

## **Cost Allocation Not Grounded in Reality**

The City's cost allocation methodology is fundamentally and legally flawed as it applies to enterprise funds. It is resulting in much higher overhead costs structure than a stand-alone Water District. We pump or own water, the cost is literally the electricity to pump it and Sebastopol has the highest water and wastewater rates in the County. Overhead it a big part of the reason.

The general concept behind cost allocation described by the Administrative Director in the staff report is that ***central services costs that support all departments—are distributed among the departments that benefit from them.*** In Sebastopol, these allocations between departments are not governed by law and are not used for rate-setting purposes, so there are no direct consequences to any method created for the purpose.

However, **California law is very clear** when it comes to Water and Wastewater enterprise funds. Only expenses that are **directly related to the delivery of water and wastewater services may be charged to ratepayers.** For the example in the staff report, Legal, this includes legal work such as reviewing contracts for enterprise operations, advising on compliance with public utility laws, or handling claims directly tied to Water or Wastewater services. Legal work unrelated to those services—such as enforcement of parking ordinances or other general city matters—cannot legally be charged to Water or Wastewater ratepayers.

For enterprise funds, the concept of a general “cost pool” to be divided across departments does not apply. **The pool must be limited strictly to expenses that are directly attributable to service delivery.** Legally, the Water and Wastewater enterprises are not simply another city department.

Similarly, allocating costs to enterprise funds based on a percentage of citywide operating expenses conflicts with state law. **Enterprise fund charges must be directly attributable to the services provided. Percentage-based allocations must be supported by clear documentation explaining how the estimate was derived.** While percentages may work reasonably well for allocating a department head's salary, **they are inappropriate for most other departmental expenses that have little or no relationship with Water or Wastewater operations.**

The use of a second allocation layer may make sense when distributing legal costs from the City Manager to other general fund departments. However, applying this approach to Water and Wastewater violates the core legal requirement that ratepayers be charged only for expenses directly related to service delivery. **A second allocation should not be used when calculating charges to enterprise funds.**

## **Recap: The Simplified Explanation (City Version)**

The City Attorney supports everyone, so everyone pays a fair share based on the size and complexity of each department, as measured by net operating expenses.

### **Recap: What the Law Requires**

**Under the City Attorney’s contract, only the portion of time spent on Water and Wastewater matters—such as contract review, regulatory compliance, or enterprise-related claims—may be charged to ratepayers.** That percentage should be applied only to the attorney’s contract amount. If time is tracked, the timesheets should be used to determine the actual costs attributable to Water and Wastewater at year-end. Any litigation directly related to Water or Wastewater should be budgeted separately and billed based on actual costs incurred.

### **Proposal for Methodology Going Forward:**

- **Direct billed expenditures from various departments should be the default practice.** This encourages the identification of expenditures that relate to delivery of water/wastewater services. **Expenses only peripherally associated with the enterprises should not be direct billed or allocated.**
- **If percentages are being used, they should only be against salaries not other department expenditures.**
- **The methodology should be agreed upon prior to the beginning of the budget season (March/April).**
  - Each department should identify and document the rationale for time spent on water and wastewater. Categories and types of anticipated direct expenses can be identified if they occur routinely.
    - City Council should base it on the number of substantial agenda items for enterprise funds vs all other agenda items. Financial reports on consent calendar do not count.
    - City Manager should consider time spent in the past year and identify any issues or projects for the next year that might increase the allocation (ie. Multimillion dollar CIP project plans).
    - Public Works should identify direct bill costs attributable to enterprise work. Shared positions should be limited to only a couple of people whose time can be tracked to other city projects. Right now, every PW employee is majority paid by payers but can be pulled away for other city work when required.

- City Attorney – estimate time for budget and report actuals at the end of the year for financial close-out
- Engineer is currently contracted and should identify charges related to Enterprise work and directly place in budget and direct bill for actual expense.
- Corporate Yard is largely a placeholder to allocate Director and Supervisor costs to enterprises. Suggest direct billing the supervisor (Eric) and making him/her 100% responsible for Enterprises. No allocation of Department Director who should oversee the remainder of the city infrastructure. Just adds unnecessary layers of management and cost not typical of a stand-alone utility of this size.

### **Annual Budget Process:**

April:

Finalize allocation methodology (% time and direct bill budget categories) with approval of Oversight and Budget Committee

June:

Apply allocation methodology to the final general fund budget. This allows each department to finalize their anticipated costs before the final allocation number is determined.

December:

Mid-year budget update can correct for any significant changes in the general fund department budgets or perhaps changes in time spent by a department head on enterprise business due to unexpected demands. Changes to presumed direct billed items can be made at this time.

End of Year:

Confirm allocation assumptions were realistic. Apply allocation to actual department expenditures and show them as actuals on Enterprise financials. Identify any changes to direct billed costs. Finalize actuals

At the end of the year only actual expenses direct billed or allocated are charged to rate payers. There is a written rationale for all allocation decisions.