STAFF REPORT

DATE: November 20, 2019

TO: Utilities Commission

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SUBJECT: Enterprise Fund Reserve Policy

Recommendation

1. Review components of Utilities Commission Reserve Fund Subcommittee proposed methodology for enterprise fund reserve calculations and receive comments from staff on proposed UC methodology versus industry standards; and
2. Receive substantive information from discussion at Finance and Budget Commission (FBC) on Thursday, November 14; and
3. Review staff comments on methodologies on the reserve funds for each of the City's four utilities; and
4. Consider recommendation of methodologies to present to Council for review and adoption in January 2020.

Brief Recap of Enterprise Reserve Fund Development

As detailed in the staff report to the Finance and Budget Commission on November 14, 2019 (Attachment 1), and in the staff report to the UC on October 16, 2019, the process to develop a recommendation for enterprise fund reserve methodology has been marked by some confusion. Specifically, mixed direction from staff in regards to the intended involvement of each commission to develop a recommended methodology, and which commission should take the lead on the discussion, has complicated the process.

After some review over the past month, staff returned to the FBC on November 14 to request that the discussion within the FBC refocus to the specific questions presented in March of 2019, when the original UC recommendation on methodology came before the FBC. The recommendation stated "*...the URAC recommends to the FBC, in their consideration of the reserve policy, to look at the best way to cover reserve funds (including, but not limited to, the possibility of insurance or credit line) and to look at the merits of a sinking fund for large infrastructure projects*."

The original intent for this process was for the UC to craft a draft policy methodology recommendation for each of the City's four utility funds (Water, Wastewater, Solid Waste and Stormwater), receive input on the policy from the FBC, and then collaborate with staff (Utilities and Finance) on policy recommendations for Council consideration. The intent of staff is to proceed with this originally developed process.

Utilities Commission Subcommittee Recommendation

In February of 2019, the Utilities Commission formally approved the recommendations on reserve fund methodologies as presented by the subcommittee on Reserve Fund Policies. The method of achieving the values for those methodologies is described in detail below:

The reserve fund calculation for each of the four enterprise utilities is defined by the following calculation:

A + *max value of* [B or C] + D

Where:

A	B	C	D
(OPERATING EXPENSES)	**(VOLATILITY MEASURES)**		**(DEBT COVERAGE)**
3 Months of operating expenses (not including debt service)	The highest annual shortfall between revenue and expenditures (*Calculated from historical data as the 95th percentile of the distribution of annual expenditures minus the 5th percentile of the distribution of annual revenues*)	The highest disparity between annual budgeted Capital Improvement Project (CIP) expenditures, and actual expenditures (*Calculated from historical data as the most extreme amount by which actual annual cost of capital improvement projects exceeded the budgeted CIP cost*)	Debt coverage required for the utility based on outstanding loans and demonstrated ability to repay

(Whichever of the values is greater)

Finance and Budget Commission Discussion

At their meeting on November 14, the FBC did not make any formal recommendations in regards to the Utilities Commission methodology. Informal feedback included the desire for the calculation of the volatility reserve to be simplified, to ensure that the community at large could understand the methodology as well; a discussion about the need for reserves for the utility funds at all; and the indication that the FBC expressed interest in returning to the discussion of utility fund balances in the near future, outside of the policy discussion. The FBC also indicated that a shared definition of terminology of financial matters would also be beneficial. Should future recommendations regarding utility fund balances be made by the FBC, staff would return to the UC for discussion. Any of these discussions would be in the future, after the enterprise reserve fund policy has been established.

Analysis

Each element of the recommended methodology will be reviewed in greater detail and compared to industry and staff recommendations.

Operating Expenses

The Utilities Commission has recommended the reserve methodology include a set-aside for operating expenses, which are unrestricted assets that can support the utility in the event of loss of revenue, unanticipated increases in expenses, or working capital deficiencies, minimizing as much as possible the short-term impact of these events on the utility ratepayer.

Industry standard calculations for operating reserves are generally between 3-6 months of annual operating expenditures. The Utilities Commission has recommended 3 months of annual operating expenses for this portion of the calculation, and staff agree that the calculation is appropriate for the utilities. One complicating factor is the Solid Waste Utility, which is over 80% contract costs for Recology Davis, and is the only fund that does not have a capital component. Having separate calculations of the utility does not appear to make sense for a single fund comprised of only contract and operating costs. Initial recommendations from staff calculated the operating reserve portion of the Utilities at 15% of annual operating expenditures *minus* contract costs, which put the operating reserve at a little over $100,000. The UC recommendation also proposed that the working reserve for Solid Waste included three months of annual operating expenditures, minus the contract costs. Given the fund recovery focus of the current 5-year Proposition 218 rate structure for the Solid Waste utility, and the upcoming state-wide regulatory changes to organics processing (with currently unknown utility cost impacts), shorter term recommendations may be a wise approach.

In lieu of a separate calculation for rate variability, staff would ask the Commission to consider proposed methodology to calculate the Solid Waste operating reserve at either 6 to 12 months of annual operating expenses minus contract costs. This methodology would equate to between $600,000 to $1.1M and would capture unforeseen needs related to regulatory changes, impacts related to climate, and establish a rate stabilization within a single calculation. At 12 months, the reserve could also buffer changes requested by the City's hauler or service adjustments directed by Council. Future check-ins on the status of the Solid Waste fund (annually with the Commission and Council) could offer opportunities to re-evaluate the reserve components and adjust as necessary, as the fund's fiscal health improves.

Volatility Measures - Rate Stabilization or Capital Reserve

Perhaps the area of greatest disparity in recommendation, and of robust discussion, is the concept of a "volatility reserve," and/or a "rate stabilization reserve," which includes a capital reserve component in the UC methodology. These types of reserves reflect the goal of keeping service levels and cost as consistent as possible within the utilities, while recognizing the unpredictability inherent in utility operations. Significant regulatory changes (with infrastructure or staffing level investments necessary), catastrophic events, significant and unforeseen demand reduction, revenue shortfalls and other unanticipated events or needs can significantly impact a utility's operations, as well as impact the rate paying customers in sharp rate increases to cover associated costs. A volatility reserve, or rate stabilization reserve, helps to buffer the initial impact of the unpredictable occurrence, and allows for a smoother increase (if necessary) in rates to account for the costs.

The challenge with volatility measures is that there is no one method to calculate the necessary reserve amount, when or if a volatility reserve is warranted. The accounting is inherent to the utility and that utility's operations, utility service type, and other unique characteristics. For some jurisdictions, the Stormwater Utility may be consistent and predictable, while the Solid Waste Utility is subject to high fluctuations in costs associated with landfill fees. Or, a Water Utility may only need rate stabilization to offset potential ratepayer impacts of short-term debt repayments, where a Wastewater Utility is undergoing significant and comprehensive regulatory requirement changes and needs major construction work to meet the new standards. Due to these variations, the comparison to industry standard (outside of rate stabilization measures, which are becoming more standard) does not apply in this methodology recommendation.

The Utilities Commission recommended methodology for the volatility measures is presented as a calculation. The input to establish a savings target associated with volatility is whichever of the two are larger: the differential between annual expenditures and annual revenue, or, the highest differential between annually budgeted CIP costs and the annual expenditures, when calculated from historical data. The calculation appears to aim to individualize the methodology as much as possible for each utility, letting the greatest financial impact (in expenditures and revenue, for those utilities more likely to be impacted by rate fluctuations, or in necessary CIP work, for those utilities impacted by infrastructure needs) be part of the equation.

However, the inclusion of historical data when considering necessary reserve components for utilities can be problematic. Utilities with major structural and operational changes (for example, the current Wastewater Utility operations, versus the operations from seven years ago) could end up with reserve calculations based on factors no longer applicable to that utility, and could be artificially too high, or too low, as a consequence. Utility operations are often a practice in the art of living in the moment.

Staff would request consideration of the following reserve criteria to replace the volatility component of the UC recommendation, a combination of rate stabilization and emergency capital coverage.

Rate Stabilization

For rate stabilization, the staff recommendation is along the lines of a (burgeoning) industry standard, 5% of total annual operating revenues for the Wastewater and Stormwater utilities, and 10% of annual operating revenues for the Water utility. Water utility recommendations are based on the dual challenges of operating a water utility in California, a state prone to recurrent drought, and having a rate structure weighted to more than 80% volumetric. The calculations for each element of the reserve are based on actual City data, and likely reflect costs more relevant to current utility operations.

Emergency Capital

For emergency capital reserves, staff would recommend a straight forward approach of averaging the 5-year CIP budget projections (minus debt financed projects) for Water, Wastewater and Stormwater. This provides for a reserve based on planned asset rehabilitation or replacement in current utility operations. As previously indicated, historical differences in planned vs. unplanned CIP work may not accurately reflect actual reserve needs, as both the water and wastewater funds had balances well above current reserve targets. For example, staff, concurrent with previous UC recommendations, recommended to use these funds to "pay as you go" for some CIP work completed. The net effect of this drawdown was a larger than normal "unplanned" use of funds, as prioritization of work for future years (at the time the budgets were established) was not as critical a factor for rate setting purposes.

Debt Coverage

Although debt coverage is included in the calculation of utility reserve funds as recommended by the Utilities Commission, recent discussions with Finance staff have indicated that it will likely be the practice moving forward to separate debt coverage and debt service payments from non-restricted accounts. Staff does not recommend including the debt coverage within the reserve fund methodology for this reason.

Reserve Calculation Frequency

In the discussion of formalizing the reserve fund methodology for each utility, the Commission is also asked to provide input on the *frequency* of making the reserve fund calculation. While annual calculations would perhaps capture more quickly fluctuations or changes in the reserve based on each utility, it is unlikely that the adjustments would have a significant enough affect to rates to impact customers within the 5-year rate period. Staff recommends the reserve calculation take place every five years, during the cost of service study for each utility, and be set for the 5-year rate term.

Alternative Methodology to Consider

As discussed within the report, each of the alternative methodologies under consideration are listed below:

Reserve Element	Description/Methodology
Operating Reserve	3 months of annual operating expenses 6-12 months of annual non-contractual operating expenses for Solid Waste
Rate Stabilization Reserve	5% of annual revenues for Wastewater/Stormwater/Solid Waste 10% of annual revenues for Water
Emergency Capital Reserve	Average of 5-year CIP program projections for Wastewater/Stormwater/Water

Next Steps

Should the UC provide their recommendations for reserve methodologies, staff will prepare a staff report based on feedback and the Commission recommendations for Council review. If an

additional Commission discussion is necessary, the Commission can add the item to the Long Range Calendar for December and staff will return with a summary of the recommendations and feedback. With three cost of service studies (Stormwater, Water and Wastewater) currently underway or beginning soon, staff are preparing to present recommended methodologies to Council in January.

Attachment

1. Finance and Budget Commission Staff Report (November 14, 2019)