

Cost Allocation Plan – The Jury is Out

The debate about the allocation plan is much like a trial. There are two parties (points of view) and you, the City Council, represent the jury. One point of view is presented by the city in the staff report. The other, presented in public comments, opposes the city's proposal. As the jury you will have to decide which argument is most persuasive.

The judge would explain the law. After Proposition 13 passed cities struggled to balance budgets. Cities with public utilities such as water and sewer operations used rate hikes which did not require voter approval like new taxes. Proposition 218 and Proposition 26 specified how fees and taxes were to be defined going forward.

In 1996 voters approved Proposition 218 which tightened rules on local government fees/assessments, tying charges to service costs. Proposition 218 established requirements affecting water and sewer rates:

- **Revenue from water/sewer rates cannot fund general government operations or unrelated departments**
- **Nexus requirement – the fee charged must have a direct relationship to the service delivered.**
- **Burden of proof is on the city – must show documentation for cost basis and allocation methodology**

In 2010 voters approved Proposition 26 which broadened the definition of “tax”, making it harder for governments to label revenue as a “fee” unless it meets specific criteria. Essentially all revenue collected by the city is a tax unless it meets specific criteria:

- **The law specifies charges should not exceed the cost of delivering the service.**
- **No “profit”, no padding, no hidden transfers**

As the jury, the judge would instruct you to evaluate the proposal presented by City staff based on the following criteria:

- **Fees must be cost based – cannot exceed the reasonable cost of providing the service**
- **Nexus – fee must be directly tied to the service delivered to the payer**
- **Proportionality – each payer pays their fair share (no cross-subsidizing unrelated costs)**
- **No General revenue – cannot be used to fund general government services**

The city argues that the following allocation amounts are “reasonable”:

Agenda Item Number 3

Cost Allocation Plan Break-Down

Cost Allocation Plan						
	FY24-25			FY25-26		
Department	Water	Wastewater	Total	Water	Wastewater	Total
City Council	50,209	52,465	102,674	49,767	54,891	104,658
City Manager	129,411	150,817	280,228	128,272	157,791	286,063
City Attorney	70,129	114,458	184,587	69,512	119,751	189,263
ACM/City Clerk	38,434	62,728	101,163	38,096	65,629	103,725
Admin Svs (Finance)	306,241	323,159	629,400	303,546	338,103	641,649
Public Works - Engineering	92,548	89,999	182,548	91,734	94,161	185,895
Public Works - Corp Yard	157,315	108,077	265,393	155,931	113,075	269,006
Non-Departmental	8,575	7,230	15,805	8,500	7,564	16,064
Total	852,863	908,934	1,761,797	845,358	950,965	1,796,323

Agenda Item Number 3
Budget Committee & Enterprise Fund Oversight Committee Meeting Packet for April 21, 2026
Page 1 of 1

The opposition argues that when compared to the total department budgets being allocated the amount appears to be well in excess of anything “reasonable”.

The first evidence is the fact that rate payers are paying 41% of the department expenses for the city’s administrative departments. **Ask yourself if this seems reasonable “overhead”?**
Does it seem like the rate payers might be paying for some general government services?

Table: Proposed allocation as a % of Department Budgets

	FY25-26 Cost	26-27 Proposed	% of
	Allocation	Budget	Budget
City Council	\$ 104,658.00	\$ 171,408	61%
City Manager	\$ 286,063.00	\$ 594,766	48%
City Attorney	\$ 189,263.00	\$ 643,750	29%
City Clerk	\$ 103,725.00	\$ 282,477	37%
Admin Svs(Finance)	\$ 641,649.00	\$ 1,512,645	42%
	\$ 1,325,358.00	\$ 3,205,046	41%

City Council – 61% of Budget

Courts have expressed doubt that rate payers should pay for City Council. Council establishes city policy and has no activities related directly to the nexus of delivering water or wastewater services. **Does it seem reasonable that in Sebastopol, 61% of the City Council budget is being paid for by water-rate payers?** Included in the budget are trips to the League of Cities conference, a Fax line, Shuttle fares, Sister Cities International subscriptions and plaques. These are being lumped into “overhead”.

City Manager – 48% of Budget

City Manager is another position that gets skepticism from judges. Generally, the city manager is pretty removed from the utilities. If cities can show the cost and nexus for the charges, it can be allowed. **In Sebastopol ½ of the City Manager budget \$286,063 is being paid by the rate payers and there is no City manager. Difficult to justify that expense.** Where does the money not being spent by the city manager go. Is it not just going into the general fund to cover other city expenses unrelated to delivering water and wastewater services? This is a clear violation of California law. **It also highlights why using a model, based on historical data, will always be charge rate payers for unrelated services. The model is inappropriate for the allocations.**

City Attorney – 29% of Budget

29% of the total legal budget is being paid for by rate payers. This includes what has been recently reported as about \$10,000 in city attorney fees related to the enterprises and presumably, \$180,000 in litigation costs. The major litigation is the ACLU lawsuit.

The Administrative Director has stated in public meetings that the lawsuit is in fact part of the “overhead” of the city being assigned in the Clear Source Model. **Do you feel there is clear nexus between the ACLU lawsuit costs and the water that comes out of your faucet?**

Traditionally, legal expenses are billed in increments and could be directly charged to rate payers to avoid the allocation problem. **“Transparency” is a city goal – a little transparency here would be welcomed.**

City Clerk – 37% of Budget

City clerks have a primary role in supporting the city council, assisting the public and keeping city records. City Clerk having a role in delivering water and wastewater service may also be a stretch. **Rate payers are paying 37% of the City Clerk’s department budget.**

Administrative Services (Finance) – 42% of Budget

This is the one department most likely to have justification for allocation of expenses but as the jury **you will have to consider if \$641,649 of the admin department budget should be paid for by water rate payers?**

The Administrative Director presented to the Oversight Committee a task/time analysis of the billing and customer service function provided by 2 of her staff. **The cost of billing and customer service totaled about \$200,000. This leaves \$441,649 in charges to water and wastewater unaccounted for.**

There are expenses in the Administration budget that could be allocated or shared with rate payers:

- Citywide accounting software -\$51,000
- Banking fees -\$24,000
- Contracted costs for HR service - \$120,000
- Audit and Accounting services -\$43,000
- Technology services - \$49,600

The total cost of the allocable expenditure listed above is \$287,600. Water and sewer would be paying a fraction of these expenses.

Presumably, much of the \$442K (cost in excess of billing and customer service) collected from water rate payers is paying for general city expenditures.

Is it fair for rate payers to pay \$641,649 for admin services?

Have you been misled?

As a jury that has carefully reviewed the city's presentation in the staff report, you may be surprised that rate payers are paying \$641,649 for admin services. The staff report uses the admin department as an example to explain how the allocation model works. However, the example allocates only \$148,000 of Admin/Finance expense to rate payers

Excerpt from Staff Report:

Example: Based on allocable cost pool of Administrative Services budget of \$1,411,268 If Water represents 10% of Citywide operating expenses, then Water would receive 10% of the Finance cost. This is what you see in the allocation worksheets. For example:

- Water receives \$48,834 (1st allocation) and \$5,716 (2nd allocation) for a total of \$54,550.
- Sewer receives \$84,128 (1st allocation) and \$9,846 (2nd allocation) for a total of \$93,974.

Although the example shows that only \$148,000 is being allocated to rate payers, the actual amount of course is \$641,649. Certainly, the difference is confusing for someone trying to wade through the issues and understand what is going on. The staff report makes the \$148K allocation seem very reasonable – the actual allocation of \$641,649 tells another story.

The City’s rationale is compelling... but appears inconsistent with the laws

The city is reframing the decision outside the legal requirements established by Prop 218 and 26. **They tell you to consider the model fair, logical, not perfect and reasonable.**

Even using the city’s own justification, ask yourself:

- **Is it “reasonable” that rate payers are paying for nearly half (41%) of the budgeted cost for the administrative departments.**
- **Currently rate payers are paying a quarter of a million dollars for a City Manager that does not exist. Is this a minor imperfection?**
- **You are the city council. Do you feel that 60% of your efforts are directed at helping to deliver water and sewer services?**

As you are now aware, fair and logical for all departments is not part of Proposition 218 and 26 – charges must have a nexus for the delivery of water and wastewater services.

The city describes a Direct Cost allocation Method

The city tells you there is an alternative to change from the current full cost allocation approach to a methodology based on federal cost principles. They will impress you that this approach is compliant with (2 CFR200/Uniform Guidance) that establish standards for determining allowable cost when charging grant funds.

You by now are educated to understand that Federal laws governing allocating overhead to federal grants have no relationship to California State Laws created by the passage of proposition 218 and 26.

The Choices Offered for your Vote are pretty limited

You are instructed by the city to vote on one of the following “options”:

- 1. Select one of the cost allocation options presented.*
- 2. Apply an annual Consumer Price Index (CPI)–based inflationary adjustment for subsequent fiscal years.*
- 3. Conduct a comprehensive Cost Allocation Plan study every three to five years to reassess the methodology and underlying assumptions*

The options being offered to Council, by the City, are complicated and not well explained. The choices offered are essentially different ways to use the Clear Source Model as it is now

Instead of moving toward charging rate payers for only the costs attributable to delivering services, **they would like you to decide if you want to run the model based on last year’s budget or the actual expenses 2 years ago.**

The city would like you to consider using the model for one year and then increasing the amounts charged to rate payers by inflation for the next three years.

These choices are completely inconsistent with the standard of charging actual costs. There is no “true-up” provision in the proposed plan.

You are not offered a choice to address the inputs to the model that produced very high charges to rate payers.

There is another option not being offered

The opposition is proposing to abandon the Clear Source model. It is costly, too cumbersome for the Finance/Admin Staff to operate and lacks the transparency needed in the case of a lawsuit.

The opposition proposes a simple approach.

Directly charge the enterprise funds for costs of service.

- Public works already budgets and charges the enterprise for dedicated staff, supplies and equipment. Management time is allocated and there are shared costs for purchase of equipment.
- Finance could budget 1.5 FTE that does billing and customer service. Shared costs for HR and IT could be allocated.
- City Manager can keep track of time related to water and wastewater.
- City Council/City clerks should not be allocated at all as the nexus with delivering services is unclear.
- City attorneys, engineers and HR are contracted and should bill work for the enterprise to the enterprise cost center.

The budget process would be the same as the rest of the city. Budgets are estimated for each of the costs related to the enterprise operations and actual costs are charged as they occur. At the end of the year only actual costs are charged to the Enterprise Funds.

Financial Impact

Since rate payers are currently paying 40% of general administrative expenses it should not be unexpected that reductions will impact on the general fund budget. Unfortunately, due to a structural imbalance (Expenses are greater than recurring tax revenues) the General Fund starts every year with a budget defect that needs to be filled.

For FY 2025–26, recurring revenues—including property tax, sales tax, user taxes, and transient occupancy tax—are budgeted at \$11,460,355. Operating expenses (net of transfers out) total \$14,716,469, resulting in an **operating deficit of approximately \$3,256,114.**

The \$1.7MM collected from rate payers plugs about ½ of the deficit and thus it is difficult for the city to reduce the amount charged to rate payers. It also provides evidence that the city depends on rate payers to balance the General Fund budget each year. Recall this is the problem Propositions 218 and 26 were intended to fix.

This practice is not recent. For at least 22 years the city has been collecting this kind of money or much more. Fixing the problem is going to require some significant financial engineering. There are options.

**It is not sustainable for expenses to be 30% higher than recurring revenue. **

Final Jury Charge –

As you consider all the evidence there are a couple of ways to evaluate the alternative proposals. First, you need to look at the expenses being allocated and ask yourself if they all meet the laws passed by voters in the State of California:

- **Total fees collected must not exceed the funds required to provide the service**
- **No “profit”, no padding, no hidden transfers**
- **Revenue from water/sewer rates cannot fund general government operations or unrelated departments**
- **Nexus requirement – the fee charged must have a direct relationship to the service delivered.**
- **Burden of proof is on the city – must show documentation for cost basis and allocation methodology.**

The Final Test

Consider if the city suddenly found itself without the water and wastewater responsibilities. What city administrative items totaling \$1.7MM would you eliminate because they would no longer be needed. **If there was no responsibility for water and wastewater, would it be natural to cut 60% of the city council budget? Would you cut the city manager’s salary by 50% due to the decrease in responsibilities?**

If you would not naturally cut these costs, then they are not directly attributable to operating the water and wastewater enterprises.

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