

Finance Committee

City of Arts & Innovation

TO: FINANCE COMMITTEE MEMBERS **DATE: FEBRUARY 10, 2015**
FROM: FINANCE DEPARTMENT **WARDS: ALL**
SUBJECT: CASH RESERVE POLICY FOR ELECTRIC AND WATER ENTERPRISE FUNDS - DIRECT SUBMITTAL

ISSUE:

The item for the Finance Committee consideration is to recommend to the City Council to adopt the Riverside Public Utilities (RPU) Cash Reserve Policy.

RECOMMENDATIONS:

That the Finance Committee recommend that the City Council:

1. Adopt the RPU Cash Reserve Policy, including approval of the following designated reserve funds: Customer Deposits, Additional Decommissioning Liability Reserve, Electric Reliability Fund, Mission Square Improvement Fund, Capital Repair & Replacement Fund; Recycled Water Reserve and the Property Reserve Fund;
2. Dissolve the Electric Utility's Operating Reserve, Regulatory Risk Reserve and the Energy Risk Management Reserve Accounts and transfer the balance as of June 30, 2015 of those accounts (\$143,031,000 \$15,000,000 and \$30,000,000, respectively) into the Undesignated, Unrestricted Reserve Fund;
3. Dissolve the Water Utility's Operating Reserve Account and transfer the balance as of June 30, 2015 (\$30,435,000) into the Undesignated, Unrestricted Reserve Fund; and,
4. Direct staff to annually review, and update the Policy at a minimum, once every five years.

Board of Public Utilities Recommendation:

The Board of Public Utilities unanimously approved this item at their regular meeting on December 18, 2015.

BACKGROUND:

At Board and City Council request, RPU has updated its Cash Reserve Policy, previously adopted in 2001. In updating the policy, staff has utilized more concrete metrics and analysis

based on specific risk factors for each utility, and has outlined mitigation levels to address the significant impacts that could negatively impact customer rates. The 2001 policy used more general industry standards, which are more generic and static. If reserves were reduced to 2001 minimum levels today, credit ratings could suffer significantly. The revised policy is dynamic and offers a more quantifiable methodology that identifies target minimums to support current credit ratings and protect ratepayers from rate shock. In addition, the policy is more clearly defined and comprehensive including guidelines relating to withdrawal, replenishment and administration of reserves. The policy establishes a clear reporting structure to the Board and City Council.

The importance of credit ratings is key to reserve levels. Higher credit ratings result in lower costs of borrowing, thus saving money for ratepayers in the long-term. RPU has raised its credit ratings since 2001 from A+ to AA- for the Electric utility and from AA- to AAA for the Water utility which has saved ratepayers millions of dollars in reduced borrowing costs for capital projects.

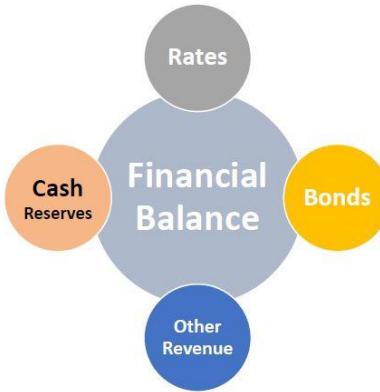
Utility 2.0

On October 2 and October 6, 2015, the Board and the City Council, respectively, approved in concept the Utility 2.0 Strategic Plan with Option 3 infrastructure, technology, and workforce trajectories to provide guidance to staff for final financial planning and recommendations. Option 3 represents a pro-active approach to updating our system, technology implementation and equipment replacement. The estimated costs associated with implementation of Option 3 are as follows:

Utility 2.0 - Option 3	
	Financial Investment
Electric Infrastructure	\$464 - \$538 million
Water Supply	\$102 - \$124 million
Water Infrastructure	\$279 - \$357 million
Total	\$845 - \$1,019 million

The Board and City Council endorsed Option 3 infrastructure and supporting workforce and technology projects contingent upon more information on financial balance and affordability.

The Thriving Financially Roadmap reviews the areas of rates, reserves, debt and other related policies to ensure the financial balance of RPU. The utility's cash reserves will play a crucial role in ensuring that the important infrastructure needs outlined in Utility 2.0 can be met with as little borrowing as possible and with as minimal impact on rates, thereby saving money for ratepayers.



As outlined in the roadmap, several projects need to be completed prior to developing the 10-year pro-forma and rate plan. These include the update and approval of RPU's reserve policy (presented herein), development of electric and water cost of service studies, and update and approval of the overall fiscal policy.

Policy History

In June 2001 the Board and City Council approved the RPU Fiscal Policy. The approved policy set minimum reserves of at least three months operating expenses, with a maximum amount of one year of operating revenues.

In fiscal year 2000-01, California experienced the energy crisis, with two of the major investor-owned utilities filing for bankruptcy protection and many others requiring double digit rate increases from the exponential run up in power supply costs caused by, among other things, market manipulation. RPU was one of a few utilities that weathered this crisis with no impact on customer rates. Following the crisis, in 2002 RPU adopted as one of its five goals the protection of RPU's financial health.

In August 2003, the Board and City Council approved three reserve funds (regulatory risk reserves, risk management reserves and operating reserves). The City Council approved transferring \$4,000,000 and \$11,000,000 into the Regulatory Risk Reserve Account and the Energy Risk Management Reserve Account, respectively, and set the operating reserves at a minimum/maximum of 90/365 days.

In July 2005, at the request of the Board, proceeds from sales of surplus property were tied to the purchase of other property or capital assets/projects. At that time, a water fund unrestricted, property reserve was set up to track the use of proceeds from the sale of surplus property.

In June 2014, at the request of the Board, \$10 million of proceeds from a lawsuit settlement was set aside for a recycled water program. A water fund unrestricted recycled water reserve was set up to track the accumulation and use of these proceeds.

Importance of Reserve Policy

Properly designed reserve policies send a positive signal to ratepayers, investors, and regulatory and credit rating agencies that the Board and City Council are committed to maintaining the long-run fiscal strength of RPU. Strong and transparent financial policies, including maintaining prudent reserves for emergencies, rate stability, working capital, capital

improvements and debt service, are consistent with best practices in the utility industry and are important to RPU as they help to:

- Maintain the short-term and long-term financial health of RPU.
- Maintain stable rates for customers and help ensure manageable rate increases.
- Fund unanticipated cost contingencies.
- Ensure funds exist for system improvements.
- Ensure cash exists for the timely payment of bills.
- Act as a significant positive credit factor in bond ratings.

Policy Development

As directed, staff has updated the reserve policy to conform to current best practices. Staff has been working with an independent accounting firm, Baker Tilly Virchow Krause, LLP, CPA's (Baker Tilly) and the RPU financial advisor, Public Financial Management, Inc., both of which have specialized expertise in utility industries, to develop an updated policy. This policy will establish guidelines to maintain the long-term fiscal health of the Electric and Water utilities.

The accumulation of reserves is permissible under the City Charter and California law, including both Prop. 26 and Prop. 218. These propositions require that the charges to provide utility service do not exceed the cost to provide such service. The accumulation of reserves is part of the operation of a utility and is common practice within the industry. Thus, such reserves do not exceed the cost of service. Charter section 1204 provides a priority listing for the expenditure of utility funds. Reserve funds, by definition, are funds that are not expended but are held in reserve. Section 1204 does not prohibit a reserve policy.

The process of creating the new policy included 1) understanding best practices for a municipal utility; 2) performing a risk assessment and quantification; 3) creating a methodical and rational formula to size reserves; 4) evaluating the policy for reasonableness and comparison to peer utilities; and 5) documenting the cash reserve policy.

Municipal Utility Best Practices: RPU is a member of the American Public Power Association (APPA) and American Water Works Association (AWWA). APPA/AWWA and their member agencies collaborate on utility best practices in a number of areas, including finance, risk, and rate setting. The APPA best practices for utility reserves were consulted and are reflected in the categories and risk factors included in the revised policy.

Risk Assessment and Quantification: The utility industry is very complex and subject to a number of environmental, market and regulatory considerations. The determination of financial strength is subjective, but ultimately relates to the expectation that RPU can continue to meet its primary financial goals in the context of the operational challenges that each enterprise faces. Fiscal responsibility requires anticipating and preparing for foreseen and unforeseen events. Prudent financial planning ensures sufficient funding for both.

Significant risk factors were evaluated which included: potential reduction in customer demand; loss of one or more large customers; wholesale market disruption that impacts financial results; new regulatory or environmental regulations that have a significant impact on costs; and, operational events that could dramatically increase costs.

Types of Reserves

RPU's reserves are either restricted or unrestricted and are classified into three categories:

1. Restricted Reserves

Restricted reserves are restricted by law and can only be used for a specified purpose. Current Restricted Reserves include:

- Decommissioning Fund (restricted by Nuclear Regulatory Commission regulations)
- Regulatory Requirement Reserve (restricted by Cap and Trade regulations)
- Unspent Bond Proceeds (restricted by public finance laws)
- Bond Redemption Reserve (restricted by public finance laws)
- Electric Public Benefit Fund (restricted by AB1890)
- Water Conservation Fund (restricted by Prop 218)

2. Unrestricted - Designated Reserves

Designated reserves are that portion of unrestricted reserves that have been set aside to meet specific purposes or Council policies. Designated reserves may be held for capital and operating purposes.

The recommended unrestricted, designated reserves are as follows:

Unrestricted – Designated Reserves	Purpose	Funding Source	Electric	Water
Customer Deposits	Monies held on behalf of the RPU's customers as required to be utilized if a customer fails to pay their utility bill.	The amount held equals amounts collected from electric and water customers based on Board and Council adopted Electric and Water Rules.	✓	✓
Additional Decommissioning Liability Reserve	Established to accumulate funds for the uncertainty of costs associated with the San Onofre Nuclear Generating Station decommissioning activities. These funds are in addition to RPU's funded trust held by the trustee included in restricted reserves. The amount of decommissioning funds held in the restricted reserve are equal to RPU's proportionate	Annual funding currently is \$1.6M which equaled the amount contributed annually to meet RPU's proportionate share of the restricted decommissioning trust. This amount can be evaluated and adjusted as needed.	✓	

	share based on the most current independent Decommissioning Cost Estimate (DCE). If the DCE is increased RPU will need to fund additional monies for decommissioning.			
Electric Reliability Fund	Established to accumulate funds received from retail customers through the Reliability Charge for the purpose of funding debt service for transmission and internal generation projects.	Funding for this reserve will inherently fluctuate based on revenue received from customers offset by approved debt service payments on transmission and internal generation projects. Funds are tracked and reconciled annually.	✓	
Mission Square Improvement Fund	Established to accumulate funds for future major improvements to the Mission Square facility.	Initial year will be funded by electric utility reserves in the amount of \$240,000, and future amounts will be funded by net revenues generated from tenant income. Reserve will be built with an annual contribution equal to 2% of the building value up to a maximum reserve equal to 25% of the building value.	✓	
Capital Repair and Replacement Reserve	Established to accumulate funds for repairs and replacement of facilities, vehicles, and technology outside of the Capital Improvement Program. Examples: roof replacement, vehicle replacement, desktop technology replacement.	Funding for this reserve will be built over a three year period based on historical 10-year average of replacement costs.	✓	✓
Recycled Water Reserve	Established to set aside funds for a recycled water program.	Initial funding was from a legal settlement from the City.		✓
Property Reserve	Established to accumulate all proceeds from surplus property sales to be used in the future for the purchase of property needed for operations, or for other	Accumulated and future proceeds from the sale of surplus property.	✓	✓

	long-term capital assets/projects.		
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As part of the revisions to this policy, staff recommends dissolving the current Electric fund's internally restricted Operating Reserve, Energy Risk Management Reserve and Regulatory Reserve Accounts. These risk factors are now evaluated and quantified as part of the unrestricted, undesignated reserve levels discussed below.

Under the revised policy, designated reserves will mitigate the impacts of known and impending exposures. The withdrawal and replenishment of Council/Board approved designated reserves and their allowable uses will be tracked individually, with the specific use of designated reserves separately approved by the Board and City Council.

3. Unrestricted, Undesignated Reserves

Undesignated reserves are the remaining unrestricted reserves that are maintained to meet and mitigate rate impacts for known and unknown risks. These reserves can be used for any lawful purpose and have not been designated for specific capital and operating purposes.

Staff Recommends maintaining the unrestricted, undesignated reserve account sufficient to cover the following risk categories:

1. Operating Reserves (Working Capital) – Operations & Maintenance, including Power Supply
2. Rate Stabilization
3. Capital Expenditures (both emergency and planned)
4. Debt Service

Unrestricted, Undesignated Reserve Policy

RPU will have sufficient unrestricted, undesignated reserves to maintain or improve its credit ratings, ensure that operating and maintenance costs will be paid in a timely manner, debt service obligations will be paid, and investments in needed capital improvements and equipment replacement will continue on a timely basis. In addition, RPU will maintain sufficient reserves to minimize needed rate increases due to temporary market volatility, weather impacts on demands, emergencies (such as natural disasters), and regulatory changes. Any of these impacts that are expected to be other than temporary may need to be addressed in a rate proceeding.

The Cash Reserve Policy outlines the appropriate risk categories and target (minimum) and maximum levels in order to size the unrestricted, undesignated reserve account as prescribed below:

Risk Category	Purpose	Target (Minimum) Calculation	Rationale	Maximum Amount	Electric	Water
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Operating Reserve (Working Capital) - Operations & Maintenance, including Power Supply Costs	Ensures sufficient resources to pay budgeted operating, maintenance expenses, including power supply costs, recognizing the timing difference between payment of expenses and receipt of revenues.	Equal to 60 days of operating expenses based on the most recent audited financial statements.	Billing and collection cycle is 60 days – difference between delivery of service and receipt of payment.	Equal to 90 days of operating expenses based on the most recent audited financial statements.	✓	✓
Rate Stabilization	Mitigate rate shock due to temporary and transitional regulatory changes, loss of a major resource, sharp demand reduction or market volatility.	10% of Operating Revenues	Based on low-end of risk quantification for power cost uncertainty due to load reduction, market energy price fluctuations, unit contingencies, transmission costs, and regulatory mandates.	20% of Operating Revenues	✓	
		7% of Operating Revenues	Based on historic fluctuation of retail sales from year to year due to unforeseen events (eg. recession, drought).	15% of Operating Revenues		✓
Capital - Emergency	Provide funds to ensure ability to repair system after an emergency or natural disaster such as a flood, earthquake or major windstorm	1% of depreciable capital assets as reported on the most recent audited financial statements.	Consistent with APPA guidelines for emergency reserves. Provides funds to pay for needed expenditures to be reimbursed by FEMA or	2% of depreciable capital assets as reported on the most recent audited financial statements.	✓	✓

			other sources			
Capital – System Improvements	Provide funds to ensure continuity of construction over fiscal years to be reimbursed by bond proceeds or other resources.	6 months of the following year's approved Capital Improvement expenditures (CIP).	Provides sufficient funding to meet planned capital expenditures – recognizing the time to procure funding (e.g., bond sale, grant)	9 months of the following year's approved Capital Improvement expenditures (CIP).	✓	✓
Debt Service	Ensure ability to make debt service payments in an extreme event that may impact RPU's ability to provide services, thus impacting revenues at a time critical infrastructure repairs are needed to restore systems.	Maximum debt service payment (semi-annual) in the upcoming fiscal year.	Prevent an event where RPU would be unable to pay its debt service.	Maximum debt service payment (semi-annual) in the upcoming fiscal year.	✓	✓

The above risk categories were evaluated in order to determine the appropriate levels of each utility's unrestricted, undesignated reserve account. These reserve allocations are consistent with industry standards for similarly rated electric and water utilities. Each component of the reserves is sized at less than the maximum possible exposure for each component because it is unlikely several of the risks each enterprise faces would materialize simultaneously.

Withdrawal and Replenishment of Reserves

RPU will treat the target reserves as practical minimums and allow reserves to increase or decrease as necessary within the minimum and maximum prescribed levels. No action would be required if reserves are between the minimum and maximum level unless directed by the Board and City Council.

If unrestricted, undesignated cash reserves exceed the maximum level, RPU would seek Board and City Council approval to finance capital improvements on a pay-as-you-go basis, pay down existing debt, offset other long-term liabilities such as pension obligations, reduce rates or fund other strategic initiatives.

The use of reserves to fund capital or other one-time strategic uses is an effective means to

mitigate the need for future rate increases, and helps to ensure RPU meets its reliability and resource objectives. Other uses, such one-time rate reductions or rebates, may be less effective and could result in higher rates over the long-term.

If unrestricted, undesignated reserve levels fall below the minimum targeted reserves, RPU could be exposed to significant operational risks. Should RPU draw down reserves below the target level, RPU will implement plans to return reserves to their target level within three years. If RPU is unable to replenish reserves within the three year period through then current electric and water rates, a rate increase should be considered by the Board and City Council.

Reporting and Oversight

Reserve levels will be monitored during the fiscal year and reported in the monthly and quarterly financial reports. Reserve target (minimum) and maximum levels will be analyzed annually and an over/under reserve determination shall be made in conjunction with year-end financial results. These results will be reported to the Board and City Council as part of the year-end financial report presentation. Should unrestricted designated or undesignated reserve levels need adjustment due to new risk factors due to changes in the industry, these will be brought to the Board and City Council as part of the year-end report.

The Policy will be reviewed annually, and updated (at a minimum of every five years) if there are material changes in the risk exposures or new conditions that require changes in reserve levels.

Revised Policy – Unrestricted Reserves - June 30, 2015

The following tables calculate target (minimums) and maximums for the fiscal year ending June 30, 2015, per the Utility's most recent audited year-end financial statements:

Reserve Level Calculations – Undesignated Reserves – 6/30/15

	Electric		Water	
	Target (Minimum)	Maximum	Target (Minimum)	Maximum
Working Capital – O&M and Power Supply	\$40,765,000	\$61,148,000	\$5,883,000	\$8,824,000
Rate Stabilization	\$33,791,000	\$67,582,000	\$4,305,000	\$9,225,000
Capital – Emergency	\$9,533,000	\$19,065,000	\$6,056,000	\$12,112,000
Capital – System Improvements	\$15,306,000	\$22,959,000	\$8,046,000	\$12,069,000
Debt Service	\$26,755,000	\$26,755,000	\$8,583,000	\$8,583,000
TOTAL	\$126,150,000	\$197,509,000	\$32,873,000	\$50,813,000
Days Cash on Hand Equivalent	186	291	335	518

Designated Reserves – 6/30/15

	Electric	Water
Customer Deposits	\$3,569,000	\$321,000
Additional Decommissioning Liability Reserve	\$3,337,000	-
Electric Reliability Fund	\$37,015,000	-
Mission Square Sinking Fund	\$240,000	-
Capital Repair/Replacement Reserve	\$2,000,000	\$750,000
Recycled Water Reserve	-	\$6,467,000
Property Reserve	-	\$26,004,000
TOTAL	\$46,161,000	\$33,542,000
Days Cash on Hand Equivalent	68	342

The following table provides a summary overview of unrestricted cash reserves, including revised policy target (minimums) and maximums and designated reserves as compared to actuals as of June 30, 2015:

	Electric			Water		
	Target (Minimum)	Maximum	Actual	Target (Minimum)	Maximum	Actual
Undesignated	\$126,150,000	\$197,509,000	\$181,264,000	\$32,873,000	\$50,813,000	\$50,322,000
Designated	\$46,161,000	\$46,161,000	\$46,161,000	\$33,542,000	\$33,542,000	\$33,542,000
Total Unrestricted Reserves	\$172,311,000	\$243,670,000	\$227,425,000	\$66,415,000	\$84,355,000	\$83,864,000

In summary, the target (minimum) is set at a level that provides for known and unknown risks to protect ratepayers from unanticipated rate shock and to support RPU's current credit ratings. Reserves above these targets provide the Board and City Council flexibility to use available funds above these target (minimums) to pay for capital projects (reducing the need for future debt), pay down unfunded liabilities such as pension obligations, decrease outstanding debt, or fund other strategic objectives.

Rating Agency Evaluation of Cash Reserves and Comparison to Peer Utilities

The above level of unrestricted reserves is consistent with industry standards for similarly rated utilities. Rating agencies will evaluate reserves in terms of Days Cash on Hand. One day of cash on hand is equal to total operating and maintenance expenditures (less depreciation) divided by 365. This is one measure of the ability of RPU to meet ongoing operating and maintenance expenses, as well as liquidity and flexibility.

The following table compares RPU's unrestricted cash reserve levels at June 30, 2015

(undesignated and designated) under the revised policy with rating agency medians and peer utilities. Results are in line with sector medians and peer utilities.

Riverside Public Utilities	Electric	Water
Undesignated	186	335
Designated	68	342
Total Unrestricted Days' cash	254	677

Fitch Rating Category - Days' Cash Medians ⁽¹⁾			
Rating Category	AAA	AA	A
Electric Retail Utility Reserve Medians	-	182	92
Water and Sewer Utility Reserve Medians	481	442	366

Peer Utility Days' Cash Levels						
Electric Utilities						
	RPU Target/Total Cash	Pasadena Water & Power	LADWP	Anaheim Public Utilities	Sacramento Municipal Utility District	San Francisco Public Utilities Commission
Rating (M/S/F)	-/AA-/AA-	-/AA-/AA	Aa3/AA-/AA-	-/AA-/AA-	Aa3/AA-/AA-	-/A+/AA-
Days' Cash ⁽¹⁾	186/254	402	203	136	207	560
Water Utilities						
	RPU Target/Total Cash	Irvine Ranch Water District	Inland Empire Utilities Agency	Anaheim Public Utilities	Eastern MWD	Western MWD
Rating (M/S/F)	Aa2/AAA/AA+	Aa1-/AAA	Aa2/AA/-	-/AAA/AAA	Aa3/AA-/AA	-/AA+/AA
Days' Cash	335/677	934 ⁽²⁾	439 ⁽²⁾	166 ⁽¹⁾	628 ⁽¹⁾	644 ⁽³⁾

Next Steps

Staff expects to return to the Board and Council in the 1st and 2nd quarters of 2016 with the APPA Hometown Connection organizational review results; Baker Tilly examination and performance audit on the Northside properties; Baker Tilly examination of financial policies and cost allocation plan; initiating work on Council-directed financial and performance audits by an external auditor; 2-year budget and electric and water cost of service studies. The 3rd and 4th quarters of 2016 will follow with net revenue projections (10-year-forma) and rate recommendations.

FISCAL IMPACT:

While not having an immediate direct impact on the current financial health of RPU, adoption of a reserve policy sets guidelines and parameters for ongoing activities that will protect the financial health of RPU for the future.

Prepared by: Girish Balachandran, Public Utilities General Manager
 Certified as to
 availability of funds: Brent A. Mason, Finance Director/Treasurer
 Approved by: John A. Russo, City Manager
 Approved as to form: Gary G. Geuss, City Attorney

Attachments:

1. Riverside Public Utilities Cash Reserve Policy
2. Presentation