City of Sebastopol

Water Enterprise Fund — DWSRF Loan Eligibility for Well 4

Can the water fund still qualify for the $2.6M well 4 replacement loan if rates are frozen and de-tiered and the EFOC reform package is not implemented?

Five-year forecast FY2026-27 through FY2030-31 · Rates frozen at 7/1/2025; residential de-tiered to $5.22/kgal

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Summary

Well 4 is the primary well, it delivers ½ of the required water supply for the city.

The City intends to finance the Well 4 replacement with a $2.6 million loan. A typical lender would be the State's Drinking Water State Revolving Fund (DWSRF). DWSRF requirements will be similar to other lenders. To qualify, the Water Fund must show that its **net revenues cover at least 1.25 times its annual debt payments** and that it maintains a healthy reserve. The lender looks forward 2 years and backward 3 years. **This memo tests that requirement against three scenarios, assessing staff-recommended council approved de-tiered rate of $5.22/kgal to the 2024 approved rates and to the full EFOC recommended Proposition 218 reform package.**

The result: the water fund would have qualified comfortably under the 2024 rate package. It would also qualify implementing the full EFOC reform package, but freezing and de-tiering rates without the reforms fails the test (This was passed by City Council 7/7/2026). Coverage falls to 0.99× by FY2030-31 and the reserve goes negative.

Given the lookback criteria, any delay in addressing the deficits created by this council's decision may make it more difficult for the city to qualify for lending. Implementing the full EFOC reform package blunts the immediate impact of the rate freeze and ensures the water system remains as credit worthy as possible. The proposed EFOC cost allocation reforms are what make a rate freeze compatible with borrowing for Well 4.

Well 4 is the City’s Primary Well

The City of Sebastopol maintains a policy requiring the city's active wells to produce **two times the average water demand** to ensure redundancy during emergencies or maintenance. Because Well 4 supplies roughly 50% of the town's water (157 million gallons annually), its prolonged absence would cause several immediate operational challenges:

Key Operational Risks

- **Zero Redundancy**: The remaining wells would have to run at or near maximum capacity just to satisfy baseline usage, leaving the city highly vulnerable if another well fails.
- **Compromised Infrastructure**: Other active municipal sources, such as Well 7, require meticulous maintenance due to localized groundwater contaminants.
- **Policy Violation**: Operating without Well 4 prevents the city from achieving its mandatory 2x peak demand cushion.

To prevent this scenario, the City Council prioritized a budget to the replacement project for Well 4, with preliminary design contracts moving forward as of early 2026 to ensure a new well can be drilled nearby before the old structure suffers a critical failure. Full replacement is scheduled for FY27-28, depending on getting an appropriate loan.

The timely replacement of Well 4 to ensure the city has sufficient water to meet emergencies is critical. How that cost will be funded is the question. The choices are for the City’s general fund to pay the full cost or to seek a loan. The DWSRF seems to be the primary source for low cost loans to municipal water districts.

What Existing Loans does the City have attributed to the Water Fund?

Audited Business-Type Long-Term Debt — Balances as of June 30, 2025 (2024-25 ACFR, Note 7)

Loan	Balance 7/1/2024	Retired FY25	Balance 6/30/2025
Refunding Lease 2021 – Truist (2006 "infrastructure" lease)	$245,041	$245,041	$0 retired
Refunding Loan 2021 – Truist ("Well 7", water-only)	$825,058	$67,415	$757,643
Syserco Finance Purchase Agreement	$3,330,963	$227,007	$3,103,956

Going forward, only Well 7 and the water share of Syserco remain, so audited water debt service drops to $83,954 + $168,593 = $252,547 per year beginning FY2025-26 — the figure used in the projection.

What is DWSRF – What are the loan requirements?

In the past the city has used Truist Financial to finance Well 7. As a private lender it does not publicly state lending terms which are set deal by deal. It is likely that the Truist loan would take less time than the DWSRF process described below. It is likely the interest rate will be higher and the term of the loan shorter than the subsidized DWSRF loans. Requirements for debt-service coverage will be similar. Payments would be much higher.

Longer terms and lower interest mean lower payments which makes more revenues available for other capital improvements that are also much needed. The DWSRF process is public and transparent and educational to the Council and Oversight Committee members unfamiliar with municipal financing.

The Drinking Water State Revolving Fund (DWSRF) is a federally capitalized, state-administered loan program run by the California State Water Resources Control Board's Division of Financial Assistance (DFA). It provides below-market financing for drinking-water infrastructure. Publicly owned community water systems — cities, counties, and special districts — are directly eligible, so the City of Sebastopol qualifies by type. Eligible projects include water sources (wells), treatment, distribution and pipeline work, storage, meters, and consolidations, so a Well 4 replacement fits the program squarely.

The financing terms are attractive: the interest rate is set at **half of the most recent State General Obligation bond rate**, with repayment terms up to 30 years (40 for some communities). These terms, 2% / 30-years for a $2.6MM loan (CIP budget) would add $116,090 in debt payments to the Water Enterprise budget.

Core Requirements

- **Complete application and review.** DFA conducts technical, environmental, legal, and financial reviews. A construction loan requires final plans, specifications, and completed environmental (CEQA) documentation; if those are not yet complete, the City may first obtain planning/design financing.
- **Financial capacity ("ability to pay").** A dedicated revenue source and demonstrated capacity to repay — detailed in the next section.
- **Regulatory compliance.** Good standing under the Safe Drinking Water Act plus state cross-cutting requirements (labor/wage rules, disadvantaged-business outreach, etc.).

Funding is **prioritized** by public health risk, Safe Drinking Water Act compliance need, and the neediest communities on a per-household basis. A relatively well-off city replacing a functioning asset competes for a place on the annual "Fundable List" against communities with contaminated or failing supplies and may rank lower.

Sebastopol always faces issues as a relatively well-off city. However, there is an argument for water quality and safety as I believe that well is contaminated with dry cleaning fluid.

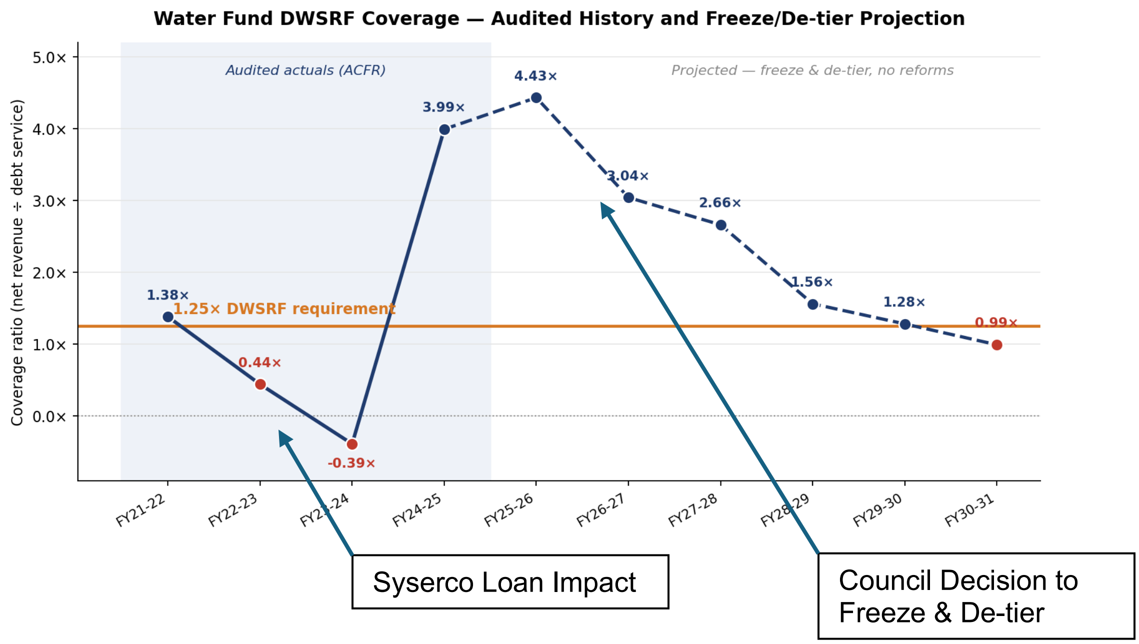
What Constitutes “Ability to Pay”

Ability to pay is defined concretely through a pledge of revenues and a rate covenant — not a general judgment. For a public water enterprise, the criteria are:

1. **Pledge of net enterprise revenues.** The loan is secured by the net revenues of the water enterprise fund (operating revenue less operating and maintenance costs), normally in a senior-tier lien position. DFA reviews all existing debt documents — including the City's Syserco energy lease and Well #7 debt — to establish lien positions and total debt load.
2. **A 120% rate covenant (the key test).** Net revenues must equal at least 120% of annual debt service for senior/parity debt (100% for subordinate debt) — a minimum 1.2× debt-service-coverage ratio.
3. **Coverage tested over five years.** Coverage is calculated using a minimum of three years of historical data plus two years of projections, so the 1.2× ratio must hold looking backward and forward.
4. **Additional debt test and reserves.** To add the loan, net revenues must still meet the coverage ratio counting any adopted/pledged rate increases. Sebastopol must be in compliance with any reserve-fund requirement. Transfers from a reserve fund are excluded from the coverage calculation — thin margins cannot be masked by drawing down reserves.

Qualifying for a loan due to the rate freeze and de-tier decision.

Under the current rate structure and operating budget, the city probably would have difficulty qualifying for a low cost DWSRF loan. The graph below shows the immediate impact on net revenue of the council's decision to remove tiers and freeze rates.



Coverage ratio (net revenue ÷ debt service) by year. Solid navy = audited ACFR actuals (FY2021-22 through FY2024-25); dashed navy = projected under the freeze and de-tier at $5.22/kgal with no reforms. Orange line = 1.25× DWSRF requirement; red points fall below it (FY2022-23, FY2023-24, FY2030-31).

The lookback requirement also raises doubts. In FY20-21 the Water Enterprise Fund had 138% debt coverage. Once the Syserco Finance Purchase Agreement was approved by City Council and began charging the water fund on July 1, 2022: audited net revenue covered only 44% of debt service in FY2022-23 and turned negative in FY2023-24 (0% coverage).

The controversial City Council Decision was apparently made without anyone noticing that the addition of this loan violated the covenants of the Truist loans in existence at the time. Perhaps that is why it was couched as a lease agreement with terms such as interest, duration and payments.

The Financial Audit expressly notes the covenant was breached in those years and that the City "underwent a rate study to ensure compliance — audited FY2024-25 water revenue reached $3,441,843 against operating costs of about $2.17 million, leaving net revenue of roughly $1,270,000, nearly 4.0× the $318,126 of debt service (about 400% coverage)".

It took 2 more years before the City Council approved the 2024 rate increases producing a dramatic recovery. During that time the Annual Financial Auditor advised that existing loan coverage requirements were breached. The fact that the city not only allowed the reserves to deteriorate, and was slow to react, might not be viewed favorably by potential lenders including Truist if they were not previously informed.

The 2024 rate increases produced a dramatic recovery — audited FY24-25 water revenue reached $3,441,843 against operating costs of about $2.17 million, leaving net revenue of roughly $1,270,000, nearly 4.0× the $318,126 of debt service (about 400% coverage). These rates were selected to quickly restore the depleted reserves and achieve the expected lending requirements to fund a loan to replace well 4 in FY26-27.

The recent Council Decision to freeze and de-tier rates, however, reverses that recovery. With revenue held flat while operating costs — and, once Well 4 comes online, debt service — continue to rise, net revenue erodes each year and slips back below the 1.25× requirement by FY2030-31 (0.99×).

In other words, this option does not merely draw the reserve down; it re-creates the very same credit coverage failure that made the water fund uncreditworthy before 2024 and would put any loan for the Well 4 replacement at risk. Keeping the Water Fund eligible for the loan requires significant reforms.

Are Loans Difficult to Get? How Long is the Process?

Well 4 is thirty years old. It might last longer, maybe not. The DWSRF loan process takes a great deal of time. With the uncertainty brought on by Council's July 7 decision, that time has been extended by the requirement to do a new rate study, fulfill the legal requirements to notify ratepayers, await protests approving new rates, provide a second public notice and then wait 30 days to implement. That is realistically a six-month process. Perhaps as long as 1 year depending on the depth of the rate study. It may be difficult to give the information below to complete all the requirements and get a loan quickly. The work is currently in the approved CIP plan to be completed in the FY27-28 time period. The DWSRF is already processing application for awards by June 2027.

The council decision to reduce rates and de-tier rates likely made it necessary to go to other lenders at higher rates and shorter terms resulting in higher payments and an increased burden on rate payers going forward.

The documentation burden (engineering, environmental, legal, and financial packages) is substantial, and the health-risk priority ranking can push a lower-risk applicant down the Fundable List.

Applications are accepted **continuously**. DFA aims to execute financing agreements for Fundable-List projects by the end of each fiscal year (June). The expedited grant pathway targets roughly 180 days, but a **standard construction loan realistically runs about one to two-plus years** end to end, because planning/design and environmental (CEQA) review generally must be completed before the construction loan, followed by the multi-part review and placement on the funding list. **The question has Sebastopol completed these requirements already?**

What obligations do loans from DWSRF or Truist place on Sebastopol?

A loan is secured by a pledge of the Water Fund's net revenues, with a rate covenant requiring net revenues (operating revenue less operations & maintenance) to equal at least 1.25 times annual debt service.

The State tests this over recent history plus projections and also looks for a healthy working-capital reserve as evidence of financial capacity. **If a scenario cannot demonstrate the 1.25× coverage — or draws its reserve negative — it jeopardizes both approval of the loan and compliance with the covenant afterward.**

We don't know how lenders will view the "recent history". Past council and a past city manger ran deficits spending for several years until reserves were depleted. There may be consequences of prolonged mismanagement. The repetition of that behavior again on July 7, 2026, suggests question about mismanagement of the funds and thus credit risk. Lenders raise rates and shorten the loan period t address credit risks.

How can the city fix this - Three Scenarios

Three scenarios are examined to understand the opportunities to fix the situation quickly. The first scenario S1 Baseline shows the expected financial situation as planned developing the last rate study.

- **S1 Baseline —** Rate plan approved by City Council in 2024; cost allocation and existing debt (including the Syserco energy lease) stay in the water fund. (Provided for reference, this ship sailed with the City Council vote on July 7, 2026.

The second scenario looks at the financial impact of the recent freeze and de-tier decision.

- **S2 Freeze + De-tier only —** all rates frozen at 7/1/2025 and residential de-tiered to $5.22, with no other changes (full cost allocation, Syserco debt still in the water fund).

The third scenario looks at the financial impact of the full EFOC reform package that has been presented to the City Council.

- **S3 Freeze + full EFOC package —** same freeze and de-tier, plus the reforms: reformed cost allocation (Council removed), the legal-fee refund, and the Syserco energy loan shifted to the General Fund.

While the plan implemented by the 2024 Rate Study made the Water financials strong, the July 7, 2026 decision to remove tiers and freeze rates (S2) unfortunately created a financial situation where the city does not meet the DWSRF qualifications going forward. It may be an issue for other lenders as well.

Implementation of the full reform package recommended by the EFOC along with the freeze and removal of the rate- tiers would maintain the financial health of the enterprise and meet the loan requirements going forward. This was the reason the EFOC recommended a full package of changes designed to remove rate tiers (prop 218 compliance) and maintain the water enterprise in good financial health.

Scenario	Worst-year coverage	Ending reserve range	DWSRF result
S1 Baseline	3.04×	\$2.1M – \$2.9M	**ELIGIBLE**
S4 Freeze + De-tier only	**0.99×**	\$2.1M → (\$0.1M)	**NO LOAN**
S7 Freeze + full EFOC package	2.76×	\$2.5M – \$3.3M	**ELIGIBLE**

Why the reforms make the difference

The solution is to increase revenue, decrease expense or decrease current debt such that net revenues meet the 1.25x requirement.

The EFOC reform package proposes financial reforms that both increase revenue, decrease expense and decrease the debt burden on the Water Funds. These actions improve credit qualifications and are designed to address the Grand Jury recommendation to return $5.5 million to the enterprise funds to fund needed infrastructure.

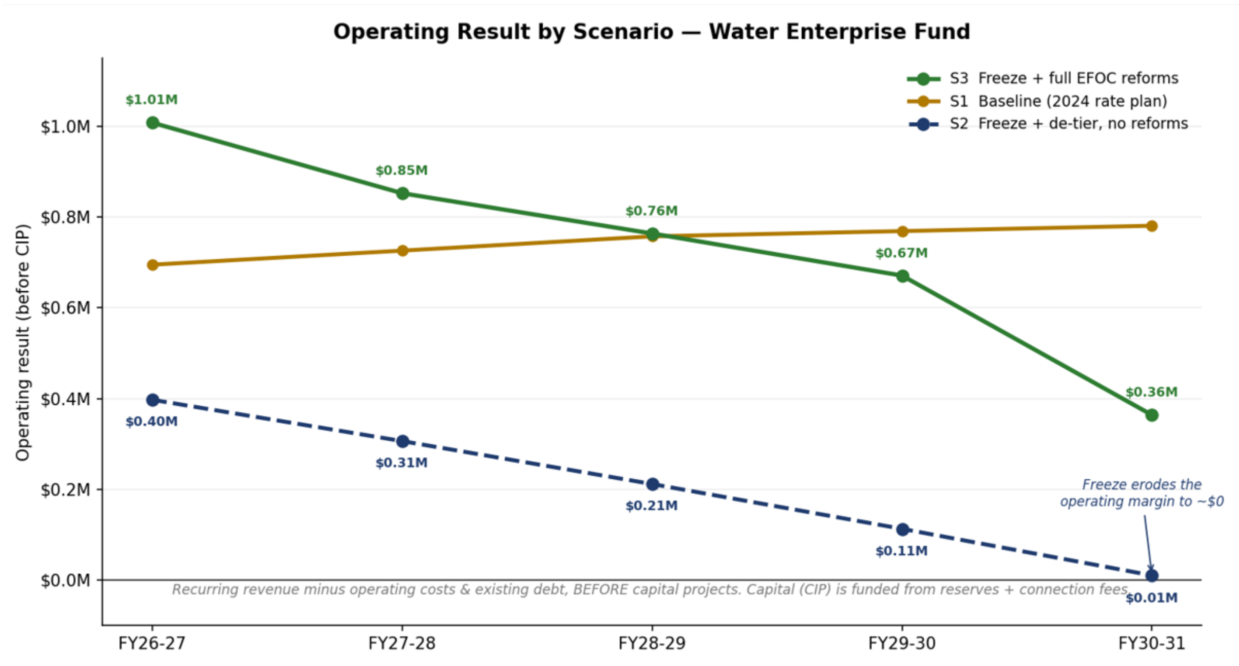
Revenue is increased by the city reimbursing the Water Enterprise for allocated costs that are far higher than the actual costs. Proposed reimbursement includes **$139,000 in attorney fees** charged to water rate payers with no documentation that the fees were for sewer and water related legal costs.

Reimbursement is also proposed for loan payments for the water meter leases provided by Syserco. These water meters were purchased without competitive bids. Diligence was limited to the belief that the total cost of the meters would be realized by energy and water savings. These savings have not been realized. Purchasing without bids resulted in the city paying 2x the cost of meters being purchased this year in a nearby water district. The loan reimbursement is estimated at more than **$800,000 refunded to the Water Enterprise over a four-year period.**

Finally, the EFOC package proposes moving the $**168,593 loan payments** for water meters to the general fund. The EFOC package shifts the Syserco loan to the General Fund who is the party responsible for the no-bid decision. That cuts the water fund's debt service roughly in half — to about $200,000/yr (Well #7 plus Well 4) — and lowers its O&M. The same frozen revenue then covers debt service 2.8× to 11×, and the reserve stays at $2.5–3.3 million throughout. In other words, the reforms are what let the City deliver rate relief and still borrow for Well 4.

The full package is financially responsible choice

The chart below shows the impact of the decision to freeze rates on the net operating margins for Water Enterprise. S1 Baseline is the rates approved in 2024. They were structured to provide a stable financial base that would both help to expedite the Well 4 loan and support other required CIP projects. The S2 Freeze and de-tier decision results in a steady decline in net operating margins and to preserve the reserves, planned CIP projects will have to be cut. The S3 Freeze and EFOC Proposition 218 reforms helps to blunt the impact of the freeze and de-tier decision and while operating margins decline, they are overall healthy and provide sufficient time to get the Sewer study results and then commence a new rate study.



Conclusion

At the staff-recommended $5.22 de-tiered rate, the water fund does **not generate sufficient net revenue to qualify for the Well 4 loan** unless full EFOC reform package is adopted. Reimbursement of past overpayments for unrelated legal expenses and the ill-conceived Syserco Loan provide a short term boost to reserves.

Lowering departmental cost allocations modestly helps to offset the This would move the city toward full Proposition 218 compliance and create a net cash flow going forward that will certainly please any lender reviewers. Most importantly it will provide the financial resources to do all of the required infrastructure repairs identified in the Water Master Plan Study.

Once adopted a new rate study may in fact show that water rates can even be reduced further. It makes sense that since we produce our own water and pipe it in a 2-square mile zone that we should have the lowest rates not the highest in the county as we do now.

What does not work is freezing and de-tiering rates on their own: without increased revenues or lower costs (reduced FG cost allocations) the Enterprise will have difficulty qualifying for any loan.

One other option is raising rates. In the absence of a consultant to do the math for us we can do it ourselves. We discover that raising rates from $5.22 to $6.00-$6.50/kgal would likely bring the city into compliance with the loan requirements.

It was not considered here because of the critical nature of getting into the cue for the well 4 loan as soon as possible. Going through the legal requirements for a new rate study, public hearing, issuing notices, another public hearing and a second reading of the ordinance with then a 30-day waiting period before implementing the increase will take months. If that is the chosen process the city will have little hope of getting a loan approved before June of 2028. Do you roll the dice and hope the well keeps operating?

Although the Well 4 issue is the primary subject of this memo. The role of the City Council and the Oversight Committee is to ensure that the city meets it fiduciary responsibilities to maintain the Enterprises in good financial condition.