business Plan would assist with this, as it would critically evaluate CWA operations and provide options to help guide the organization towards a path to sustainability given declining regional demand. A Business Plan should consider things

such as the future operations site for CWA, the future of the Twin Oaks Treatment Plant, future reservoir projects, and other initiatives, with a focus on making the size and scope of the organization fit today's and future regional needs. The Metropolitan Water District (MWD) recently began updating its official Business Plan in light of these changing conditions; it is critical that this work continue at CWA. **The City's representatives should request CWA to prepare an updated business plan in the next year that addresses its long-term financial issues.**

Right Sizing the CWA's Water Supplies

Beyond keeping CWA's water delivery costs reasonable, the City's representatives should also focus on lowering the CWA's own largest expense: water purchases. As with PUD, water purchases make up the majority of CWA's budget, accounting for 63% of the FY 2026-27 CWA budget. These purchases are primarily made through three agreements: the Quantification Settlement Agreement (QSA), projects that relined various canals in order to transfer additional water to CWA, and the agreement to purchase water from the Carlsbad desalination plant. The QSA provides CWA with a minimum of 200,000 AF of water every year, and the canal lining projects provide another 77,700 AF of water every year, both of which come from the Colorado River via MWD's conveyance system. The Carlsbad desalination plant agreement requires that CWA purchase a minimum of 48,000 AF of water per year. This provides CWA with a total *minimum* of 325,700 AF of water that it must pay for every year.

However, CWA's water sales have been trending downwards and are projected to remain below this minimum number in the coming years. According to the CWA's Annual Comprehensive Financial Report for FY 2025, water sales were only 323,781 AF. Additionally, as noted in PUD's Outlook report, the new LRFP for CWA shows that anticipated sales, even at an upper range, will fall below the volumes CWA is contractually obligated to purchase. If CWA's own projections hold true, CWA will be required to buy water under the QSA and desalination agreements that it does not need. This is the largest driver of their own rate increase needs, since when CWA's water sales drop below its minimum water purchase volumes it increases rates in order to maintain the same amount of revenue.

Notably, these excess water purchases cannot be stored for later use: in recent years, production at the desalination plant was turned off because CWA had no storage capacity to absorb the produced water. While this did result in some savings from reduced operations costs, CWA was still paying for a plant that was not producing water for the region. Additionally, if sales projections are below mandated purchase amounts, there is no benefit to storing excess water that will never be used given lower demand.

That said, there have been some encouraging developments over the past year. The largest one is the settlement of the long running dispute with MWD over their charges for transporting the QSA and canal lining water. The settlement not only provided CWA with price certainty on transportation costs, making the costs for these water supplies more predictable, but it also gave CWA the ability to initiate water transfers to other jurisdictions within MWD's service territory. This is an important first step to CWA being able to sell water to other agencies that need more reliable supplies, and CWA has already issued letters out to others letting them know supplies are available. Additionally, CWA leadership is working on agreements that could allow for water transfers beyond MWD territory, where there are potentially more water agencies that would be

willing to pay for the excess water that CWA currently has rights to. However, no large transfers, sales, or exchanges have been successfully negotiated as of this report.

This next year will be vital in securing a deal to offload water supplies as each of the region's water recycling projects is projected to start producing water in the next 18 months. Water purchases are already straining regional water agency budgets beyond the City as well, with agricultural users securing lower rates that remove reliability safeguards in exchange for more affordability. The region cannot afford to lose more water users due to affordability concerns, thereby increasing the costs on those that remain. **A reliable supply that no one can afford is not actually reliable nor in the public's interest. The City's representatives should focus on continuing to right-size CWA's water supply and purchasing costs, particularly through selling excess supplies, and progress towards this, including an agreement to sell a significant portion of CWA's supply, should be targeted in the next year.**

CONCLUSION

This PUD Outlook continues to show a need for additional rate increases due to rising costs, including increases in CIP expenditures and debt service, water purchases, and operating costs, combined with static water sales and wastewater flows that necessitate increasing rates in order to increase revenue. Based on our analysis of the PUD Outlook, we find that the assumptions contained in the Outlook are reasonable, given current policies.

As the Pure Water systems begin to come online, it will be *crucial* for the City's representatives on the CWA Board of Directors to keep the wholesaler's costs in check to ensure the City can realize financial savings from its own renewable source of potable water. **Our Office recommends that the City's representatives request CWA to prepare an updated business plan in the next year that addresses its long-term financial issues and focus on right-sizing CWA's water supply and purchasing costs, particularly through selling excess water supplies in the next year.**

This Outlook maintains the rate increases contained in the previous Outlook, and the recent COS study, despite increasing cost pressures. If there are no dramatic changes to expenditure assumptions, such as lower water purchase costs, increases in local water available, lower operating and capital expenditures, or additional revenue sources identified, *the rate increases included in this Outlook will be the rate increases that Council will need to approve in a future rate case in order to maintain the reliability and functionality of the water and wastewater system.* **If there are mitigation actions that the Council wishes for PUD and our Office to research, such as operating expenditure reductions or alternative revenue sources, this is the time to make those desires known.**

Our Office will continue to work with PUD over the next year to identify any mitigation measures that we believe could help the system, including appropriate updates to the Urban Water Management Plan, a cost-benefit analysis on the City's reservoirs and local water production system, potential budget mitigations, and a potential Commercial Paper program for wastewater. Timely progress on these items is critical, especially since the water system only has rates approved through the next fiscal year.

We would like to thank PUD for responses to questions that went into the development of this report.

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