RAFTELIS

Memo

To: Sarah Buckelew, Finance Officer, City of Fair Oaks Ranch
From: Angie Flores, Project Manager, Raftelis
Date: July 16, 2021
Re: Financial Policy Review

Introduction

The City of Fair Oaks Ranch (City) engaged Raftelis Financial Consultants, Inc. (Raftelis) to review the City's financial policies and provide observations and recommendations for the City's Financial Policy update. The focus of this financial policy update includes:

- Debt financing policies – review and evaluate the City's current method(s) and practices for financing the City's long-term debt. Policies related to funding sources, bond issuance timing and terms, interest rates, debt service structuring, debt service reserve funding practices (cash, bonds, etc), debt service coverage requirements and other issues will be reviewed with recommendations provided to enhance these practices, as deemed appropriate.
- Operating, emergency and capital reserves – review and evaluate all current reserve policies for funding operating (working capital), emergency (contingency) and future capital improvements (major infrastructure repair and replacement) needs. Provide recommendations to the City regarding changes to reserve target levels and annual contributions that better meet the needs of the City..
- Rates and Charges – review the City's rates and charges policies. Provide recommendations for rate stability, revenue stability, affordable essential use, equitability and water conservation incentives.

This memo summarizes the observations and recommendations resulting from Raftelis's analysis of the City's financial policies and recommendations to address key elements of the City's objectives.

Summary

Utility financial policies can help ensure long-term stability so that the utility is able to maintain operations when unexpected problems arise. Financial policies can also guide future financial and rate decisions. Since each utility has unique operations and service characteristics, financial policies should be tailored to the utility's circumstances. A utility's financial policy document is often reviewed by credit rating agencies and is considered a utility best management practice. Certain aspects of the document may help enhance the City's rating and ensure that there is a continuous stream of revenue for debt service.

Financial policy documents can have several elements and the utility's financial policy document can be a part of the City's overall comprehensive financial policy document. The document typically addresses cash reserves, debt-related policies, accounting, capital and rate policies. In the overview below, Raftelis considers best practices for the utility.

Overview of Best Practices

Raftelis reviewed industry best practices related to utility financial strength. A key source of industry best practices related to financial metrics are bond rating agency criteria scorecards. The three primary bond rating agencies include Moody's, Fitch, and Standard and Poor's (S&P). Each rating agency publishes rating criteria or scorecards used specifically for rating water and wastewater utilities. In addition to the bond rating agencies, the Government Finance Officers Association (GFOA) publishes best practices for the government management sector.

All water utilities face the inherent industry risk related to revenue volatility. Some agencies experience a higher level of revenue uncertainty depending on their distribution of fixed versus variable rate revenue. In the City's case, revenues are collected via a minimum charge, a tiered volumetric charge, a fixed surface water fee, a fixed Texas Commission on Environmental Quality (TCEQ) fee, a fixed Debt Service Fee, and a fixed Capital Reserve Fund Fee. As a part of the engagement with the City, Raftelis analyzed the revenue associated with each of these fees and how they impact key financial metrics for the City.

Evaluating financial sustainability involves two key financial performance metrics: unrestricted fund balance as a % of utility operating expenditures, and debt service coverage.

Unrestricted Fund Balance as a % of Utility Operating Expenses is a common measure of liquidity. It is a measure of the ability of the utility to deal with unanticipated declines in revenue or emergency expenditures without reducing service quality or dramatically increasing rates. It is determined by dividing the dollar amount of unrestricted fund balance by projected operating expenditures. It is not uncommon for utilities to maintain balances much higher than this minimum. Utilities with the strongest ratings from debt rating agencies (S&P, Fitch and Moody's) frequently maintain balances of 100% of annual operating expenses. The City's operating reserve is typically the equivalent to the unrestricted fund balance.

Debt Service Coverage is a measure of a utility's ability to support ongoing operations and repay bondholders, with room to spare. A typical ratio is calculated by dividing net revenues (revenues, less operating expenses) by annual principal and interest payments. A ratio above 1 indicates that current net revenues (operating revenues less expenses) are sufficient to meet current debt service obligations with room to spare for unforeseen emergencies. A ratio of less than 1 would mean that the utility does not have sufficient current revenues to cover operating expenses and meet debt service payment obligations. Debt Service Coverage targets are often defined in the City's bond documents.

Establishing and maintaining reserves is an important part of utility financial management. Historically, operating reserves have been the primary means for utilities to account for any lag

between expenses incurred and revenues received. Other common reserves include capital/construction/depreciation reserves and bond reserves. Emerging trends in the water industry include additional reserves to address revenue stability concerns through a revenue stabilization fund. Lower consumption results in lower revenue from volumetric rates. The number of reserves maintained by a water utility to address revenue instability should correlate to the potential volatility of rate revenues. It is important to note, that if a governing body elects to fund such a reserve, in years where the reserve is tapped to cover any shortfall in revenues, rates would need to be adjusted in the following rate setting period to restore the reserve with contributions. This allows the utility to draw on the fund balance in years when revenue is lower than projected due to lower consumption.

When assessing a utility's financial health, and specifically its ability to handle revenue volatility and meet current obligations, the reserve levels, and their corresponding liquidity ratios, are the best measure of financial strength. Liquidity can be measured by a utility's level of unrestricted cash available to fund operating, capital, and other expenses including unforeseen or emergency spending. Industry associations and rating agencies measure the financial strength of utilities based on liquidity metrics, including days cash on hand and days working capital. Both metrics assess the utility's liquidity, or financial flexibility to pay term debt. Specifically, days cash on hand is a measurement of the number of days the utility could continue to operate if it were to suddenly cease collection of revenues. The measure of working capital indicates the relatively liquid portion of the utility's capital, which constitutes a margin or buffer for meeting obligation. The formulas for each metric are as follows:

1) *Days Cash on Hand (DCOH):*

$$DCOH = \frac{Unrestricted\ cash\ and\ liquid\ investments}{Opertating\ and\ maintenance\ expenses\ less\ depreciation} \times 365$$

2) *Days Working Capital (DWC):*

$$DWC = \frac{Current\ assets - Current\ liabilities}{Operating\ and\ maintenance\ expense} \times 365$$

Industry Best Practices

A key consideration in the development of financial targets and policies for use in the multi-year financial plan is industry best practices. Two sources of financial best practices in the water and wastewater utility industry come from bond rating criteria scorecards and the GFOA. Each best practice source is discussed in detail below.

Bond Rating Agency Scorecards

Rating agencies recognize the significant risk inherent to water and wastewater utilities. As Fitch states[1], "numerous factors can cause financial volatility, including variations in water supply, weather related demand and economic cycles. Highly rated utilities set goals for appropriate margins, including debt service coverage, debt affordability, and reserve funding (rate stabilization, R&R, operating), and set rates that comply with these goals. Utilities operating in areas especially prone to rainfall volatility that consider the effect of such variability on their revenues and establish financial cushions or rate structures to deal with potential weather events are considered stronger than those that do not consider such risks."

The rating agencies quantify liquidity for local government utilities by comparing available cash (excluding debt service reserve amounts) to annual cash O&M expenses, or days cash on hand. Additionally, S&P reviews the actual cash balance when assessing a utility's risk profile, recognizing the economy of scale benefits recognized by larger utilities.

The following three tables summarize the three rating agency liquidity scorecard metrics - days cash on hand and actual cash balance.

Moody's Rating Scorecard						
Financial Target	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B and below**
Days Cash on Hand	> 250	250 - 150	150 - 35	35 - 15	15 - 7	< 7

Fitch Rating Scorecard			
Financial Target	**Stonger**	**Midrange**	**Weaker**
Rating	*(AAA)*	*(AA)*	*(A and Below)*
Days cash on hand	> 120	75	< 60

S&P Rating Scorecard						
Financial Target	**1**	**2**	**3**	**4**	**5**	**6**
Days cash on hand	> 150	150 - 90	90 - 60	60 - 30	30 - 15	< 15
Cash Balance	> $75 MM	$75 - $20 MM	$20 - $5 MM	$5 - $1 MM	$1 - $0.5 MM	< $0.5 MM

The ratings agency thresholds for the strongest score vary from 120 to 250 days of cash on hand. The days cash on hand is just one factor of many that go into determining a utility's bond rating but is nevertheless useful for establishing reserve best practices. The average of the three strongest thresholds equals approximately 180 days.

rating agencies complete due diligence on utilities across the U.S. when they are issuing debt. The rating agencies' recommendations are designed for credit investors, but their guidelines are used across the utility industry as a benchmark. Both utilities that plan on issuing debt and those that do not plan on issuing debt use these standards to guide their financial decision making. Utilities that do not plan on issuing debt must rely more heavily on cash financing. The highly rated credit

[1] Fitch Ratings. U.S. Water and Sewer Rating Criteria, November 30, 2017

recommendations emphasize high cash reserve levels, which relate directly to utilities that most rely on cash financing.

Government Finance Officers Association

The GFOA's published best practice of working capital targets for enterprise funds is relevant to the City. An enterprise fund in governmental accounting is a fund that provides goods or services to the public for a fee that makes the entity self-supporting, meaning no subsidization from a general fund. GFOA recommends that governments adopt a working capital target for enterprise funds. A working capital target is a measure of an enterprise fund's liquidity and ability to meet obligations. The calculation is equal to current assets minus current liabilities, expressed in days of operating expenses.

Specific considerations for calculating working capital include the utility's collection process, and only current assets that are anticipated to be realized in cash in the next year should be included in the calculation.

GFOA recommends starting with a baseline working capital target of 90 days of annual operating expenses (which includes depreciation expense) and adjust based on characteristics of the utility. As an absolute minimum, GFOA recommends 45 days of working capital. Additionally, GFOA best practices suggest segregating reserves for specific purposes, such as a capital reserve fund.

The GFOA lists the following considerations for adjusting the 90 days working capital target:

- Support from local government
    - If the enterprise fund is supported by taxes or transfers from general government, the target may be adjusted down.
- Transfers out
    - If the enterprise fund is expected to make transfers to general government, higher levels of working capital may be warranted.
- Cash cycles
    - Volatile cash position throughout the year may warrant higher working capital targets. Water utilities are used as an example in the GFOA best practices standard, pointing out that they may have higher cash positions in the summer compared to winter, when higher consumption volumes result in higher revenue in summer months. These higher summer revenue months are in turn when the utility is at the most risk for revenue volatility, as high rainfall can drive down outdoor irrigation consumption. Also, the length of the billing cycle may warrant an adjustment in working capital.
- Demand for services
    - The level of volatility in demand. While water is relatively stable as it will always be necessary to customers, the amount used by the customers, however, can fluctuate greatly from year to year.
- Asset age and condition

    - Enterprise funds with newer and/or well-maintained assets may be able to adjust working capital target down but will still need capital emergency reserves.
- Volatility of expenses
    - The more stable expenses, the lower working capital target can be.
- Control over expenses
    - High fixed costs, such as the proposed annual debt service expenses, warrant a higher working capital target.
- Management plans for working capital
    - If there are internally restricted funds, even though they may be reported as unrestricted on balance sheet, a utility may want to adjust these values out of the calculation to be conservative.
- Separate targets for operating and capital needs
    - Highly capital intense enterprise funds should consider designating operating and capital reserves separately.
- Debt position
    - Highly leveraged enterprise funds with variable debt service payments may warrant higher working capital targets.

Observations and Recommendations

Raftelis evaluated the City's current Financial Management Policy (Policy), most recently updated on Seeptember 2021. The Policy is a comprehensive document that defines the City's various financial requirements including Accounting and Financial Reporting, Internal Controls, Budgeting process and Reserve targets. Raftelis would consider the City's Policy as meeting the recommendation of GFOA and industry standards. In this section we provide a few observations where the policy may be enhanced to meet the unique circumstances of the Fair Oaks Ranch utility.

Operating Reserves

As stated above, the industry best standard is to have on average of 180 days of cash on hand. The City currently exceeds this requirement. Currently, as will be discussed below, the City recovers most of its revenues through fixed fees, which would imply that revenue volatility is low due to this. Still, the City has 634.8days of cash on hand, which indicates a healthy reserve. The City's policy defines its operating reserve target at one year. [2]

Debt Service Coverage

The City currently has a debt service coverage requirement according to its bond covenants. There may be a desire to have a coverage target above 1.00 times to generate cash to fund future capital and repair and replacement.

Debt Service Reserve

Debt service reserve requirements are typically defined in bond covenants. These requirements range from maximum annual debt service or an average annual debt service payment. The City's policy states that the reserve should include a minimum amount equal to the City's principal and

[2] Section V.B.1 of the City's Financial Management Policy

interest payment. The City is currently meeting this requirement. As more debt is issued, the City should consider the impact of this reserve if it is to be cash-funded.

Rates and Charges

Revenues are currently collected via a minimum charge, a tiered volumetric charge, a fixed surface water fee, a fixed Texas Commission on Environmental Quality (TCEQ) fee, a fixed Debt Service Fee, and a fixed Capital Reserve Fund Fee. As a result of this structure, over 70% of the City's revenue is collected via fixed fees. This provides a revenue stability but can hurt the City's objectives of customer impact and essential use affordability while not sending clear pricing signals (such as conservation) to rate payers. To properly provide recommendations, Raftelis looked at the rate structure, pricing objectives and industry standards to determine what changes the City may want to consider.

Fees

Observation: As mentioned above, the City charges a number of fees in addition to the typical volumetric and minimum charge fees that appear on every bill. These fees include:

Water

- Surface Water Fee: The cost of water distributed by the Guadalupe-Blanco River calculated in dollars per one-thousand gallons' time 6,000 gallon minimum.
- TCEQ Fee: The annual TCEQ water fee divided by number of service connections the month the payment is made to TCEQ
- Trinity Glen Rose Groundwater Conservation District: The ratio of total monthly water produced divided by total monthly water billed times the TGRGCD prevailing rate per thousand gallons.
- Debt Service: The water portion of the total bond payment (including principal and interest) in the upcoming fiscal year divided by number of service connections as determined on June 1st.
- Capital Reserve: The budget goal divided by number of service connections as determined on June 1st.

Wastewater

- TCEQ Fee: The annual TCEQ wastewater fee divided by number of service connections the month the payment is made to TCEQ
- Debt Service: The wastewater portion of the total bond payment (including principal and interest) in upcoming fiscal year divided by number of service connections as determined on June 1st.
- Capital Reserve: The budget goal divided by the number of service connections as determined on June 1st.

These fees provide a level of revenue stability by charging fixed amounts per bill. It is not uncommon to have fees to recover specific amounts of the revenue requirement. Based on our current analysis and discussions with City staff, these amounts are not currently being separated into specific funds to pay for the costs associated with the fees, which would be a GFOA best practice.

Additionally, the master plan for the City is projected to increase debt service dramatically over the next several years which may make the debt service fee unaffordable going forward. Major projects such as the new wastewater treatment plant are projected to more than double the City's current level of debt service which can pose rate shock and essential use affordability issues to rate payers.

Recommendation: It is recommended that the fee structure is simplified going forward. Revenues from fees associated with specific expenses should also be segregated into a separate fund to make sure they are being used for the intended purpose. We recommend that the debt service fee, Trinity Glen Rose Groundwater Conservation District Fee and Surface Water Fee be recovered in the minimum charge and volumetric charges instead of recovered in separate fees. Changes to the rate structure would enable the City to still accomplish the objective of revenue stability while simplifying the overall rate structure.

It is recommended that the Capital Reserve Fee continue to be charged separately. The revenues from this fee should be put into a separate Capital Reserve to be used for new projects along with repair and replacement projects. The financial planning model can be used to forecast uses for this fund. This separate reserve is considered a GFOA best practice.

Rates

Observation: A well-stated rate policy describes the cost of service underpinning the rates and gives a timeframe for rate increases. A stated rate policy defining the general timing of rate decisions gives stakeholders the ability to easily plan for rate changes. Regularly updating and reviewing rates allows utilities to plan for future capital expenditures and adequately cover costs. The City's current policy states that there will be an "annual review of fees and charges to ensure that fees provide adequate coverage of costs of services."[3]The City may consider providing more details in this section in addition to the annual review. One consideration would be the addition of a cost-of-service analysis being completed at least every five year to ensure equity of cost recovery between classes.

The development of reasonable rates and pricing must start with the premise that all expenditures including operating expenses, maintenance, debt service, and non-debt financed capital additions will be covered. However, beyond the coverage of costs, the reasonable rate goal may include factors such as competition and essential use affordability concerns. Additionally, rates must be set to maintain adequate financial reserves. These financial reserve objectives are laid out in the beginning of this memo and the objective should be consistent with industry best practices.

Conclusion

Recommendations for reserves and working capital have not significantly changed over the years. Having reserves and cash on hand that are needed to maintain the financial soundness of the agency remain important. Industry-standards provide a framework for meeting the goals of the City. In developing any new short-term or long-term goals, the City should consider how current policies

[3] Section VII.H of the City's Financial Management Policy.

are performing. If current policies are not being met, it must be understood why that is occurring. Changes in policy must have attainable goals and objectives.