

To the Mayor and Members of the City Council**November 8, 2016**

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**SUBJECT: FINANCIAL MANAGEMENT POLICY STATEMENTS – RESTATED POLICY GOVERNING PAYMENTS FROM WATER AND SEWER FUND TO OTHER FUNDS**

The purpose of this Informal Report is to outline a Mayor and Council Communication (M&C) that will be presented for consideration on November 15, 2016 to adopt an amendment/addendum to the City's Financial Management Policy Statements (FMPS) to address payments that the Water and Sewer Fund makes to other City funds.

The M&C contains some of the revisions that staff committed to bringing forward when the re-adoption of the FMPS and revision of the gas-related revenue and expenditure policy were presented on November 1 (M&C G-18872). Proposed revisions are the result of staff's comprehensive review of both the FMPS and the Investment Policy and Strategy, and other changes that are currently being finalized will follow via M&C in the coming weeks.

Staff's intent in recommending adoption of a restated policy for payments from the Water and Sewer Fund (the "Fund") is two-fold. The first goal is to more completely explain the policy rationale behind current practices. The second is to articulate the relationship between the City's financial policies and the Water and Sewer System's Master Ordinance (Ordinance 10968), which establishes the revenue structure that provides for issuance of System revenue bonds to finance capital improvements.

Prior iterations of the FMPS were limited to the PILOT payment and focused more on mechanics than policy. The restated policy encompasses all three major payments that the Water and Sewer Fund makes to other City funds - 1) the Payment in Lieu of Taxes ("PILOT"); 2) Street Rental Fees; and 3) the Fund's contribution in support of the City's Public Art program. The policy also includes a purpose statement, an explanation of the interplay of the Master Ordinance and the FMPS, and a high-level overview of payment calculation and recovery.

Purpose and Relationship to Master Ordinance

As an enterprise fund, the Water and Sewer Fund operates similar to a business in the private sector. However, as a tax-exempt governmental unit, the Fund does not pay property taxes or franchise fees that would be required of a private utility. The restated policy articulates that the purpose of the PILOT and street rental fees is to provide the General Fund with revenue comparable to what would be received from a private utility, which is philosophically consistent with the Fund's enterprise fund status. The policy also addresses the contribution that the Fund makes to support the City's Public Art program.

The proposed policy explicitly acknowledges the supremacy of the System's Master Ordinance and its supplements when it comes to System revenues. In issuing revenue bonds to finance capital improvements for the System, the City has pledged the System's net revenues to paying interest, principal, and premium, if applicable, on both first priority and subordinate lien debt. What that means is that all revenue that the System generates that is not required to pay operating expenses must be used first for meeting financial obligations related to the System's outstanding debt. Only after those obligations have been met is there "Excess Pledged Revenue" that can be used for making payments under the policy.

The restated policy assigns responsibility to the Financial Management Services Department to make an annual calculation as part of the annual budget process to determine if Excess Pledged Revenues are projected to exist to make the three payments. Under the policy if Excess Pledged Revenues are projected to exist but not be sufficient to make the full amount of the calculated payments, the amount of each payment is reduced on a pro rata basis so that their total does not exceed the amount of projected Excess Pledged Revenues. The policy also requires that (i) another Excess Pledged Revenue calculation be conducted after the close of each fiscal year to ensure that payments made do not exceed the actual Excess Pledged Revenue that was generated and (ii) adjustments be made to make the Fund whole if the total of the payments is found to have exceeded actual Excess Pledged Revenue.

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Calculation and Recovery

Each of the three payments has its own calculation methodology, as more fully described below:

- **PILOT:** This payment, which is intended to mimic property tax, is calculated by multiplying the current tax rate by the net value of certain System property. Determining the net value involves reducing the value of Plant Assets by depreciation and adding to that total the value of Construction Work in Progress.
- **Street Rental Fee:** This payment emulates a franchise fee that would be paid by a private utility in return for use of the City’s street and rights-of-way. Consistent with most other franchise fees the City receives, the System is charged five percent of its gross service revenue for Water and Sewer customers, unless an applicable wholesale contract specifies otherwise. In this context, gross service revenue is calculated by reducing the total revenues of the system by non-service revenues, which consist of items like investment earnings and impact fees.
- **Public Art:** This payment is calculated in accordance with the current City Code requirements and developed through the City’s annual budget process.

The restated policy also memorializes current practice, under which the cost of making these payments is included when calculating the System’s revenue requirements and setting its rates. One exception to this practice is the Public Art payment, which under City Code is not passed through to the City’s wholesale customers. In addition, some of the City’s current wholesale contracts do not allow for recovery of the costs of the PILOT or street rental payment. However, as those contracts expire and are renegotiated, staff will be working to ensure the System’s true operating costs, including those related to PILOT and street rental payments, are passed through to and recovered from the System’s wholesale customers.

Overview of Payments in Recent Fiscal Years

The following is a five year financial history for these payments.

Payment Type	2017 Budget	2016	2015	2014	2013
PILOT	\$5,559,860	\$6,156,289	\$5,448,144	\$5,190,611	\$5,246,185
Street Rental Fee	\$20,880,383	\$20,577,792	\$19,119,745	\$17,698,623	\$17,318,480
Public Art	\$1,044,429	\$0	\$1,034,485	\$1,041,685	\$1,010,302

If you have any questions, please call Aaron Bovos, Chief Financial Officer, at 817-392-8517

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