TOWN OF
HILLSBOROUGH
NORTH CAROLINA

May 13, 2024

Honorable Mayor Bell and Board of Commissioners:

Submitted is Hillsborough's FY25-27 Annual Budget Workbook. The budget is prepared in accordance with the Local Government Budget and Fiscal Control Act. As this proposed document is transmitted from the town manager it becomes the governing body's budget to review, question, debate, adapt and ultimately adopt. It is expected that changes will be made to the proposed budget as information becomes available and alternatives are considered. Staff will provide any information the board deems necessary to make well-informed decisions on the budget and financial plan. Therefore, the mayor, town board, advisory boards, and community are encouraged to share their views on what should be funded or modified, starting with the public hearing and first workshop on May 28. It's anticipated that the Water & Sewer Rate Model will be presented by *Raftelis – Local Government & Utility Management Consulting* then as well. This will provide additional information for the board to consider as it evaluates and makes budget decisions.

FY24-25 Budget Highlights

Expenditures	
General Fund	$20,128,523
Water and Sewer Fund	$13,524,648
Stormwater	$ 1,128,570
Total Budget	**$34,781,741**
Property Tax Rate	$0.6070 per $100 valuation Increase of 2 cents over FY23-24 tax rate.
Water Rate	7.5% increase over FY23-24 rate.
Sewer Rate	7.5% increase over FY23-24 rate.
Stormwater Fee	$90 for residential properties Increase of $15 over FY23-24 fee; non-residential tiers modified for FY25 with proportional fee adjustments.

Multi-year Forecasting

The multi-year forecasting component of this document, used since 1998, makes it easier to look forward, identify and mitigate potential problems while they are still manageable. The financial plan acts as a "fiscal radar," giving Hillsborough more time and flexibility to plan responses to problems and needs. Hillsborough is one of the only local governments in North Carolina using a multi-year budget format. While only the first year of the budget is legally binding, years two and three of the financial plan include critical information that provides a more accurate picture of the town's fiscal and operational challenges.

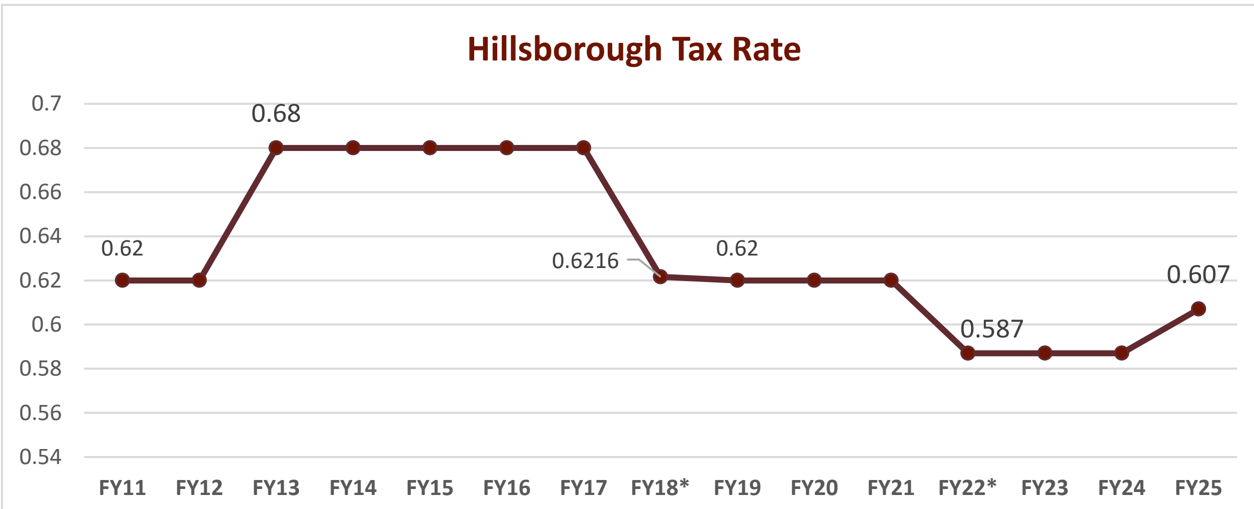
"Taking care of what we have"

The town's mission, vision, strategic priorities, and objectives can't be achieved if the basic tools of service implementation are not in working order: the town's infrastructure, equipment, buildings, employees, and systems. The longer a municipality waits to repair or replace these assets (tangible and intangible), the more expensive it becomes in the long term. Governments are notorious for not adequately maintaining assets as is evidenced in the American Society of Civil Engineers' infrastructure report cards. This is an excellent reminder to avoid the errors others routinely make in budget prioritization and ensure we are properly maintaining Hillsborough's assets. This is especially relevant in the FY25-27 Budget and FY25-31 Capital Improvement Plan (CIP), which includes millions of dollars to replace larger portions of the water and sewer system that are roughly 50 – 100 years old.

Tax and Rate Highlights

<u>Property tax</u>. 2 cent increase, from 58.7 to 60.7 cents.
If approved, this means there will have only been three property tax rate increases over the past 15 years. The most recent was the two-cent increase in FY22 that was earmarked annually for climate and sustainability priorities.

It is projected that another increase in FY26 will be needed to fund the commitment of dedicating two cents on the tax rate ($320,000) for affordable housing initiatives. The town has significantly increased funding for affordable housing-related programs over the past several years but has been absorbing those expenses in the General Fund budget.

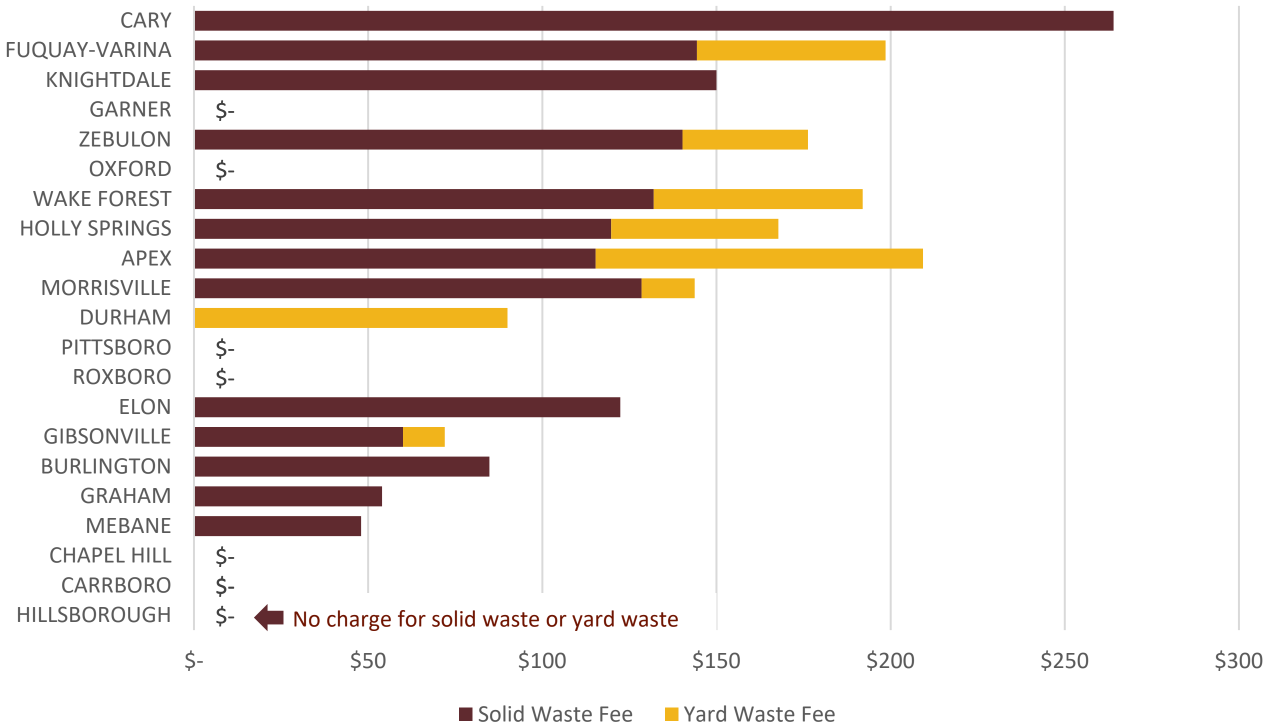


How much would my property bill change?				
Home Value	**FY23-24 58.7¢**	**FY24-25 60.7¢**	**Monthly Change**	**Annual Change**
$200,000	$1,174	$1,214	$3.33	$40
$300,000	$1,761	$1,821	$5.00	$60
$400,000	$2,348	$2,428	$6.66	$80
$500,000	$2,935	$3,035	$8.33	$100
$600,000	$3,522	$3,642	$10.00	$120
$700,000	$4,107	$4,249	$11.83	$142

<u>Solid waste and yard waste collection</u>. No fees
It's important to note that of the 21 municipalities in the region, Hillsborough is only one of seven that does not charge a user fee for solid waste or yard waste, with these services included in the annual tax rate. The dollar signs next to the municipality in the chart below indicate no additional charge. The North Carolina Department of Environmental Quality administers a solid waste and recycling annual report that includes information reported by municipalities. Of the 551 municipalities in North Carolina that were included in the database, 265 municipalities (48%) assessed a solid waste fee for FY2023. The maximum reported solid waste user fee was $375. The average user fee was $80.40 per year, with 56% of the municipalities assessing a fee charging between $100 and $199 per year.

Annual Fees

(Regional Benchmarks)



<u>Water rates</u>. 7.5% increase

While the FY25 deficit is $318,000 with an 8.9% rate increase needed to break even each of the next three years, the reason for recommending a smaller increase is to take a step toward addressing the gap while continuing to pursue options to limit future rate increases. Rate stabilization strategies are discussed below in the Water and Sewer Fund Highlights section.

<u>Sewer rates</u>. 7.5% increase

While the FY25 deficit is $86,000 with a 9.7% rate increase needed to break even each of the next three years, the reason for recommending a smaller increase is to take a step toward addressing the gap while continuing pursuing options to limit future rate increases. Rate stabilization strategies are discussed below in the Water and Sewer Fund Highlights section below.

Rate Impact

FY23-24 → FY24-25

How much higher will water and sewer rates be per month after the rate increases?

	Average Household Consumption 4,000 gallons/month	**Minimum Household Consumption** 2,000 gallons/month
In-Town		
Water	$3.20	$1.60
Sewer	$4.52	$2.26
Out-of-Town		
Water	$6.32	$3.16
Sewer	$8.80	$4.40

Water and sewer minimum rates. Completes the four-year plan to reduce monthly charge from 2,500 to 2,000 gallons.

Billing data recently analyzed by the consulting firm building the new rate model indicates this adjustment provides savings to about 45% of customers, thus a large number of customers have been and will continue to benefit from this billing change. The town board made the decision during the FY22 budget process to provide relief and a more equitable way of charging low volume customers, who are often on fixed incomes, elderly, or living alone. This builds on the similar initiative recommended by the Water and Sewer Advisory Committee and approved by the town board that decreased the minimum rate from 3,000 to 2,500 gallons over the four-year period from FY14 to FY17. In addition to providing an incentive for customers in this use category to conserve, the change provided substantial relief to lower volume users. The FY22-25 reductions take the prior FY14-17 efforts a step further. Of the approximately 54% of water systems that use the volumetric charge, as opposed to a base rate, the most typical monthly minimum charges are in the 2,000 to 3,000 per month range. Thus, with the minimum rate decreasing to 2,000, Hillsborough will be at the most equitable end of the range when it comes to this rate method. The table above shows the savings to customers who use 2,000 gallons or less per month:

Cost Reduction for Low Volume Users

Via Minimum Rate Reduction Plan

In-Town Customer	Gal/Month 2,500	Gal/Month 2,000	Monthly Savings	Annual Savings
Water	$28.83	$23.06	$5.77	$69.24
Sewer	$40.55	$32.44	$8.11	$97.32
Total Combined	$69.38	$55.50	$13.88	**$166.56**
Out-of-Town Customer				
Water	$56.22	$44.97	$11.25	$135.00
Sewer	$79.07	$63.26	$15.81	$189.72
Total Combined	$135.29	$108.23	$27.06	**$324.72**

Stormwater rates. Increasing the stormwater fee's residential tier by $15 and non-residential tiers proportionally, adding a non-residential tier for properties between 200,001 and 600,000 square feet, and changing the final tier to properties greater than 600,000 square feet. This would be the first change in the fee since the Stormwater Fund was created in Fiscal Year 2017. The new tier will effectively lower the stormwater fee for the new Tier 5 properties.

Stormwater Rates	
Residential Property	$90
Non-Residential Property	
Tier 1 – 0 to 10,000 sq. ft.	$180
Tier 2 – 10,001 to 30,000 sq. ft.	$630
Tier 3 – 30,001 to 100,000 sq. ft.	$2,070
Tier 4 – 100,001 to 200,000 sq. ft.	$4,860
New Tier 5 – 200,001 to 600,000 sq. ft.	$12,870
Tier 6 – 600,001 sq. ft. and above	$22,500

These options were discussed during last year's budget process but deferred one year so more time could be spent examining the needs and resources of the Stormwater Fund. The FY25-27 plan also recommends additional $15 increases in FY26 and FY27 to the residential property tier for a total of $45. The town board could choose to phase these increases in a different way, such as all $45 in one of the years, splitting it ($22.50) over two years, or other ways.

General Fund Highlights

Financial Overview

As is often the case, the budget and three-year financial plan projects deficits due to being conservative on revenue projections and cautious on expenditure amounts. After the audit, most years end up with deficits less than projected or with an actual surplus generated. With that said, the projected deficits in the General Fund are large enough to give staff concern and thus it's important to discuss expansion items during the budget workshop(s) to ensure they align with the town board's priorities and assessment of Hillsborough's needs. It may be that some requests need to be deferred or alternatives found to scale back. The projected deficits over the next three years are as follows:

- FY25 - $1,013,884 (5.0% deficit)*
- FY26 - $912,629, (5.1% deficit)
- FY27 - $1,381,908 (7.8% deficit)

* The actual FY25 deficit is $3,222,884 or 16% due to likely paying for the entire Public Works Relocation project with cash, instead of debt financing but that is a decision the town board will have to make. The $1,013,884 (5.0%) deficit figure above represents a more accurate figure once this large capital project is removed.

The following are a few points to consider when weighing the approach to this budget and financial plan (i.e., what is an appropriate deficit level):

✓ Addressing priorities strains the budget. A wide variety of needs, priorities, and interests have been added to the budget in recent years - that trend continues with this proposed FY25-27 plan. The chart below shows some of the major initiatives included in the plan, their projected annualized costs, and their cost equivalent in terms of cents on the property tax rate. These projects represent the equivalent of about 18.12 cents on the tax rate. Thanks to recent growth and a few strong years of sales tax, the budget has been able to absorb some of these costs and other additions. But the General Fund can only absorb so much before additional revenue must be raised or significant cuts made in other areas. Property tax is the only revenue source the town can adjust that generates a substantive amount of revenue.

This is the reason tax rate increases are proposed for the next two years: two cents in FY25 and another two cents in FY26 to cover the town's affordable housing commitment. Still, that's only four cents compared to the 18.12 cent impact listed below. It's possible that greater increases may be needed, but the recommendation is to start with minimal increases and pursue other strategies to balance the budget. Another revenue option would be to start assessing a solid waste fee like many other jurisdictions do, but the preference for many years has been to include these costs within the property tax and overall General Fund revenues.

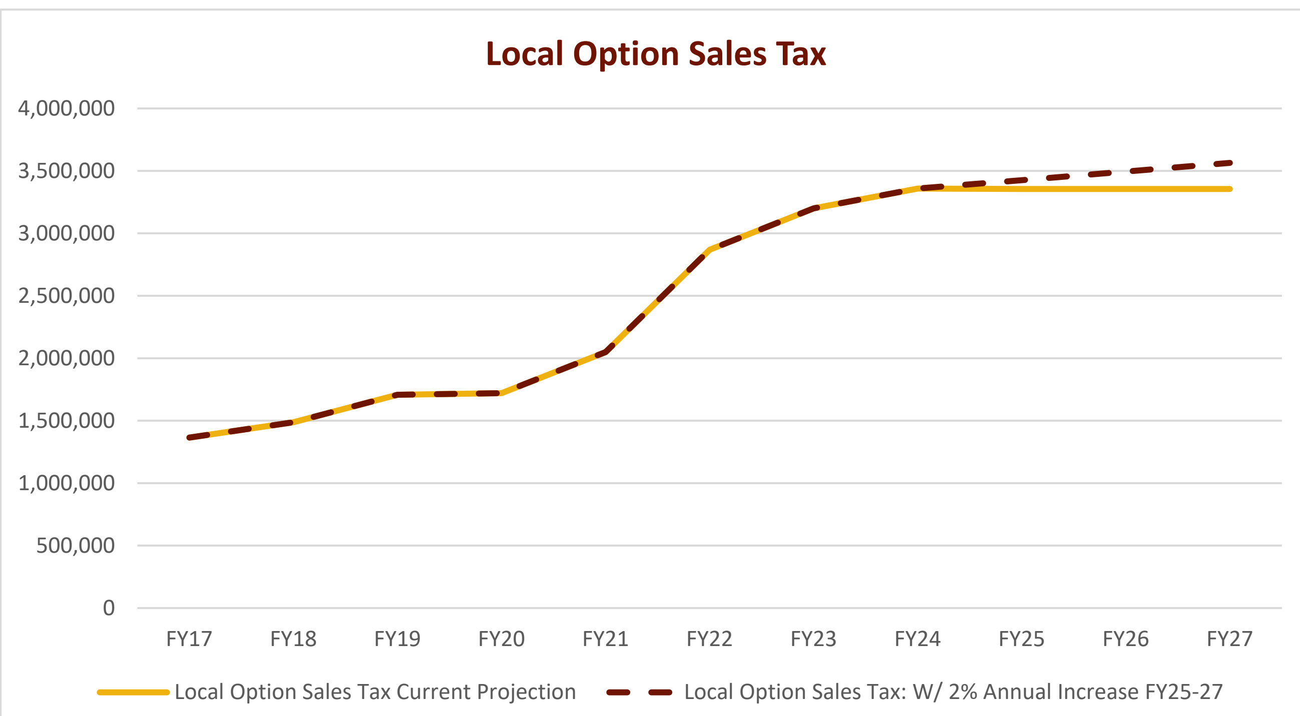
Project	**Annual Cost**	**Tax Rate Equivalent (in cents)**
NC-86 Facility Renovation	$434,000*	2.71
Affordable Housing	320,000	2.00
Train Station	162,000	1.01
Fire Personnel Expansion	114,000	0.71
Fire Station	300,000	1.88
Ridgewalk Greenway	583,000	3.64
Police Social Worker	80,000	0.50
Accounting Software	100,000	0.63
Police Vehicle Replacement Fund	225,000	1.41
Streets Vehicle Replacement Fund	81,000	0.51
Solid Waste Vehicle Replacement Fund	335,000	2.09
Market Pay Adjustments	165,000	1.03
	Total	**18.12 cents**

* Reflects annual debt service if project were debt financed. Budget assumes paying for the project using cash.

- ✓ Fund balance level strong. Even with higher than preferred deficits, the fund balance at the end of FY27, or Year 3 of the Financial Plan, is 36.5%. The goal is to not allow the savings level to drop that low, thus work needs to be done to reduce these deficits each year. Savings accrued during the COVID years provide a little cushion to use fund balance to address some high priority needs and provide a small window of time to make adjustments to maintain a strong fiscal position.

- ✓ Future growth should bring additional revenue, but when? There are still about 877 residential units that have been approved but have not yet started construction in town (see the chart later in this message). Plus, there are other proposed developments seeking approval from the town board (e.g., Waterstone South at about 650 units). At some point the Daniel Boone property will be redeveloped and that could provide a substantive revenue boost, but no plans have been submitted and that's likely years away from happening. The recent slowdown in new home construction makes it hard to predict when these units will come online. Minimizing new expenses related to serving these projects via absorbing with current assets and staff can provide resources to pay for portions of longer term and expensive projects that are in the Capital Improvement Plan. Even after new units are occupied, there is a delay before they start paying property taxes, thus we are still several years out from getting another influx of revenue to help with pressure on the budget.

- ✓ Sales tax slow down. Little growth is projected during the three-year plan. If the economy performs a bit better than projected, a small improvement can be a big help in reducing deficits. Sales tax is a volatile and elastic revenue source with a high sensitivity to economic conditions. Currently, the local option sales tax budget of $3,026,000 in FY24 is on pace to be met and exceeded with a total estimated collection of $3,358,404. A decision was made last year in the FY24-26 budget to freeze future years' sales tax projections and not project year-over-year growth due to signs that consumer spending may be slowing down. The same approach is implemented in the FY25-27 budget with a slightly higher new estimate of $3,355,000 collected in each of those three fiscal years. Budget staff are most comfortable with the current approach to sales tax projection due to continued concerns about slowed growth. However, FY25-27 projections could be increased no higher than 2% year-over-year preferably. Even with this revenue adjustment, there will only be marginal improvements to budget deficits.



Noteworthy Expenses

- ✓ Passenger Rail/Multi-Modal Station ($10.4 million). Approximately $8.2 million comes from the State Transportation Improvement Program (TIP), NCDOT Rail TIP, and Transit Tax. The town will be responsible for any costs over that amount and for the cost of the town offices. Construction is anticipated to start in approximately 2025 and to be completed by February 2028.
- ✓ Ridgewalk Greenway Phase I & II Design. FY25 includes $325,000 to continue design for Phase 1 (downtown to train station) and Phase II (train station to Collins Ridge Greenway). Phase III would extend from the Collins Ridge Greenway over I-85 to Cates Creek Park in Waterstone.
- ✓ Ridgewalk Greenway Phase 1 – "Ramp-up" Savings Plan to Pay for the Project. This started by including $50,000 in the FY24 budget, then increases by an additional $50,000 annually over seven years to "ramp up" to reach the amount needed to make the estimated yearly debt service payments of $582,771, over 10 years for this projected $4.5 million project expected to be completed in FY30. The "ramp up" only generates $350,000 of annual debt service capacity. The remaining amount will be offset by reserved parks debt capacity of $232,355. Banked funds can be used to offset project costs (e.g., lower the amount that needs to be borrowed, pay for cost escalations, and/or cover debt payments until full coverage is met).
- ✓ Affordable Housing. Last year, the board agreed to the "ramp-up" plan where annual spending is increased in this area annually until meeting the equivalent of two cents on the property tax rate, or about $326,000 in FY27. At this year's budget retreat, the board discussed staying with the previously adopted ramp-up plan. That increases the FY25 set aside from $100,000 to $175,000, then $250,000 in FY26 and finally $326,000 in FY27. (Note that FY26 and FY27 equivalent amounts may change due to the countywide revaluation occurring next summer). See the chart below for details. The board and staff plan to complete a series of affordable housing workshops over the next year, building towards a comprehensive affordable housing plan. As such, the recommended budget does not include a use for the FY25 funding or accumulated FY24 funds.

Ramp Up to 2 Cents for Affordable Housing

	FY22	FY23	FY24	FY25	FY26	FY27
Community Home Trust	$2,500	$2,500	$2,500	$2,500	$2,500	$2,500
HOME Funds Match	$4,200	$6,486	$6,281	$6,281	$6,281	$6,281
OC Partnership to End Homelessness	$15,788	$59,080	$61,128	$39,852	$39,852	$39,852
Subtotal, Current Commitments	$22,488	$68,066	$69,909	$48,633	$48,633	$48,633
Ramp-up Funds	$22,488	$68,066	$100,000	$175,000	$250,000	$326,000
Remaining Funds for Housing (New and Preservation)	**$0**	**$0**	**$32,884**	**$126,367**	**$201,367**	**$271,367**
Cumulative Housing Funds	**$0**	**$0**	**$32,884**	**$159,251**	**$360,618**	**$631,985**

- ✓ Public Works facility and relocation ($4.85 million). After being in the flood plain, in substandard facilities, with no equipment shelters, and little storage for about 50 years, funds are allocated to move the Public Works Division from their Dimmock's Mill Road location to the NC 86 North facility. If a 15-year loan was used to pay for the project, annual debt payments would be approximately $434,000. Instead of borrowing money to construct this facility, a combination of savings from fund balance and operating revenue ($3,821,000) and reallocation of the reimbursement from the Valley Forge Road bridge repair ($1,029,000) are being used to pay for this project. Paying cash for the project has several big advantages: 1) avoid the annual impact of $434,000 on future budgets, thus freeing up capacity to fund other needs or avoid/reduce future tax increases, and 2) save additional funds by avoiding a loan at a time when interest rates are high.
- ✓ Additional Firefighters. The fire protection contract with Orange Rural Fire Department (ORFD) increases by 6.75% to cover inflationary pressures and other operational needs. The contract increases an additional $63,292 in FY25 to share the cost of adding four firefighters projected to be added five months into the fiscal year. The

full impact of those additions will be $113,925 in FY26. Additional firefighters are needed to help ORFD have sufficient staff on the firegrounds, as well as coverage when multiple calls occur simultaneously (e.g., first responder calls for EMS and rescues).

- ✓ Downtown fire station: 1) Continue "ramp-up" savings plan ($300,000) and 2) Preliminary Design/Site Analysis ($75,000). The town is responsible for building and paying for the new downtown station at 604/618 North Churton Street, the old furniture store site. The new downtown station is estimated to cost $8 million. Funds were included for the first time in FY22 ($75,000) and increased by $75,000 annually to "ramp up" to the eventual annual debt service amount. FY23 included $150,000, $225,000 in the FY24 budget, $300,000 in FY25, $375,000 in FY26, $450,000 in FY27, and $525,000 in FY28, which should be close to the anticipated annual payments going forward. These funds are being placed in a capital project fund to help pay for design costs first, decrease the loan amount, and provide a funding source for the annual debt. "Ramping up" to the annual debt service amount prevents other items from crowding out the ability to pay for this top priority. Relocating the old fire station provides a modern facility for ORFD, improves overall coverage and allows the current station and downtown property to be redeveloped as part of a future economic development project.

  The FY25 budget includes $75,000 to pay for preliminary design/site analysis. The cost of fire stations has grown rapidly in recent years. The analysis will help provide a likely cost range to better refine budget projections and financing options, as well as confirming what sitework and adjustments may be needed to make the current site work for the station.

- ✓ Fairview Community Watch. $45,000 for building improvements in FY25 and $10,000 annually for operations.
- ✓ Transit Oriented Development Plan/Feasibility Study for Hillsborough Station ($75,000).
- ✓ Code enforcement. Hire a contractor to increase monitoring and enforcement to manage nuisance properties and other issues throughout town: $60,000 in FY25, then $50,000 annually after that.
- ✓ Additional recycling amenities at parks ($30,600).
- ✓ LED Streetlights ($30,000). Transition the remaining non-LED fixtures to LED to meet the town standard and reduce overall energy consumption by an estimated 11,000 KWH/month. The new streetlights will also provide a more consistent light pattern at night, making town roads safer for the travelling public.
- ✓ Police Department
  - Live-scan fingerprint machine ($15,000)
  - Radio replacements, required for compliance ($82,000)
  - Replace in-car cameras (FY26 - $100,000; FY27 - $100,000)
  - Vehicle replacement fund, annual contribution to smooth purchases ($225,000).
  - FY25 includes replacement of four vehicles that will all be 16-20 years old.
- ✓ Public Works
  - Street repaving: $882,500
  - Solid waste vehicle/equipment replacement fund (FY25 - $190,000, FY26 - $190,000, FY27 - $135,000).
  - FY25: leaf truck replacement ($376,506)
  - FY26: garbage truck replacement ($362,006), knuckle boom truck replacement ($227,006)
  - Replace truck in the streets division ($69,106)
  - Replace mobile electric cart ($23,000)
  - Snowplow blade replacement ($10,000)

Cost Reduction Strategies

- ✓ No staffing additions for the General Fund (FYs25-27). While all departments have struggled to keep up with the workload in recent years, as a cost containment effort due to projected deficits, the manager requested departments try to develop their budgets with no new personnel. There may be situations that warrant adding positions over the next three years, but the goal is to add no permanent positions during this time. Two notes: the Stormwater Fund is paying for a position in Year 2 of the plan (FY26) so increased maintenance can be done on drainage systems throughout town. This has become a priority as more intense rain events are taxing ditches, drains, and culverts. The position would be located in public works but paid for by the Stormwater Fund. Grant funding for the social worker added to the police department in FY24 position ends in FY25, but funding is included to continue this position in FY26 as early indications are that this expertise has been a helpful resource for the officers as well as members of our community who are in distress.

- ✓ Public Works Relocation to Old NC86 North Facility – Use of Cash Reserves to Avoid Debt. This was discussed in the project summary above.
- ✓ Eliminated "ramp-up" savings to construct new police department building. One notable cut to the list of capital projects was to remove the "ramp-up" savings plan for a new police headquarters. While this was not taken lightly, the finances just cannot take any more strain, especially with the cost likely being in the $10 million range. Fortunately, significant refurbishments have been made to the current Churton Street headquarters building and the Police Department Annex that's next door. Thus, those facilities should be sufficient for operations until funding becomes available for long-term plans. The $100,000 that had been saved is now being used to make repairs at the headquarters, including expensive repairs to the elevator.
- ✓ Use freed debt capacity due to paying off loans on Riverwalk/Gold Park and Riverwalk Phases II and III for Ridgewalk. While this is only a fraction of the anticipated debt for Ridgewalk, about 40%, it still provides a substantive amount of funding to direct towards the annual debt payments.

Water and Sewer Fund Highlights

Financial Overview

Please see pages 150 and 151 of the budget that shows the breakdown of deficits in more detail, separated by water and sewer operations. Deficits in the Water and Sewer Fund are significant, especially given the large capital projects coming online in the next few years, and thus a key reason for the proposed rate increases. It's important to note the deficits are projected even with spending a large amount of one-time revenues from grants, system development fees, savings, and other sources. Staff will continue refining the schedule of capital projects to look for further opportunities to defer implementation, where practical and given risk level (e.g., sewage spills, system outages, development moratoriums, and other), to spread costs out to limit the impact on rates. As stated later in this section, staff has already deferred millions of dollars in high priority projects. Finding ways to best leverage our resources and schedule projects to minimize rate increases is a focus of the rate model that's nearing completion. The following are current deficit projections that include the projected rate increases:

- FY25 - $403,988 (3.0% deficit)
- FY26 - $249,890 (1.8% deficit)
- FY27 - $710,507 (4.8% deficit)

These projected deficits need to be addressed to maintain a strong fiscal position. The fund cannot afford to risk having key financial metrics and ratios falling behind industry standards as well as to ensure we meet requirements from the Series 2018 and 2020 Revenue Bonds issued to pay for the reservoir expansion. The bond covenants provide non-negotiable standards for funding levels to provide adequate capacity to make debt payments and remain fiscally sound. If those standards are not met, then the Trustee for the bondholders and/or the Local Government Commission has the right to compel the increasing of our rates to whatever level is needed to meet the various bond coverage ratios. In addition, even getting close to key metrics would have a negative impact on our bond rating and thus make future borrowings more expensive and difficult.

Rates are already high, why are they going up again?

Most who have lived in Hillsborough for a while are familiar with the unique challenges Hillsborough's water and sewer systems must contend with: 1) high debt levels to pay for the reservoir expansion, wastewater plant upgrade, water tank at Waterstone, and other expensive system needs, 2) stringent Falls Lake Rules, some of the tightest in the country that escalated the wastewater plant upgrade costs as well as limiting the feasibility of future expansion, 3) costs of maintaining 25 sewage pump stations, 4) small systems find it hard to benefit from economies of scale, thus the reason many small units get absorbed by larger cities utilities, 5) aging assets, many near 50 years old and up to 100 years, need to be repaired or replaced, and 6) new growth is putting pressure to spend money on certain upgrades before there are enough new customers to help spread the costs and minimize rate increases.

Some of these issues were already embedded in the budget and thus not new, such as debt on already constructed assets. Inflation has increased costs across the board and the utilities industry nationally is seeing higher annual increases just to keep pace with daily and annual operations. In addition to the tens of millions of dollars required over the next seven years to replace aging pipes, pumps, systems, and tanks, there is also a deficit when it comes to funding the "continuation budget" or those items needed to carry daily operations, as well as projects already in the pipeline. Some of the reasons for the projected deficits and need to increase rates include:

- ✓ <u>Decreased usage</u>. While the number of residential accounts increased by 472 (about eight percent) between 2019 and 2023, total consumption decreased during that time. Usage has ebbed and flowed but has generally been trending downward. In 2023, less water was billed than in 2019 in all but one class, and that one was flat.

  This could also explain why the 6% rate increases in FY24 are only generating about 2-3% additional revenue. This is an indicator that growth is not likely to help as much as expected with mitigating rate increases, especially given the slowdown in new development.

- ✓ <u>Annual revenue lost (approximately $520,000) from lowering the minimal monthly rate charge from 2,500 to 2,000 gallons per month</u>. While this initiative provides substantial savings to low volume users and provides a more equitable charge methodology, the rate model estimates this billing change will cost about $115,000 of revenue for the last of four reductions in FY25. When coupled with the three prior fiscal year reduction this equates to about $520,000 in lost annual revenue. This revenue loss continues every year going forward.

- ✓ <u>Construction "slow down</u>." The effects of inflation, increases in building material costs, labor shortages, and high interest rates have put the brakes on new residential development, even on developments that have already received approval. The chart below shows that all but 45 approved units that are under construction have been completed. Another 76 from Collins Ridge 1B could start in the near future. From discussions with the development community our staff has heard that investors are waiting for the federal government to drop the interest rate, so the construction industry has also turned into a waiting game. Everyone is getting their projects shovel ready and then just waiting. This stall means fewer new units are available to help share with the cost of operating the system.

  Even if there is a "groundbreaking" today on a new development, it's roughly a year out before a residence will be constructed, receive a certificate of occupancy, then start paying water/sewer bills. Thus, it's likely to be at least two to three more years before we see a noticeable increase in accounts that can provide relief as contributing rate payers. The good news is there are 877 units approved but have not yet started construction (e.g., Collins Ridge apartments, Collins Ridge Phase 2 (single-family and townhomes), East Village at Meadowlands, and Persimmon (apartments and townhomes). Having these units completed and connected to the system can be a significant help, but there is no way to accurately project when that will occur, as well as other developments going through the approval process, such as Waterstone South.

Approved & Under Construction

Project name	Approved units	Permitted	Completed	Approved, not complete	Permits remaining	Under construction
Collins Ridge						
Phase 1A-1 - sfd	59	59	59	0	0	0
Phase 1A-2 - townhome	89	89	89	0	0	0
Phase 1A-3 - sfd	36	36	36	0	0	0
Phase 1A-4 - townhome	16	16	16	0	0	0
Phase 1A-5 - sfd	13	13	11	2	0	2
Phase 1A-5 - townhome	21	21	21	0	0	0
Phase 1B	76	0	0			
Fiori Hill	46	46	46	0	0	0
Forest Ridge	235	235	235	0	0	0
Total	**591**	**515**	**513**	**2**	**76**	**2**
Misc. infill lots	na	202	157	na	Not yet completed	**45**

Approved, Not Under Construction (In the Pipeline)

Project name	Units	Type
Collins Ridge Pod D	326	Apartments
Collins Ridge Phase 2	51	Townhomes
Collins Ridge Phase 2	79	Single Family
East Village at Meadowlands	75	Townhomes (Habitat)
Moren Tract- Beach Co- Persimmon	30	Townhomes (Rental)
Moren Tract- Beach Co- Persimmon	316	Apartments
Not yet under construction	**877**	**Potential units, no estimated start dates.**

✓ Cost escalations and inflation. This has impacted line items across all utility operations from chemicals, equipment costs, contractors, supplies and materials such as pipes/valves, and market rate salary adjustments to retain and recruit skilled staff.

✓ Significant system rehabilitation projects and overdue upgrades. The number and cost of highly expensive projects needed to address system needs now is more than the fund can afford; plus, it's more than staff can manage at one time. Thus, difficult decisions have been made to defer high priority needs, such as further delaying the replacement of the 90-year-old Hasell Street water tank and 50-year fragile asbestos concrete water lines. The focus is starting with the needs that exist at the "core" of our system, such as replacing the sewer interceptors along the Eno River and the River Pump station. In most cases, these assets affect all system users, even in new developments located on the edge of the service area. Taking care of the "core" assets must be done first, before spending funds to accommodate new development via projects like upsizing the Cates Creek Outfall and Elizabeth Brady Road Sewer Pump Station.

Not keeping pace with replacement of assets, referred to as depreciation, is a common flaw with utility systems where maintenance and replacement of assets is delayed to avoid rate increases. It's typical that utility systems won't even replace 1-2% of their assets annually. This means the catch-up gets expensive. This is a national problem and a primary reason why the American Society of Civil Engineer's report cards for water and sewer systems are so poor across the country. While Hillsborough has emphasized "taking care of what we have," it's not been done to the levels needed as evidence by prior UNC Environmental Finance Center financial metrics in which Hillsborough has traditionally been in the "yellow" or caution zone, which is better than red but not in the desired green. While Hillsborough is likely far better than most in this area, at approximately 36%, asset replacement is not nearly where it needs to be. Thus, more must be invested in system maintenance.

- ✓ Projected deficits.
  - Water. Continuation budget is running a $810k/yr deficit (Breakeven rate = 4.44%/yr). The CIP changes smoothed out the Continuation + Expansion deficits to $1.2M for all 3 years (previously yr-2 spiked to $3.6M). Breakeven rate for Continuation + Expansion = 8.90%/yr
  - Sewer. Continuation budget is running a $300k/yr deficit (Breakeven rate = 2.16%/yr). The Continuation + Expansion deficits are $500K in year-1, $718K in year-2 and $1.8M in year-3 = 9.71%/yr
  - The water and sewer Continuation + Expansion deficits are $1.2M in year-1, $2M in year-2 and $3.4M in year-3.
  - Breakeven rate for water and sewer Continuation + Expansion = 9.30%/yr

  Even if rates are increased to the "break-even" figures listed above, the budget still does not have the capacity to fund many of the projects to replace/update Hillsborough's aging assets. Once the one-time revenues, savings, and grants are spent, there will be no way to pay for these needs.

- ✓ Maintaining financial health and complying with bond covenant requirements.
  - To maintain the town's bond rating and meet bond covenants, the town must maintain a debt coverage ratio of at least 1.00. This metric is an indicator of whether the town's operating revenue (i.e. rates) are sufficient to cover annual debt obligations. Even with 7.5%/yr rate increases, the projected debt coverage ratio is at the bare minimum in years 1 and 2 at 1.00 and 1.01 respectively, increasing slightly to 1.13 in year-3. The industry standard is 1.20.
  - Days of cash on hand is another key metric in determining the town's ability to meet short-term obligations. Days of cash on hand is projected to be below the industry standard of 365 days in all three years, at 363 in year-1, dropping to 345 in year-2, and then 323 in year-3, even with 7.5%/yr rate increases.
  - Steps will need to be taken to ensure the town continues to not only meet minimum requirements but improve the financial condition to be more in line with industry standards.

Major expenses

- ✓ Main console replacement at the water plant ($100,000): FY25
- ✓ Sewer lift station abandonment analysis ($95,000): FY25
- ✓ Water system rehabilitation for larger repairs that require contractor assistance ($110,000 annually)
- ✓ Wastewater system rehabilitation for larger repairs that require contractor assistance ($110,000 annually)
- ✓ Water plant generator replacement ($350,000): FY26
- ✓ Adron Thompson operational facility ($7,295,600): FY24 and FY25. Debt service begins in FY26 with a half-payment of $249,848, the starting full payments of $499,696 in FY27.
- ✓ Lawndale sewer basin rehabilitation project ($1.2 million): FY25.
- ✓ Wastewater collection system rehabilitation projects ($1.0 million): $500,000 in FY25 and $500,000 in FY27
- ✓ Eno River sewer interceptors ($5.05 million): FY26
- ✓ Exchange Club sewer interceptors ($1.29 million): FY26
- ✓ Elizabeth Brady Pump Station design ($400,000): FY27
- ✓ Water system master plan annual improvements ($400,000): FY27

Ten Strategies for Long-term Stabilization of Water and Sewer Rates

1. **Use reserve funds, a portion of available savings and other one-time revenues to pay for long-term capital needs.** This strategy minimizes future debt services payments and reduces pressure on future budgets.

2. **Use system development fees (SDF) strategically.** Accrue and save SDFs until there is enough to pay for a capital project or reduce the amount borrowed to a manageable amount.

3. **Delay and eliminate projects where practical**. Over $23.5 million worth of capital projects were deferred in this budget process.

4. **Leverage assistance from national experts in utility financing.** Working with leading consultant on a rate model to better analyze and explore options to minimize rate impacts. This model is also intended to help find ways to address most important needs.

5. **Gain increased economies of scale through new development.** Addition of new customers in parts of the system that can accommodate water and sewer capacity can provide a large base of accounts to share cost burden of paying for system's operations.

6. **Limit staff additions.** Staffing is one of the most expensive parts of a business, thus, limiting personnel-related expenses is an important cost containment strategy.

7. **Re-evaluate interfund cost allocations.** Budget staff analyzing cost allocations to evaluate whether adjustments are needed to how Water and Sewer Fund contributes to shared services with the General Fund.

8. **Reduce service areas.** A smaller service area allows for more compact and cost-effective service provision and limits growth that would necessitate expansion of utilities plants.

9. **Reduce inflow and infiltration into the sewer system.** Reduces the loads and risk of exceeding wastewater collection and treatment capacity.

10. **Consider updating system development fee cost analysis.** While Hillsborough just updated these fees, proposed new developments are placing additional cost pressure to add or accelerate capital projects to serve some areas of town.

Note: The document that follows the budget message includes more detail on each strategy.

Stormwater Fund Highlights

- ✓ Program Updates. During FY24, the town completed its first ever state stormwater program audit and received approval of an updated Stormwater Master Plan, and receipt of a new stormwater permit is expected early in FY25. Audit recommendations that were included in the updated Master Plan include updated written procedures, expanded public input processes and additional outreach and expanded efforts for illicit discharge control, construction site runoff and pollution prevention.

- ✓ Infrastructure Maintenance. Improved levels of service and updated permit requirements will require additional investments in personnel, equipment and a stormwater capital improvement plan (CIP) to plan for large projects, such as a culvert replacement on Elizabeth Brady Road. The FY25-27 recommended budget includes ramp-up funds for a stormwater CIP and an additional Public Works employee (FY26). The requested Jet-Vac truck is not able to be funded in the recommended budget.

- ✓ Planning Ahead. While the Stormwater Fund currently has a healthy fund balance, the approval of a new Stormwater Technician position in FY24, along with the recommended investments in the FY25-27 budget and overall operating cost increases will rapidly deplete that fund balance without fee adjustments. Additionally, just beyond the "visual horizon" of the FY25-27 budget, the Stormwater Fund may need to make a sizable contribution to the Ridgewalk Greenway project for drainage-related improvements.

Employees

- ✓ Merit Pay and Cost of Living Adjustment (COLA). Compensation and staying competitive with the market continue to be a major challenge for all employers, regardless of sector in the economy. The budget recommends the same adjustments as FY24: $1,500 per employee COLA and merit raises in the 3.0 – 5.0% range depending on performance.
- ✓ Health insurance. There are no cost increases for the town's health insurance coverage this year, and the cost of dependent coverage is decreasing.

Moving Forward

For the reasons covered in this message, changes to this proposed budget are expected during the review process, as well as during FY25 as new information becomes available and conditions change. Therefore, please do not hesitate to contact me, Budget Director Emily Bradford (Emily.bradford@hillsboroughnc.gov or 919-296-9427), Budget & Management Analyst Josh Fernandez (josh.fernandez@hillsboroughnc.gov or 919-296-9428), or Administrative Services Director Jen Della Valle (jen.dellavalle@hillsboroughnc.gov or 919-296-9424) if you need additional information, have suggestions, concerns, or would like to propose alternatives, Town staff will make every effort to respond quickly and objectively to help you develop a budget that you feel best addresses the needs of the community! Finally, a big "thank you" goes to all town employees, department and division heads, and the budget team for their work in preparing this year's document!

Sincerely,

Eric J. Peterson

Eric J. Peterson
Town Manager

Emily H. Bradford

Emily H. Bradford
Budget Director

Jenifer Della Valle

Jen Della Valle
Administrative Services Director

Ten Strategies for Long-term Stabilization of Water and Sewer Rates

1. **<u>Use reserve funds, a portion available savings, and other one-time revenues to pay for long-term capital needs</u>**. Paying cash for capital needs, when the opportunities present themselves, minimizes future debt service payments and reduces pressure on future budgets. If a capital item or project can't be entirely paid for with these types of funds, it can still reduce the amount that must be borrowed. Given high interest rates, whenever cash can be used to pay for projects, it helps the fund over the long term. It can be tempting to use "one-time revenues" as a short-term fix to reduce operating deficits, but once that money is gone the deficits are even larger and the opportunity to invest in long-term capital projects has been lost. Thus, one-time revenues, capital reserve funds, and reserves earmarked funds are best used for larger capital expenses and projects. The following list includes the one-time revenues being recommended for use in this financial plan:
    a. <u>Cash, Reserves, and One time funding sources being leveraged to pay capital needs in FY25-27</u> - Growth is a double-edged sword – it places additional pressure and costs on the system, but also brings additional revenues in the form of monthly revenues and System Development Fees (SDFs) to assist in paying for their impact on system capacities.
        - Water – SDF's (collected): *$886,000* for US-70 water improvement project.
        - Sewer – SDF's (collected): *$1.1 Million* for collection system rehab.
        - Sewer – Capital Facility Fees: *$630,000* for wastewater collection system rehab and $625,000 for US-70 water improvement project.
        - Water & Sewer – SDFs (projected): The timing of receiving future fees is always difficult as it's dependent on the schedule of developments that often change. Future receipt of these revenues will be used to help pay for major capital projects but are not incorporated into this financial plan. SDFs will be factored into the new Capital Financing Plan that staff will start to work on this summer.
        - Building Resilient Infrastructure and Communities (BRIC) Grant - *$5.81 million* for the River Pump Station. Covers 70% of the project cost based on current construction estimates.
        - Building Resilient Infrastructure and Communities (BRIC) Grant or STAG Grant - *$1.01 million* for the OWASA water booster pump station. Covers 70-80% of project cost based on construction estimates.
        - Perpetual Maintenance Fees: *$66,000* to help pay for wastewater collection system rehab.
        - AIA (Grants from the State of N.C.) - *$170,000* for Hasell Street Water Tank and US-70 Waterline Preliminary Technical Memos, Water System Master Planning.
        - Retained earnings (savings). As staff works on the Capital Financing Plan this summer and updates the key financial metrics, such as operating and various debt ratios, depreciation coverage, days of cash on hand, and others, there will be recommendations on how much savings can be used to pay for projects. In the meantime, savings are being used temporarily to cover projected deficits in FY25 and beyond.

2. **<u>System development fee (SDF) usage strategy</u>**. These fees are collected when new connections are made to the system. Fees are proportional to the cost the new connection is projected to have on the capital facilities or their share of the impact on the system's capacity (e.g., plants, reservoir, pumping stations, mains, etc.). Sizeable projects are planned for Hillsborough that will eventually generate millions of dollars to help pay for some of the expensive projects. Unfortunately, it's difficult to predict when these fees will be paid since developments often pause, change, or get cancelled. It's risky to rely on an unpredictable revenue source to pay for projects scheduled over the next few years. To make sure the financial plan includes this potentially sizeable source of funding, yet limiting risk, the following approach is being used: <u>accrue and save SDFs until there is enough "in the bank" before proceeding with certain projects</u>. Here are a few examples:

- ✓ Wait to proceed on a project, such as the Highway 70A Business water line replacement & upsizing, Hassell Street water tank replacement, Cates Creeks Sewer Outfall, Elizabeth Brady pumping station, or others, until there is enough to either completely pay for the project or reduce the amount borrowed to a manageable amount.

- ✓ Pay for cost overruns preventing high priority projects from moving forward. For example, if bids for River Pump or something else come in higher than we have funding for, then SDFs could be used to fill the gap.

This flexible approach allows the timing to be adjusted (done earlier or delayed longer) depending on when enough funds are accrued to allow the project to move proceed. This protects the budget and thus rate payers from further expenses, prevents or minimizes debt load, helps meet key financial metrics such as debt coverage ratio, and prevents key operational needs from being crowded out.

3. **Delay and eliminate projects where practical**. The following are some large projects deferred in this budget process:

    a. **Hillsborough Station sewer pump station ($725,000**) large enough to accommodate future development at the 20-acre project surrounding the train station. This is considered an economic development and affordable housing priority, but the project was eliminated from the budget and CIP. Funding will have to be paid for by future developers of the land. A small pump station will be included in the train station design to accommodate that facility.
    b. **Cates Creek Outfall upgrade ($8.1 million**) to serve current land in the southern parts of town near I-40.
    c. **Elizabeth Brady Road Pump Station upgrade ($4.5 million**) to serve development in the southern part of town.
    d. **Hasell Street water tank replacement - $3.7 million** (90 years old)
    e. **US-70A Business Water Line Improvements ($3.0 million)** to replace fragile asbestos-concrete lines that supply emergency water from Durham, and to improve pressure in the central zone.
    f. **Eno River West Sewer Interceptor Upgrade - $2.1 million** (100 years old)
    g. **Fire hydrant and valve replacement project in oldest parts of town - $545,000** (many units are 90 years old)
    h. **Water system improvements ($800,000**) recommended by the recently completed Water System Master Plan The plan was to start spending $400,000 annually to address system-wide needs. This initiative is now delayed three years and will start in FY27.
    i. **Water plant expansion** was eliminated from the CIP, even preliminary planning. If additional water is needed to meet peak day demand in the future, then it will need to be purchased from neighboring utilities. There is not a specific estimate for the project, but it would likely exceed **$10 million**. Any increase in water plant capacity or even outside purchases could necessitate a far costlier expansion to the wastewater treatment plant, thus the rationale for the cut.

4. **Assistance from national experts in utility financing and new finance and rate models currently being built**. *Raftelis*, a national leader in advising water and sewer utilities on ways to maximize resources and financial management, is nearing completion of the model for the town. The "rate model" combines the town's three-year budget, multi-year CIP, multi-year forecasts for all expenses, revenues, and other key financial data to better analyze and explore options to minimize rate impacts. The model is also a capital financing plan that will help find ways to move forward with addressing the most important system needs as well as daily operations. The model will be reviewed by *Davenport Public Finance*, who specialize in assisting local governments to find the best way to maximize their funds via managing their financial assets (e.g., when/how to spend cash, issue debt, debt timing, what type of instrument to borrow funds, such as revenue bones, installment-purchase, or others). Finally, the model provides industry standard metrics to show the impact of decisions on the system's

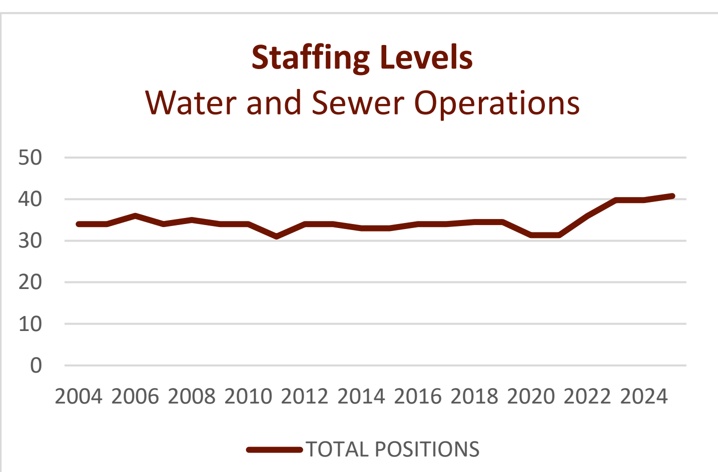
financial health. This is critical in maintaining the strong bond rating to save money when borrowing funds in the future and complying with required bond covenants from the WFER expansion projects. These are further areas that both Raftelis and Davenport will advise the town.

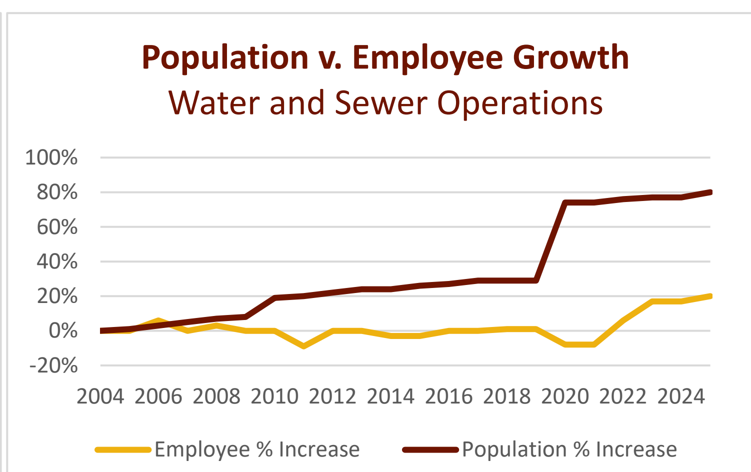
Raftelis staff will make a public presentation once the first draft of the model is complete. Thus, recommendations in the proposed budget could change depending on the model. This means proposed rate increases could be adjusted down or up. And, the timing for capital projects could be delayed or accelerated. We are hoping the draft will be ready for presentation before budget adoption, so the findings can be considered, but it's difficult to project a completion date at this time.

5. **New development and the potential for economies of scale**. Hillsborough's capacity to serve new development is limited due to the capacities of the plants, pipes, pumps, and reservoirs. Depending on one's view, this is either a positive or a negative. Even with growth limited to those areas and densities recommended in the Comprehensive-Sustainability Plan, the addition of new customers in parts of the system that can provide sufficient water and sewer capacity, can provide a large base of accounts to share the cost burden of paying for the system's operations (i.e., leverage the benefits of economies of scale that's a challenge for small utilities like Hillsborough). Note: in potentially adding new rate payers to the system, the benefits of additional revenue go away if the cost of connecting to the system is not paid by the new development. Otherwise, existing customers end up subsidizing the cost of adding the new development if expensive capital improvements are needed to serve it, such as larger lines and pump stations. Thus, it's essential that any new developments are evaluated closely to ensure they are paying their fair share. This will not be popular, but there are going to be areas where it does not make financial sense to add new customers to the system due to the cost of connections, upgrading the size of pipes, pump stations, and other assets. Future discussions will likely include identifying parts of the service area that cannot handle new connections.

   As mentioned earlier, there has been a development slowdown. When the economy changes there are 877 units at Collins Ridge, East Village at Meadowlands, and the Moren Tract-Beech Company-Persimmon projects that have the potential for construction, but have not yet started. There are still other significant properties that will be developed at some point, including the former Daniel Boone between South Churton Street and I-85, as well as the current Waterstone South Project near the hospital. These projects offer the potential to provide significant financial assistance to stabilize rates.

6. **Limit staff additions**. Staffing is one of the most expensive parts of a business, thus limiting personnel-related expenses is an important cost containment strategy. There is only one position added to the Water and Sewer Fund in the three-year budget. This includes General Fund operations that share costs with the Water and Sewer Fund (e.g., administration, finance, human resources, safety, communications, and information technology). There are no position adds in these General Fund operations during this period as well, thus reducing cost impacts to Water & Sewer Fund. The graphs below demonstrate that water and sewer operations have had





modest staffing increases over the past 22 years, averaging a 0.91% annual increase during this long span. While staffing has increased 20% during the past 22 years, the town's population has increased by 80%. In addition, the miles of pipes, customers, generators, and many other assets have increased significantly as well. It's important to note that in addition to modest staffing additions, the use of use of inmate worker assistance from the Orange Correctional Facility ended in 2019. This meant the loss of approximately four positions that worked in the field with staff daily and also responded to after-hours emergencies.

7. **Re-evaluate interfund cost allocations**. The Water and Sewer Fund is assessed for its portion of shared services with General Fund departments such as governing board, administration, human resources, accounting, fleet maintenance, facility management, communications, safety, and information technology. This includes all operational, capital, and debt related expenses for these operations. At $2.7 million, these expenses make up 20% of the Water and Sewer budget. Budget staff is currently doing an analysis of the cost allocations to evaluate whether adjustments are needed. Even a small adjustment could yield noteworthy savings. For example a five percent change in favor of the Water and Sewer Fund could generate approximately $135,000 in savings. On the other side of the coin, this would cost the General Fund a corresponding amount and require cutting costs, increasing property taxes, or a combination, to make up the difference. Staff expect to have the analysis completed soon and ready for review.

8. **Reduction of service areas** via recommendations from the Comprehensive-Sustainability Plan. A smaller service area allows for more compact and cost-effective service provision. In addition, limiting development so growth pressure does not necessitate expansions of the water and wastewater plants is essential for long-term cost stabilization as increasing either plant's daily production would likely be exceptionally expensive.

9. **Reducing Inflow & Infiltration (I&I), into the sewer system.** I&I that gets into lines increases the loads and risks exceeding the capacity of the wastewater collection systems pipes, pumps, and plants. Plus, it greatly increases the risk of sewer overflowing manholes and pump stations during heavy rain events. It's far less expensive to repair, replace, and upgrade components of the collection system than to pay for an expansion of the wastewater treatment plant, which is often the most expensive project a utility system can undertake. An expansion in Hillsborough could cost $30-40 million. Thus, the budget includes funding for projects that repair, seal, and fortify those parts of the collection system experiencing the highest levels of I&I (e.g., sealing manholes, replacing or relining mains/interceptors).

10. **Consider updating System Development Fee (SDF) cost analysis**. Water and sewer utilities are required by state statute to update these fees every five years. While Hillsborough just paid a consultant to update the formulas and fees about a year ago, proposed new developments are placing additional cost pressure to add or accelerate capital projects to serve some areas of town. In some cases, the required new/accelerated projects were not factored into last year's SDF updates. There are other components that may need to change in the formulas used depending on what new developments may be approved by the town board.