

# FGFOA School of Governmental Finance

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## Best Management Practices: Strong Adopted Financial Management Policies

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# Financial Management Policies – General Topics



**Why Should Your Local Government Have Adopted Financial Management Policies?**



**Financial Targets**



**Financial Management Policies Document**



**Master Bond Resolution or Ordinance**



**Rate-Related Financial Policies**

# **Why Should Your Local Government Have Adopted Financial Management Policies?**

# Financial Management Policies Should Be Adopted By Governing Body

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- **Help Guide Future Financial and Rate Decisions**
- **Demonstrate to a Variety of Stakeholders That Local Government Is Being Transparent, Is Following Sound Financial Practices, and Has (Or Is Working Toward) Financial Stability**
  - **Show Rate Payers That Government Is Looking Ahead at Rate Demands and Has a Plan to Use Revenues to Accomplish Mission While Keeping Rates Affordable**
    - **Can Be a Tool to Explain the Value Received for the Services Provided and the Fees Charged**

# Financial Management Policies Should Be Adopted By Governing Body (cont.)

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## ■ Stakeholders (cont.)

- Demonstrate Fiscal Responsibility by Policy Makers / Members of the Governing Body and Help Them Defend Financial Decisions
- Provide Financial Clarity and Credibility to Lenders and Credit Rating Agencies, Leading to Higher Credit Ratings and Lower Interest Rates and Issuance Costs When Debt Financing
  - Lower Implied Financial Risk
  - Credit Rating Agencies May Give Government a Lower Financial Management Score If No Financial Management Policies Have Been Adopted

# Financial Management Policies Should Be Adopted By Governing Body (cont.)

## ■ Stakeholders (cont.)

- Provide Government Staff With Clear Direction on Financial Objectives
- Show Regulatory Agencies Offering Low-Cost Loans or Grants That Government Is Positioned to Respond to Regulatory Fluctuations for Compliance and Would Potentially Benefit from Financing Programs



# **Financial Management Policies Should Be Adopted By Governing Body (cont.)**

- **Best Management Practices: Willingness of Political Leaders to Adjust Taxes / Rates When Necessary**
  - **Adopted Financial Management Policies Can Help Demonstrate Willingness or Commitment to Increase Taxes / Rates**



# Financial Targets



# The Local Government's Credit Rating Is a Reflection of Management (\*)

- **Assessment of Financial Risk**
  - Management Has Limited Control Over Some Elements of Financial Risk (e.g., One Large Customer Accounts for 50% of Revenues)
- **Best Management Practices on Controllable Factors Help to Reduce Implied Financial Risk, and Can Lead to Lower Rates Over the Long Term**
  - Higher Credit Ratings, Lower Interest Rates, and Lower Issuance Costs When Debt Financing



(\*) Management Includes Governing Body

# Publications from Credit Rating Agencies Can Be Helpful in Developing Financial Targets and Other Financial Management Policies



- **Credit Rating Agencies Will Usually Freely Provide These Publications to Issuers That They Rate, and Your Financial Advisor or Rate Consultant May Also Have Copies**
- **Rating Agencies Will Typically Request Copies of Financial Management Policy Documents**
- **Rating Criteria Are Always Evolving**
  - Median Debt Service Coverage Ratios and Cash Balances Have Been Trending Upward

# **Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises**

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- **Many Financial Metrics, But Some Financial Ratios Are Especially Important for Credit Rating**
  
- **Some Key Financial Ratios:**
  - **All-In Debt Service Coverage**
  - **Senior Lien Debt Service Coverage**
  - **Days Cash on Hand (Cash as % of Spending for General Obligation Bonds)**
  - **Outstanding Long-Term Debt Per Customer and Per Capita**
  - **Free Cash as Percent of Depreciation**

# Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises

## ■ All-In Debt Service Coverage

- **Definition: Revenues Available for Debt Service (Usually Gross Revenues Less Operating Expenses Not Including Depreciation and Other Non-Cash Expenses) Divided By Total Debt Service (Senior Plus Subordinate Lien)**
- **Measures Financial Margin to Meet Debt Obligations**
- **Better Indicator of Enterprise's Overall Ability to Pay Its Debt Than Senior Lien Debt Service Coverage Alone**

# Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises (cont.)

## ■ All-In Debt Service Coverage (cont.)

- AA-Rated Enterprise May Have All-In Debt Service Coverage of 200% or Higher

- Fitch 2020 Water and Sewer Medians



	AAA-Rated	AA-Rated	A-Rated	All Credits
<b>All-In Debt Service Coverage:</b>				
Without Impact Fees	2.6	2.5	1.7	2.4
With Impact Fees	3.2	2.7	1.9	2.7
Net of Transfers Out	3.1	2.6	1.9	2.6
Minimum Projected	2.7	2.0	1.4	2.0
3-Year Historical Average	3.1	2.6	1.8	2.5

# Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises (cont.)

## ■ Senior Lien Debt Service Coverage

- **Definition:** Revenues Available for Debt Service Divided By Senior Lien Debt Service
- Measures Financial Margin to Meet Senior Lien Debt Obligations
- Ratio Less Than Requirement Per Enterprise's Rate Covenant Represents Technical Default That May Mandate Further Action, Such as a Rate Review
- Fitch 2020 Water and Sewer Medians

	AAA-Rated	AA-Rated	A-Rated	All Credits
Senior Lien Debt Service Coverage:				
Without Impact Fees	3.3	3.0	2.0	2.9
With Impact Fees	4.2	3.4	2.1	3.3
Net of Transfers Out	3.9	3.1	2.1	3.1
Minimum Projected	3.1	2.5	1.7	2.4
3-Year Historical Average	3.1	2.6	1.8	2.5

# Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises (cont.)

## ■ Days Cash on Hand

- **Definition: Unrestricted Cash and Investments Divided By Operating Expenditures Minus Depreciation, Divided By 365**
- **Measures Financial Flexibility to Pay Near-Term Financial Obligations**
  - **Utilities With Stronger Financial Profiles:  
Days Cash on Hand Equal to One Year or More**
- **Fitch 2020 Water and Sewer Medians**

	AAA-Rated	AA-Rated	A-Rated	All Credits
Days Cash on Hand	617	555	315	545

# Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises (cont.)

## ■ Days Cash on Hand (cont.)

- Cash Is King: Improving Enterprise's Cash Position and Having "Rainy Day Funds" = One of the Most Effective Approaches for Upgrading Credit Rating

## ■ For General Fund, AAA Credit May Have Unrestricted Cash Equal to 15% of Spending

- This Level Is Considered to Offer Excellent Level of Financial Resilience





# Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises (cont.)

## ■ Outstanding Long-Term Debt Per Customer Outstanding Long-Term Debt Per Capita

- **Definition:** Principal Amount of Debt Outstanding Divided By Number of Customers; Principal Amount of Debt Outstanding Divided By Number of Persons in Service Area
- Measures Debt Burden for Ratepayers
- Fitch 2020 Water and Sewer Medians

	AAA-Rated	AA-Rated	A-Rated	All Credits
Long-Term Debt Per Customer:				
Current	\$1,122	\$1,675	\$2,852	\$1,706
Projected Year 5	1,190	1,904	2,701	1,909
Long-Term Debt Per Capita:				
Current	\$322	\$511	\$784	\$492
Projected Year 5	307	530	762	511

# Some Key Financial Ratios Used By Credit Rating Agencies When Evaluating Enterprises (cont.)

## ■ Free Cash as Percent of Depreciation

- **Definition:** Current Surplus Revenues After Payment of Operating Expenses, Debt Service, and Operating Transfers Out Divided By Current Year Depreciation
- Measures Annual Financial Capacity to Maintain Existing Infrastructure at Current Level of Service from Existing Cash Flows
  - Utilities With Stronger Financial Profiles:  
Free Cash as Percent of Depreciation  $\geq$  100%
- Fitch 2020 Water and Sewer Medians

	AAA-Rated	AA-Rated	A-Rated	All Credits
Free Cash as Percent of Depreciation	131%	143%	127%	135%

# **Financial Management Policies Document**

# Financial Management Policies Should Be Adopted By Governing Body

- **Help Guide Future Financial and Rate Decisions**
- **Government Credit Ratings Have Sometimes Been Upgraded Shortly After Adoption of Financial Management Policies Document By Governing Body**
- **Some Financial Management Policies Documents Are More Comprehensive Than Others**
  - Local Government Can Decide Which Elements to Address in Financial Management Policies Document



# Financial Management Policies Should Be Adopted By Governing Body (cont.)

- **Should Consider Existing Financial Position, Dependence on Debt, and Ability to Meet Financial Targets**
- **Could Consider Specifying Incremental Steps in Financial Management Policies Document**
  - Example: 150% All-In Debt Service Coverage Financial Target in Fiscal Years 2024 and 2025; 175% in Fiscal Years 2026 and 2027; and 200% in Fiscal Year 2028 and Beyond
- **If Financial Targets Are Not Met in Given Year, Should Ideally Specify Timeframe for Improving Financial Position to Meet the Targets**



# Financial Management Policies Should Be Adopted By Governing Body (cont.)

- **No Need to Start from Scratch – Build from the Work of Other Local Governments!**
  - Financial Management Policies Documents Are Available Online
  - Can Incorporate Best Elements from Other Documents



# Financial Management Policies Should Be Adopted By Governing Body (cont.)

## ■ Possible Financial Management Policies:

- Bond Rating
- Cash Reserves
- Debt Service Coverage
- Debt Capacity
- Debt Refunding
- Project Funding
- Capital Reinvestment
- Automatic Rate Increases
- Budget
- Investment
- Rate Review
- Fixed Charge Recovery
- Impact Fees
- Transfers to General Fund
- Closed Fund
- Policy Updates



# Possible Financial Management Policies

## Document Element: PURPOSE

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### ■ Sample:

*These rate and financial policies provide direction for planning decisions and help ensure that the Department of Public Utilities provides for an adequate supply of safe, clean water to all customers efficiently, reliably, and at the lowest possible cost consistent with prudent utility management.*





# Possible Financial Management Policies

## Document Element: PURPOSE (cont.)

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### ■ Sample:

*The [insert local government name] recognizes that one of the keys to the long-term management of the water and sewer enterprise fund is the adoption of formal fiscal policies associated with the financial management and creditworthiness of the system. This view is supported by bond rating agencies, investors, and the Government Finance Officers Association.*

# Possible Financial Management Policies

## Document Element: GOALS / OBJECTIVES



### ■ Sample:

*These financial policies are primarily intended to help protect the enterprise fund's financial resources through:*

- *Formal adoption of industry-recognized best practices for utility financial management;*
- *Guiding the enterprise fund and its managers in the financial planning cycle and decision-making process;*
- *Establishing appropriate levels of operating and capital cash reserves and provide available funds for emergencies and extraordinary expenditures;*

# Possible Financial Management Policies

## Document Element: GOALS / OBJECTIVES

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### ■ Sample (cont.):

- *Developing a process to efficiently finance necessary capital improvements;*
- *Providing a framework for the enterprise fund to achieve and maintain a strong credit rating; and*
- *Maintaining reasonable and justified levels of rates and fees to promote the long-term sustainability of the enterprise fund.*

# Possible Financial Management Policies

## Document Element: DEFINITIONS

- **Definitions Promote Understanding of Terms Used in the Financial Policy Document**

- **Samples:**



*All-in Debt means all outstanding debt and long-term liabilities incurred for the financing of Capital Improvements, additions, renewals, replacements, and betterments to the system or to establish reserves as a condition of issuing the debt; or assigned by the [insert local government name] to be paid through system revenues.*

# Possible Financial Management Policies

## Document Element: DEFINITIONS (cont.)

### ■ Samples (cont.):

*Capital Improvements represent expenditures for utility plant additions, betterments, replacements, and upgrades which benefit future periods and are capitalized for financial reporting and cost recovery purposes; such amounts are not considered as Operating Expenses.*



# Possible Financial Management Policies

## Document Element: DEFINITIONS (cont.)

### ■ Samples (cont.):

*Capital Reserve represents the amount of cash, cash equivalents or investments for Capital Improvements to i) mitigate risks regarding unanticipated capital expenditures or increases in materials, labor, or other costs from ongoing or planned capital projects; ii) provide for changes in capital expenditure priorities resulting in the advancement or addition of certain capital projects; iii) promote the availability of funds for capital reinvestment for the existing infrastructure intended to limit outages and inability to provide service from equipment or infrastructure failures or as a result of force majeure incidents due to weather events and other occurrences; and iv) ensure reliable service and ameliorate the effects to monthly service rates from unanticipated costs.*

# Possible Financial Management Policies

## Document Element: DEFINITIONS (cont.)

### ■ Samples (cont.):

*Debt Service represents the annual deposits required from system revenues to a sinking fund, loan repayment fund, or its equivalent as required for the principal and interest payments made by the enterprise fund for repayment on outstanding indebtedness of the system. Debt Service includes general obligation debt assigned to the system.*



# Possible Financial Management Policies

## Document Element: DEFINITIONS (cont.)

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### ■ Samples (cont.):

*Debt Service Coverage is a requirement of [insert local government name]'s bond and loan agreements and represents the ratio of the Net Revenues divided by the Debt Service. The ratio indicates the ability of revenues, after the payment of Operating Expenses, to meet the annual Debt Service obligation. The financial policies target a coverage ratio above the minimum requirement to maintain a strong credit and to reduce the cost of future borrowings with the objective to provide for long-term rate stability and overall lower rates.*



# Possible Financial Management Policies

## Document Element: DEFINITIONS (cont.)

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### ■ Samples (cont.):

*Gross Revenues means the total revenues derived from the operations of the system and includes income from rates, fees, and charges; income on investments; and other revenues associated with the operation of the system. Gross Revenues does not include property and cash capital contributions and non-recurring fees such as government grants for capital, contributed utility plant and impact fees received by the [insert local government name] as part of the land development process.*

*Net Revenues means Gross Revenues less Operating Expenses.*

# Possible Financial Management Policies

## Document Element: DEFINITIONS (cont.)

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### ■ Samples (cont.):

*Operating Expenses means the expenses for the operation, maintenance, repairs, and replacements with respect to the system calculated in accordance with Generally Accepted Accounting Principles. Operating Expenses for purposes of compliance with these financial policies shall include transfers to the General Fund from the utility that recover the allocated cost of services provided to the utility by the General Fund (indirect cost reimbursement). Operating Expenses does not include depreciation and amortization expenses (non-cash expenses) or the payment of interest expense on outstanding indebtedness.*

# Possible Financial Management Policies

## Document Element: BOND RATING POLICY

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### ■ Samples:

*The [insert local government name] will strive to maintain an uninsured bond rating of "AA" or better for the combined water and wastewater utilities.*

**AA**

*Rates and charges will be maintained at a level consistent with an average credit rating of AA for the utility.*

# Possible Financial Management Policies

## Document Element: CASH RESERVE POLICIES

- **Recommended to Be Separated Into Operating / Working Capital and Capital Replacement Components**
- **Overall Objective Could Be to Maintain Unrestricted Cash Equal to 365 Days Cash on Hand or Higher**
  - **Consistent with Rating Agency Standards for Enterprise With Stronger Financial Profile**



**Days Cash on Hand = Unrestricted cash and investments divided by operating expenditures minus depreciation, divided by 365**

# Possible Financial Management Policies

## Document Element: OPERATING CASH RESERVE

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### ■ Sample Operating Cash Reserve Policy:

*The [insert local government name] will maintain a cash-funded operating reserve to provide adequate levels of working capital to i) mitigate current and future risks regarding revenue shortfalls and unanticipated expenses; and ii) ensure stable services and rates.*

*The [insert local government name] will maintain a minimum unencumbered and unrestricted operating reserve balance equal to 180 days of the current fiscal year budgeted user rate revenue.*

# Possible Financial Management Policies Document

## Element: OPERATING CASH RESERVE (cont.)

### ■ Sample Operating Cash Reserve Policy (cont.):

*If the operating reserve unrestricted balance at the end of the preceding fiscal year is less than the operating reserve target, the [insert local government name] will develop a plan to re-establish the operating reserves over a period not to exceed three (3) fiscal years.*



# Possible Financial Management Policies

## Document Element: CAPITAL CASH RESERVE

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### ■ Sample Capital Reserve Policy:

*The [insert local government name] will maintain a minimum unappropriated and unencumbered Capital Reserve equal to the prior year's annual depreciation expense.*

*The Capital Reserve will be in addition to the funds held on deposit for purposes of maintaining the minimum operating reserve.*

# Possible Financial Management Policies Document

## Element: CAPITAL CASH RESERVE (cont.)

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### ■ Sample Capital Reserve Policy (cont.):

*If the Capital Reserve balance at the end of the preceding fiscal year is less than the Capital Reserve target, the [insert local government name] will develop a plan to re-establish the capital reserves in an amount equal to the Capital Reserve target over a period not to exceed three (3) fiscal years.*



# Possible Financial Management Policies

## Document Element: DEBT SERVICE COVERAGE

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### ■ Sample Debt Service Coverage Policy:

*The [insert local government name] will establish rates, fees, and charges for services that will provide in each fiscal year Net Revenues which are greater than or equal to 200% of the annual All-in Debt service payment. The debt service coverage ratio shall be determined as follows:*

*Annual Net Revenues / Annual All-In Debt Service Payments from Net Revenues*

# Possible Financial Management Policies Document

## Element: DEBT SERVICE COVERAGE (cont.)

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- **Sample Debt Service Coverage Policy (cont.):**

*If the debt service coverage for a given fiscal year is less than the debt service coverage target, the [insert local government name] will develop a plan to meet the debt service coverage target over a period not to exceed three (3) fiscal years.*

# Possible Financial Management Policies

## Document Element: DEBT CAPACITY

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- **Some Local Governments Have a Separate Debt Management Document for Debt Issuance Policies, Including Types, Terms, and Suitability Under Specific Conditions**
- **Sample Debt Capacity Policy:**

*The outstanding principal amount of debt compared to the net fixed assets or utility plant investment of the system indicates how much the system has leveraged the cash flow of the enterprise fund for utility plant capital investment. The Debt Ratio presents the net equity of the System and provides an indication of the reliance on debt to fund existing assets as well as the flexibility in terms of funding future capital assets and overall rate stability. The [insert local government name] will maintain a Debt Ratio that will not exceed fifty percent (50%) during any year of the outstanding principal of the All-in Debt.*

# Possible Financial Management Policies

## Document Element: DEBT REFUNDING



### ■ Sample Debt Refunding Policy:

*The enterprise will consider the issuance of debt obligations to refund outstanding debt when market conditions indicate at least a 3% present value savings or when other management considerations, as recommended by the agency's financial advisors, indicate the refunding is appropriate.*

# Possible Financial Management Policies

## Document Element: PROJECT FUNDING

### ■ Sample Project Funding Policy:

*The enterprise shall:*

*Cash fund renewal and replacement capital projects and assets with estimated useful lives of ten years or less.*

*Fund renewal and replacement and extension and expansion capital projects and assets with estimated useful lives of over ten years by using debt or cash financing, depending on prevailing economic conditions.*



# Possible Financial Management Policies

## Document Element: CAPITAL REINVESTMENT

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### ■ Sample Capital Reinvestment Policy:

*The [insert local government name] will annually make a deposit into the Capital Reserve account and/or any other account established within the utility reserves to provide funds for the purpose of paying the cost of major extensions, improvements or additions to, or the replacement or renewal of capital assets, or extraordinary repairs of the system. The annual deposit to the established capital accounts may not be less than ten percent (10%) of the monthly user rate revenue for the preceding Fiscal Year. The deposit will be made annually from rates regardless of the level of Capital Improvement expenditures budgeted for the respective fiscal year and regardless of whether the balance in the Capital Reserve account is greater than or equal to the Capital Reserve target.*

# Possible Financial Management Policies Document

## Element: CAPITAL REINVESTMENT (cont.)

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- **Other Than a Percentage of Revenues, Minimum Deposits to Capital Reserve Account Could Also Be Based on:**

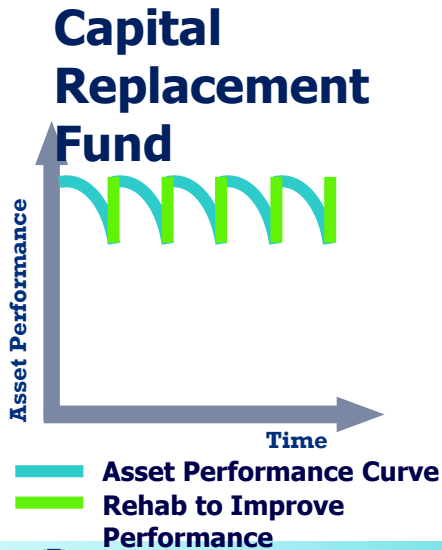
- **Prior Year's Depreciation Expense**
- **Asset Management Plan**

**DEPRECIATION**

**AMORTIZATION**

# Sample Asset Management Plan

Description	Estimated Replacement Cost [1]	Percent to Be Cash-Funded [2]	Amount to Be Cash-Funded	Asset Service Life (Years)	Annual Funding Amount [3]	In-Service Year	Replacement Year
Asset 1	\$1,000,000	50.00%	\$500,000	30	\$16,667	1996	2026
Asset 2	25,000,000	25.00%	6,250,000	30	208,333	2012	2042
Asset 3	6,000,000	25.00%	1,500,000	30	50,000	2017	2047
Asset 4	50,000	100.00%	50,000	10	5,000	2017	2027
Asset 5	25,000	100.00%	25,000	5	5,000	2020	2025
Asset 6	5,000	100.00%	5,000	5	1,000	2019	2024
Asset 7	3,100,000	25.00%	775,000	30	25,833	1993	2023
Asset 8	400,000	50.00%	200,000	15	13,333	2017	2032
Asset 9	250,000	50.00%	125,000	10	12,500	2020	2030
Asset 10	12,500	100.00%	12,500	5	2,500	2021	2026
<b>Total</b>	<b>\$35,842,500</b>		<b>\$9,442,500</b>		<b>\$340,167</b>		



Description	Fiscal Year Ending September 30,				
	2022	2023	2024	2025	2026
Starting Balance	\$3,648,000	\$3,988,167	\$3,553,333	\$3,888,500	\$4,203,667
Annual Contributions	340,167	340,167	340,167	340,167	340,167
Additional Contributions [4]	0	0	0	0	0
Expenditures (Cash)	0	775,000	5,000	25,000	512,500
Ending Balance	<b>\$3,988,167</b>	<b>\$3,553,333</b>	<b>\$3,888,500</b>	<b>\$4,203,667</b>	<b>\$4,031,333</b>

## Notes:

- [1] Includes allowance of 3% per year construction cost inflation.
- [2] Remainder to be funded from debt-financing or alternative funding source.
- [3] Annual transfer to be funded from user rates.
- [4] Includes additional contributions required to address funding deficiencies.



# High-Level Capital Replacement Fund Balance Analysis

## Utility Asset Analysis

Description	Amount
Installed Cost of Depreciable Assets as of September 30, 2022	\$40,844,644
High-Level Replacement Cost of Assets	\$84,816,616
Weighted Average Service Life of Depreciable Assets (Years)	32
Annual Accrual for Capital Replacements	\$2,689,925
Weighted Average Age of Depreciable Assets	23
Calculated PayGo Capital Replacement Fund Balance	<u>\$62,880,087</u>

# Possible Financial Management Policies Document

## Element: AUTOMATIC RATE INCREASES

### ■ Sample:

*In the absence of a formal study recommendation or action by the [insert governing body name], the rates, fees, and charges in [insert applicable sections] shall be automatically increased for inflationary effects on the costs of operations – without a public hearing – effective [insert effective month and day] of each fiscal year. The percentage increase shall be the percentage increase, if any, in the [insert index name, index publisher, and any other information] from [insert month] of the preceding calendar year to [insert month] of the current calendar year. The first increases under these provisions, if any, shall become effective on [insert effective date].*

### ■ Will Be Discussed in Further Detail Later

# Possible Financial Management Policies

## Document Element: BUDGET

### ■ Sample:



*The enterprise fund annual operating budget will i) be structurally balanced, with revenues sufficient to meet expenses (those that are ongoing in nature); ii) reflect rates set at levels intended to support the direct and indirect costs of the system, with the intent to provide the lowest reasonable rates over time, not necessarily the lowest fees and user charges during the current or budget fiscal year, and at a level necessary to ensure the adequate maintenance and operations of the system; and iii) reflect these financial policies and include amounts necessary to maintain the required operating and capital reserves.*

# Possible Financial Management Policies

## Document Element: INVESTMENT

### ■ Sample:



*The enterprise's investment portfolio will be managed to achieve, in order of priority: safety of capital, sufficient liquidity to meet disbursement schedules, and a rate of return at least equal to the return on a comparably maturing U.S. Treasury bill. The enterprise shall not make any investments with a long-term issuer rating lower than "A" from Moody's Rating Services and Standard & Poor's.*

# Possible Financial Management Policies

## Document Element: RATE REVIEW

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### ■ Sample:

*The [insert local government name] staff shall analyze the financial position of the system annually to evaluate the need for changes in rates and fees, so that if increases in rates are necessary, the resulting impact to customers will be minimized or phased over time. The level of rates charged to system customers will be based on the following principles, in order of priority:*

- *Meeting debt service coverage and cash reserve requirements set forth in these financial policies; and*
- *Maintaining competitive rates, primarily with those of neighboring utilities.*

# Possible Financial Management Policies

## Document Element: RATE REVIEW (cont.)

### ■ Sample (cont.):

*As part of the annual financial planning process, the [insert local government name] staff will prepare multi-year rate forecasts and recommend the adoption of rate resolutions for adoption by the [insert governing body name] in order to limit the amount of financial risk to the enterprise fund and provide overall revenue stability in the funding of enterprise fund expenditures.*



# Possible Financial Management Policies Document

## Element: FIXED CHARGE RECOVERY

- **Promotes Revenue Stability**
- **Sample:**

*The fixed charge components of the utility's monthly user rates shall be established to generate over 30% of the total user rate revenues.*



# Possible Financial Management Policies

## Document Element: IMPACT FEES

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### ■ Sample:

*In accordance with State law, collections from each impact fee shall be placed and accounted for in a separate trust or account. Water impact fees may only be used to pay for extensions, expansions, oversizing, or other future capital construction expenditures for the water system to enable the water system to provide service to new customers or for the purpose of retiring bonds or other indebtedness issued previously for the expansion of the system to serve new customers now requiring service from the water system. Similarly, wastewater impact fees may only be used to pay for growth- or expansion-related wastewater capital projects as well as expansion-related debt allocable to the wastewater system.*



# Impact Fees or Capacity Charges

- **Support Policy of “Growth Paying for Growth”**
- **Dual Rational Nexus Requirements Established Through Case Law**
  - **Fee Must Be Proportionate to Benefit Received**
- **Can Legally Be Used to Pay for Growth-Related Projects or Growth-Related Debt Service**
  - **Should Maintain Expansion Factor for Debt**



# Impact Fees (cont.)

- **Florida Impact Fee Act – Section 163.31801, Florida Statutes**
  - **Calculation of Impact Fees Must Be Based on Most Recent and Localized Data**
  - **Impact Fee Collections and Expenditures Must Be Accounted for in a Separate Accounting Fund**
  - **Administrative Charges for Collection of Impact Fees Must Be Based on Actual Costs**
  - **Notice Must Be Provided No Less Than 90 Days Before Effective Date of Ordinance Imposing a Higher Impact Fee**
    - **No 90-Day Notice Required for Impact Fee Decreases**
  - **If Impact Fees Challenged, Government Has Burden of Proving By Preponderance of Evidence That Fees Meet Requirements of Impact Fee Act and State Legal Precedent**

# Impact Fees (cont.)

- **Does Not Apply to Water and Sewer Connection Fees (Not All Attorneys Agree That Water and Sewer Impact Fees Are Exempt Based on This Language)**

## ■ **Additions to Florida Impact Fee Act in 2021**

- **Increase in Impact Fee Rate of Not More Than 25% Must Be Implemented in Two Equal Annual Increments**
- **Increase in Impact Fee Greater Than 25% But Not More Than 50% Must Be Implemented in Four Equal Installments**
- **Impact Fee Increase May Not Exceed 50% of Current Fee**
- **Impact Fee May Not Be Increased More Than Once Every 4 Years**

# Impact Fees (cont.)

- **Additions to Florida Impact Fee Act in 2021 (cont.)**
  - **Local Government Can Increase Impact Fees Beyond the Phase-In Limitations If:**
    - **A Demonstrated Needs Study Has Been Completed Within Past 12 Months That Expressly Demonstrates Extraordinary Circumstances Necessitating Need to Exceed Phase-In Limitations**
    - **Local Government Holds Two Publicly Noticed Workshops Dedicated to the Extraordinary Circumstances**
    - **Impact Fee Increase Is Approved By At Least Two-Thirds Vote of Governing Body**

**Local Governments Should Obtain Guidance from Their Attorney to Ensure That Implementation of Any Impact Fee Increases Is in Compliance With Florida Law!**

# Impact Fees (cont.)

- **Spend Fees in Timely Manner**
  - **May Have to Be Refunded If Not Spent Within Certain Period of Time**
- **Maintain Paper Trail of Growth-Related Projects or Growth-Related Debt Service Funded With User Rates or Other Funding Source Due to Insufficiency of Impact Fee Collections at the Time**
  - **May Be Able to Reimburse User Rate / Operating Funds at a Later Date When Impact Fee Cash Balances Are Available**
- **Develop Formal Procedure for Applicants to Submit Alternative Impact Fee Calculation If They Believe Their Impact Would Be Less Than Under Current Methodology**

# Transfers to General Fund from Enterprise Fund

- **Best Management Practice Per Rating Agencies: Limit Non-Enterprise-Related Transfers to General Fund**
  - **Substantial Amount of Capital (Often Secured Through Debt Financing) Is Required to Provide Service**



- **Should Reinvest in System**

# Transfers from General Fund to Enterprise Fund (cont.)

## ■ Rates and Charges Must Be Just and Equitable

- **Counties: Florida Statute 153.11(1)(c) Water Service Charges and Sewer Service Charges; Revenues**

*"Such rates, fees and charges shall be just and equitable..."*

- **Municipalities: Florida Statute 180.13(2) Administration of Utility; Rate Fixing and Collection of Charges**

*"The ...legislative body of the municipality...may establish just and equitable rates or charges..."*

# Transfers from General Fund to Enterprise Fund (cont.)

- **Rosalind Holding Company, Etc., Appellant, v. The Orlando Utilities Commission, et al., Appellee. District Court of Appeal of Florida, Fifth District. July 22, 1981.**
  - *"Absent a controlling statute, a municipal utility, like any other utility, is entitled to earn a reasonable rate of return on its capital and its rates may be set so that it earns a rate of return on its equity comparable to other similar businesses."*
  - *"The parties all agree that basing rates on cost of capital is the most universally adopted and reasonable method in the industry."*

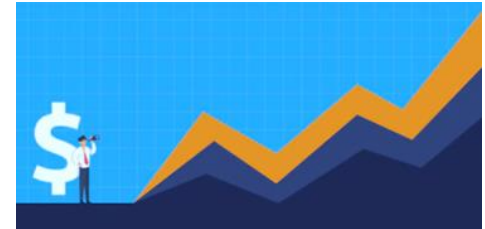




# What Is a Defensible Level of Transfers to General Fund from Enterprise Fund? (cont.)

## ■ Defensible Transfers to General Fund from Enterprise Fund:

- Allocable Costs – Direct or Indirect
- Reasonable Rate of Return



## ■ Potential Approaches for Determining Reasonable Rate of Return

- Estimating Allowable Return on Investment If Enterprise Were Private and Regulated By Florida Public Service Commission (Cost of Capital Analysis)
- Consistent With Industry Norms

## ■ Should Monitor Future Bills By Florida Legislature

- Historical Efforts By Representatives to Limit Non-Utility-Related Transfers to General Fund

# Possible Financial Management Policies

## Document Element: CLOSED FUND

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- **Sample:**

*The balance of any Gross Revenues remaining after required payments shall remain in the enterprise fund and may be used for any lawful purpose of the system.*

- **Open Fund Policy Would Indicate That Any Balance Could Be Used for Any Lawful Purpose of the Local Government**

# Possible Financial Management Policies

## Document Element: CLOSED FUND (cont.)

- **With a Closed Fund Policy, the Local Government Can Still Make Transfers to the General Fund If the Transfers Are Treated as:**
  - **Operating Expenses**
  - **Interfund Loan: Arms-Length with Established Repayment Terms (Could Be a Very Long Repayment Schedule)**



# Possible Financial Management Policies

## Document Element: POLICY UPDATES

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- **Sample:**

*These policies will be updated at a minimum once every three (3) years to reflect needed changes in policy.*

# **Master Bond Resolution or Ordinance**

# **To the Extent Possible, Can Incorporate Best Financial Management Practices Into Bond Resolution / Ordinance**

- **Binding Agreement Between Governing Body and Bondholders**
- **Credit Rating Agencies Prefer to See Stronger Coverage Requirements (e.g., 125%)**
- **Can Require Annual Renewal and Replacement Funding**
- **Can Make Enterprise Fund Closed-Loop – Surplus Funds Can Only Be Used for Lawful Purposes of the Enterprise Fund**
- **Can Have Maximum Annual Debt Service Additional Bonds Test**
  - **Promotes Interperiod Equity – Cannot Push All Debt Service to the Future**



# Before Issuing / Incurring Debt


- **Adopt All Rate Increases Needed During Forecast Period**
  - Shows a Commitment By Governing Body to Raise Rates When Needed
  - Many Debt Financing Options Require Demonstration That Enterprise Can Repay Debt / All Required Increases Have Been Adopted (During Application Process, SRF Loan Program May Not Count Any Necessary Increases Above 2% That Have Not Been Adopted)
- **Consider Adopting Automatic Rate Increase Provisions Based on an Inflationary Index (e.g., CPI, ENR Construction Cost Index, etc.) or Other Method**
- **If Utility Is a Wholesale Customer of Another Utility, Consider Adopting Provisions to Automatically Pass-Through Future Rate Increases from Wholesale Provider**



# **Rate-Related Financial Management Policies**



# Considerations When Developing Comprehensive Schedule of Rates and Charges

- 
- **Opportunities to Shift Cost Recovery from More Politically-Charged Fees Such as User Rates**
    - Fees Which Do This Are Usually Easier to Get Approved
  - **Services to Be Specifically Charged for Versus Services Provided as "Cost of Doing Business"**
    - Management Policy Decision
    - May Not Want to "Nickel and Dime" Customers
    - Consider Utilization of Staff and Time Spent Away from "Normal" Jobs to Perform Requested Services

# Considerations When Developing Comprehensive Schedule of Rates and Charges (cont.)

## ■ Established Fee Amount Vs. General "Actual Cost"

**ACTUAL**

**ACTUAL  
RATE**

**ACTUAL  
COST**

- **Set Fee May Be More Customer-Friendly**
  - **Customers Know Amount to Pay in Advance By Looking at Schedule Rather Than Securing Cost Estimate from Staff**
- **Actual Cost (as Defined) Can Adjust Over Time Without Need to Adopt New Rate**
  - **Government Staff May Not Like Spending Effort or Going Into Field to Provide Estimates of "Actual Cost"**

# Considerations When Developing Comprehensive Schedule of Rates and Charges (cont.)

- **Need to Educate Staff on Adopted Fees and How / When to Charge Them**
  - **Staff May Be Unaware That Some Fees Exist or That Fees Must Be Charged Under Certain Conditions**
  - **Staff Input Is Very Important When Developing and Making Decisions on Rate Schedule and Potential New Fees**



# Consider Revenue Enhancement Opportunities

- **Miscellaneous Service Charges**
  - **Recover Direct Costs Associated With Service That Benefits One Customer Instead of Entire Customer Base**
- **Guaranteed Revenue Charges**
- **Capital Financing Recovery Fees**
- **Fire Protection Charges**



# Outside-Municipality Surcharges

## ■ Outside-Municipality Surcharges

- Florida Statute 180.191 Limitation on Rates Charged Consumer Outside City Limits
- Should Monitor Future Legislation – Historical Attempts to Limit Outside-Municipality Surcharges

*"[A municipality] may charge rates, fees, and charges that are just and equitable and which are based on the same factors used in fixing the rates, fees, and charges for consumers inside the municipal boundaries. In addition thereto, the municipality may add a surcharge not to exceed 25 percent of such rates, fees, and charges for said services to consumers outside the boundaries. However, the total of all such rates, fees, and charges for the services to consumers outside the boundaries shall not be more than 50 percent in excess of the total amount the municipality charges consumers served within the municipality for corresponding service."*

# Inactive Account Policy

- **Potential Policy: Property Owners Responsible for Payment of Monthly Charges for Service Where Service Is Available, Regardless of Whether Property Is Considered Active Account**
  - **Utility Has Built Supply, Treatment, Transmission, and Distribution / Collection Infrastructure to Provide Service and Utility Continues to Incur Fixed Costs to Maintain “Ready-to-Serve” Condition**
  - **Billing Inactive or “Vacant” Accounts Reduces Overall Costs to Year-Round Customers and Helps Keep User Rates Lower**

**VACANT**

# Mandatory Connection Policy

- **Potential Policy: Property Owners Must Connect and Pay Applicable Impact Fees / Connection Fees Within Certain Timeframe After Service Becomes Available**



- **Can Help Ensure Reasonable Payback Period**
- **Can Be Unpopular Among Unconnected Residents**
- **Sometimes Incorporated as Covenant in Bond Resolutions / Ordinances**

# Late Fees

- **Late Fee Charged By State of Florida for Several Types of Taxes: 10% of Unpaid Tax Per Month, Not to Exceed 50%**
  - **May Be Reasonable Not-to-Exceed Late Fee for Local Governments**
- **Appropriate to Have Minimum Charge to Recover Correspondence Costs (e.g., Stamps, Printing of Delinquency Notices)**

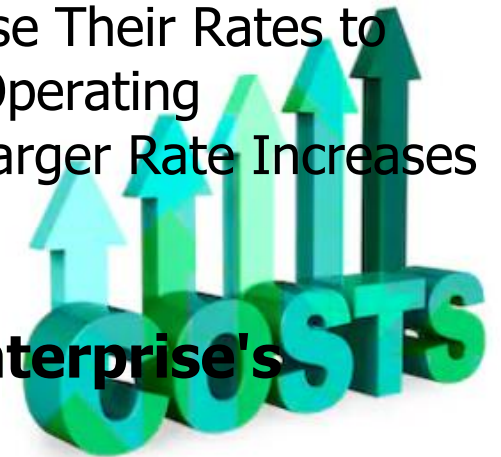




# Many Enterprises Do Not Annually Increase Their Rates for Inflationary Effects on the Cost of Operations

**HOWEVER, Due to the Regulatory Environment and Commodity Cost Increases (Electricity, Chemicals, Food, etc.), Utility Costs Typically Increase at a Higher Rate Than General Inflation (Consumer Price Index)**

- **Important for Governing Bodies to Recognize That Inflation Represents Permanent Increase in Costs**
  - To the Extent That Enterprises Do Not Increase Their Rates to Recover Regular Permanent Cost Increases, Operating Deficiencies Will Progressively Increase and Larger Rate Increases Will Be Required to Fix the Problem
- **Many Cost Increases Are Beyond the Enterprise's Control**
  - Examples: Costs of Fuel and Construction Materials That Are Driven By Global Market Forces



# Several Local Governments Have Now Made Annual Rates, Fees, and Charges Increases Automatic

- **"Automatic" Means That Increases Are Implemented Without the Need for a Formal Hearing Unless Specific Action Is Taken By Governing Body**
  - Fines Are Generally Not Recommended for Indexing, and There May Be Statutory Limitations on the Amounts
- **Considered a Best Management Practice and Favored By Credit Rating Agencies**
  - From Financial Risk Standpoint, Provides More Assurance That Rates Will Keep Up With Inflation
  - If Financial Projections Are Submitted as Part of Securing Debt Financing, Credit Rating Agencies and Lenders Will Want to Know If All Rate Adjustments Needed to Support the Debt Have Been Adopted



# Selection of the Index or Automatic Rate Increase Provision

- **Indexes Commonly Used for Automatically Increasing Rates**
  - National, Regional, or Local CPI as Published By Bureau of Labor Statistics ([www.bls.gov](http://www.bls.gov))
  - Municipal Price Index as Published By *American City and County* ([www.americancityandcounty.com](http://www.americancityandcounty.com))
  - Annual Increase Allowed for Utilities Regulated By the Public Service Commission
  - ENR Construction Cost Index as Published By *Engineering News-Record* ([www.enr.com](http://www.enr.com))
- **Water and Sewerage Maintenance Index (Component of National CPI) May Not Be Good Option for Indexing Utility Rates Since It Is Not Linked to a Specific Utility's Cost Increases**
  - Measures Increases Water and Wastewater Prices in Areas Surveyed Throughout Nation
  - Can Be Used as Gauge for National Rate Adjustment Trends

# Selection of the Index or Automatic Rate Increase Provision (cont.)

- **When Selecting Index, Should Review Historical Changes in Index Options Vs. Historical Changes in Utility's Operating Costs**
  - Some Utilities Have Switched from a CPI Basis to the ENR Construction Cost Index Because They Considered That the CPI Adjustments Were Significantly Lagging Increases in Utility Costs
- **In Lieu of Automatic Increases Based on Index Changes, Many Utilities Have Established Fixed Percentages for Increasing Rates**
  - Fixed Percentage Does Not Have the Fluctuations in Rate Adjustments Under Indexing Approach
  - May Be Appropriate If Utility Would Like to Annually Increase Rates at Higher Percentage Than What Is Typically Recognized Through Indexing
    - Alternative: Add Percentage to Index Measurement (e.g., CPI plus 1%)

# Measurement Basis

- **If a Government Uses Indexing Approach, the Earlier the Month Selected, the Sooner the Government Will Know During the Budget Process What the Following Year's Rate Increases Will Be**



- **Governments Should Consider:**
  - How Soon Following Year's Rate Increase Should Ideally Be Known for Planning and Budgeting Purposes
  - When the Index Data Will Be Available
    - For Example, April Data May Not Be Published Until Middle or End of May
  - Months in Which the Index Is Published
    - Some Inflationary Indexes Are Published Every Two Months, and So Some Months May Not Be Available as a Measurement Basis

# Fee Rounding

- **User Rates Can Usually Be Indexed and Rounded to Nearest Cent**
- **For Certain Other Charges, It May Make Sense to Round or Round Up to Nearest Dollar or Nearest Five-Dollar Increment**
  - For Example, Charging \$49.73 for a Service Call May Seem Silly – A Rate of \$50 May Be More Practical and "Cleaner"
  - Customer Deposits Could Possibly Be Rounded Up to Nearest Five-Dollar Increment
- **Rounding Up Instead of Rounding May Be Needed for Rates Under a Certain Threshold**
  - For Example, If Annual Adjustment Is 2% and Existing Rate Is \$24,  $\$24 * (1+2\%) = \$24.48$ , Which Would Round to \$24 (the Existing Rate) – Should Round Up to \$25

# Not Limited to Annual Increases

## ■ Utility Can Be Creative in Developing Customized Provisions Appropriate for a Specific Fee

- Example: Every Three (3) Years, Fee Is Automatically Increased By Cumulative Increase in Index
- Example: Every Two (2) Years, Fee Is Automatically Increased By \$1
- From Franchise Agreement:

*"[The Utility] may not compound indexing for more than any two year period. Stated otherwise, if Utility fails to index in year one, it may index in year two for years one and two, but if it fails to do so, it may not, for example, in year three index for more than years two and three."*



# Development of Automatic Rate Increase Language in Resolution, Ordinance, or Tariff

- **May Not Want Rates to Decrease If Index Change is Negative**
  - A Floor on the Rate Adjustments Can Be Established By Only Referencing Increases in the Language

*In the absence of a formal study recommendation or action by the [insert governing body name], the rates, fees, and charges in [insert applicable sections] shall be automatically increased for inflationary effects on the costs of operations – without a public hearing – effective [insert effective month and day] of each fiscal year. The percentage increase shall be the percentage increase, if any, in the [insert index name, index publisher, and any other information] from [insert month] of the preceding calendar year to [insert month] of the current calendar year. The first increases under these provisions, if any, shall become effective on [insert effective date].*



# Development of Automatic Rate Increase Language in Resolution, Ordinance, or Tariff (cont.)

- **If One of the Bureau of Labor Statistics Indexes Is Selected, Specifying the Series ID as Well as the Index Name in the Rate Indexing Language Can Facilitate Access to Appropriate Data for Calculating Automatic Increase**
  - <https://data.bls.gov/cgi-bin/srgate> Can Be Used to Look Up Any Index – Just Need Series ID
  - Sample Series ID:  
CUUR0000SA0 for CPI – U.S. City Average, All Urban Consumers



The screenshot shows the Bureau of Labor Statistics website. At the top is a red banner with the BLS logo and the text "BUREAU OF LABOR STATISTICS". Below the banner is a navigation bar with links: Home, Subjects, Data Tools, Publications, and Econom. The main heading is "Series Report". Below this is a link for "Series ID Formats". The form prompts the user to "Enter series id(s) below:" and shows the example ID "CUSR0000SEHG01". At the bottom of the form are two buttons: "Next ->" and "Clear Form".

# Annual Increase References

- **Some Local Governments Have Added an "Annual Increase Reference" Column to Their Rate Schedules to Specify Automatic Rate Increase Provisions**
  - Provides an Easy Way to Manage and Update the Increase Provisions for Each Rate, Fee, or Charge
  - Various References Can Be Defined at Bottom of Rate Schedule

## Sample Rate Schedule

		Annual Adjustment (References shown are defined at the end of this table)
Description	Amount	
Fee 1	\$100.00	[A]
Fee 2	\$50.00	[B]

### Annual Adjustment Reference Definitions:

[A]

[B]

# Communication to Governing Bodies for Getting Automatic Rate Increase Provisions Adopted

- **With Proper Communication, Governing Bodies (and the Public) Are Often Accepting of Smaller, Inflationary Adjustments That Are Implemented Automatically**



# Key Communication Points for Getting Automatic Rate Increase Provisions Adopted

## ■ Common Among Local Governments

- Helpful to Present List of Local Governments That Have Automatic Rate Increases

## ■ Emphasize "Permanent Increase in Costs" Concept

- Many Costs Beyond the Local Government's Control
- Automatic Rate Increases Can Help Prevent Future "Catch Up" Rate Increases and "Rate Shock"

## ■ Best Management Practice

- Favored By Credit Rating Agencies
- Benefits of Higher Credit Rating

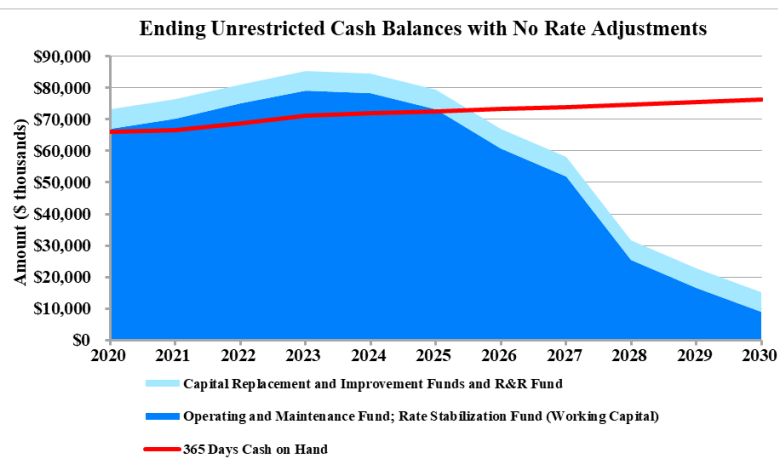
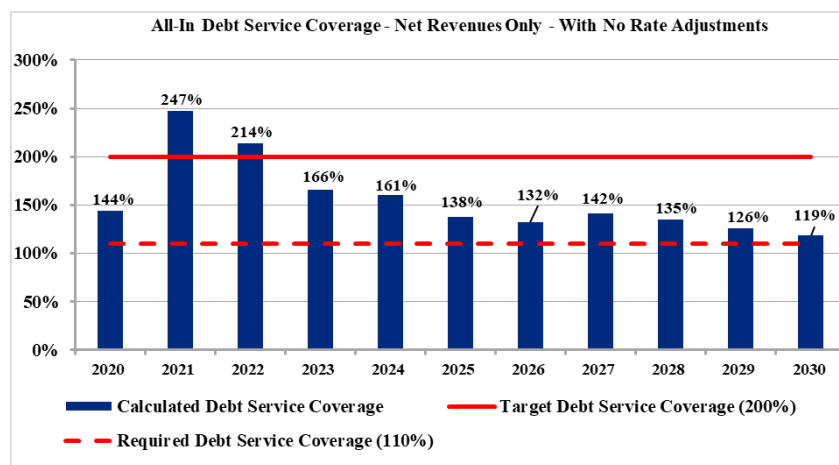
## ■ Always Have Option to Take Action to Not Implement Automatic Rate Increases in a Given Year

- Could Also Increase Rates By a Lower Percentage



# Key Communication Points for Getting Automatic Rate Increase Provisions Adopted

- **Showing (Perhaps Graphically) What Might Happen If the Automatic Rate Adjustments Were NOT Implemented**
  - Possible Debt Service Coverage Problems, Inability to Fund All Operating and Capital Needs, Etc.



# **SOME FINAL THOUGHTS:**

- **Strong Financial Management Policies Adopted By the Local Governing Body Can Help Guide Financial and Rate Decisions as Well as Improve an Enterprise's Credit Rating**
- **There Are Many Considerations When Developing a Financial Management Policies Document, and Such Policies Should Be Reviewed Periodically**
  - No "One Size Fits All"
  - Can Build Upon Policy Documents Developed By Others
- **Automatic Rate Increases Are a Recommended Policy**
  - Different Rates, Fees, and Charges Can Have Different Increase Provisions



## **SOME FINAL THOUGHTS (cont.):**

- **Should Ideally Build / Establish Long-Term History of Following Financial Plan and Meeting Targets**
- **For the Long-Term Interests of Customers, Financial and Rate Planning Should Be Proactive, Not Reactive**
  - **Keep Up With Inflation or Permanent Increases in Costs**
  - **Lower User Rates Over the Long-Term**
  - **Balanced Debt Risk**
  - **Higher Credit Rating and Lower Interest Rates When Debt Financing**



# QUESTIONS AND DISCUSSION





# THANK YOU

**If You Have Questions  
Regarding This  
Presentation or Would  
Like Additional  
Information, Please  
Contact Us!**

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