

**COUNCIL POLICY NO. C-14**

**TITLE:** UTILITY FUND FINANCIAL POLICY

**POLICY:** See attached.

**REFERENCE:** City Council Finance Committee Report dated 3/17/14, Agenda Item No. 3a; Public Works and Administrative Services Staff Report dated April 14, 2014, Agenda Item No. 3.3 (f); City Council Finance Committee Report dated November 21, 2016, Agenda Item No. 4a; Finance Division Staff Report dated December 12, 2016, Agenda Item No. 3.2a, Finance Committee Staff Report dated 2/20/2024, Agenda Item No. 4.a.

## Utility Fund Financial Policy

### **I. Introduction**

Salem provides water, wastewater, and stormwater services to all Salem residents. In addition, Salem provides water and/or wastewater services to Keizer, Turner, and unincorporated areas of East Salem, Jan Ree, Orchard Heights, Eola/Chatnicka, and Labish. Meeting the funding needs for the maintenance and reinvestment in each system is critical.

### **II. Purpose**

This policy establishes practices, which will guide forecasting, and rate proposal development for sound financial management of the Utility Fund (“the Fund”). To this end, this policy will include the establishment of operating and debt reserve levels, a subordinate debt coverage ratio, capital funding strategies, and a defined schedule for financial planning, modeling, and rate cases to support Fund management.

### **III. Scope**

This policy applies to the Fund including water, wastewater, and stormwater utility revenue and other associated fees and charges.

### **IV. Related Financial Policies**

Debt Management, City Council Policy C-2

Budget and Revenue Policies, City Council Policy C-8

General Fund Balance/Reserve Policy, City Council Policy C-11

### **V. Policy Statement**

For the purposes of developing the biennial rate proposal and preparing the annual budget, the following shall be modeled and maintained in forecasting:

1. Debt Reserve shall be fully funded as required by the Master Water and Sewer System Revenue Bond Declaration and/or Policy.
2. Reserves for Full Faith and Credit obligations shall be funded at one year of outstanding debt service, equivalent to highest single year of total Full Faith and Credit debt service payment.
3. Operating Reserve equal to 120 days of operating expenditures shall be fully funded.
4. Parity and subordinate coverage ratios will be maintained as required by the Master Water and Sewer System Revenue Bond Declaration with calculations included in the

Annual Comprehensive Financial Report.

5. An expense ratio (expenditures/revenues) shall be maintained at or below 100 percent over the long-term. As long as financial projections stabilize or improve in future years, the Fund may use reserves in the short-term.
6. Capital funding allocations are to increase over time as debt service is retired. The long-term goal is to increase annual funding for capital projects consistently until the level approaches one percent of total asset value.
7. The Fund shall be managed either in aggregate with the revenue slope applied uniformly to each utility or separately, where a revenue slope for each utility service may be established independently.
8. A financial plan and rate proposal shall be prepared and presented to Council biennially in even numbered years. A Cost of Service Analysis (COSA) update shall be prepared every four (4) years.

**VI. Use of Contingency/Reserves (in usage order):**

1. Contingency funds may be used for unanticipated expenditures that are either operating or capital in nature. When the contingency is sufficiently funded, most issues can be addressed without a supplemental budget.
2. Capital Reserve may be accumulated and used for a specified project purpose. Retention and identification of these funds as they are accumulated provides transparency in financial planning efforts.
3. Operating Reserve is held as a best practice and to enhance bond ratings. The City of Salem includes the amount reserved for rate stabilization in the calculation (120 days of operating expenditures) of total Operating Reserves. The Operating Reserve may be used when consumption declines, or there is a revenue shortfall so significant that net revenue (after operating expenditures) is insufficient to meet debt coverage requirements as stated in the Master Water and Sewer System Revenue Bond Declaration. The Operating Reserve may be used in lieu of an immediate mandatory rate increase.
4. A Debt Reserve is established for payment of the final year of debt service based on the amount specified in the debt service schedule; usually calculated as the highest year of annual debt service. The purpose is to protect bondholders from an insufficiency of funds to pay debt service resulting from a sharp decline in consumption or revenue. For the

protection of the General Fund, this policy establishes the requirement of a debt reserve for full faith and credit debt equivalent to the highest annual payment of this debt.

## Glossary

**Beginning Working Capital**—Funds available at the beginning of a fiscal year representing the sum of debt reserves (both required by covenant and by policy), operating reserves, capital construction reserves, unused contingency, and unrestricted fund balance. These resources may or may not be budgeted for expenditure.

**Capital Reserve**—Accumulation of funds for a capital project(s). Funds may be held in the capital reserve until project(s) are budgeted and undertaken. The capital reserve shall not exceed one percent of the asset value. It is the Public Works Department's practice to retain unused capital funds in the Utility Fund rather than in a construction fund.

**Contingency**—Budgeted funds available during the fiscal year, with the approval of City Council, for unanticipated expenditures.

**Cost of Service Analysis (COSA)** – The process of determining the cost of providing utility service to each of the defined customer classifications. This includes the functionalization and allocation of system revenue requirements followed by the distribution of costs by customer classification based on usage, peak demands, and customer-related costs for which each class of service is responsible.

**Coverage Ratio**—Calculation comparing net revenue (total revenue less operating expenditures) to total annual debt service on parity bonds. Net revenue/parity debt service = 1.25 minimum as required by the Master Water and Sewer System Revenue Bond Declaration adopted resolution of City Council.

**Debt Reserve**—Amount, equivalent to highest single year of total debt service payment, to be set aside for debt service on revenue bonds in the event of a revenue shortfall. The reserve ensures a year of payments is available until a rate increase, or other financial solution, may be implemented to balance the fund. Debt reserve requirements are typically stated in the Master Water and Sewer System Revenue Bond Declaration.

**Full Faith and Credit**—Bonds issued by the City of Salem on behalf of the Fund and backed by the General Fund. Although identified as an obligation of the Fund, the Master Water and Sewer System Revenue Bond Declaration does not require a debt reserve for this obligation.

**Master Water and Sewer System Revenue Bond Declaration**—Legal document approved by City Council governing conditions for the sale of utility revenue bonds. The document establishes debt reserves, rate stabilization reserves, coverage ratios, and requirements for the issuance of additional debt.

**Operating Reserve**—Funds equal to 120 days of the annual operating expenditure budget. A 120-day reserve is considered “good” by rating agencies and should be sufficient in case of an emergency need for additional funds. The calculation does not include capital outlay, debt service, or contingencies. Operating Reserve includes Rate Stabilization Reserves as required by the Master Water and Sewer System Revenue Bond Declaration.

Parity Debt—Debt that has a first priority requirement to be paid with net revenue.

Rate Stabilization Reserve—The amount established in the Master Water and Sewer System Revenue Bond Declaration to be used in case net revenue is insufficient to meet debt coverage requirements. Per the Master Water and Sewer System Revenue Bond Declaration, if Rate Stabilization Reserve funds are required and used, the funds will be reclassified as revenue.

Rates—Individual fees and charges for each utility service based on customer class and service area. Annual rate adjustments for each fee may not match the overall revenue slope identified for the Fund.

Revenue Bond—Long term debt issued by the Fund and backed by utility sales revenue.

Revenue Slope—Projected change in combined revenue from all sources in the Fund.

Subordinate Debt—All debt other than Parity Debt, including loans or other obligations such as Full Faith and Credit bonds backed by the General Fund and issued on behalf of the Fund.

Total Debt Ratio—Net revenue less parity debt service divided by total subordinate debt service.

Unrestricted Fund Balance—Amount of fund balance or beginning working capital not specified for expenditure or reserves including debt reserve, capital reserve, operating reserve, or rate stabilization reserve.