



To: Mayor and City Council  
From: Howard S. Lazarus, City Administrator  
Date: January 4, 2019  
Subject: Water and Sewage Disposal Funds Financial Positions without Mid-Year Increases

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The current financial models for the Water Supply System and Sewage Disposal System support Ann Arbor's safe, reliable, and financially healthy utility systems. These models require 6 and 7 percent increases in the Water Supply and Sewage Disposal System for FY 19-27, respectively. The impact on postponing or not implementing this rate increase has implications in both the near and long-term.

**Water Supply System Near-Term Impacts:**

Should the rate increase be delayed or eliminated, a correlating delay or elimination of capital reinvestment of approximately \$2.5 Mil. will result. The delay in water capital may result in other systems capital reinvestment being delayed, such as roads. This is due to projects being aligned to minimize roadway disturbances. For instance, should the Barton Drive Northside to Pontiac Trail Water Main Replacement Project be delayed, the associated road resurfacing project would also be delayed. Further, it may result in capital projects that have been designed being put on the shelf. At the same time, the Water Supply System is facing regulatory pressure for additional capital reinvestments that are required for regulatory compliance. As an example, the Ultra-Violet Disinfection Project at the Water Treatment Plant is necessary to meet the requirements of the Safe Water Drinking Act. If the proposed 6% water rate increase is not approved, in order to avoid additional capital delays or eliminations, a significantly higher rate increase will be proposed for July 1, 2019 to allow for regulatory compliance projects to be completed.

**Water Supply System Long-Term Impacts:**

With the current expected capital expenditures for the Water Plant Rehabilitation, the ratio between operating revenue and the amount of debt service (also called debt-coverage ratio), would drop to 1.27 in the later years of the financial plan, if all other rate changes are passed, with the exception of the proposed 6% increase. If the debt-coverage ratio were to drop below 1.25, the bond ratings of the water fund would be in jeopardy of a decrease, thus increasing the overall financing costs for the fund. Any credit decrease recovery would take years.

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**Sewage Disposal System Near-Term Impacts:**

The Sewage Disposal System consequences of delaying the rate increase are an increased risk of falling below the debt-coverage ratio this fiscal year. Currently, the debt coverage ratio as planned is 1.39, inclusive of the proposed 7% rate increase. Without the proposed rate increase and based on adopted budget and projected financial obligations, the debt-coverage ratio is projected to be 1.21, which is below the floor set by the bond prospectus, current financial policies and bond-rating agencies (1.25). If current year revenue projections are not realized or a large unanticipated operating expense occurs, there is an additional risk of falling further below this requirement. Going below this debt-coverage floor would lower the City's bond rating.

**Sewage Disposal System Long-Term Impacts:**

A lowered bond-rating has long-term financial consequences in that it would increase the total cost of borrowing. Any credit decrease recovery would take years.

In summary, any deviation from the current rate projections would have different yet impactful consequences both near and long-term for both systems. In order to provide a safe, reliable, and financially healthy utility system, staff recommends implementation of the rate increases as planned.