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Memorandum 10-131

Date: October 12, 2010

To: Walt Wrede W. Wrede

From: Regina Harville Regina
Finance Director

Subject: Water/Sewer Enterprise Funds

Back in May of 2010, the City sent me to the Western NARU Utility Rate School. This class was great as it educated me from a regulatory basis on the methodology of rate setting. The mock case that was utilized was a water utility, so it had added benefits.

Although the State of Alaska has a commission to regulate rates, we as a City do not fall under its umbrella as, "There are utilities that are not economically regulated; these include local, government owned utilities…", according to the Regulatory Commission of Alaska.

The Utility Rate School clearly defined what was to be considered and not to be considered in rate setting. It identifies that depreciation expense is to be recognized and those costs should be shared with the users of the utility. In the rate setting for the City of Homer, only 20% of the actual depreciation expense is considered.

This lead to the discussion of what type of entity Water / Sewer is, because it is being subsidized by taxpayer dollar through HAWSP. Waterlines and major acquisitions are purchased through HAWSP and through the consumer. LID's are created for the laying of water lines in neighborhoods and the customer is required to pay 75% of the cost of those lines. HAWSP (or taxpayer dollar), pays for the rest through low interest loans through ADEC. All assets purchased through HAWSP are considered assets of the Water/Sewer Enterprise Fund and are depreciated accordingly. Depreciation Expense is appropriately accounted for in the audited financial statements, which reduces annually the fund balance.

I believe that Water/Sewer should be accounted for as a 'Special Revenue Fund' opposed to an enterprise fund. A Special Revenue Fund is established to finance particular activities and is created out of receipts of specific taxes or other designated revenues. Such funds are authorized by statutory provisions to pay for certain activities with some form of continuing revenues.

Water/Sewer Fund accounts for operations of the water treatment plant and the sewer treatment plant. User charges are designed to recover cost of operation and maintenance of the system, exclusive of depreciation and capital improvements. Capital improvements are paid largely by the taxpayers as well as home owners who pay 75% of the cost of running water lines to their properties.

The Finance Department contacted our auditors for clarification on any implications that they could foresee with changing an Enterprise Fund to a Special Revenue Fund. Michelle Drew, Vice President/Director in the Audit Department with Mikunda Cottrell, stated that although she understood the logistics behind moving from an Enterprise Fund to a Special Revenue Fund, that the rate setting would be in a more favorable position for the customers, she did caution us that the one thing that would cause us an issue is if we were at any time in the future attempt to get Revenue Bonds, Water/Sewer would have to be an Enterprise Fund in accordance with rules and regulations set forth in the accounting world.

She does not envision seeing this as a setback for us with the readily available low interest loans we receive through ADEC.

Beth Verrelli with ADEC was also contacted. Bill Jaroke with Boise State University reviews all requests for funds for the ADEC and our question was deferred to him. In accordance with Mr. Jaroke, it doesn't matter what the entity is called, they are concerned if there is a dedicated source to pay back the loan(s) in the future years, and that monies are being set aside for future replacement/depreciation costs for the wear and tear on infrastructure.

In talking with Mr. Jaroke, these items are already being addressed through the HAWSP fund as it was specifically designed to be the vehicle to pay back loans taken out through ADEC, and we actively are putting monies aside for "Depreciation Reserves".

Because Water/Sewer is not a true enterprise fund as it receives a large part of revenues steadily from sales tax dollars, and because the infrastructure that is being put into service (i.e. water lines), is not being built in its entirety by the City rather by the customers (as they pay 75% of costs associated with putting water lines to their neighborhoods), and through sales tax dollars (HAWSP), it is not logical to pass on the full depreciation expense as suggested through the Rate Setting School.

By changing the structure, rates can be set considering the dollars set aside for depreciation reserves rather than the depreciation expense. Additionally, by not having to decrease the Net Assets (Fund Balance), the Net Assets/Fund balance would have an opportunity to grow. All being a plus for this struggling Fund.

Where the Land Ends and the Sea Begins