

DATE: October 10, 2019
TO: Finance and Budget Commission
FROM: Nitish Sharma, Finance Director
Kiran Sanghera, CPA, Financial Analyst
SUBJECT: Draft Utility Reserve Policy Presentation

Recommendation

It is respectfully recommended that the Finance and Budget Commission receive the final draft of the Utility Reserve Policy as prepared by the Department of Finance.

Fiscal Impact

No fiscal impact; however, a solid reserve policy allows the City to mitigate against the unforeseen expenditures or a decrease in the revenues.

Council Goal(s)

N/A

Background and Analysis

The purpose of establishing this reserve policy is to ensure the financial resilience of the utilities department and to adhere to best practices within the industry. The finance department has researched and reviewed industry guidelines/practices in the development of the Utility Reserve Policy. Finance worked with Stan Gryczko, Utilities director, to ensure the reserve policy met their requirements. Stan made suggestions and provided industry standards to set target amounts. The Utilities department will present the reserve policy to URAC for review.

Next Steps:

A copy of the draft policy shall be provided by the Public Works Department- Utility and Operations management staff to the Utilities Commission for their guidance/directions. Once the final draft is complete after incorporating the comments from the both Commissions, the Finance department will present the policy to City Council.



**CITY OF DAVIS
WATER, WASTEWATER, SOLID WASTE, AND STORMWATER FUND RESERVE POLICY**

1. PURPOSE

The purpose of this policy is to establish targeted levels of Water, Wastewater, Solid Waste and Stormwater Utility fund reserves, a crucial component in the financial resilience of public owned utilities. Strong and transparent financial policies, including maintaining adequate reserves for emergencies, rate stability, and working capital, are consistent with best practices in the utility industry, as they help to:

- 1) Ensure cash for daily financial needs to counter revenue volatility and unanticipated expenses is readily available
- 2) Fund equipment and infrastructure purchases to mitigate damages related to a catastrophic event such as a natural disaster
- 3) Protect constituents from rate increases due to unexpected variances from forecasted results that arise from non-recurring events or factors

2. BACKGROUND

The City of Davis Public Works – Utilities and Operations Department provides water, wastewater, stormwater and solid waste services for citizens, businesses, and organizations. Public owned utilities are expected to provide uninterrupted service 24 hours a day, 7 days a week while relying largely on service-based revenue. As highlighted by the American Water Works Association, cash reserve balances are a critical component to the utility's financial resiliency and sustainability. Aging infrastructure is a critical issue materializing for the water-resources and sewer industries. The repairs for water, wastewater, and stormwater tend to be costlier than easily accessible infrastructure due to underground and complex infrastructure.

3. DEFINITIONS

Operating Reserve: liquid, unrestricted assets that an organization can utilize to support its operations in the event of an unanticipated loss of revenue, working capital deficiencies, or an increase in expenses. The City Manager shall have authority to approve appropriation of Operating Reserve funds.

Emergency Capital Reserve: Funds reserved in this category shall be used to mitigate costs associated with capital purchases due to unforeseen emergencies, including natural disasters. Should unforeseen and unavoidable events occur that require expenditure of City resources beyond those provided in the annual budget, the City Manager shall have authority to approve appropriation of Emergency Reserve funds. The City Manager shall then present to the City Council -no later than its first regularly scheduled meeting after the emergency – a resolution confirming the nature of the emergency and formally authorizing the appropriation of Emergency Reserve funds.

Rate Stabilization Reserve: Rate stabilization reserves are established to cover wide fluctuations in projected revenue from season to season or year to year. A rate stabilization reserve allows a utility to draw on the fund balance during revenue shortfalls that result from lower than expected revenue. Use of the Rate Stabilization Reserve funds will only take place in the context of a rate setting analysis as presented to the City Council.

4. POLICY

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The policy illustrated below is the framework established for the Water, Sewer and Storm Water fund. The City Treasurer shall review the reserve balance framework on an annual basis and provide any updates as deem appropriate to the Finance and Budget Commission, Utilities Commission and the City Council.

Reserve Type	Key Considerations	Policy	Methods to Achieve Funding Levels
<p style="text-align: center;">Operating</p>	<ul style="list-style-type: none"> • Revenue fluctuations • Working capital • Potential risks • Risk management • Daily financial needs • Operating expenditures 	<p>Industry standard is 3 to 6 months in reserves. We seek to maintain a target 3-month reserve balance.</p>	<p>At the end of each fiscal year, the Finance Department will report on the audited year-end budgetary results. Should the Utility funds revenues exceed expenditures and encumbrances, an operating surplus shall be reported.</p>
<p style="text-align: center;">Emergency Capital</p>	<ul style="list-style-type: none"> • Cost of critical assets • Critical facilities • Catastrophic events such as natural disasters • Availability of other funds • Address unanticipated, nonrecurring needs. 	<p>Seeks to maintain one-year of annual depreciation expense as a reserve balance as stated in the Comprehensive Annual Financial Report (CAFR)</p>	<p>At the end of each fiscal year, the Finance Department will report on the audited year-end budgetary results. Should the Utility funds revenues exceed expenditures and encumbrances, an operating surplus shall be reported.</p>
<p style="text-align: center;">Rate Stabilization</p>	<ul style="list-style-type: none"> • Impacts of revenue shortfalls • Drought restrictions • Revenue volatility • Weather • Regional economic conditions • Rate variability • Sharp demand reduction 	<p>Minimum target balance of 5% of operating of operating revenue for Stormwater and Wastewater. Minimum target balance of 10% of operating revenue for Water.</p>	<p>At the end of each fiscal year, the Finance Department will report on the audited year-end budgetary results. Should the Utility funds revenues exceed expenditures and encumbrances, an operating surplus shall be reported.</p>

SOLID WASTE RESERVE FUND POLICY

The City of Davis Solid Waste Division is responsible for recycling, garbage, organics collections, street sweeping, and landfill tipping. Eighty-six percent of the total cost in the fund is a franchise agreement with the waste hauler and the other fourteen percent accounts for state mandated programs, city administrative costs related to operations, and debt service requirements. To ensure the fiscal sustainability of the fund, it is recommended that the reserve levels be set to fifteen percent of ***noncontractual*** expenditures. Noncontractual expenditures are defined as expenditures relating to obligations not expressed in a contract.

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Solid Waste Reserve Policy

Reserve Type	Key Considerations	Policy	Methods to Achieve Funding Levels
<p>Operating</p>	<ul style="list-style-type: none"> • Revenue fluctuations • Working capital • Potential risks • Risk management 	<p>We seek to maintain a target 15% of non-contractual expenditures as reserve balance.</p>	<p>At the end of each fiscal year, the Finance Department will report on the audited year-end budgetary results. Should the Utility funds revenues exceed expenditures and encumbrances, an operating surplus shall be reported.</p>

CITY OF DAVIS FINANCE & BUDGET COMMISSION
FUND BALANCE, DEBT, REVENUE SUBCOMMITTEE

September 25, 2019

To: Mr. Nitish Sharma

Cc: Ms. Pam Day
Members of the Finance & Budget Commission (via Ms. Pam Day)
Members of the Utility Rate Advisory Commission

Subject: Draft Utility Reserve Policy

Dear Mr. Sharma:

Purpose

- We would like to thank you for the opportunity to review the draft Utility Reserve Policy.
 - We wish to express our support for a written policy.
 - Based on our review and research, we would like to recommend the following clarifications and changes to the draft policy:
- 1) We recommend clarifying whether the reserve policy recommendations are for the Enterprise funds in the aggregate, or separately to each Enterprise fund.
 - It was unclear whether, for example, whether the draft policy called for a total Emergency Capital reserve of \$2 million in total, or \$2 million for each fund (\$8 million or \$10 million if the Public Transit fund is included).

Response from Finance Staff:

This issue was addressed by separating different components of the utility fund including solid waste. The Water, Sewer, and Storm Water fund will be governed by the same principles within each reserve type. Solid Waste will be governed by an alternative methodology. The policy now accounts for emergency reserves to one year of the audited annual depreciation expense. Public transit fund is a special revenue fund and any shortfall in this fund is covered by the reserve amount set-aside in the General Fund.

- 2) We recommend clarifying whether the proposed policy includes the Public Transit fund.
 - We note that due to the unique structure of the city's public transit system (i.e., the relationship with Unitrans) that this fund is often excluded from discussions of the other Enterprise funds (Water, Sewer, Storm Sewer, and Sanitation).

Response from Finance Staff:

Public transit fund is a special revenue fund and any shortfall in this fund is covered by the reserve amount set-aside in the General Fund. This policy is to solely establish reserves for the Utility funds.

- 3) We recommend updating the policy to include a Capital replacement policy.
 - Over time, capital expenditures will likely exceed expenditures for operational fluctuations, emergency repairs, and rate stabilization combined.
 - Annual depreciation (i.e., the reduction in value of assets due to the passage of time, typically due to wear and tear) for the Enterprise funds totaled more than \$7.7 million per the 2018 CAFR – more than the combined proposed reserves.
 - As such, a policy that excludes these expenditures is significantly incomplete.
 - Broadly, the two primary options for capital equipment replacement are to:
 - a. "Pay As You Go": Reserve the expected replacement cost prior to the expected replacement.

- b. "Debt Financing": Use debit financing at the time of need and repay these costs over the life of the newly acquired asset.
- To the degree that "Pay As You Go" is implemented, the reserved funds would be available to fund required operational volatility, emergency, or rate stabilization expenditures.
 - Reserves expended for these purposes could then be replaced with a surcharge or other temporary revenue measure.
- A long-term multi-year plan should be established to identify the estimated expenditures and timing for capital repairs, replacements, expansions or other major expenditures for any assets funded by the Enterprise funds.

Response from Finance Staff:

The purchase of debt through the reserve will need additional analysis and council approval. We will not pursue this item until guidance from the sub-committee is received. The multi-year plan will take time to complete and we will pursue this option under the guidance of the new finance director.

4) We recommend a discussion of the economic cost of holding a reserve.

- The interest received on fund balances has, in the last several years, been minimal – typically less than 1.0%.
- Alternative uses for these funds (i.e., paying off debt or paying pension/OPEB liabilities) typically has a far greater return or expected return of 2% to 4% for debt and 6%+ for long-term pension/OPEB investments).

Response from Finance Staff:

Staff is not proposing this policy change; the cost of service study determines the payment of City's long-term liabilities related to pension and other post-employment benefits.

5) We recommend a more thorough evaluation of alternatives to specific reserves noting:

- a. A Bank Line of Credit could provide significant funding for operational fluctuations at a cost of (typically) 0.10% to 0.25% of the available balance annually.
 - While there would be some additional initial loan fees, given that the city has a stable financial structure and decades of audited statements, an evergreen or very long-term facility should be available, thus allowing the cost of the line to be amortized over a lengthy period.
- b. Insurance can offset unexpected damage:
 - We note that:
 - i. California State law requires insurers to effectuate prompt, fair, and equitable settlements of claims and to otherwise process claims in a fair and reasonable manner. [California Insurance Code Section 790.3 (h)]
 - ii. Insurers are required to respond to claims within 15 days of submission [California Code of Regulations Title 10, Chapter 5, Section 7.5, Section 2695.5]
 - iii. Insurers are required to respond to accept or deny claims within 40 days [California Code of Regulations Title 10, Chapter 5, Section 7.5, Section 2695.7]
 - iv. Insurers are required to respond to tender payment or otherwise fulfill their claim obligation within 30 days [California Code of Regulations Title 10, Chapter 5, Section 7.5, Section 2695.7]
 - As the total time (15 days + 40 days + 30 days totaling 85 days at maximum) for claim payment is less than three months, other funds would be required only to "bridge" expenditures until claim payment – a much lower amount than inferred during the presentation.

Response from Finance Staff:

Staff will further evaluate these options once we have some financial details related to bank financing or other short-term borrowings. It is important to note that the City is self-insured up to a certain amount and the reimbursement process could be far greater than 85 days. The industry standard is to maintain reserve balances to offset any issues that may arise.

- c. Inter-fund borrowing from other fund reserves/surpluses or capital reserves could be used to fund immediate needs and then replaced, as required, with an appropriate revenue measure.
- We note the city policy to hold a 15% general fund reserve.

Response from Finance Staff:

The policy established by the City Council states that the City shall maintain a reserve fund balance with a minimum of 10% to maximum of 15% of the General Fund expenditure budget.

- We note that both 28 C.F.R. §§ 35.150(a) (3) and 35.164. specifically state that a public entity is not required to take any action that would result in an undue financial or administrative burden.

Response from Finance Staff:

The policy does not present any undue financial or administrative burden; however, it does achieve the goal of maintaining a prudent reserve balance to mitigate against revenue losses, extraordinary event, and future rate increases. This policy has been updated to account for depreciation and capital expenditures. By setting reserves to one year of annual depreciation expense, we have funds readily available to address or at the very least commence repairs while more funding is secured.

7) We recommend omitting rate volatility reserves noting:

- The combined Water and Sewer funds compose more than two-thirds of the Enterprise Funds, and customer usage of water and sewer service is completely correlated.
- The city's purchase of rights to Sacramento River water provide a constant supply of water protected by law.
- Since the water supply is constant, the only things that would reduce usage would be:
 - a. Mandatory water rationing
 - b. A significant change in technology
 - c. A significant ongoing change in population
 - d. A significant ongoing change in business activity
- In any case where usage drops sharply, it would seem logical to immediately respond with a temporary or permanent rate increase that would correlate with the external cause (vs. a future increase well after the cause).
- The American Water Works Association report provided noted that "Where these conditions [drought restrictions and variable weather impacting water sales] are less prevalent, maintaining not rate stabilization reserve or a lesser amount than other areas where these factors are more prevalent may be appropriate".

Response from Finance Staff:

We will seek additional direction from Utilities Commission on this subject and will further conduct further analysis in conjunction with the costs of service study.

8) We recommend that the reserve policy be expanded to define the usage of excess funds.

- Rather than being held as, effectively, cash and earning a minimal rate of return, such funds should be used to:
 - a. Fund necessary capital repairs, upgrades, replacements, or other major expenditures.
 - b. Reduce or retire debt (2% to 4% effective return)

- c. Reduce or eliminated any unfunded pension or OPEB expenditures (expected long-term return of 6%+)

This may be addressed in more detail in future cost of service studies.

- 9) In the event that an emergency or other infrequently accessed reserve be established, we recommend that the City purchase some portion of existing or newly issued City debt with these reserves.
 - Purchasing the city debt would:
 - a. Avoid net interest costs (since interest would be paid to the City)
 - b. Be saleable in the event the funds were required (since the debt would have already been through the necessary registrations, filings, etc.)
 - c. Provide a much more significant return to the reserve (2%+ bond yield) vs. <1% for cash and cash-like reserves.

Response from Staff:

This will require a change in policy by the City Council and staff will not pursue this further until direction from the Council sub-committee is received.

Actions Requested

We recognize that some of the changes here will require additional fiscal analysis to determine their efficacy and we recommend that any necessary analysis be performed. If it is determined that these actions will result in fiscal savings or greater efficiency, we recommend the following:

- We ask that the changes and additions listed above be incorporated into the Reserve Policy.
- We ask that the revised policy incorporating these changes be reviewed with the Finance & Budget Commission prior to submission to the City Council.

We would be happy to meet with you and/or to discuss or answer any questions that you or your staff may have regarding these recommendations.

Thank You,

Donna Neville

Ray Salomon

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