

Financial Policies Work Group
Recommendations on Guiding Principles for Reserves and Short-term Debt

I. Recommendations on Guiding Principles for Reserves

Background

In 2001 and 2002 King County made a series of financial policy changes and recommendations designed to strengthen the financial integrity of the wastewater utility. Combined, the actions taken in 2001 and 2002 led to relative financial stability for the utility which was reflected in bond rating upgrades on subsequent debt issuances. These initiatives were a response to the effects of institutional changes, the energy crisis, drought and recession occurring during this period. In their rating reports, the rating agencies typically note the strong financial management of the utility as the basis of the utility's relatively high ratings.

With the refunding of the last remaining Metro bonds in 2002, several long-standing reserves needed to be redefined including an operating reserve, a contingency reserve and a betterment reserve. There were significant external events in 2001 that impacted the finances of the wastewater utility including the 2001 Nisqually Earthquake, the drought in the winter of 2000-01 and the deregulation of the energy industry in California. The drought and energy deregulation impacted both operating revenues, and more significantly, energy costs. Documents at the time noted that energy costs at South Plant went from a daily average of \$7,000 to between \$15,000 and \$137,000 per day almost overnight. The financial impact was severe enough that the County used Financial Accounting Statement 71 to amortize the unexpected energy costs on the balance sheet during 2002-04. This accounting procedure essentially allowed the County to avoid violation of its wastewater bond covenants which require an excess of revenue over debt service after operating costs are paid.

At the same time, the County was embarking on a large-scale capital program to implement the Regional Wastewater Services Plan. The combination of all of these

factors and a trend of decreasing debt service coverage had the rating agencies concerned about the financial stability of the utility. The County, along with its regional partners, took action to address these issues.

First, the refunding of the old Metro bonds led to the elimination of the old reserves noted above and the creation of new reserves. These were in effect implemented with the refunding and the adoption of the 2002 monthly sewer rate. An operating (or liquidity) reserve of 10 percent of operating expenses was established as a practice. In addition, what has been referred to as the asset management reserve was created. This reserve was established, in part, as a response to the Nisqually earthquake. It was first referred to in the Official Statement for the 2001A and 2001B Sewer Revenue Bonds as a “disaster reserve”. This reserve replaced the old betterment reserve maintained by Metro. Since 2001, WTD has maintained this reserve at the maximum \$15 million.

A. Recommendation on Guiding Principles for a Liquidity Reserve

1. Discussion

The King County Wastewater Treatment Division (WTD) has consistently maintained a liquidity reserve equal to ten percent of operating expenses plus a \$5 million minimum balance in the construction fund. At the end of 2009, the required reserve in accordance with this policy was \$10,316,500 for the 10 percent of operating expenses and \$5,000,000 in the construction fund for a total of \$15,316,500.

King County Code (K.C.C.) 28.86.160, Financial Policies (FP)-6 requires that WTD “maintain for the wastewater system a prudent minimum cash balance for reserves, including but not limited to, cash flow and potential future liabilities. The cash balance shall be approved by the council in the annual sewer rate ordinance.” Prudent is not defined in the K.C.C.

In business in general, the health of an organization is indicated partly by the amount of its working capital which is the net of current assets over current liabilities. Working

capital can also be expressed in terms of the ratio of current assets to current liabilities (the current ratio). The WTD liquidity reserve is related to the concept of the current ratio.

A positive current ratio (or positive working capital) means that the company has the ability to meet its current obligations on time – is able to pay for day-to-day operating costs in a timely manner. An entity should seek a current ratio that is “prudent” in that all current expenses can be paid timely without having to borrow on a short-term basis but that is also not too high. In the case of WTD or similar utilities, too much working capital could indicate customer rates are too high or that long-term debt is not being utilized sufficiently in financing long-lived assets.

A general rule of thumb is to have an operating reserve or working capital sufficient to pay for two months of operating expenses. With a 2009 operating expense of \$103,165,000, two months of operating expenses would be equivalent to \$17.2 million. This rule of thumb, however, would be most appropriate in retail business entities where accounts receivable and inventory are major components of current assets. A lower working capital amount than two months of expenses is justified for WTD because inventory is not a factor, receivables are predominately from other local government entities with only limited seasonal variations, and exposure to bad debt expense is also very limited.

With the adoption of the RWSP financial policies in 2001, the county began maintaining a liquidity reserve in the operating fund of ten percent of operating expenses, as well as a debt coverage ratio of 1.15 times. At that time, old bonds issued by Metro with a variety of reserve requirements were refunded. The liquidity reserve and debt coverage ratio policies responded to concerns by bond rating agencies that there was a downward trend in debt service coverage in the utility. As a result of these actions, the County successfully maintained its bond rating.

The current practice of maintaining a liquidity reserve of at least 10 percent of operating expenses plus \$5 million in the construction fund has worked well for WTD. These policies continue to provide “comfort” to the rating agencies and have worked in the County’s favor in bringing ratings up over the past few years.

2. Recommendation

The financial policies should be revised to require a liquidity reserve of 10 percent of operating expenses plus \$5 million in the construction fund. In the case of a drawdown of the reserve, the financial policies should require restoration of the reserve in the next rate setting cycle and such restoration should be documented in the financial plan.

The work group recommends that K.C.C. 28.86.160 FP-6 be revised as follows: The county shall maintain for the wastewater system a prudent minimum cash balance, including but not limited to, cash flow and potential future liabilities, in an amount equal to ten percent of operating expenses plus \$5 million in the construction fund. If the cash balance is drawn down below the minimum, steps shall be taken to replenish this reserve during the next sewer rate-setting cycle and such steps shall be reflected in the financial plan.

The work group further recommends that K.C.C. 28.86.165B., relating to reporting policies for the RWSP, be revised to incorporate a periodic review of the adequacy of the \$5 million requirement as follows:

B.1. Comprehensive regional wastewater services plan review. The executive shall submit a written report to council and RWQC that provides a comprehensive review of the RWSP. The report will review the following:

a. assumptions on the rate and location of growth, the rate of septic conversions and effectiveness of water conservation efforts;

b. phasing and sizing of facilities; ~~and~~

c. effectiveness of RWSP policies implementation, for infiltration and inflow reduction, water reuse, biosolids, CSO abatement, water quality protection, environmental mitigation and public involvement; and

d. adequacy of the monetary amount stipulated for the construction fund in K.C.C. 28.86.160 FP-6.

2. The next comprehensive regional wastewater services plan review is due in September 2007. Subsequent reports will be prepared every three to five years as established by the council and RWQC following their review of the current report. The specific due date will be based upon the availability of necessary information, the completion of milestones, and the time needed to collect and analyze data. The executive may recommend policy changes based on the findings of the report and other information from changing regulations, new technologies or emerging or relevant factors;
3. The comprehensive regional wastewater services plan review will include all elements of the RWSP annual report, replacing it for that year;

Currently, the next established reporting date for the comprehensive regional wastewater services plan review for the period 2007 through 2011 is September 2012 pursuant to King County Motion 12723 adopted March 17, 2008.

B Recommendation on Emergency Capital Reserve

1. Discussion

While a reserve of \$15 million may not go far in the case of a major natural disaster, a reserve of this magnitude would be prudent in the case of unexpected facilities failures such as to a major pump station or a sewer main. The reserve could be used quickly to make repairs or purchase replacements to restore the facilities. Restricting this reserve to emergencies such as natural disasters would be too narrow; allowing for its use to quickly address any unexpected problems within the system would be far more beneficial. Additionally, the reserve can be an element in a prudent risk management approach.

2. Recommendation

It is recommended that from this point forward this reserve be referred to as the ‘Emergency Capital Reserve’ and be maintained at the \$15 million level with interest earnings available for operating expenses. Specifically, the work group recommends that

K.C.C. 28.86.160 FP-6 be revised as follows: The county shall maintain for the wastewater system a prudent minimum cash balance, including but not limited to, cash flow and potential future liabilities, in an amount equal to ten percent of operating expenses plus \$5 million in the construction fund. If the cash balance is drawn down below the minimum, steps shall be taken to replenish this reserve during the next sewer rate-setting cycle and such steps shall be reflected in the financial plan. (Note: the work group recommended this revision to FP-6 to address the Liquidity Reserve.)

In addition to this minimum cash balance, the wastewater system shall maintain an Emergency Capital Reserve at a minimum of \$15 million. Interest earnings on the Emergency Capital Reserve shall be available for operations. If the Emergency Capital Reserve is drawn down below \$15 million, the County shall establish an explicit replenishment plan that returns the reserve to the \$15 million minimum balance within 5 years. This plan shall commence no later than the next sewer rate-setting cycle.

It is also recommended that the preamble of the legislation adopting this proposed revision to FP-6 include the purposes for which the funds will be used as indicated above, including:

- 1) as collateral in the risk management of select, low-risk facilities, and
- 2) to provide funding for emergency capital projects prior to receipt of additional capital funding.

The work group further recommends that K.C.C. 28.86.165B., relating to reporting policies for the RWSP, be revised to incorporate a periodic review of the adequacy of the \$15 million minimum requirement for the Emergency Capital Reserve as follows:

B.1. Comprehensive regional wastewater services plan review. The executive shall submit a written report to council and RWQC that provides a comprehensive review of the RWSP. The report will review the following:

- a. assumptions on the rate and location of growth, the rate of septic conversions and effectiveness of water conservation efforts;
- b. phasing and sizing of facilities; and

c. effectiveness of RWSP policies implementation, for infiltration and inflow reduction, water reuse, biosolids, CSO abatement, water quality protection, environmental mitigation and public involvement; and

d. adequacy of the monetary amounts stipulated for the construction fund and the Emergency Capital Reserve in K.C.C. 28.86.160 FP-6.

2. The next comprehensive regional wastewater services plan review is due in September 2007. Subsequent reports will be prepared every three to five years as established by the council and RWQC following their review of the current report. The specific due date will be based upon the availability of necessary information, the completion of milestones, and the time needed to collect and analyze data. The executive may recommend policy changes based on the findings of the report and other information from changing regulations, new technologies or emerging or relevant factors;

3. The comprehensive regional wastewater services plan review will include all elements of the RWSP annual report, replacing it for that year;

(Note: the language above regarding the “construction fund” refers to the work group’s recommendation on the liquidity reserve.)

Currently, the next established reporting date for the comprehensive regional wastewater services plan review for the period 2007 through 2011 is September 2012 pursuant to King County Motion 12723 adopted March 17, 2008.

II. Recommendation on Guiding Principles for Variable Rate Demand Bond Limits ("Short Term" Debt Limit)

A. Background

When the financial policies for WTD were adopted in 2001, the use of short-term debt was limited to "no more than fifteen percent of total outstanding revenue bonds and general obligation bonds" (K.C.C. 28.86.160 FP-14). The County's financial advisor notes that this is a "conservative policy in that it is a percentage of fixed rate debt instead of overall debt of the utility and it doesn't net out any short-term assets (reserves, ongoing fund balances) that the utility has on its books." He believes it "was seen as an initial conservative step that would be revisited once the utility had established a track record with variable rate debt."

WTD now has a track record of successful use of short-term debt that has resulted in savings to the utility and to ratepayers. The primary advantages of the use of short-term variable rate debt are to lower the overall cost of capital to the utility and to act as a hedge against investment rates on any of the utility's short-term investments.

Certainly, the use of short-term variable rate debt has its risks. In fact, during the financial crisis in 2008, WTD was forced to take steps to mitigate potential interest rate increases and accelerated maturities on the 2006 issue. MBIA, the financial services firm that insured that issue, was downgraded by the credit rating agencies, leading to significantly higher interest rates on MBIA-insured securities and ultimately no market for MBIA securities. The subsequent move by the liquidity provider for that issue, KBC Bank, to accelerate the repayment schedule on the bonds with high principal and interest payments left WTD with two options: issue refunding bonds through KBC or redeem the 2006 bonds.

WTD opted to redeem the bonds through the facility of an interfund loan from the King County investment pool. This is the only problem that has occurred with variable rate debt since King County first used this type of financing in 1995.

Current municipal bond market conditions are leading to very favorable rates on long-term bonds. This is evidenced by the most current issue of WTD revenue bonds – i.e., a true interest cost of 4.54 percent on 40-year bonds. Historically, however, rates in the market have fluctuated sharply over relatively short periods of time. The low rates today could be significantly different in 2011 or 2012.

B. Discussion

The financial policies of the Wastewater Utility are intended to be for the long-term. These policies since being adopted in 2001 have gone essentially unchanged except for changes in 2006 that clarified business practice planning and review and added a new policy on reporting requirements. With the interest by the Regional Water Quality Committee in 2009 that established a work plan, membership and process for an in-depth review of the financial policies, there is an opportunity now to make sure that the short-term debt policy is relevant to today as well as being viable for the longer term. It could be argued that a revision in the limit is unnecessary at this time because there is currently little reason to increase the level of short-term debt due to the favorable rates for fixed rate debt. However, given that reviews of financial policies have only occurred every several years, revision of this policy now would provide the flexibility to act in the future as market conditions change.

The current limit on short-term debt of 15% was established when WTD had little experience with this type of financing. With fifteen years of successful use of short-term debt, it is time to review the limit. Increasing the limit to 20 percent would provide greater flexibility to the utility in the long-term to utilize this method of financing when opportunities arise and certain conditions are met.

C. Recommendation

The work group recommends that K.C.C. 28.86.160 FP-14 be revised as follows: To achieve a better maturity matching of assets and liabilities, thereby reducing interest rate

risk, short-term borrowing may be used to fund a portion of the capital program, provided that:

Outstanding short-term debt comprises no more than ~~fifteen~~ twenty percent of total outstanding revenue bonds and general obligation bonds; and

Appropriate liquidity is available to protect the day-to-day operations of the system.

In amending the current policies, the preamble of the ordinance should specify the following factors are to be considered before increasing the percentage of short-term debt:

1. The difference in yields of variable rate bonds compared to fixed rate bonds;
2. An estimate of potential risk and ability to manage the variable rate debt, including monitoring market conditions;
3. The total costs of issuing variable rate debt;
4. The need for an externally provided liquidity facility; and
5. Strategies for long-term financing and debt management.

As an example of the savings potential of short-term debt, the Wastewater Utility in 2009 paid an average of 0.7% on already outstanding variable rate bonds. By comparison, the interest rate on the July 2009 fixed rate bonds was an average of 5.2%. On \$100 million of variable rate bonds as opposed to \$100 million of fixed rate bonds in 2009, the interest “saved” with the short-term debt over twelve months would have amounted to \$4.5 million.

Variable rate bonds are typically issued so that converting them to fixed rate bonds can be accomplished relatively quickly in case short-term rates are increasing to the point that fixed rate debt is more advantageous.