CITY OF SEBASTOPOL CITY COUNCIL
AGENDA ITEM REPORT FOR MEETING OF: July 21, 2026

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To:	Honorable Mayor and City Councilmembers
From:	City Attorney Alex Mog City Manager Mary Gourley
Department:	City Administration
Subject:	City Response to Grand Jury Report Regarding Water and Sewer System

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RECOMMENDATION(S):
That the City Council:
1. Approve the City's formal response to the Sonoma County Civil Grand Jury Report.
2. Authorize the Mayor to sign the response letter on behalf of the City Council.

PROCESS OF AGENDA ITEM:
- Presentation by staff
- Council questions and discussion
- Public comment
- Council deliberation and action

EXECUTIVE SUMMARY:
The Sonoma County Civil Grand Jury's May 2026 report identifies historical challenges with cost allocation, rate sufficiency, infrastructure funding, and transparency in the City's Water and Wastewater Enterprise Funds. The City takes these matters very seriously and is continuing to take steps to address these issues. The response acknowledges valid concerns raised by the Grant Jury and highlights corrective actions the City is taking to address these issues.

BACKGROUND:
Under California law, each county has a Civil Grand Jury. The grand jury is an independent body comprised of regular citizens serving one-year terms. Grand juries investigate and report on the operations of local government agencies. A grand jury decides for itself what topic to investigate, and may interview witnesses and issue subpoenas. Grand jury investigations are secret, and witnesses are prohibited from revealing the existence of an investigation. At the end of an investigation the grand jury is required to issue a written report stating the grand jury's findings and recommendations. By law, the city council of a city that is subject to a report is required to comment on the findings and recommendations within 90 days of publication.

DISCUSSION:
On May 20, the Sonoma County Civil Grand Jury issued a report titled "City of Sebastopol's Water and Sewer Systems: Deferred Action has Consequences". A copy of the full report is available at
https://sonoma.courts.ca.gov/general-information/civil-grand-jury/2025-2026-reports-and-responses
The Grand Jury report highlights legitimate issues with historical underfunding, infrequent studies, and the need for transparency in Sebastopol's Water and Wastewater Enterprise Funds. The report also found that the City's failure to update its Cost Allocation Plan resulted in over-allocating the Sewer and Water Enterprise Funds for cost of services provided by the General Fund.

The Grand Jury's specific findings and recommendations are copied below.
Grand Jury Report Findings:
1. Finding F1: The Grand Jury estimated that the City's failure to update its Cost Allocation Plan for more than 20 years resulted in the City over allocating approximately $5.5 Million of indirect costs to the Enterprise Funds. This was non-compliant with Proposition 218 and left the Enterprise Funds without sufficient money for maintenance and capital improvements.

2. Finding F2. When the City updated its Cost Allocation Plan in 2024, reduced allocation of indirect costs left approximately $714,000 in the Enterprise Funds to be used for systems maintenance and capital improvements.
3. Finding F3. Because the rate study conducted by the City in 2019 underestimated a reduction in consumption due to conservation measures, the rate adjustment for 2019-2023 was insufficient to keep pace with escalating costs. This resulted in the need for a 37% increase on July 1, 2024, which has been difficult for many ratepayers to accept.
4. Finding F4. In November 2025, the City Council reinstituted an Enterprise Fund Oversight Committee. This promises to provide the City Council with insights and expertise regarding decisions concerning oversight of these critical systems.

<u>Grand Jury Recommendations:</u>

1. Recommendation R1: By October 1, 2026, commit to fully comply with Proposition 218 by conducting cost allocation and rate studies at least within 3-5 years intervals and adjusting its cost allocation and ratepayer fees accordingly.
2. Recommendation R2. By October 1, 2026, reach an agreement on the dollar value of mis-allocated indirect costs and commit to a repayment schedule to restore funds transferred from the Enterprise Funds to the general fund by overallocation of indirect costs. This money can be used to implement critical improvements identified in the Master Plan.
3. Recommendation R3. By October 1, 2026, consider adding a Certified Public Accountant to the Enterprise Fund Oversight Committee to assist the City Council and City Manager with fiscal compliance, analysis, and transparency.

STAFF ANALYSIS:
The General Fund can be reimbursed for services provided to the Enterprise Funds either through “direct charges” or a cost allocation plan (CAP). Direct charges require detailed time tracking for specific services but do not fully capture indirect costs (e.g., central administration, IT, insurance). A CAP assigns the Enterprise Funds their proportional share of these indirect costs.

As the Grand Jury’s report points out, the City had not updated its CAP for approximately 20 years. In 2024, the adopted a revised CAP that was prepared by ClearSource Financial Consulting using data supplied by City staff. It identifies each department’s allocable costs and determines the appropriate percentage to allocate to each Enterprise Fund. Going forward, the City will:

- Charge legal fees to the Enterprise Funds based on actual expenses billed (segregated and detailed), rather than as part of the CAP.
- Use allocable costs based on actual expenditures, not budgeted expenses.
- Pursue implementation of time tracking for staff
- Implement a new cost allocation study after data has been achieved on time tracking

The City’s new CAP better reflects actual proportional costs and reduces the burden on ratepayers compared to the prior method.

In 2024, the City Council adopted the 2024 Water and Wastewater Rate Study and established water and wastewater rates for Fiscal Years 2024-25 through 2028-29. These adopted rates included significant rate increases, the purpose of which was, in part, to address deferred maintenance and capital needs.

However, even before the Grand Jury issued its report, the City Council recognized that additional work was necessary in order to improve the fiscal standing of the Enterprise Funds and the public’s trust in administration of the Enterprise Funds. In fall 2025, the City Council proactively created and appointed an Enterprise Fund Oversight

Committee to advise on matters related to the Sewer and Water Enterprise Fund. No other city in Sonoma County has such a committee, and we're not aware of any other city in California that has such a committee.

In response to information and reports prepared by the EFOC and Grand Jury, the City has recent taken additional steps to address concerns and as a show of good faith to the community that all options are being explored. These actions include:

- Direct billing of all city attorney costs
- Exploring options for implementing time tracking for City employees
- Suspension of tiered water rates
- Suspension of planned FY 25-26 water rate increase
- Directing staff to retain consultants to prepare a new Cost Allocation Plan and rate study
- Forgiveness of $1.1 million General Fund loan to Wastewater Fund

The City Council takes the Grand Jury Report and work of EFOC very seriously, and these actions demonstrate a commitment to sustainability and transparency. The City is committed to continuing this work to help restore public trust.

The proposed response to the Grand Jury's specific recommendations and findings is attached. The City's response is due by mid-August.

CITY COUNCIL GOALS/PRIORITIES AND GENERAL PLAN CONSISTENCY: This agenda item supports **Goal 4: HIGH PERFORMANCE ORGANIZATION** – Restore public trust, improve public communications, and strengthen collaborative partnerships with outside agencies and service providers.

PUBLIC COMMENT: As of the preparation of this staff report, public comments received are listed on the City website. Additional comments will be provided as supplemental materials. Public comment will also be accepted during the meeting.

COMMUNITY OUTREACH: This item has been noticed in accordance with the Ralph M. Brown Act and was available for public review at least 72 hours prior to the meeting.

FISCAL IMPACT: There is no fiscal impact with approving the proposed response to the Grand Jury.

RESTATED RECOMMENDATION: Approve the formal response to the Grand Jury Report.

CITY COUNCIL OPTIONS:

1. Modify the response or loan forgiveness recommendation.
2. Provide other direction to staff.

ATTACHMENT(S):

- Draft Response to Grand Jury
- Grand Jury Report

DRAFT GRAND JURY RESPONSE

Honorable Christopher Honigsberg
Presiding Judge
Superior Court of Sonoma County
Hall of Justice
600 Administration Drive
Santa Rosa, CA 95403

Re: Response to Sonoma County Civil Grand Jury Report "City of Sebastopol's Water and Sewer Systems – Deferred Action Has Consequences" (Report dated May 2026)

Dear Judge Honigsberg:

The City of Sebastopol appreciates the time, effort, and public service of the 2025-2026 Sonoma County Civil Grand Jury. The City takes the report seriously and welcomes input that advances transparency, fiscal accountability, and the long-term sustainability of essential water and wastewater infrastructure.

The City has already implemented meaningful reforms, including a new activity-based Cost Allocation Plan (ClearSource, FY 2024-25), a comprehensive Water and Wastewater Rate Study with cost-of-service analysis (Raftelis, 2024), establishment of the independent Enterprise Fund Oversight Committee (EFOC), and adoption of rate adjustments following a full Proposition 218 process. A formal response to each finding and recommendation appears below, in accordance with California Penal Code §§ 933 and 933.05.

Response to Findings

Finding F1: The Grand Jury estimated that the City's failure to update its Cost Allocation Plan for more than 20 years resulted in the City over allocating approximately $5.5 Million of indirect costs to the Enterprise Funds. This was non-compliant with Proposition 218 and left the Enterprise Funds without sufficient money for maintenance and capital improvements.

The City partially agrees with this finding. Prior to 2023–2024, the City had not conducted a formal, comprehensive cost allocation study for more than two decades and relied on annual percentage-based adjustments. This practice was outdated relative to best practices and industry standards. The City recognized the need for an updated cost allocation plan, and retained an independent consultant, ClearSource Financial Consulting to prepare a new cost allocation plan.

The City acknowledges that relying on the old cost allocation plan for an extended period of may have resulted in overallocation. The City is proactively taking steps to ensure this does not occur in the future. The industry standard is for cost allocation plans to be updated every 3-5 years. The City Council has directed staff to begin the process of retaining a consultant to prepare a new cost allocation plan that can be in place for the start of FY 27/28, 3 years after the current cost allocation plan was adopted. Additionally, the City is expanding its use of time-tracking and direct billing to supplement and refine the cost allocation plan. The City has begun charging the Enterprise Funds for legal costs using direct billing, and the City is currently exploring different tools and software to facilitate more detailed time tracking by staff.

Finding F2. When the City updated its Cost Allocation Plan in 2024, reduced allocation of indirect costs left approximately $714,000 in the Enterprise Funds to be used for systems maintenance and capital improvements.

The City partially agrees with this finding. The Cost Allocation Plan adopted in 2024 uses detailed cost pools and allocation bases (e.g., compensated labor hours, gross expenses, capital asset values, utility accounts) for allocating costs to the Enterprise Funds. As a result of this approach, the Cost Allocation Plan calculates lower maximum interfund charges to the Water and Wastewater Funds than were previously budgeted under the old method. Specifically, charges under the 2024 Cost Allocation Plan were approximately $510,000 less for Water and $204,000 less Wastewater. The savings from these reductions are not allocated to a specific purpose. They may appear in the form of increase spending on operation and maintenance, additional capital improvements, and additional reserves, or offset the need for otherwise necessary rate increases.

Finding F3. Because the rate study conducted by the City in 2019 underestimated a reduction in consumption due to conservation measures, the rate adjustment for 2019-2023 was insufficient to keep pace with escalating costs. This resulted in the need for a 37% increase on July 1, 2024, which has been difficult for many ratepayers to accept.

The City partially agrees with this finding. The 2019 rate study did not fully anticipate the revenue effects of successful conservation efforts. The 2021-2022 drought was one of the most severe in Sonoma County's history, and many agencies were subject to mandatory conservation measures. This results in significant public awareness and efforts regarding conservation. The effect in Sebastopol, like many cities, was decreased water demand, which also resulted in decreased revenue. The 2024 Raftelis Rate Study properly identified the need for adjustments to achieve financial sufficiency, cover operations and maintenance, fund capital improvements, and build appropriate reserves. The resulting rate adjustments (approximately 37% combined impact in the first year under the adopted lower-rate option, with subsequent annual increases) were implemented following a Proposition 218 process.

The City recognizes that any increase in water and sewer rates can impact families struggling to make ends meet. Each household's consumption and use is unique, but any time there is a significant rate increase, it can put pressure on tight budgets. However, the City also believes that failure to implement the 37% increase in 2024 would have resulted in the need for even greater increases in the future. Years of insufficient rate adjustments combined with the prior allocation methodology contributed to underfunding of the Enterprise Funds, resulting in deferred maintenance and the need for significant infrastructure investment.

Finding F4. In November 2025, the City Council reinstituted an Enterprise Fund Oversight Committee. This promises to provide the City Council with insights and expertise regarding decisions concerning oversight of these critical systems.

The City partly agrees. An Enterprise Fund Oversight Committee was not reinstituted, it was proactively created by the City Council for the first time in November 2025 based on the City Council's desire to create additional citizen oversight of the enterprise funds. No other city in Sonoma County has such a committee, and we're not aware of any other city in California that has such a committee. The City Council created the Committee shall act in an advisory capacity to the City Council and perform the following duties:

a) Reviewing Annual Budgets and Financial Reports: The Committee will analyze the financial health of the Enterprise Funds, ensuring that budgets and financial statements reflect accurate and sustainable practices.
b) Analyzing Rate Studies and Rate Adjustment Proposals: The Committee will evaluate proposed rate changes, including providing recommendations on cost allocation methods to ensure fairness and financial viability.

c) Evaluating Long-Term Financial Planning and Capital Improvement Needs: The Committee will assess capital improvement plans (CIP), master plans, and long-term financial forecasts related to Enterprise Fund operations, ensuring that projects are properly prioritized and funded and that master planning efforts align with Enterprise Fund financial sustainability.
d) Engage with the public and other stakeholders to ensure that the community's interest and concerns are reflected in the Committee's recommendations.
e) Such other duties as assigned by the City Council.
f) Shall submit an annual report to the Council in early June before the next fiscal year budget is adopted.

Response to Recommendations

Recommendation R1: By October 1, 2026, commit to fully comply with Proposition 218 by conducting cost allocation and rate studies at least within 3-5 years intervals and adjusting its cost allocation and ratepayer fees accordingly.

This has been implemented. The City adopted the ClearSource activity-based Cost Allocation Plan in 2024 (FY 2024-25). Additionally, the Raftelis Rate Study was completed and implemented following Proposition 218 procedures in June 2024. The City Council recently directed staff to retain consultants to prepare new cost allocation plan and rate study to be implemented no later than FY 27-28, 3 years after the current cost allocation plan and rate study were approved. The City Council included money for these studies when adopting the FY 26/27 Budget.

Recommendation R2. By October 1, 2026, reach an agreement on the dollar value of mis-allocated indirect costs and commit to a repayment schedule to restore funds transferred from the Enterprise Funds to the general fund by overallocation of indirect costs. This money can be used to implement critical improvements identified in the Master Plan.

The recommendation requires further study and analysis. While the City acknowledges the likelihood that outdated cost allocation plan may have resulted in overallocation of General Fund costs, the City has not yet determined a specific dollar amount. However, the City has already begun taking steps to address this matter. On July 21, the City Council approved the forgiveness of a $1,100,000 loan from the General Fund to the Wastewater Enterprise Fund, resulting in a significant fiscal benefit to the Wastewater Enterprise Fund due to the elimination of the repayment obligation.

Recommendation R3. By October 1, 2026, consider adding a Certified Public Accountant to the Enterprise Fund Oversight Committee to assist the City Council and City Manager with fiscal compliance, analysis, and transparency.

The City agrees. The EFOC is currently required to include "at least one person who has expertise in accounting, auditing, or another financial field." Unfortunately, during the last open recruitment process, the City did not receive any applications from a person with those qualifications (even though the recruitment process was extended twice due to lack of applications). During the next recruitment cycle, the City will make a concerted effort to solicit applications from certified public accountants, including by reaching out to relevant professional organizations.

The City remains committed to responsible stewardship of ratepayer funds, long-term infrastructure sustainability, open communication, and rebuilding public trust. The recent actions by the City Council reflect responsiveness to community input while the City works to address the issues raised in the Grand Jury report.

A copy of this response is being provided electronically to the Sonoma County Civil Grand Jury and will be placed on file with the City Clerk as a public record. The City Council considered and approved this response at its meeting on July 21, 2026.

Sincerely,

Jill McLewis Mayor,
City of Sebastopol On behalf of the Sebastopol City Council

cc: Sonoma County Civil Grand Jury (grand.jury@sonomacounty.gov)
City Manager Mary Gourley City Attorney

CITY OF SEBASTOPOL'S WATER AND SEWER SYSTEMS

Deferred Action has Consequences

May 2026

SUMMARY

The 2025-2026 Sonoma County Civil Grand Jury (Grand Jury) responded to two citizen complaints by undertaking an investigation into the City of Sebastopol's (the City) management of its Water and Wastewater Enterprise Funds (Enterprise Funds). These funds depend on ratepayer fees to provide potable water for consumption and fire protection and to maintain the infrastructure required to deliver water and remove wastewater through the sanitary sewer and stormwater systems.

The citizen requests for a Grand Jury investigation included evidence the City was not complying with state laws that establish how user *fees* differ from *taxes* and how fees may be established. In 1996, California voters passed Proposition 218 (Prop 218), also known as The Right to Vote on Taxes Act. Prop 218 required that new taxes be approved by a two-thirds vote of affected citizens. In 2010, the passage of Proposition 26 (Prop 26) further distinguished between a general tax and a "special tax" or *fee*. A key difference between a general *tax* and a special tax or *fee* is that a *fee* is for a specific service that benefits identifiable properties, whereas a general *tax* benefits the public. Another difference is that a fee may not exceed the reasonable costs of providing a service plus a reasonable proportion of the shared or indirect costs of government operations, such as legal services and general administration. Revenue from a fee may only be used to provide the specific service for which it is charged.

To set fees in accordance with state law, cities typically engage consultants at three-to-five-year intervals to conduct two types of studies. A rate study determines the direct

costs of a service and how it will be shared among ratepayers. A cost allocation study examines the city's general administrative costs and establishes what percentage should be allocated to each department or function. It results in a cost allocation plan (CAP).

The complaints alleged and the Grand Jury confirmed that, prior to 2023, the City had not conducted a cost allocation study and revised its CAP for more than 20 years. The cost allocation rates were adjusted in 2024 to conform with the new study, but to date, no steps have been taken to restore lost Enterprise Funds that are sorely needed to pay for deferred maintenance and system upgrades. When a new CAP study was conducted in 2024, it revealed that the City had overallocated indirect costs to the Enterprise Funds. The Grand Jury estimated that the overallocation had resulted in approximately $5.5 million dollars being moved from the Enterprise Funds into the City's general fund over the past nine years.

The complaints also questioned the legitimacy of the greatly increased water and sewer rates that took effect on July 1, 2024. The Grand Jury learned that while the City had conducted a rate study in 2019, the rates set for 2019 through 2023 did not anticipate the impact of successful water conservation programs. Because the rates were based on consumption, in part, less consumption resulted in less revenue. Based on its 2023 rate study, the City adjusted the fees to compensate for lower consumption. This resulted in a shocking 37% increase in water and sewer fees effective July 1, 2024, with approximately 4% annual increases scheduled for each of the next four years.

The Grand Jury found that the Enterprise Funds' insolvency resulted from a combination of overallocation of indirect costs for more than 20 years and insufficient user fees that were based on infrequent rate studies and adjustments, and on inaccurate projections of usage for fees in place between 2019 and 2023. Despite steps the City has taken to correct course, Sebastopol's Water and Wastewater systems suffer from years of underfunding that have resulted in deferred maintenance and neglected upgrades.

This report describes the laws governing how cities may establish user rates for services such as management of water and wastewater. It explains how the City departed from these laws by overallocating shared, indirect costs to its Enterprise Funds, thereby shifting money intended to support specific services into its general operating budget. To enhance public information and awareness, the report also describes critical infrastructure which residents depend on for potable water and fire protection and the removal of wastewater and stormwater.

METHODOLOGY

The 2025-2026 Sonoma County Civil Grand Jury:

- Conducted multiple interviews with City's staff and leaders, third party contractors and consultants, and service providers.
- Researched public records and information to gather documents, recordings of public meetings and interviews, contracts, etc. posted on the City's' website.

GLOSSARY

- **Annual Comprehensive Financial Report (ACFR):** A detailed annual financial report prepared by state and local governments to present their financial position and operating results.
- **Best Practices:** These are the industry-wide practices described by experts as the preferred methods used by practitioners in their fields. The Grand Jury interviewed experts in rate setting, allocating costs and water system management.
- **Cost Allocation Plan (CAP):** A formal method used to distribute indirect costs among different departments in a fair and systematic way to ensure that shared or overhead costs are properly assigned to the areas that benefit from them.

- **Depreciation:** The accounting process of allocating the cost of a tangible asset over its useful life.
- **Enterprise Fund:** A type of municipal accounting fund used to account for government activities that are generally intended to be self-supporting through user charges rather than taxes.
- **General Fund:** The main pool of money used to pay for everyday government services.
- **Potable/Fire:** The drinking/cooking/bathing and gardening water that comes out of your tap is called potable water. This is also piped to hydrants for fire protection.
- **Ratepayers:** Individuals or businesses that pay local property taxes to a municipal or local government authority for a specific service.
- **Rate Study:** A financial analysis conducted to determine the appropriate rates for services provided, usually by a government utility or public enterprise, so that revenues are sufficient to cover costs.
- **Sanitary Sewer:** The gravity powered, non-pressurized system of pipes that collects the wastewater from toilets, showers, and sinks in homes and commercial establishments and pipes it to a sewage treatment facility.
- **Storm Sewer:** The storm sewer removes water from the streets, such as from rain or overwatering a lawn. It is water that runs in street gutters and goes underground into pipes (often called culverts) and from there, in the case of the City, to the Laguna de Santa Rosa (Laguna). It ultimately ends up in either the groundwater aquifer or streams, or ponds and rivers to the ocean. When flooding occurs, the culprit is generally a storm sewer system that cannot handle all the run-off at a given time.

BACKGROUND

Laws Governing Rate Setting

Proposition 218 – “The Right to Vote on Taxes Act” created a 1996 constitutional provision (California Constitution Article XIII C) that established new procedural requirements for levying assessments and imposing new, or increasing existing, property-related fees and charges. It also placed substantive limitations on the use of the revenues collected from assessments and property-related fees and charges, as well as on the amount of the assessment, fee, or charge that may be imposed on each parcel. Prop 218 was amended in 2010 by Proposition 26 (Prop 26), which is discussed below.

Constitutional Article XIII C defines two types of taxes: general and special taxes. By definition, general tax revenues must be placed into the general fund of a local agency and made available for any and all governmental purposes. Such general taxes must be approved by the electorate.

In contrast, a special tax is imposed for specific purposes. Article XIII C, section 2(a) provides that “special purpose districts or agencies, including school districts, shall have no power to levy general taxes.” “The revenues from any special tax shall be used only for the purpose or service for which [the tax] was imposed, and for no other purpose whatsoever”. (Cal. Gov’t Code § 53724(e).) If the special tax exceeds the reasonable cost of providing the service or product, then the tax must be approved by the electorate. In effect, if a special district’s property-related fees exceed the costs of providing the services for which the fees are imposed, those fees may be deemed to be a general tax and therefore must be approved by a two-thirds vote of the electorate.

California voters amended Article XIII C in November 2010 by adopting Prop 26. Section 1(e) was added, which defined the term “tax” and determined that, in relevant part, the “local government bears the burden of proving by a preponderance of the evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor’s burdens on, or benefits received from, the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity."

Prop 218 requires that the rates applied must be proportional and Prop 26 requires that the special district has the burden to prove that the rates are reasonable. Moreover, Prop 218 is applicable to both independent special districts and dependent local government agencies directed by a county board of supervisors or a city council. (*Patz v. City of San Diego* (2025) 113 Cal.App.5th 225, 250)(Cal. Sup. Ct. denied review October 29, 2025).) Fees or charges for water service are fees imposed as an incident of property ownership and fall within Section 6(b)(3)'s purview. Accordingly, the City's Enterprise Funds are subject to the limitations of Prop 218.

The key question then is whether water and wastewater rates exceed the reasonable cost of providing the service or regulatory activity to parcels. If they do, they are taxes, not fees exempt from the requirement that the electorate approve it. (*County of Placer v. Corin* (1980) 113 Cal.App.3d 443, 449.) "Special assessments are not taxes and are not levied for general revenue purposes." (*Id.* at 452.) "Moreover, to the extent that an assessment results in revenue above the cost of the improvement or is of general public benefit, it is no longer a special assessment but a tax." (*Id*. at 451.) Accordingly, it is up to the City to prove that the rates charged are reasonable and proportional. (*Coziahr v Otay Water District* (2024) 103 Cal. App. 5th 785.) For a water agency to "carry its burden, an agency must generally provide evidence identifying the data used, analyzing the cost of service, and demonstrating the proportionality of the rate . . ." (*Id*., citing *KCSFV I, LLC v. Florin County Water Dist.* (2021) 64 Cal.App.5th 1015, 1030.)

Best Practices for Rate Setting and Allocating Costs

To comply with laws governing water and wastewater rates, cities typically conduct two studies at three-to-five-year intervals. Rate studies evaluate the direct cost of providing the services and establish what ratepayers will be charged to cover these costs.

The City conducted rate studies and adjusted water and wastewater rates in 2005, 2012, 2019, and 2023, but the 2023 study revealed that past increases had been insufficient to produce sufficient revenue.

Cost allocation studies examine how much a city is spending on general administration and determine a Cost Allocation Plan (CAP) to allocate a proportional amount of these costs to each department or function. Prior to 2023, the last CAP had been done more than 9 years before. The Grand Jury estimated that during the past nine years, overallocation of indirect costs resulted in approximately $5.5 million dollars being moved from the Enterprise Funds into the City's general fund. This overallocation unreasonably exceeded the Enterprise Funds' share of the City's indirect costs.

Fiscal Accountability and Transparency

In reviewing the overall financial position of the City, the Grand Jury found the 2022-23 Annual Comprehensive Financial Report (ACFR) Letter of Transmittal (page vii) identified the following in the Future Challenges section:

- Requests for City services far exceed available resources.
- The City balanced FY 23-24 with the use of $1,678,000 in reserves.
- The City will be challenged to adhere to Council-adopted fiscal sustainability policies.
- The City faces a financial deficit that will result in a complete depletion of all reserves by FY 2025-26 unless there are substantial changes that bring additional revenue into the City.
- On November 21, 2023, the City declared a fiscal emergency.

The City identified several fiscal sustainability goals and priorities that had financially significant impacts. The Grand Jury focused on the following two statements within the Letter of Transmittal:

- c. i. The City will conduct a water rate study to analyze the cost of service for the enterprise utilities to ensure an equitable distribution of utility costs across customer types.
- c. ii. The City's cost allocation plan has not been updated since 2000. The CAP guides the distribution of costs…between the General Fund and Enterprise Funds that use general government services.

DISCUSSION

Non-Compliance with Proposition 218

The citizen complaints alleged that the City did not comply with Prop 218 by overallocating indirect costs to the Enterprise Funds, thereby moving fee revenue into the general fund. The Grand Jury investigation supports this allegation.

As described in the Background section of this report, Prop 218 permits cities to allocate indirect costs to Enterprise Funds as long as the cost allocation is proportional and reasonable. The costs must bear a fair or reasonable relationship to the benefits and burdens of providing water and wastewater services to rate payers. It is up to the City to provide the evidence that a levy, charge or other exaction can be justified as necessary to cover reasonable costs.

Best practices recommend that cities update their CAP every three to five years, but the City did not do so for more than 20 years. In 2024, after two decades of increasing allocated costs for water and wastewater services, the City contracted with Clear Source Financial Consulting to update its CAP.

Clear Source recommended that the indirect cost allocations be revised significantly. For 2023-2024, the single year that Clear Source studied, it recommended that the City lower the annual indirect cost allocations attributed to the Enterprise Funds by approximately $714,000.

Rate studies are the basis for water and wastewater fees charged to customers. The resulting revenue may only be used to provide the services for which it is charged. Without regular, accurate rate studies and appropriate adjustment of fees, a city risks serious financial, legal, and operational consequences.

The City's infrequent and inaccurate rate studies meant that the Enterprise Funds were generating insufficient revenues for their level of expenses. Best practices advise cities to update their Rate Studies at regular intervals and adjust rates to cover, without exceeding, the direct cost of services. The City conducted rate studies in 2005, 2012, 2019, and 2023, but increases were insufficient to keep pace with direct costs. The 2023 rate study revealed that rates established in 2019 did not anticipate a significant reduction in water consumption due to conservation efforts. Lower consumption resulted in less revenue. Based on the 2023 rate study, the City raised water and sewer rates by a shocking 37%.

Fiscal Accountability and Transparency

The Grand Jury noted that prior to fiscal year ending June 30, 2023:

- The Enterprise Funds operated at a net loss in three consecutive years (2020, 2021 and 2022).
- The Enterprise Funds continued to operate at a net loss for two more years (2023 and 2024) before showing net gain in 2025.
- However, shortfalls in the Enterprise Funds actually began in fiscal 2018, as shown in the following table of Enterprise Funds Business-type Activities.

Business-type Activities:				
	Revenue	Expense	other	Net
2016	5,320,925	4,556,861	(31,024)	733,040
2017	5,782,632	4,606,024	(31,023)	1,145,585
2018	5,298,554	4,984,637	1,705	315,622
2019	5,334,287	5,266,857	(370)	67,060
2020	5,190,769	5,956,440	76,237	(689,434)
2021	5,637,786	6,010,098	60,631	(311,681)
2022	5,573,214	6,417,735	(386,034)	(1,230,555)
2023	5,359,319	6,270,942	83,488	(828,135)
2024	5,304,163	7,192,644	28,702	(1,859,779)
2025	8,462,607	6,560,705	66,478	1,968,380

2024-25 ACFR pages 138 – 141, Changes in Net Position Last Ten Fiscal Years

The Grand Jury analyzed revenue and expense for the fiscal periods 2016 – 2025 and noted fluctuations in revenue that appeared inconsistent with expense fluctuations.

- Revenue in fiscal 2024 was less than revenue in fiscal 2016. Overall, revenue declined while expenses steadily increased.
- After fiscal 2017, Net Change in Position dropped significantly and didn't recover until fiscal 2025.

When asked what might have caused the declines in revenue and net position, the City was unable to provide an explanation. The 2024-25 ACFR Changes in Net Position Last Ten Fiscal Years report shows the impact of two factors: 1) Indirect costs had been overallocated and credited to the general fund; and 2) Conservation of water resulted in less revenue.

The Grand Jury analyzed allocated costs for Water and Wastewater Business-Type Activities. The City's 2024-25 ACFR, Management's Discussion and Analysis, Economic Factors and Next Year's Budgets and Rates section included the following statement: "There is $714,000 less in funds transferred from the Water and Sewer funds for administrative costs due to a new allocation method determined in early 2024". (ACFR, 2024-2025, p. 2)

The City's allocated indirect costs are reported as Interfund charges for services on the Statement of Revenues, Expenses and Changes in Fund Net Position. The statements are found in the City's ACFRs for each fiscal year, which can be seen below in the Appendix.

The chart below summarizes the Statements of Revenues, Expenses and Changes in Fund Net Position for fiscal 2017–2025. The Grand Jury noted Interfund charges for services (cost allocation) steadily increased each year even though revenues and personnel services expenses did not increase each year, until 2025. As a percentage of revenue, the Interfund charges to the Enterprise Funds for shared services (cost allocation) increased from 30% in 2017 to 52% in 2024 for Water, and increased from 18% in 2017 to 36% in 2024 for Wastewater, as displayed in the table below.

Summarized Statements of Reveues, Expenses, and changes in Fund Net Position, Proprietary Funds

For year ended:	6/30/2017	6/30/2018	6/30/2019	6/30/2020	6/30/2021	6/30/2022	6/30/2023	6/30/2024	6/30/2025
WATER (W):									
Total operating revenues	2,457,698	2,270,224	2,229,367	2,295,614	2,613,289	2,519,592	2,353,715	2,433,539	3,441,843
Personnel services	354,041	379,506	420,984	522,936	447,255	495,575	279,697	559,642	641,718
Interfund charges for services	726,329	838,117	874,193	1,004,772	1,011,522	1,182,152	1,199,387	1,261,494	852,863
Other opg services and supplies	608,626	631,111	590,350	794,074	913,897	869,842	984,153	1,045,753	918,221
Non-opg rev/exp/transf	(42,657)	(61,701)	(26,935)	(55,096)	(356,194)	(130,744)	(5,794)	(55,079)	(120,441)
Change in net position	726,045	359,789	316,905	(81,264)	(115,579)	(158,721)	(115,316)	(488,429)	908,600

For year ended:	6/30/2017	6/30/2018	6/30/2019	6/30/2020	6/30/2021	6/30/2022	6/30/2023	6/30/2024	6/30/2025
WASTEWATER (WW):									
Total operating revenues	3,324,934	3,028,330	3,104,920	2,895,155	3,024,497	3,053,622	3,005,604	2,870,624	5,020,764
Personnel services	266,375	283,978	249,689	364,322	307,020	457,548	242,407	494,737	549,012
Interfund charges for services	589,885	680,710	724,321	830,851	831,627	981,322	990,306	1,041,462	908,934
Treatment costs	1,518,743	1,594,680	1,674,414	1,620,981	1,650,401	1,650,401	1,737,404	1,952,842	2,118,436
Other opg services and supplies	489,958	506,788	662,332	725,130	701,991	754,471	766,376	746,933	486,723
Non-opg rev/exp/transf	(7,706)	(8,416)	32,598	22,353	(17,999)	(49,444)	18,070	(6,000)	102,121
Change in net position	452,267	(46,242)	(173,238)	(623,776)	(484,541)	(839,564)	(712,819)	(1,371,350)	1,059,780

	6/30/2017	6/30/2018	6/30/2019	6/30/2020	6/30/2021	6/30/2022	6/30/2023	6/30/2024	6/30/2025
WATER:									
allocation as % of revenue	30%	37%	39%	44%	39%	47%	51%	52%	25%

	6/30/2017	6/30/2018	6/30/2019	6/30/2020	6/30/2021	6/30/2022	6/30/2023	6/30/2024	6/30/2025
WASTEWATER:									
allocation as % of revenue	18%	22%	23%	29%	27%	32%	33%	36%	18%

In 2025, based on the 2024 Cost Allocation study, the Interfund charges for services were 25% and 18% of revenue for Water and Wastewater respectively. This is the result of the use of the updated CAP. The Grand Jury asked the City to explain what factors contributed to the significant change from the old CAP to the new CAP. The City provided no explanation.

The Grand Jury calculated what the impact to the Water and Wastewater Enterprise Funds might have been had the cost allocation been 25% and 18% respectively, as a percentage of revenue over the past nine years. The results can be found on the following Interfund charges for services (cost allocation) analysis table for both Water and Wastewater Enterprise Funds. The 25% column represents what the Interfund charges could have been under an updated CAP. The "Actual" column represents the actual Interfund charges allocated to Water and Wastewater Enterprise Funds in each year. The "Difference" column is the mathematical computation of the 25% column minus the Actual column.

Interfund charges for services (cost allocation) analysis showing the approximate overallocation of $5.5 million:

WATER	25%	Actual	Difference
6/30/2018	567,556	838,117	(270,561)
6/30/2019	557,342	874,193	(316,851)
6/30/2020	573,904	1,004,772	(430,869)
6/30/2021	653,322	1,011,522	(358,200)
6/30/2022	629,898	1,182,152	(552,254)
6/30/2023	588,429	1,199,387	(610,958)
6/30/2024	608,385	1,261,494	(653,109)
			(3,192,802)
WASTEWATER	**18%**	**Actual**	**Difference**
6/30/2018	545,099	680,710	(135,611)
6/30/2019	558,886	724,321	(165,435)
6/30/2020	521,128	830,851	(309,723)
6/30/2021	544,409	831,627	(287,218)
6/30/2022	549,652	981,322	(431,670)
6/30/2023	541,009	990,306	(449,297)
6/30/2024	516,712	1,041,462	(524,750)
			(2,303,704)

Source: Summarized Statements of Revenue, Expenses, etc. as referenced above.

Water and Wastewater Infrastructure

The operation and maintenance of the City's water and wastewater systems are funded by revenue from the fees charged to their customers. Financially, the water utility is operated as a self-supporting enterprise relying primarily on the revenues from water rates to fund the costs of providing services and maintaining the system.

At the City Council Meeting on October 24, 2024, the Public Works Superintendent presented an overview of the water infrastructure including these statistics:

- The City owns, operates and maintains approximately 36.7 miles of water mains and pipelines, three storage facilities, one booster pump station, one blending pump station, four active groundwater wells, and two arsenic treatment systems to produce, treat, and distribute water to the City's water customers.

- The City provides potable water to approximately 2,975 water meter accounts as well as providing water through the City's water G tower located at the City Corporation Yard. The City's municipal water system produced approximately 289 million gallons of treated drinking water in 2023. View the Dante Del Prete Presentation to Sebastopol City Council October 15, 2024 Here.

Overview of the Conditions of the Systems

The water systems have elements that were installed over 100 years ago. The systems demonstrate the accumulated problems from deferred maintenance. The lack of capital investment in equipment improvements puts the City at risk of water supply failure or flooding in the streets. Many of the pipes in the system are beyond their expected life, some are over 100 years old. Indeed, the City's financial records show that the critical components have been fully depreciated.

The condition and needs of the systems are very well documented. The recently completed Master Plan calls for repairing, replacing, and bringing the systems into good condition. While there has been an on-going program to replace the aging pipes, because of the underfunding of the water system budget, the program is not getting ahead of the aging mains – creating potential (and actual) failures, and requiring emergency repairs. GHD Sewer Master Plan presented to the City by GHD: View the GHD Sewer Master Plan Final April 21, 2026 Here.

Replacing mains and branch lines is expensive and disruptive. However, it is far less expensive and disruptive than leaks and emergency repairs that can leave households or businesses without services for extended periods. A loss of service to a potable water main also leaves a section of the city without water at pressure to fight a fire – that is only a risk unless it happens when there is a fire, then it is a disaster. Clearly failures in the sanitary sewer system can cause health and environmental disasters, besides the obvious impact to homes and businesses. Storm drain failures result in street flooding, with the attendant costs to homes and businesses in the flood zone, as has happened in the past. The City is currently experiencing water leakage into the sanitary sewer system, which causes the City to pay more for water treatment than if the system were properly sealed.

The City is completely dependent on wells for potable water. Fortunately, the aquifer is adequate to provide the needed water at current usage rates. Besides pumping, the water must be treated for contaminants, stored and then pumped through often old, to very old, pipes to the end users, hydrants, homes, businesses etc. It is critical that the wells and the pumping and treatment plants be kept in reliable, dependable condition. The master plan includes projects and programs to upgrade or repair the well and treatment sections of the potable water system.

In the City, water comes from several city owned wells. After treatment in one of several plants, it is pumped to the meters via a system of main and feeder lines. The City has a combined potable and fire water system, which is not uncommon. In this case, the same pipes, particularly the mains, feed the fire hydrants and the potable water distribution system.

The storm water system is critical to prevent flooding, particularly in the downtown area. Keeping standing water off the streets is an important safety measure. The City's storm water system has two sixty-inch pipes that discharge into the Laguna de Santa Rosa. These require regular maintenance, which primarily consists of debris removal to keep capacity up. This maintenance has not happened, leaving the pipes at about 50% capacity. This has created the potential for flooding in the downtown area, as has occurred in the past. Without the regular debris removal, the buildup is not only larger, but much more difficult and costly to remove.

The City uses the Santa Rosa Sewage Treatment Plant (STP) to treat its sanitary sewage. The City pays a fee to Santa Rosa based on the amount of sewage going through the pipe to the Santa Rosa STP. Leakages in the system cause two kinds of problems:

1. If sewage leaks out, there is public health and ground water problem.
2. If water leaks in, then the city is paying for ground water going to Santa Rosa. (This is primarily a gravity, non-pressurized system, so ground water can leak into the pipes.)

The recently completed Master Plan does a good job of documenting and estimating the repair/replacement costs to the systems. Sebastopol citizens and rate payers need to be aware of the condition, challenges and potential costs of failures of the systems. The list below is not a complete list of planned repair and capital projects, but a sampling of the types of projects and some of the costs and risks involved. Many of these should have been dealt with years ago.

1 – Pleasant Hill Loop (Estimate $900,000 +): This is a critical safety element lacking in the water system. Redundancy is common to any well-engineered system, particularly for health or safety related systems. In good practice, fire/potable waters system main lines are loops so that an individual break or leak can be isolated and water is still available to users, fire hydrants etc. Currently there is a section of the water system that is not looped and a rupture in this line, be it a leak or a rupture caused by a seismic event, could leave more than half of the city without water pressure to fight a fire for as long as it takes to repair the rupture. This could be catastrophic. (For example, although the City's 2005 Master Water Plan recommended that the Pleasant Hill looping project be completed, the City has yet to fund and complete the project.)

2 – Well 4 Replacement (Estimate $3 million): Well 4 is the workhorse of the City's water system. This is a multi-year, multi-faceted program which needs reliable, consistent funding to ensure the entire project is completed in a timely matter.

3 – There are significant water main and branch projects in the Master Plan. These are projects that need to be engaged and completed to avoid costly and disruptive water outages. It is much less expensive and inconvenient to replace mains as planned projects rather than on emergency basis.

4 – Clearing the 60-inch storm drains to the Laguna. Storm drains are part of the funded maintenance program for the City's infrastructure system. Failure to permit, fund and execute the clearing of the outfall lines puts parts of the city, particularly the downtown, in jeopardy of flooding in the event of major rain events, such as atmospheric rivers.

Sebastopol Wasn't the Only One Not Paying Attention

This Grand Jury notes that Sonoma County's independent Local Area Formation Commission (LAFCO) has an oversight role in the City's water and wastewater enterprises. The current 2025-2026 Grand Jury report on LAFCO notes:
"LAFCOs are responsible for coordinating logical and timely changes in local governmental boundaries; conducting special studies that review ways to reorganize, simplify, and streamline governmental structure; and prepare mandatory Sphere of Influence reports and Municipal Service Reviews for each city and special district within the county". The last Sebastopol Municipal Service Review by LAFCO was in 2006.

CONCLUSION

The Grand Jury was encouraged that the City has taken steps to right the ship. After conducting overdue studies, it has reduced the allocation of indirect costs to the Enterprise Funds and adopted painful but necessary water and wastewater rates. In November 2025, the City Council reinstated the Enterprise Fund Oversight Committee that will advise the City regarding the operation of the Enterprise Funds. The Grand Jury views this as a positive step to ensure future compliance and improved performance of the Enterprise Funds for their intended purpose.

FINDINGS

F1. The Grand Jury estimated that the City's failure to update its Cost Allocation Plan for more than 20 years resulted in the City overallocating approximately $5.5 Million of indirect costs to the Enterprise Funds. This was non-compliant with Proposition 218 and left the Enterprise Funds without sufficient money for maintenance and capital improvements.

F2. When the City updated its Cost Allocation Plan in 2024, reduced allocation of indirect costs left approximately $714,000 in the Enterprise Funds to be used for systems maintenance and capital improvements.

F3. Because the rate study conducted by the City in 2019 underestimated a reduction in consumption due to conservation measures, the rate adjustment for 2019-2023 was insufficient to keep pace with escalating costs. This resulted in the need for a 37% increase on July 1, 2024, which has been difficult for many ratepayers to accept.

F4. In November 2025, the City Council reinstituted an Enterprise Fund Oversight Committee. This promises to provide the City Council with insights and expertise regarding decisions concerning oversight of these critical systems.

RECOMMENDATIONS

The Grand Jury recommends that the Sebastopol City Council:

R1. By October 1, 2026, commit to fully comply with Proposition 218 by conducting cost allocation and rate studies at least within 3-5 years intervals and adjusting its cost allocation and ratepayer fees accordingly.

R2. By October 1, 2026, reach an agreement on the dollar value of mis-allocated indirect costs and commit to a repayment schedule to restore funds transferred from the Enterprise Funds to the general fund by overallocation of indirect costs. This money can be used to implement critical improvements identified in the Master Plan.

R3. By October 1, 2026, consider adding a Certified Public Accountant to the Enterprise Fund Oversight Committee to assist the City Council and City Manager with fiscal compliance, analysis, and transparency.

REQUIRED REPONSES

Pursuant to Penal Code section § 933.05, the following response is *required*:

The City of Sebastopol's City Council: respond to F1-F4 and R1-R3 within 90 days of receipt of this report.

APPENDIX

1. Timeline of Events at the City of Sebastopol below:

Date	Description of Study	Action
2000	Rate and Cost Allocation Study	Implemented
2005	Master Water Plan	Recommended implementing the Pleasant Hill 14" main loop.
2008	Master Water Plan	"Water and sewer fees show a small increase at this time due to the increases indicated in the yearly rate study."
2012	Water and Sewer Rate Study	Rates roughly doubled (about $10.79 a month to

		$24.92 and the sewer charge would go from about $25.67 to $49.92)
2019	Willdan Water and Sewer Rate Study	Rates increased effective 1-1-2020 .
2024	Raftelis Water and Sewer Rate Study	Implemented in 2024, the City chose the lower rate option (current combined bill of $114.24 increased to $151.80)
2024	Clear Source Cost Allocation Study	Implemented in 2024
2026	GHD Water Master Plan	Accepted by the City Council

2. Statements of the City's ACFRs for each fiscal year below:

Fiscal year	Link	Page
The City's Documents Directory	View the City's Document Directory Here	
2025	View FY 2024-2025 Annual Comprehensive Financial Report Here	45 (55 PDF)
2024	View FY 2023-2024 Annual Comprehensive Financial Report Here	37 (51 PDF)
2023	View FY 2022-2023 Annual Comprehensive Financial Report Here	39 (55 PDF)

2022	View FY 2021-2022 Annual Comprehensive Financial Report Here	41 (57 PDF)
2021	View FY 2020-2021 Annual Comprehensive Financial Report Here	39 (55 PDF)
2020	View FY 2019-2020 Annual Comprehensive Financial Report Here	39 (55 PDF)
2019	View FY 2018-2019 Annual Comprehensive Financial Report Here	39 (55 PDF)
2018	View FY 2017-2018 Annual Comprehensive Financial Report Here	39 (55 PDF)
2017	CAFR for 2017 is not available online and had to be requested from City of Sebastopol.	39 (51 PDF)

Reports issued by the Grand Jury do not identify who have been interviewed during the investigation. Penal Code § 929 requires that reports of the Grand Jury not contain the name of any person or facts leading to the identity of any person who provides information to the Grand Jury.