



MEMORANDUM

Resolution 23-048, A Resolution of the City Council of Homer, Alaska Amending the Water and Sewer Utility Financial and Rate Setting Policies and Utility Financial Plan. City Manager/Public Works Director.

Item Type: Backup Memorandum
Prepared For: Mayor Castner and Homer City Council
Meeting Date: 08 May 2023
From: Elizabeth Walton, Finance Director

City Council requested at the Work Session on April 24, 2023 that the Utility Financial Policy be brought forward at the next meeting for update coinciding with the proposed utility rate adjustment for Fiscal Year 2024.

Staff has begun the process of updating the Policy to align with the proposed rate, but more work needs to be done before presenting a final version to Council for review and adoption.

Recommendation: Staff recommends that Council postpone the Resolution adopting the Utility Financial Policy until the next meeting on May 22, 2023.

City of Homer Water and Sewer Water and Sewer Utility Financial/Rate Setting Policies (PW AMENDED 2023)

Not a final draft, still under staff review

Introduction

Financial policies are an important tool for maintaining a financially healthy and sustainable utilities while also maintaining required and/or mandated measures. The Government Finance Officers Association (GFOA), bond rating agencies, and other industry organizations (e.g., the American Water Works Association (AWWA), the Water Environment Federation (WEF)) recommend written financial/rate setting policies to provide clear policy direction and guidance.

The establishment of written financial policies is intended to:

- Institutionalize sound financial practices
- Clarify strategic intent
- Define boundaries
- Support bond ratings
- Promote long range strategic thinking
- Manage risk
- Adhere to established best practices

Financial Policy Goals and Objectives

The goals of the City’s financial policies are to:

1. Maintain sufficient revenues for operating and capital needs,
2. Maintain sufficient reserves, and,
3. Provide rate stability. Notwithstanding (1) and (2) above, rates will be set to provide rate/revenue stability and avoid major periodic increases.

A detailed set of financial policies have been adopted to establish consistency in utility financial planning and rate setting decision-making for the City Council and City management team.

This framework provides recommendations that take into consideration the typical or median reserve levels for a “AAA” versus a “AA” rated utility. This framework will also enable the City Council to make more informed decisions in establishing the financial targets contained within the financial policies.

Review and Discussion of the City's Financial/Rate Setting Policies

The Utility Financial Plan will take into consideration the following financial policies. The financial planning period will be for a minimum of five years to determine overall trends and impacts to reserves and rates over a long-term horizon. The Utility Financial Plan is an integral component of the City's approach to effectively managing the utilities at a sustainable level to support the service levels of the community.

1. Reserve Funds

Reserve funds shall be established for the City to properly account for the City's funds, but to also provide adequate reserve levels to address the different types of funding requirements of the City. The City's reserve policies shall be as follows:

- 1.1 **Operating Reserve** – The City's operating reserve is an unrestricted reserve. The minimum operating reserve shall be established at 90 Days of annual O&M expenses (approximately 25% of annual O&M for both the Water and Sewer Funds) as outlined in Exhibits 4 and 6 in the Utility Financial Planning models for water and sewer.
- 1.2 **Capital Reserve** – The City currently has two different capital reserves for the water and sewer utilities. The first is the Homer Accelerated Water and Sewer Program (HAWSP). HAWSP is funded through a portion of the voter approved sales tax and assessments levied on benefited properties. The second is the Capital Asset Repair and Maintenance Allowance (CARMA). ~~CARMA is funded annually through a rate surcharge equal to 15% of water and sewer costs and collected through the water and sewer rates.~~

In general, HAWSP is intended to provide seed money to support expanded access to the City water and sewer system while CARMA is intended to support improvements, repairs, and replacements of the City's existing infrastructure, and may also be used for Capital Contingencies or Infrastructure Replacement. CARMA and HAWSP funds may be used jointly to fund a project where applicable. The development of the projection of CARMA and HAWSP funds is provided in Exhibits 8 and 9 respectively of the Utility Financial Plan.

1.2.1 Homer Accelerated Water and Sewer Program (HAWSP) – Voters in the City of Homer established the HAWSP fund to improve the Health and Welfare of the community by funding capital improvements to the City's water and sewer system. The HAWSP is funded by a voter approved dedicated sales tax, and assessments levied on benefited properties. (See HCC 9.16.010(b).) Specifically, the HAWSP Fund is built from a levy of $\frac{3}{4}$ of a percent on the retail sales tax. This tax was established by voters and can only be modified through another ballot measure. The key objectives of the HAWSP fund are as follows:

- Provide for water/sewer improvements without placing a heavy financial burden on individual property owners. (Resolution 99-53.)

- Increase the number of users to the system(s), thereby increasing revenues to the Water and Sewer Enterprise Funds. (Resolution 99-53.)
- Promote construction of additional improvements to the City water and sewer systems. (See Ordinance 99-14(S)(A).)
- Protect public health. (2016 HAWSP Policy Manual.)

The HAWSP ~~may also be used is generally intended~~ to provide “Seed Money” for major projects (projects that exceed \$1.1 million). The target HAWSP fund value is to be maintained at a level to provide sufficient funding for current long-term debt obligations and annual funding needs as outlined in the Utility Financial Plan. The HAWSP fund may additionally be used to pay off HAWSP-project debt, subject to City Council approval, and may furthermore be used in conjunction with CARMA for project funding, especially where an element of the project involves extension of service, expansion of capacity, or promotion of public health.

1.2.2 Capital Asset Repair and Maintenance Allowance (CARMA) – The CARMA reserve was established to fund improvements, repairs, and replacements to the City’s existing water and sewer systems. The level of CARMA funding can be adjusted by the City Council. “The amount of the CARMA funds shall be established by City Council in the biennial budget based on the projected maintenance and repair needs of the City.” (Ordinance 19-35(S)(A)). **For many years, CARMA was funded annually through a rate surcharge equal to 15% of water and sewer costs and collected through the water and sewer rates. The City experimented with a new method with the FY 22/23 rates; that is, using the Asset Management Plan to identify high risk components of the utility systems, estimate the costs of repairs to those components, and add a capital repair item to the rate model to cover the designated repairs. This experiment proved to be a failure. In 2022, the clarifier belts in the WWTP failed, triggering a repair cost of over \$900,000, which significantly adversely affected the Sewer CARMA. The City realized it needed a reserve to accommodate Unknown Unknowns and reinstated the 15% rate surcharge in the FY 24/25 rates. Further, the City identified minimums and maximums for the CARMA accounts; that is, a minimum of \$500,000 and a maximum of \$1,500,000 for the water utility and a minimum of \$500,000 and a maximum of \$1,500,000 for the sewer utility. Additionally, the CARMA accounts may be supplemented by transfers from the Fund Balance.**

~~CARMA shall be funded as an element of the rates at a sufficient level to fund capital improvements as identified in the Utility Financial Plan.~~

The intent of the City of Homer Water and Sewer CARMA Fund is “for appropriation and expenditure for equipment replacement, fleet replacement, engineering or planning services, major maintenance of city facilities, or any other purpose as identified and recommended by the City Manager and authorized by the City Council...and to extend the life and use of taxpayer funded assets, facilities and infrastructure.” (See Ordinance 19-35(S)(A)). The Water and Sewer Utilities - which operate independently - use CARMA Funds for improvements, repairs, and replacements to the City’s existing water and sewer systems. CARMA Funds may additionally be used for capital contingencies or infrastructure replacement and can be used in conjunction with HAWSP to jointly fund a project.

- 1.3 Bond Reserve** – A bond reserve fund is a restricted reserve. A bond reserve fund shall be established, as required and in accordance with anticipated bond covenants for specified projects where the City Council intends to pursue bond funding. The minimum fund balance of the bond reserve shall be equal to bond reserve requirements set by applicable bond covenants.

2. Debt Issuance and Debt Management

The City, during the course of normal operations, may issue long-term debt to fund certain capital projects. The establishment of policies related to debt issuance and debt management are intended to minimize the overall long-term costs of the City and utilize long-term debt to the benefit of the City's customers. Provided below are the debt issuance and debt management policies.

- 2.1 Funding of Annual Renewal and Replacement Capital Projects** – The City will not need to issue long-term debt to fund annual renewal and replacement capital projects, as it will use rate funding, through CARMA, to properly and adequately fund the City's annual renewal and replacement capital projects. Accordingly, the minimum annual funding from rates shall be at least equal to or greater than the City's annual renewal and replacement needs as determined in the Utility Financial Plan.
- 2.2 Long-Term Debt as a Funding Mechanism for Capital Projects** – The City can consider the use of long-term debt to fund significant non-reoccurring capital projects. The policy objective when issuing long-term debt is to minimize the financial and rate impacts of significant non-reoccurring capital projects, **particularly projects with an estimated cost of at least \$300,000.** When structuring such long-term debt, the City shall consider the following factors as:
- Current interest rates (costs)
 - Current amount of the utility's outstanding debt levels
 - Consistency with the City's debt policy and overall debt level

The City shall avoid an over-reliance upon debt by considering the debt service coverage ratios of rating agencies to measure whether the City's debt to capitalization or debt to operating revenue ratios are appropriate. Specifically, the City should maintain a debt/equity ratio which is less than 50% for utility financial planning. In certain circumstances the City may need to exceed this target to fund critical infrastructure projects. In these cases, the City Council will provide guidance on the appropriate target debt/equity ratio. For each debt issuance, the City will identify the funding source for annual principal and interest payments, prior to the approval issuing the debt.

- 2.3 Types of Long-Term Debt** – To minimize the overall costs of debt, the City shall strive, at all times, to utilize the lowest and best available cost option for issuing debt.
- 2.4 Bond Covenants** – The City, at all times, shall adhere to and meet any bond covenants put forth by bonds issued by the City. Bond covenants are legal obligations placed upon the City. If the City is not in compliance with bond covenants, the City's management team shall inform the City Council and appropriate action will be taken.
- 2.5 Debt Service Coverage Ratio** – At all times, the City shall meet the minimum debt service coverage (DSC) requirements associated with bond covenants. For financial

planning and rate setting purposes, the City shall target a minimum DSC of 1.25 times annual debt service on all outstanding debt.

- 2.6 **Debt Funding Through Assessment Revenues** – For certain capital improvements the City may use Assessment District’s to fund improvements to provide service to these areas. In these circumstances the City will establish specific criteria for each assessment to ensure the adequate repayment of the assessment to reimburse the funding of the infrastructure providing service. When structuring debt the funding sources will be identified prior to approving the Assessment District.

3. **Balanced Operating Budget**

- 3.1 **Self-Supporting** – The water and sewer utility shall be self-supporting, where current revenue fully funds current operating and capital expenditures on an annual basis.
- 3.2 **Adequate Funding to Preserve System Assets** – The City’s assets shall be properly operated and maintained to provide for a long life. Annual operating expenditures will be budgeted and funded at a level that promotes the efficient operation of and preservation of assets through the asset’s useful life.
- 3.3 **Evaluation and Monitoring of Cost** – Costs will be monitored monthly to ensure the utility is operated in a cost effective and economically prudent manner and reported to the City Council on a quarterly basis.
- 3.4 **Positive Annual Net Income** – The City shall plan for annual net income (total revenue less O&M, taxes or transfers, debt service, and capital projects funded from rates) greater than or equal to zero (positive balance of funds).
- 3.5 **Strive for Rate Stability** – The City’s rates should be stable over time while generating sufficient revenue. As a part of the annual budgeting process, the City shall review the rates to confirm the adequacy of the current rates.
- 3.6 **Disposition of “One-Time” Revenue** – In instances of large one-time revenues (e.g., legal settlement), if not specifically earmarked, the funds will be transferred to an appropriate reserve(s) (operating, capital, or rate stabilization).
- 3.7 **Alternative Funding/Revenue Diversification** – To minimize overall rates, the City should explore alternative revenue sources such as grants and direct developer contributions.
- 3.8 **Fund Balance – the Fund Balance is the difference between budgeted expenses and actual expenses at the end of the FY. The Fund Balance is used to purchase inventory items. It may also be used to replenish the CARMA accounts or “buy down” rates.**

4. **Establishing Rates and Fees**

The City shall establish rates utilizing industry recognized “generally accepted” rate setting methodologies. This will provide the City with consistency in their ratemaking process, while also establishing rates which are legally defensible. The City’s policies on establishing the water and sewer rates and fees, and the general methodologies to be utilized, are as follows:

4.1 **Revenue Requirement Analysis**

The revenue requirement analysis provides a projection of the City’s revenues and

expenditures for a defined time period. The revenue requirement analysis shall provide the City Council with the information and cost-basis to determine the size and timing of any proposed rate adjustments. The City's revenue requirement analysis methodology shall consider the following:

- 4.1.1 The revenue requirement (financial plan) analysis will be developed **from the current year's budget, as part of the budget process.** ~~for a minimum projected five-year time period.~~
- 4.1.2 Revenue requirements will be established using the "cash basis" methodology. The "cash basis" methodology includes O&M expenses, taxes/transfer payments, debt service (P+I) and capital improvements (renewal and replacement) funded from rates. The revenue requirements may include a component for change in working capital/rate stabilization funds to manage reserve balances and mitigate rate impacts.
- 4.1.3 Costs shared across utilities shall be allocated to each utility based an equitable allocation method. These may include, but not be limited to, labor ratios, number of customers, revenues, usage etc. The allocation method should be whichever method most equitably allocates the specific cost.
- 4.1.4 Any wholesale increases imposed upon the City by a water supplier or wastewater treatment agency will be reviewed for financial/rate impacts.
- 4.1.5 The City's revenue requirement analysis shall fully incorporate the City's reserve, debt and budgeting policies.
- 4.1.6 The City's goal is to project revenue requirements for a minimum of five years into the future.**

4.2 Cost of Service Analysis

A cost of service analysis provides an equitable method to allocate the City's water and sewer revenue requirements to the customers utilizing the service. The City's cost of service analysis for the water utility shall use generally accepted cost of service methodologies as defined by the American Water Works Association (AWWA) and the analysis developed for the City's sewer utility shall use cost of service methodologies as defined by the Water Environment Federation (WEF). The City's water and sewer cost of service shall be developed to provide an equitable allocation of costs by taking into consideration a customer group's (e.g. residential, commercial) facility requirements and usage characteristics. The City's specific cost of service policies are as follows:

- 4.2.1 The cost of service shall be developed for a projected one-year time period or the period over which rates will be set, utilizing the revenue requirements as developed in 4.1.
- 4.2.2 The cost of service analysis shall be designed and developed to consider the unique and specific circumstances of the City's water and sewer system.
- 4.2.3 The City shall allocate costs to customer class of service based upon facility requirements and usage characteristics.
- 4.2.4 When necessary, the City may phase-in the cost of service results to transition to fully-cost based rates.

4.3 Rate Design Analysis

The development of cost-based rate designs concludes the City's rate setting process. The development of rate designs utilizes the results from the revenue requirement and cost of service analysis to establish the target level of revenues for each customer class of service (rate schedule). The City's rate design analysis is primarily focused on the structure of the rates. The City's rate design analysis policies are as follows:

- 4.3.1 The City shall utilize the results of the revenue requirement analysis and cost of service analysis in the development of final proposed rate designs.
- 4.3.2 Rates shall be designed to collect the overall target level of revenues for each customer class of service.
- 4.3.3 The City's rate designs shall be reflective of the City Council's rate design goals and objectives, while also being reflective of the greater public purpose (e.g., economic development, conservation, etc.).
- 4.3.4 The City shall take into consideration both fixed and variable costs in the development of final proposed rates. The average unit costs calculated within the cost of service analysis provides the cost-information related to fixed and variable costs.
- 4.3.4 Bill comparisons shall be developed for all proposed rate designs to illustrate the general impacts to customers across a range of consumption.
- 4.3.5 In establishing the final water and sewer rates, the City's Council may take into consideration neighboring utility rates, but not to the financial detriment of the City.

4.4 Other Rate Setting Considerations

Provided below are other policies related to the City's rate setting process.

- 4.4.1 At a minimum, the City shall conduct a comprehensive rate study every five (5) years to update assumptions and determine financial sustainability.