Utility Fiscal Policies

Background

In 1993 the Utility Board and staff worked closely to establish financial policies to guide future rate and budget decisions. In 2006 the Utility Board reviewed and modified the financial policies related to the Water Utility. The financial policies analysis consisted of identifying, describing, and to the extent possible, evaluating impacts of various elements of the policies. Elements discussed included types and levels of utility reserves, methods of capital improvement funding, methods of capital replacement funding, rate structure and equity, and related objectives such as water conservation.

The fiscal policies, which have been approved by the Utility Board, consist of four major categories that are briefly described below. A complete copy of the policies is included on the following page.

A. Reserves

This section sets the policy for the amount of operating reserves necessary. Sewer and Storm Water operating reserves are set at 30 days of operating expenses while water is set at 90 days (due to the greater seasonality of revenue). The need for a capital replacement reserve is also discussed and the format for establishing such a reserve is fixed.

B. Financing

A policy is set that capital replacement projects will be financed from the replacement reserve established in the reserve section. It also discusses the concept of financing most improvements on a pay-as-you-go basis; however, consideration must always be given to the effect of the rate impacts on customers. It proposes that for projects estimated to cost $2 million or more other financing alternatives should be considered.

C. Revenue Requirements

This section summarizes and formalizes our policies to set rates sufficient to meet all utility cash requirements including operating expenses, debt service, and additions to reserves and capital costs. It also reflects the policy to set rates to meet any bond or other debt covenants.

D. Rates and User Charges

There are two policies established in this section. The first policy concerns water conservation. It establishes that the City wishes to promote water conservation and will set water rates that reflect that policy. The second policy concerns the concept of a “lifeline rate” to provide basic water and sewer services at an affordable level. The lifeline rate works with the water conservation volume based structure to provide low levels of water usage at the lowest cost.

Budget Policies for 2019-2020

- Propose rates for the Utilities that reflect the financial policies adopted by the Utility Board.
- Perform annual rate updates for each of the utilities (Water, Sewer, and Storm Water). For preparation of the biennial budget, rates are also forecast for the second year of the biennium.
Fiscal Policies for Water and Sewer Enterprises

This document is to be read in conjunction with the Level of Service Standards established for the Water and Sewer Systems. Together they form the basis for 1) the updating of the Comprehensive Plans for both Water and Sewer through the end of the decade; 2) the Capital Facilities Plan prepared as part of the City’s Comprehensive Plan in response to the Growth Management Act; and 3) the biannual operating plans for each utility. It is intended that these policies be reviewed periodically; at the minimum each time either the Utility’s Comprehensive Plan is updated or when the Capital Facilities Plan is updated.

A. Revenue Requirements

1. Cash Needs

   Each utility will establish rates sufficient on an annual basis to meet all utility cash requirements including operating expenses, debt service, additions to reserves and rate-funded capital costs.

2. Coverage

   Each utility will establish rates sufficient to meet all security conditions of outstanding debt, including any bond coverage requirements. Typically bond covenants require a minimum coverage factor of 1.25, although the City may elect to establish a higher factor in order to enhance its potential bond rating. Should the coverage requirement result in a revenue requirement in excess of cash needs, the budget shall identify the use, transfer or addition to reserves intended for the surplus. Such cash surplus cannot be used to meet operating expenses.

If debt is jointly issued, or issued under conditions pledging all utility revenue, the debt service will be allocated to the water or sewer utilities based on the use of bond proceeds, and the coverage requirement will be allocated to each utility based on their share of the debt service.

B. Rates and User Charges

1. Rate Equity

   The City will establish rates and charges, which equitably recover the cost of service from each utility’s customers. Changes in rate structure will be accompanied by a cost of service analysis justifying the equity of such changes. Rate structures considered will, to the extent practical and equitable; incorporate other rate objectives as defined in these policies.

2. Conservation

   The City wishes to promote efficient and conservative use of water. Therefore, water and sewer rates will, to the extent practical, promote water conservation through an emphasis on volume-based charges and allocation of the cost of meeting peak demands to those users imposing the cost.

3. Lifeline Rates

   The City wishes to provide water and sewer service to meet basic human needs at an affordable level. Therefore, rate structures should consider the opportunity to maintain reasonable water and sewer bills at lifeline usage levels. Features such as volume-based sewer charges, increasing block water rates, and low fixed service costs among others help to promote this objective.
C. Reserves

1. Operating (Working Capital) Reserve

It is appropriate to maintain sufficient cash reserves to accommodate routine fluctuations in revenues and expenses. The City therefore establishes operating reserves for the water and sewer utilities. Utility budgets will target ending cash balances sufficient to meet the reserve targets. The following operating reserves are established:

- Sewer - 30 days of operating expenses (8.2% of annual operating budget)
- Storm Water - 30 days of operating expenses (8.2% of annual operating budget)
- Water - 90 days of operating expenses (24.7% of annual operating budget)

(utility Board increased the water reserve during the 2006 water cost of service study)

The water reserve has been established at a higher level than sewer and storm water to reflect the greater seasonality of revenues and to protect against reduced water sales in wet years or during restrictions.

Should the operating reserves for either utility fall below the target level, or should the target level be increased, additions to the reserve will be budgeted to reach and maintain that level within no more than two budget years.

2. Capital Improvement Reserve

It is considered that both the water and sewer utilities are completed to their capacity and that it is not required or prudent to establish a reserve for capital improvements.

There are, however, water and sewer systems now existing on Mercer Island which are not part of the City Utilities. It is the Board’s recommendation not to incorporate those other systems into the City Utilities unless those systems meet the performance standards established for the City’s water and sewer utilities.

3. Capital Replacement Reserve

It is prudent to protect the City’s multi-million dollar investment in utility assets. The City therefore establishes a capital replacement reserve and funding strategy. These reserves should enable the City to support future replacement needs without extraordinary rate increases, while recognizing the responsibility of existing customers to fund both current and future replacement needs on a regular basis.

It is intended that all replacement projects that are to be funded on a pay-as-you-go basis be funded from the appropriate replacement reserve. This requires that the City carefully plan and schedule replacement projects so that the integrity of the replacement reserve is maintained.

The following capital replacement reserve is to be maintained:

Water: 1-2% of original asset value (this formula was originally recommended as 1% by the Utility Board as part of their 2006 Water Cost of Service Study). The reserve is to be funded by excess revenue in high water use years, and not by raising rates. As of 2019, the Capital Replacement Reserve is 2% of original asset value.
Sewer: Same formula. As of 2019, the Capital Replacement Reserve is 2% of original asset value.

4. **Contingency (Emergency) Reserve**
   It is not considered necessary to establish a separate reserve for the Sewer and Storm Water Funds to handle emergency situations in addition to the replacement reserve. It is considered prudent however that the capital replacement reserve not be scheduled to be less than $100,000. Should situations arise where the replacement reserve does drop below that level due to an emergency, the reserve level should be restored to at least the minimum level within the following budget year.

5. **Bond Reserves**
   It is an obligation of the City to meet reserve requirements of bonds and loans, which it uses for utility purposes. It is the policy of the City to fully fund such reserves as required by bond covenant or loan agreement.

D. **Financing**

1. **Capital Facilities Planning**
   Due to the impact of capital costs on rates and charges and due to the variation in funding levels needed over time, each utility will establish and maintain a capital projects schedule of at least six years in duration. Said schedule will be consistent with the Utility's Comprehensive Plan. This schedule will include project description, scheduled year of construction and total estimated cost. Each project will be identified as an improvement project or a replacement project (including repair and rehabilitation). If projects provide both improvement and replacement benefits, then the schedule will include an appropriate allocation of project costs to the two categories and then use the criteria below for the allocated portions.

2. **Improvement Projects**
   Improvements to the system shall be scheduled and budgeted with consideration of the rate impacts that may result. It is the City's intent to make such improvements without the issuance of new debt, except when opportunities for below market rate loans may arise. However, in the case of projects involving a capital outlay of $2 million or more, the City will evaluate alternatives including phasing, deferral or debt financing as methods to mitigate rate impacts.

3. **Replacement Projects**
   Replacement projects are normally to be funded from the replacement reserve. However, for projects where the funding need exceed $2 million per year, the City will evaluate alternatives to total rate funding to mitigate rate impacts. Alternatives to be considered include phasing and/or deferral of projects or debt financing.