Seattle Public Utilities
2011-2012 Rate Proposals
Financial Policies

IMPORTANCE OF FINANCIAL POLICIES

The multiple financial policies for each SPU fund provide a balanced framework for the finances of the utility, ensuring that the utility can meet its financial obligations and maintain a strong credit rating, which provides access to low cost borrowing. The direct effect of the policies is to determine the level at which a utility's rates shall be set, given its estimated costs and sales, and to define the general manner in which the utility's capital improvement program is to be financed. The indirect effects of the policies:

- shape the financial profile each utility presents to the financial community;
- establish the utility's exposure to financial risk, and;
- allocate the utility's costs between current and future ratepayers.

The following table provides information on the importance and usefulness of each financial target in maintaining the financial health of the Water Fund, Solid Waste Fund, and Drainage and Wastewater Fund.

Parameter	Importance
Net Income	Positive net income insures that revenues cover expenses and is a contingency against projection errors and uncertainties regarding revenues. It is also a signal to bond rating agencies that the City is committed to establishing fees that cover costs.
Debt Service Coverage	A higher debt service coverage ratio means that more "excess" revenue is available after debt payments are made. This reduces financial risk and provides more flexibility to respond to unanticipated needs or revenue shortfalls.
Year-End Cash Balance	Cash reserves are important to ensure bills are paid on time, and they can be used to respond to unanticipated needs or revenue shortfalls.
Cash-Financing of CIP	This policy 1) helps to prevent a rapid increase in debt levels, and 2) limits the escalation in the debt-to-assets ratio.
Debt-to-Asset Ratio	This ratio provides an indicator of how reliant an organization is on debt to finance its infrastructure. A high ratio suggests less flexibility, as a greater portion of each year's revenues is used to repay debt.
Variable Rate Debt	A cap on variable rate debt balances the advantages of lower interest costs with the risk of unexpected increases in interest rates.

SOLID WASTE SCENARIOS

Question: Is there room to mitigate the rate increases by moving closer to the policy target for debt service coverage or year-end cash balance in 2011-12?

For the Solid Waste Fund, net income is the binding constraint in both 2011 and 2012. This means that the proposed rate increases are set at a level to just meet the net income target. At this level all other financial policy targets are met (or exceeded). If the net income policy is to continue to be met, any reduction in rates from proposed levels must be accompanied by an equal or greater reduction in expenses that are included in the calculation of net income (bond principal payments and CIP cash financing are notably *not* part of the net income calculation).

The table below presents three scenarios with projected financial performance and rate increases:

- The "Proposed" scenario was presented by SPU to the SPUN Committee on 7/13/2010.
- The "Year End Cash Reduced to Target" scenario ignores binding constraints in order to reduce year-end cash to the policy target of one month of contract expenses.
- The "DSC Toward 1.7x" scenario also ignores binding constraints and shows financial performance if Debt Service Coverage is reduced toward the policy target of 1.7x.

Missed Target

		Rate Proposal		Alternative #1 Year End Cash Reduced to Target		Alternative #2 DSC toward 1.7x	
Parameter	**Policy**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**
Net Income	Generally Positive	$0.40	$0.70	($6.5)	($1.1)	($8.3)	($13.6)
Debt Service Coverage	1.70 times	4.13	3.12	3.1	2.9	2.9	1.7
Year-End Cash Balance	One month contract cost *Target*	$11.50 *$5.10*	$13.70 *$5.20*	$5.1 *$5.10*	$5.2 *$5.20*	$3.6 *$5.10*	($7.9) *$5.20*
Cash Financing of CIP	$2.5m ($2003) *Target*	$2.90 *$2.90*	$3.60 *$3.60*	$2.9 *$2.90*	$3.6 *$3.60*	$2.9 *$2.90*	$3.6 *$3.60*

Avg Rate Increase	7.5%	6.8%	1.4%	14.3%	0%	0%
SF Typical Bill	$35.15	$37.55	$33.15	$37.90	$32.70	$32.70

The second scenario reduces the rate increase in 2011 to 1.4% to drive year-end cash down to the policy target of $5.1M, but produces an undesirable negative net income. Net Income in 2012 is still negative, though less so, but a higher than proposed rate increase of 14.3% is required to meet the year-end cash target. This is because less cash was carried forward from 2011 than under the proposed scenario. It should be noted that by 2012 the typical single family bill is actually higher than under the smoother more gradual rate increases originally proposed.

The third scenario, driving Debt Service Coverage down to the policy level of 1.7x, requires no rate increases in 2011 or 2012, but produces increasingly negative net income. In addition, the year-end cash target is missed in 2011, and the Solid Waste Operating Fund would have a large negative cash balance at the end of 2012.

It is likely that performance under either alternative scenario in which financial policies are purposefully violated would lead to a credit ratings downgrade for the Solid Waste Fund, meaning increased cost to finance major capital projects for many years to come. **For example, an additional 0.50% added to the interest rate on a $75 million 25-year bond issue would add nearly $7 million of interest over the life of the bond.**

The City of Seattle Debt Manager, Michael Van Dyck, submitted the following comments regarding the value of meeting all financial policies and preserving Debt Service Coverage above the policy target:

> **Solid Waste systems are viewed as extremely risky and usually have single – A ratings. Seattle's solid waste system has extremely high Aa3/AA- ratings. We think there are few, if any, other solid waste systems anywhere in the country with ratings in the double-A category. Once again, there is an expectation of very high DSC to justify this rating for a solid waste system. …there is a huge cost of capital difference between AA- and A+, so Seattle really can't afford even a single-notch downgrade for Solid Waste. Furthermore, accepting negative net income and blowing this policy target would be viewed very negatively and call into question the value of the policies.**

SPU's Bond Financial Advisor, Rob Shelley of Seattle-Northwest Securities, submitted comments highlighting the importance of maintaining the fund's credit rating in context of long-term capital financing costs:

> **For Solid Waste, a change in financial position that lowers your rating could be very significant; certainly more so than for the other SPU borrowing entities. The reason is that Solid Waste's ratings are at the bottom of the Aa category and right now there is a significant difference (about 50 bps) in borrowing costs between a Aa and A rated issuers. In fact, 12-18 months ago, the difference was roughly twice the amount it is today so there is a chance that the cost of a lower rating could even be greater. A rating is intended to reflect the long-term financial position of a borrower so any change in rating could be expected to persist for a significant amount of time. Because of this, it would likely impact more than just one borrowing meaning that a short-term rate benefit may very well have significant long-term costs.**

DRAINAGE & WASTEWATER SCENARIOS

Question: Is there room to mitigate the rate increases by moving closer to the policy target for debt service coverage or net income in 2011-12?

For the Drainage & Wastewater Fund, required cash to meet cash balance and cash financing of CIP is the binding constraint in both 2011 and 2012. This means that the proposed rate increases are set at a level to meet the cash targets. At this level all other financial policy targets are met (or exceeded). If the cash policies are to continue to be met, any reduction in rates from proposed levels must be accompanied by an equal or greater reduction in expenses.

The table below presents three scenarios with projected financial performance and rate increases:

- The "Proposed" scenario was presented by SPU to the SPUN Committee on 7/13/2010.
- The "Net Income toward Zero" scenario ignores binding constraints in order to reduce net income towards the policy target of "generally positive".
- The "DSC Toward 1.8x" scenario also ignores binding constraints and shows financial performance if Debt Service Coverage is reduced toward the policy target of 1.8x.

	Missed Target	Rate Proposal		Alternative #1 Net Income toward Zero		Alternative #2 DSC toward 1.8x	
Parameter	**Policy**	**2011**	**2012**	**2011**	**2012**	**2011**	**2012**
Net Income	Generally Positive	$9.02	$11.86	$0.4	$0.1	($4.0)	($14.3)
Debt Service Coverage	1.8x	2.7	2.8	2.0	2.3	1.9	1.8
Year-End Cash Balance	1 Month Treatment Target	$9.15 *$9.15*	$9.09 *$9.09*	$9.0 *$9.20*	($1.2) *$9.10*	$3.1 *$9.20*	($20.8) *$9.10*
Cash Financing of CIP	25% (4 year rolling avg)	25%	25%	22%	20%	23%	21%
Debt to Asset Ratio	Less than or equal to 70%	*0.62*	*0.64*	*0.67*	*0.66*	*0.67*	*0.68*
	Wastewater Revenue Increase	4.0%	4.0%	1.6%	4.9%	0.0%	0.0%
	Drainage Revenue Increase	12.5%	10.8%	3.6%	4.7%	0.0%	0.0%

The second scenario reduces net income towards zero in 2011 and 2012, but results in missing both the cash balance and cash financing of CIP targets in both years.

The third scenario, driving Debt Service Coverage down to the policy level of 1.8x, requires no rate increases in 2011 or 2012, but in addition to missing the cash balance and cash financing of CIP targets in both year, net income is significantly negative, particularly in 2012.

SUMMARY

Mitigating short term rate increases at the expense of meeting financial policies is not recommended. SPU has maintained strong bond ratings in all its funds and it would take many years to recover if a fund were to be downgraded. Any rate savings achieved in the short run is more than offset by potential increased borrowing costs and higher long run rate impacts, which increases the likelihood of financial performance being further impaired.