November 7, 2019

GFOAT – Fall Conference

Financial Well Being Beyond Utility Rates – A Check Up on Financial Policies and Other Fee Considerations
Agenda

1. Overview of Financial Policies
2. Key Metrics and Indicators
3. Potential Impact on a Utility’s Credit Rating
4. Other Fees and Charges
5. Questions and Wrap-up
Regular Check-Ups are Important

• Take a long-term view
• Assess regularly
• Identify issues early
• Leads to better health and longevity
Policy Administration

• Develop a dynamic financial planning tool which measures and monitors key metrics established in the financial plan
  – Use scenario analyses to test and establish the adequacy of reserve funding levels
  – Use reserve balances to stabilize rate path forward
Common Financial Policies

- Debt Service Coverage (Retail Systems)
- Capital Funding • Debt vs. PAYGO
- Liquidity Ratios • Working Capital • Operating Reserves
- Customer Affordability
- Revenue Stability
Running on Empty Does Not Feel Good!
Fitch Statement about Policies

“A utility’s credit rating is more likely to be enhanced by policies and targets that are achievable and adhered to by management, as opposed to those that are stronger but are either not likely to be reached or would adversely affect other credit fundamentals if maintained”

**Policy impact on customers must be assessed**
Current Ratings Rationale Examples

- Fitch Ratings excerpt (AAA DFW Metroplex Issuer)

  “The city’s prudent management team has implemented various fiscal policies, including the maintenance of financial reserves for capital outlays and rate stabilization, which have historically contributed to positive financial performance and robust liquidity levels”
Fitch Metrics (Debt Service Coverage)

**Stronger**
- DSC of 2.0x or greater
- Rate Covenant of more than 1.25x coverage of ADS by net revenues

**Mid-range**
- DSC of approximately 1.5x
- Rate Covenant of 1.15x – 1.20x coverage of ADS by net revenues

**Weaker**
- DSC of 1.25x or less
- Rate Covenant of 1.10X or less coverage of ADS by net revenues
Fitch Metrics (Liquidity)

**Stronger**
- Days cash equal to 1 year or more
- Days working capital equal to 1 year or more

**Mid-range**
- Days cash equal to 6 months
- Days working capital equal to 6 months

**Weaker**
- Days cash equal to 3 months or less
- Days working capital equal to 6 months or less
Rating Agency Opinion

• Fitch Ratings Criteria
  – Best Management Practice – “Policies to ensure appropriate financial margins, including debt service coverage and operating liquidity levels.”
  – “Highly rated utilities set goals for appropriate financial margins”

• S&P Ratings Criteria – Financial Management Assessment
  – “Generally, higher-rated entities will, over time, develop ‘best practices’ that not only serve as guiding rules of thumb (or actual codified policies) . . . but also ensure logical rhyme-and-reason to decisions that are being made”
Current Ratings Rationale Examples

• Standard and Poor’s excerpts (AA DFW Metroplex Issuer)
  – “Strong financial management, as the city has a number of policies and best practices that should support a consistent financial performance in the future. It is also a key in maintaining the current rating…”
  – “The city maintains most of the best practices deemed critical to supporting credit quality…Formal policies support many of these activities…These include regularly updated long-term financial and capital plans, monthly budget-to-actual reports available on the city’s website, and robust policies on debt management and permitted investments”
• Moody’s keys factors:
  – Cost recovery framework within service territory
  – Willingness and ability to recover costs with sound financial metrics
  – Management of generation risks
  – Competitiveness
  – Financial strength
    • Liquidity
    • Leverage
    • Operating resiliency
Policy Overview – How Do You Compare to Others?

- Comparisons and ratings:
  - Meaningful, but remember caveats
    - Meet your needs
    - Consider risk profile
    - Other policies
    - How calculated
### Debt Service Coverage Ratio

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>75th percentile</td>
<td>4.29</td>
</tr>
<tr>
<td>Median</td>
<td>2.34</td>
</tr>
<tr>
<td>25th percentile</td>
<td>1.67</td>
</tr>
</tbody>
</table>

- Margin of safety ratio associated with bonded indebtedness
- May 2019 Moody’s Statement for Water and Sewer Utilities Sector: “Debt service coverage remains healthy at a median just above 2.0...”
## Days of Working Capital

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Value</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>75th percentile</td>
<td>209</td>
<td>Days</td>
</tr>
<tr>
<td>Median</td>
<td>367</td>
<td>Days</td>
</tr>
<tr>
<td>25th percentile</td>
<td>586</td>
<td>Days</td>
</tr>
</tbody>
</table>

- Liquidity measure; ability to meet obligations
- Many considerations and variations on calculation; i.e. may or may not include depreciation, annual capital outlays, uncollectible expense
### Days of Cash on Hand

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>75th percentile</td>
<td>598 Days</td>
</tr>
<tr>
<td>Median</td>
<td>321 Days</td>
</tr>
<tr>
<td>25th percentile</td>
<td>183 Days</td>
</tr>
</tbody>
</table>

- Revenues available for potentially adverse conditions and future needs
- May 2019 Moody’s Statement for Water and Sewer Utilities Sector: “Days cash on hand rose to a median of 447 in 2017 from 420…”
Weighing It All....

- “Lifestyle Choices”
- “Family History”
- Preventive “Screenings”
Other Sources of Revenue -- User Fees
User Fees and Charges Overview

- Purpose is to fund services
- Often benefit only a particular group; equitable assessments
- Include both direct and indirect costs for full cost of providing service
- Periodically review and update
- Public involvement and notification options
One Reason to Assess Fees Regularly...
Benefits of User Fees

• Aid in management of utility’s strategic direction and financial position

• Revenues useful in establishing financial stability

• May aid meeting capital funding needs

• May be useful in shaping behavior
Is a Specific Fee Warranted?

- Frequency of occurrence
- Existence of reliable data/estimates
- Effort justified by revenues
- Allowable under laws and statutes
Legal and Ethical Considerations

• Fees should reimburse only what it costs to run the program (provide the service) and bear a reasonable relationship to the cost so as to avoid being found an “unauthorized tax”
  – The fee must be related to the benefit received
  – The fee must be charged only if the service is used
  – The revenues from the fee must be earmarked; used only to cover expenses associated with the service provided
Legal and Ethical Considerations -- GFOA Recommendations

- Consider applicable laws and statutes
- Adopt / align with formal policies regarding fees & charges
- Utilities need to understand the customer impact of policies and balance policies with overall policy goals
- Value in regularly evaluating and updating other charges and fees
Documenting Reasonableness of Fees

• Evaluate the cost before establishing or raising fee

• Cost of service analysis
  – Labor Costs (fully loaded)
  – Directs Costs (materials, supplies)
  – Internal Indirect Costs (Administration of program)
  – External Indirect Costs (Central Services support)
  – Units of service performed to derive per unit cost
Common User Fees Related to Utilities

- Permitting and Inspection Fees
- Credit Card fees
- Drainage fees
- Impact fees
- Drought surcharge fees
- Connection / disconnection fees
- Fire hydrant/construction meter fees
- Bulk water fees
- Tap fees
- Backflow testing fees
- NSF fees
- Right of Way rental fees (Franchise fees)
Indirect Cost Allocation

- Central Services support Enterprise Fund, other departmental operations
- Examples of Central Services: Planning, Purchasing, HR, Accounting, Information Technology
- Identify indirect O & M costs incurred on behalf of other departments
- Provide quantified data for bases for allocation
- Useful for User Fee development as well
Conclusion

• Formal financial policies can result in better financial and utility management and a better credit rating
• Better ratings can reduce long-term borrowing cost
• Utilities need to understand the customer impact of policies and balance policies with overall policy goals
• Value in Regularly Evaluating and Updating Other Charges and Fees
Questions?
Resources for Additional Information

- TML Manual “Revenue for Texas Cities”
- AWWA Report “2018 AWWA Utility Benchmarking; Performance Management for Water and Wastewater”
- Water Environment Federation “Financing and Charges for Wastewater Systems; Manual of Practice No. 27”
- ICMA “Capital Budgeting and Finance: A Guide for Local Governments”
- GFOA “Determining the Appropriate Levels of Working Capital in Enterprise Funds”