



City of Homer –

Financial and Rate Setting Policies

Water and Sewer Utilities



May 18, 2021

Agenda

- 01 **Overview of financial and rate setting policies**
- 02 **Review industry standard approaches**
- 03 **Discuss draft financial and rate setting policies**
- 04 **Overview of the Preliminary Financial Plan**
- 05 **Council discussion and feedback**

Financial and Rate Setting Policies

Why Establishing Written Financial Polices Are An Important Tool

- Provides management with clear direction
- Provides consistent and logical financial/rate decisions
- Provides future Council and staff with the basis or reasoning behind past decisions (documentation)
- Helps the City's customers to better understand the Council's philosophy
- Provides a strong message to the outside financial community (bond ratings)

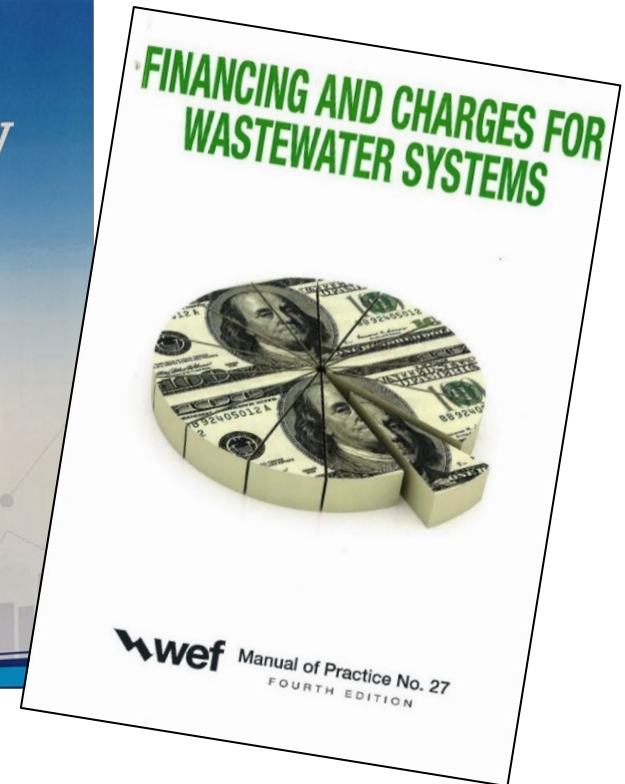
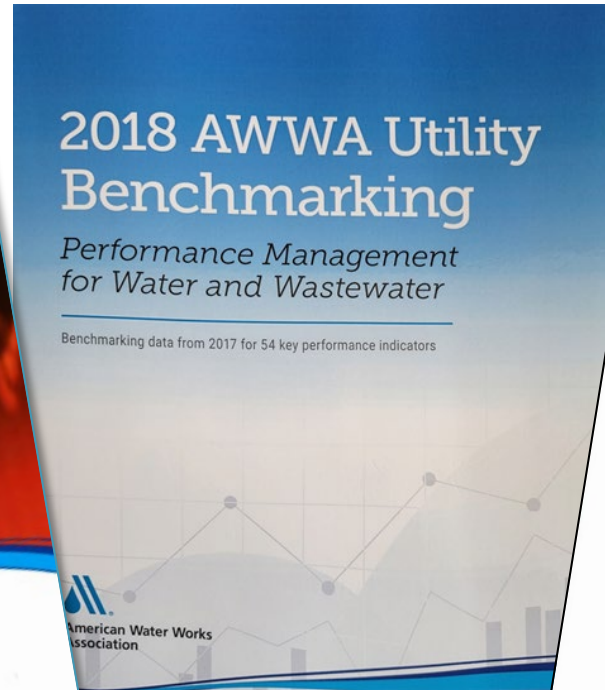
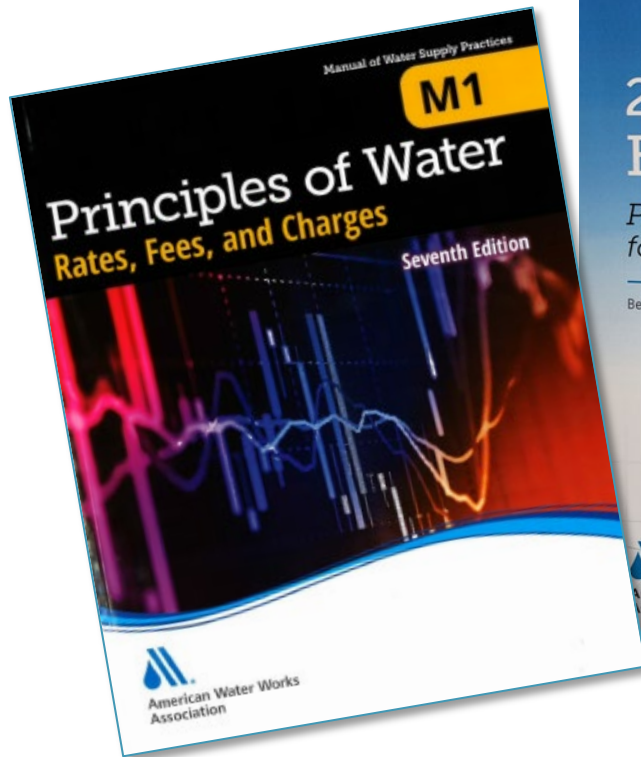
Typical Financial/Rate Setting Policies

- Capital improvement funding from rates
- Funding renewal and replacements, growth, and regulatory required capital
- Minimum ending target reserve levels
- Target debt service coverage (above covenant requirements)

Role of Financial Polices

- Provides financial framework for decision making
- Maintains financial viability if followed
- Utilize as a capital and strategic planning tool
- Use as a basis to develop and minimize (smooth) rate impacts

Based on Industry Standard Approaches



Cash Basis Revenue Requirement





$(i + Term)$

- + O&M Expenses
- + Taxes/Transfer Payments
- + Debt Service (P+I)
- + Capital Projects Funded from Rates
- = Revenue Requirements
- Miscellaneous Revenues
- = Balance Required from Rates

$\Rightarrow Ann.$
Depr. Exp.

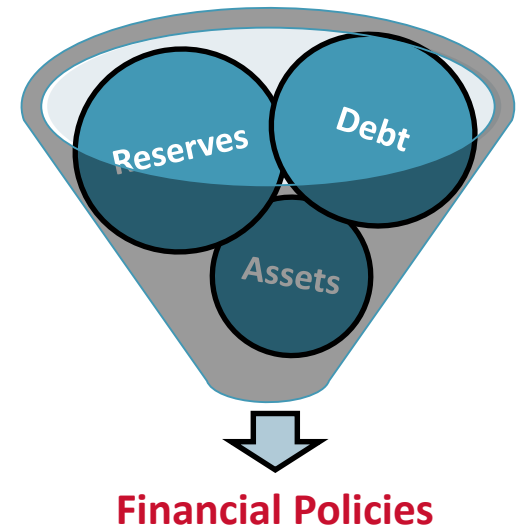
- = Total Capital Improvement Projects
 - ✓ Renewal and Replacement
 - ✓ Regulatory Required
 - ✓ Growth/Expansion
- Outside Funding Sources
 - ✓ Long-Term Borrowing
 - ✓ Growth Related Fees
 - ✓ Reserves
 - ✓ Grants
- = Capital Projects Funded from Rates

Policy Goals and Objectives

-  Maintain sufficient revenues for operating and capital funding needs
-  Provide rate (revenue) stability
-  Maintain sufficient reserve levels
-  Maintain required debt service coverage requirements

Relevant Areas for Financial Rate Setting Policies

- Financial policies can be arranged into major policy categories
 - ❖ **Establishing Minimum Reserve Levels**
 - Type of reserves and basis for establishing minimum reserve levels
 - ❖ **Establishing Minimum Level of Asset Maintenance from Rates**
 - Funding from rates \geq annual depreciation
 - ❖ **Establishing a Debt Policy**
 - Parameters around issuance of debt
 - ❖ **Approach to Establishing a Budget**



Financial Policies – Reserves



- Operating (O&M) Reserves
 - ❖ Target minimum balance typically **60-365** days of O&M expenses
 - ❖ Water min. 2021 target **\$340,000**, Sewer min target **\$270,000**
- Capital Reserves
 - ❖ Target minimum balance typically of **1**-year of annual depreciation expense or average annual capital projects (e.g., 5-year period)
- Bond Reserves
 - ❖ Bond reserves will be established in accordance with the legal covenants of the debt issue
- System Development Charge (Growth) Reserves
 - ❖ No minimum / based on use of growth funds

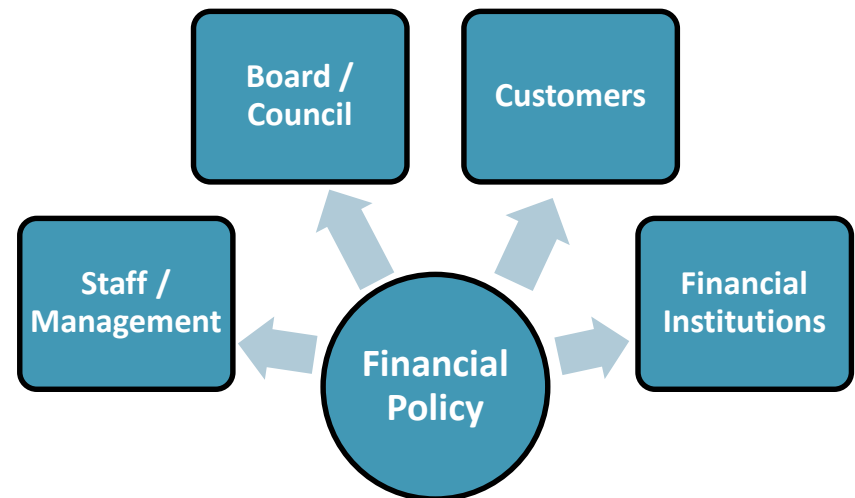
Reserves should not, on their own, trigger action, but be a signal for attention and review

Homer Reserves - HAWSP and CARMA

- Homer Accelerated Water and Sewer Program (HAWSP)
 - ❖ Provides “Seed Money” for major projects
 - ❖ Also used to service HAWSP-project debt
 - ❖ Funded by a voter-approved dedicated sales tax
 - ❖ Current balance **\$2.17M**
- Capital Asset Repair and Maintenance Allowance (CARMA)
 - ❖ Funds improvements, repairs, and replacements to the City’s existing water and sewer systems
 - ❖ Historically funded annually through a rate surcharge equal to 15% of water and sewer costs
 - Not funded in 2020
 - ❖ Current balance **\$2.6M** water and **\$2.1M** sewer
 - ❖ Recommend shift to rate-funded capital approach guided by financial policies

Performance Benchmarking

- Management tool to measure efficiency and financial health of each utility
 - ❖ AWWA surveyed utility medians to establish financial targets (e.g., target debt service coverage, number of days of O&M for working capital reserves, etc.)
 - Performance comparisons to industry best practices
 - Demonstrates efficiency of utility
 - ❖ Bond rating agency perspectives
 - Standard & Poor's Ratings Services
 - Fitch Ratings (of working capital)
 - Moody's Investors Services



Benchmarking of Reserve Levels

Table 2: Determination of the City's Days of Cash on Hand

Rating Agency	Fund Balances Included in Calculation	AA/Aa Target	Homer
S&P Ratings Services	Operating Reserve Capital Reserve (e.g., CARMA) Rate Stabilization Reserve	90 to 150 days	~460 days
Fitch Ratings (Days of Cash)	Same as S&P + Bond Reserve	180 to 365 days	~460 days
Moody's Investors Service	Operating Reserve + Rate Stabilization Reserve	150 to 250 days	0 days
AWWA	Undesignated cash & cash equivalents	321 days (median)	~460 days

- The city does not have reserves except for HAWSP and CARMA
 - ❖ HAWSP and CARMA are designated (restricted)
 - ❖ CARMA could be unrestricted but current City policy is to only use for capital
 - ❖ CARMA – Water = **460** days of O&M
 - ❖ CARMA – Sewer = **457** days of O&M

Financial Policies – Debt Policy

- Establishment of policies related to debt issuance and management are intended to minimize the overall long-term costs and impact to rates
 - ❖ Rate funded capital (renewal and replacement)
 - Renewal and replacement capital is generally a component of the rates
 - ❖ Long-term debt may be appropriate for large and/or non-recurring and regulatory capital projects
 - ❖ Strive for the lowest cost option when issuing long-term debt
 - ❖ Maintaining minimum debt service coverage ratios (may be stated in bond covenants)
 - For example, “Greater than 1.25”
 - ❖ Comply with reporting and legal standards/requirements



Benchmarking of Renewal and Replacement Funding

Table 3: Level of Rate Funding for Renewal and Replacement Capital Funding

Rating Agency	AAA/Aaa Target	AA/Aa Target
S&P Ratings Services	N/A	N/A
Fitch Ratings (Days of Cash)	Free cash relative to depreciation equal to 100% or greater	Free cash relative to depreciation equal to approximately 85%
Moody's Investors Service	Net Fixed Assets/Annual Depreciation Greater than 75 Years	Net Fixed Assets/Annual Depreciation 25 to 75 Years

AWWA benchmarking based on % of reserves or annual funding compared to present value of existing infrastructure

Benchmarking of Debt Service Coverage Ratio¹

Debt Service Coverage Ratios

Rating Agency	AAA/Aaa Target	AA/Aa Target
S&P Ratings Services (All-in Ratio) ²	Equal to or Greater than 1.6	1.4 to 1.6
Fitch Ratings ³	Equal to or Greater than 2.0	1.5 to 2.0
Moody's Investors Service ⁴	Equal to or Greater than 2.0	1.7 to 2.0
AWWA Benchmarking	Median combined water/wastewater	2.34

1. Debt Service Coverage Ratio = Net Operating Income/Total Debt Service
2. Standard & Poor's Ratings Services, P. 24, Table 17
3. Fitch Ratings, P. 6 Attributes: Financial Profile (Table)
4. Moody's Investors Service, P. 12, Exhibit 7

Financial Policies – Balanced Operating Budget

- Self-supporting
- Adequate Funding to Preserve System Assets
- Evaluation and Monitoring of Cost
- Positive Annual Net Income
- Strive for Rate Stability
- Disposition of “One-Time” Revenue
- Alternative Funding/Revenue Diversification

Financial Policies – Establishing Rates and Fees

Revenue Requirement Analysis

Compares the revenue of the utility to the expenses to evaluate the level of overall rates



Cost of Service Analysis

Equitably and proportionally allocates the revenue requirement between the various customer classes of service



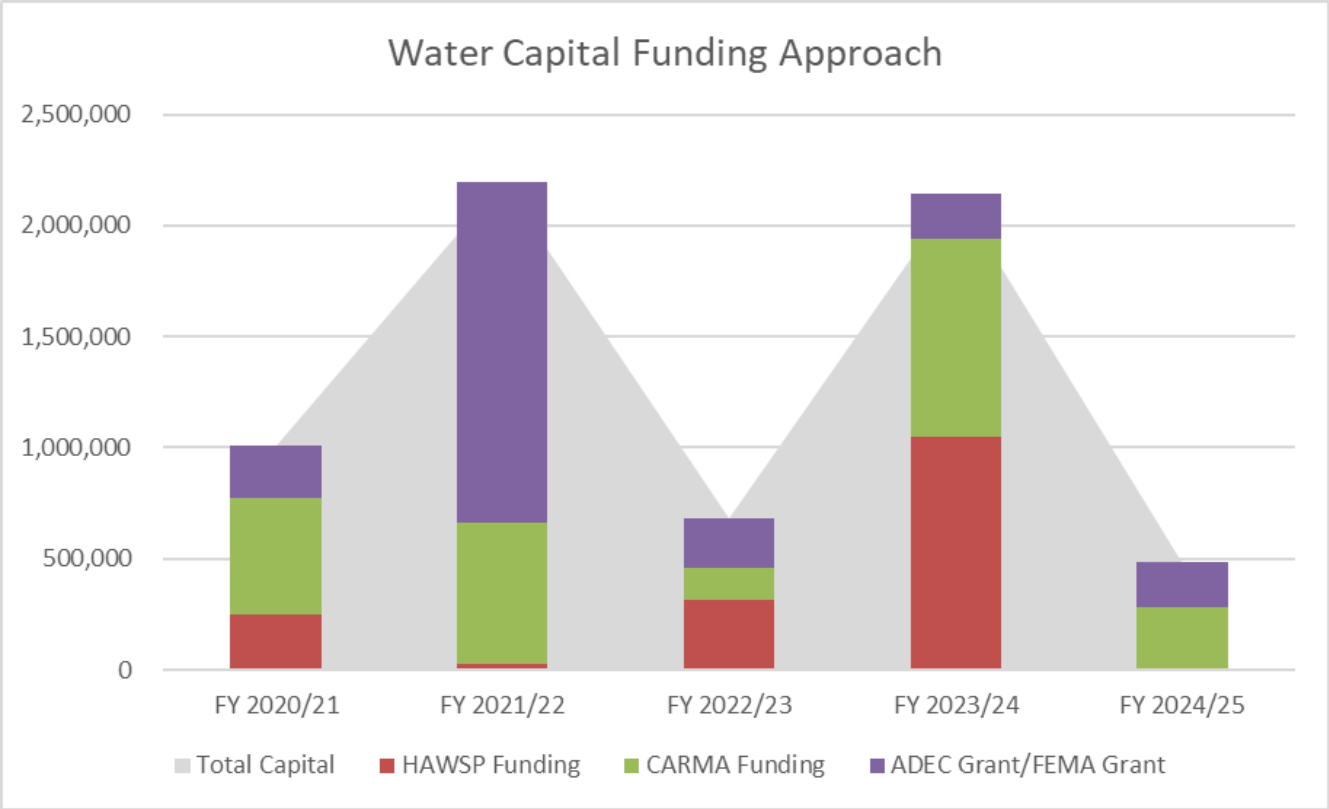
Rate Design

Design cost-based rates for each class of service to meet the revenue needs of the utility, along with any other rate design goals and objectives

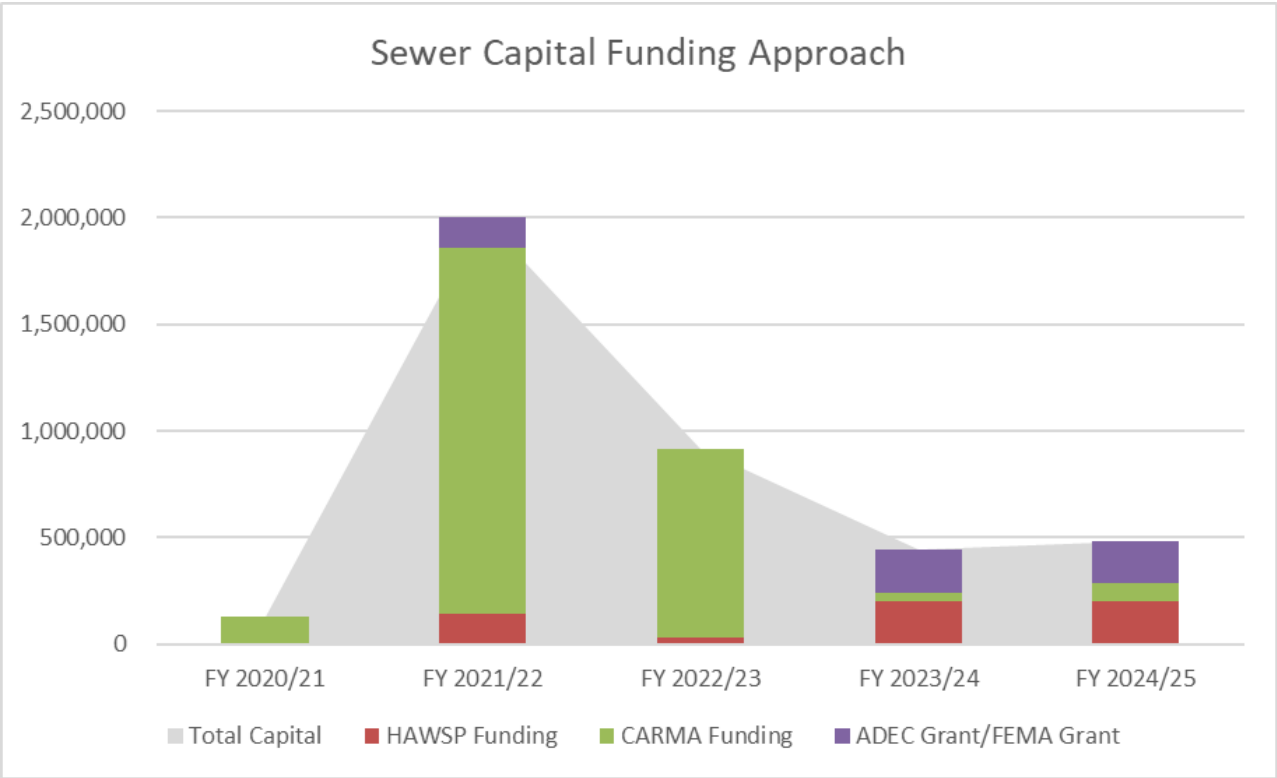
Preliminary Long-Term Financial Plan

- Developing a financial plan for water and sewer
 - ❖ Illustrate the sources and uses of funds
- Includes a capital funding component
 - ❖ Outlines future capital needs and funding sources
- Provides the City with tool to assist in evaluating future funding needs
 - ❖ Allows for the financial policies to be included
 - ❖ Evaluates the adequacy of existing and future reserves and funding needs
- Is not intended to establish rates or replace current rate model

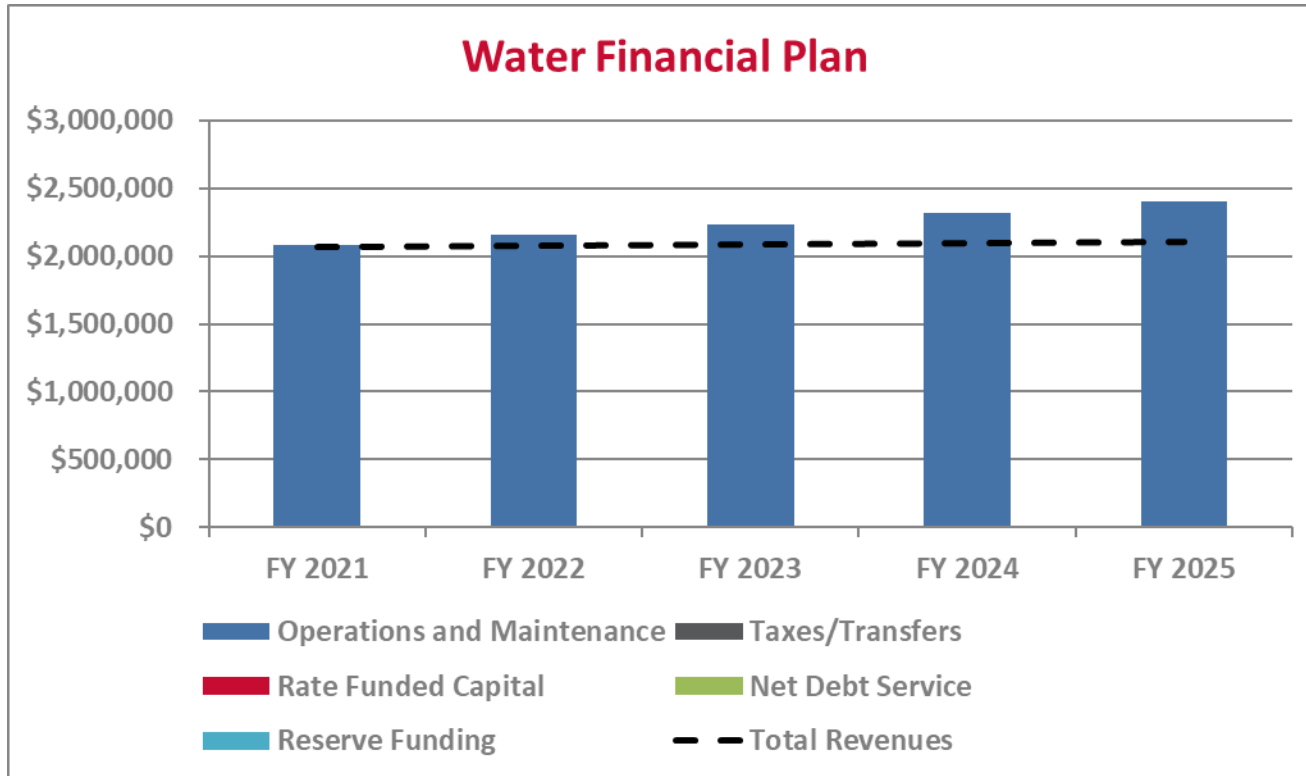
Preliminary Capital Funding Approach



Preliminary Capital Funding Approach (Cont'd)

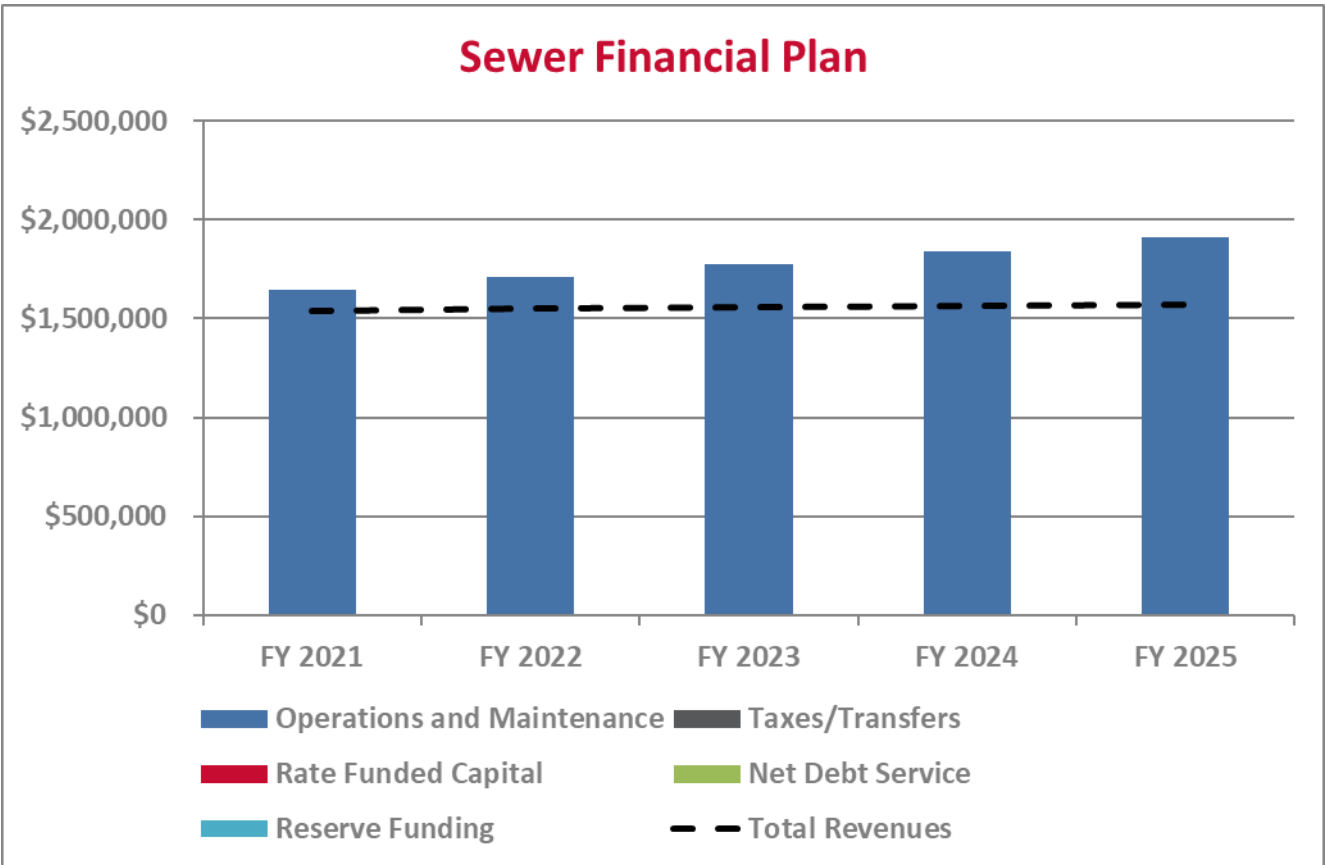


Preliminary Financial Planning Summary



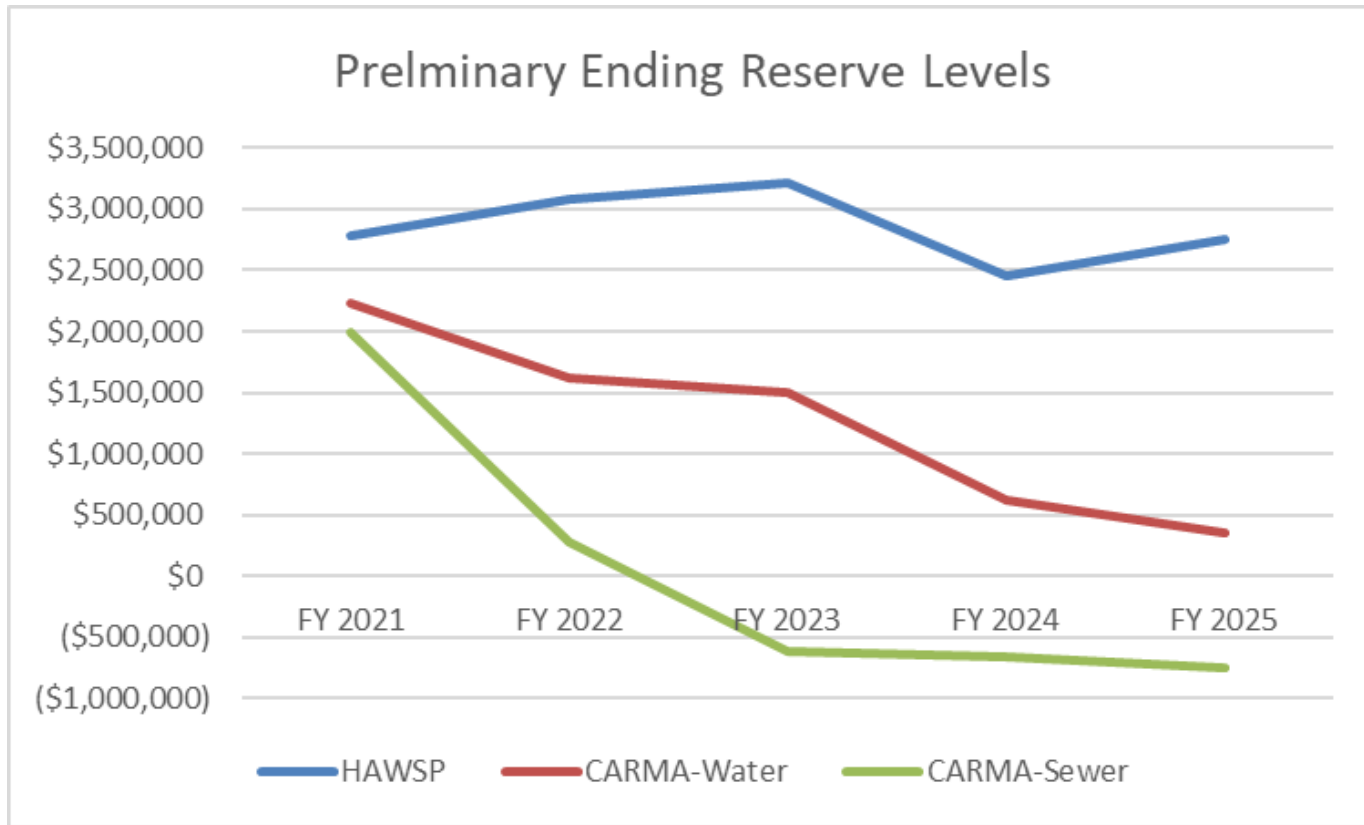
- Chart only compares current operating expenses and current revenue levels
- Current debt is funded through HAWSP
- No transfers or rate funded capital

Preliminary Financial Planning Summary (Cont'd)



- Chart only compares current operating expenses and current revenue levels
- Current debt is funded through HAWSP
- No transfers or rate funded capital

Preliminary Reserve Summary



- Projected FY 21/22 through FY 24/25 water and sewer capital funding plan impacts HAWSP and CARMA levels
- CARMA excludes annual revenue contribution (i.e., 15% charge)

Preliminary Observations and Recommendations

■ Observations:

- ❖ Financial policies are not “set in stone” as City goals and objectives change policies may need to be revised
- ❖ Preliminary financial plan provides a forward looking (proactive) analysis to review key financial metrics and funding needs

■ Recommendations:

- ❖ Development of written financial policies to guide rate setting approach
 - Establish an operating reserve to reflect industry standards
- ❖ Need to continue to develop the long-term capital plan (e.g. 5-10 years)
 - Identify future capital needs
 - Identify future funding approaches (e.g., reserves, loans, bonds)
- ❖ Develop a long-term financial plan (e.g., 3-10 years)
 - Rate and funding impacts for future (unknown) major capital projects (e.g., future borrowing)
 - Project long-term rate levels based on funding of future operating and capital expenses
 - » Does not need to replace current rate setting approach, just inform on future possible needs
- ❖ Need to identify sustainable funding for annual renewal and replacement needs
 - Annual funding level in rates and impact to CARMA funding approach

Questions/Discussion

