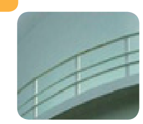
May 2021

# Austin Water Financial Policy Review

## Report by the Residential Rate Advocate



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NewGen Strategies and Solutions, LLC (NewGen) was engaged by the City of Austin (City) to serve as the Residential Rate Advocate in the financial policy review of Austin Water (AW). This report conveys our comments and recommendations based, in part, on the public presentation AW facilitated on this topic on February 9, 2021 and a follow-up meeting on April 29, 2021.

## AW's Proposed Changes to Financial Policies

AW has 16 financial policies that are reaffirmed each year in the budget approved by City Council. Only four of these 16 financial policies were subject to this review. Three of the four financial policies that AW has proposed to amend deal with financial ratios that are commonly used in the industry. The fourth involves the review process for selected capital improvement projects. In support of its position on the three financial ratios, AW primarily relied upon how the proposed targets compare with:

1) The rating criteria utilized by credit rating agencies (e.g., Moody's, Standard & Poor's, and Fitch);
2) Data from credit rating agency medians reports; and
3) The actual results reported for various municipal utilities across the state and nation in the last two years.

### Other City Departments

AW also referred to how the proposed financial policies compare with the policies of other City departments. While comparisons of AW's policies to policies for the airport, convention center, and Austin Energy may be anecdotally interesting, they do not provide support for a change to AW's policies. The water utility, airport, convention center, and electric utility operate in very different environments with very different financial risks.

For example, Austin Energy owns and operates electric generation sold into the wholesale ERCOT market. While this provides Austin Energy's customers with a hedge against price volatility in the wholesale market for power, if there is an unplanned outage at one or more of Austin Energy's generation plants, Austin Energy is exposed to prices in the wholesale market that can increase from the recent "normal" average of between $20 and $40 per MWh to the cap of $9,000 per MWh. A single event could represent $100 million or more in exposure. This risk was plainly demonstrated during the February 2021 Winter Storm Uri event in Texas. Further, although Austin Energy has a Power Supply Adjustment (PSA) rider to recover the costs of fuel and purchased power, the PSA is not designed to address immediate, short-term needs for cash stemming from outages or market events since adjustments to the PSA will not yield increased cash for Austin Energy for approximately 90 days, whereas payments to ERCOT are generally due two business days after settlement. There is no similar or analogous risk to AW of this magnitude or that impacts AW so quickly. This is simply one example of the differences in operating environments these utilities face. Thus, Austin Energy's need for financial reserves or debt service coverage are no basis on which to develop financial policies for AW.

### Medians Reports

AW provided information from various medians reports to support its proposed changes to the financial policies. Medians reports show how AW's actual financial metrics compare with other utilities by group, such as all utilities in the same part of the country or generally of the same size based on population served. These reports are a snapshot in time and are not a substitute for the ratings criteria or ratings process employed by the credit ratings agencies, as stated in the reports themselves. AW and PFM Financial Advisors (AW's financial advisors on debt matters) seem to have acknowledged that these medians should not be used as the basis for financial policies during the February 9, 2021 presentation.[1] The medians change over time as the industry experiences periods of either financial health or weakness, making them poor bases to set long-term financial policies. For example, as noted by Fitch, liquidity metrics in the industry are now over 50% higher than those a decade ago and are approximately double what they were relative to Fitch's 2007 medians.[2] Further, the medians are comparing actual financial results – not financial policies. Thus, the medians reports are of limited use in setting financial policies and NewGen did not rely on these to assess the reasonableness of AW's proposed changes.

## Benchmarking

AW provided benchmarking information on three financial ratios related to financial policies that AW would like to change. This included how AW's actual results compared with the actual results for selected other municipal utilities across the state and nation in the last couple of years. However, similar to the medians reports, this data is not adequate support for a change in financial policy. First, there are myriad differences in the circumstances and operating environments between one utility and another – even in the same state. Second, knowing what the actual results for a certain metric were does not correlate with the financial policies related to that metric. For example, the City of Arlington was reported to have a debt service coverage ratio of 3.46x in fiscal year 2019, whereas AW reported a coverage ratio of 1.83x for that same year. However, this comparison does not provide information about the financial policies for the City of Arlington or, more importantly, the appropriate financial policy level for AW. In fact, the City of Arlington achieved a relatively high coverage ratio in fiscal year 2019 under its existing financial policy that indicates it should set rates to achieve a coverage ratio of 1.50x.[3] Thus, this type of benchmarking information does little to support a change in AW's financial policies. As a result, NewGen largely ignored this benchmarking to assess the reasonableness of AW's proposed changes.

## Ratings Criteria

The ratings criteria used by rating agencies to assess the creditworthiness of AW is, in NewGen's view, an appropriate consideration in setting financial policies. AW's ratepayers have an interest in AW maintaining access to capital at reasonable borrowing costs. Generally, the better the credit rating of a borrower, the lower the cost to borrow at any given time. Thus, aligning AW's financial policies with a reasonable target credit rating is appropriate. AW's stated goal is to maintain a 'AA' credit rating.[4] This is a reasonable goal in NewGen's assessment, but it should be noted that only a little over 15% of combined water and wastewater utilities in a recent Moody's Public Finance report have a credit rating higher than AW and the median in that report was a credit rating a notch below AW.[5] Thus, AW's current credit rating places it in a fairly elite group of public water and wastewater utilities.

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[1] AW Financial Policy Update Stakeholder Meeting on February 9, 2021, from approximately 1 hour 34 minutes 30 seconds to approximately 1 hour 40 minutes into the 1 hour 56 minute meeting; https://www.youtube.com/watch?v=cWH3nUEvfXo&t=190s

[2] Fitch Ratings, Public Finance, 2019 Water and Sewer Medians, November 12, 2018.

[3] City of Arlington, Water Utilities Department, Financial Policy Statements, Revised 09/12/2011, item III.

[4] Response to question number 992 submitted by Grant Rabon through the Rate Study website during the 2018 rate review.

[5] Moody's Investor Service, US Public Finance, Water and Sewer Utilities, *Medians – Financial Performance Signals Continued Stability*, Appendix D, Exhibit 15, May 29, 2019.

While the ratings criteria may be relevant for consideration in setting financial policies, the ratings criteria do not clearly support a particular target for each of the financial metrics AW would like to change. Instead, they provide general ranges of acceptable results based on the various credit ratings. Thus, NewGen suggests that a change in the current financial policies might be warranted if the existing policies are inconsistent with the ratings criteria associated with AW's target 'AA' credit rating. **However, it is important to note that the existing financial policies have not prevented AW from achieving or maintaining its target 'AA' credit rating.** Thus, in NewGen's opinion, changing the financial policies is not essential to maintaining AW's credit rating.

## Proposed Financial Policies

### Debt Service Coverage (Financial Policy 5)

Financial Policy 5 currently states that a debt service coverage ratio of at least 1.50x shall be targeted. The 1.50x minimum target is greater than the requirement for 1.25x coverage as mandated in AW's debt covenants, which is typical as it would be unwise to target only satisfying the minimum requirement in the debt covenants because only modest variations in expenses or revenues could put the utility into technical default on its debt obligations. The relevant question is how much more than the minimum required coverage is appropriate and necessary?

AW has requested that the target coverage written in the financial policy be increased from 1.50x to 1.85x. This higher target is consistent with AW's internal goal as most recently set in the 2018 Rate Study[6]. According to Exhibit 3 of Moody's Rating Methodology publication (Moody's Rating Methodology)[7], a 'Aa' credit rating is consistent with a debt service coverage ratio of between 1.70x and 2.00x. Further, according to Table 17 of S&P's rating criteria publication (S&P Rating Criteria)[8], the highest initial assessment for all-in debt service coverage is associated with coverage of 1.60x or greater. Thus, an increase in the target coverage, although certainly not required, is supported by the credit rating criteria and the proposed 1.85x coverage target is at the midpoint of the range cited in the Moody's Rating Methodology for a 'Aa' credit rating. On this basis, NewGen finds the proposed change to Financial Policy 5 to be acceptable, but not critical.

### Cash Capital Funding (Financial Policy 10)

Financial Policy 10 currently states it is desirable for capital projects to be financed with an equity contribution ratio of at least 20%. The equity contribution represents cash and pay-as-you-go financing from current revenues. The balance of the capital project funding, no more than 80%, would presumably come from debt. The more capital funding is provided by equity, the less debt the utility incurs and the less leveraged the utility becomes. A utility with less debt (all things equal) should have more financial flexibility and more favorable treatment from lenders of capital. However, cash funding assets that have long lives (some with average service lives of 60 years or more – and may, in reality, last much longer)

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[6] The 2018 Rate Study conducted for AW included a detailed review of the cost of providing service to AW's various customer classes and a series of public engagement meetings with representatives from various customer groups. AW's internal goals were listed as Executive Team Decisions on slide 19 of the Public Involvement Committee PowerPoint presentation given on March 6, 2017.

[7] Moody's Investor Service, *Rating Methodology: US Municipal Utility Revenue Debt*, October 19, 2017.

[8] S&P Global Ratings, *US Public Finance Waterworks, Sanitary Sewer, and Drainage Utility Systems: Rating Methodology and Assumptions*, January 19, 2016.

implies the utility is asking current customers to pay for assets that will benefit future customers long into the future. There should be an appropriate balance between equity and debt funding for long lived assets to recognize and, where possible, minimize the potential for intergenerational equity issues.

AW has requested that the desirable target equity contribution written in the financial policy be increased from at least 20% to a range of between 35% and 50%. This higher range is consistent with AW's internal goal as most recently set in the 2018 Rate Study. Further, the proposed range is aligned with AW's reported actual equity capital funding since FY 2016.

NewGen is not aware of a specific credit rating criteria that measures the proportion of capital spending funded by equity[9], but there are other credit rating criteria that are related to this concept. For example, the assessment of debt to capitalization is a credit rating criteria that is influenced by the proportion of capital spending funded by equity. The more debt is utilized by a utility to fund capital projects, the higher the utility's debt to capitalization ratio will be (all else equal). Moody's measures debt to operating revenues as part of its financial strength assessment for utilities. Here again, this is not the exact same metric as the proportion of capital spending funded by equity, but it is related.

Given there is not a specific credit rating criteria for the proportion of capital spending funded by equity, NewGen's view of the proposed change to the financial policy is assessed based on its general impact on metrics that are measured by the credit rating agencies and AW's recent practice. While there is not a direct, linear relationship to evaluate, the proposed range of between 35% and 50% equity funding for capital projects is generally aligned with outcomes that are favorable to AW's assessment by the credit rating agencies. Further, the proposed range is consistent with AW's recent practice (since FY 2016). Given the proposed policy provides a range, AW can presumably adjust the level of equity funding (within the range) to reflect the nature of the projects involved, potential intergenerational equity issues, and the financial conditions at the time. On this basis, NewGen finds the proposed change to Financial Policy 10 to be acceptable, but not critical.

## Operating Cash Reserves (Financial Policy 12)

Financial Policy 12 currently states AW shall maintain operating cash reserves equivalent to a minimum of 60 days of budgeted operations and maintenance expense. It is worth noting there is a separate financial policy, Financial Policy 16, that requires an additional 120 days of budgeted operations and maintenance expense be maintained in a Water Revenue Stability Reserve Fund (WRSR) for the purpose of offsetting current year water service revenue shortfalls below budgeted revenue levels. Financial Policy 16 only applies to the water utility (and not the reclaimed water or wastewater utilities).

AW has requested that the minimum number of days written in Financial Policy 12 be increased from 60 to 245. This higher target is consistent with AW's internal goal as most recently set in the 2018 Rate Study. If adopted, between Financial Policy 12 and Financial Policy 16 the water utility would be required to maintain a minimum of 365 days of budgeted operations and maintenance expense in reserve. This would imply AW would have one full year of budgeted operations and maintenance expense in reserve for the water utility. AW has argued that the requirements in Financial Policy 12 and Financial Policy 16 should not be combined when assessing the reasonableness of the overall level of cash reserves because the funds in the WRSR are restricted and, therefore, should be ignored when assessing liquidity. It is true that the WRSR is restricted so that any use of these funds must be approved by City Council and, by policy, this

[9] It is NewGen's understanding, based on an April 29, 2021 meeting, that PFM Financial Advisors is similarly unaware of any specific credit rating criteria that measures the proportion of capital spending funded by equity.

should only occur when actual water revenue is less than budgeted revenue by 10% or more. The financial policy also indicates only 50% of the WRSR balance can be utilized in any fiscal year. These restrictions on the WRSR prevent credit rating agencies, such as Moody's, from including funds in the WRSR in their calculations of unrestricted days cash on hand, a key measure of liquidity. However, it is worth noting that these restrictions are only self-imposed and not mandated by an external body. Therefore, the City Council could remove these restrictions on the WRSR, if desired. Further, it is difficult to imagine AW having the need for liquidity, and therefore the need to access the WRSR, under circumstances other than in the situation where actual revenue is at least 10% below budgeted revenue. Thus, restrictions on the WRSR technically exist, but they are inconsequential to limiting AW's access to these funds and, in NewGen's opinion, should not be excluded when evaluating the liquidity of AW for the purposes of setting financial policies.

According to Exhibit 3 of Moody's Rating Methodology, a 'Aa' credit rating is consistent with days cash on hand of between 150 and 250 days. Further, according to Table 18 of S&P Rating Criteria, the highest preliminary assessment for days cash on hand is associated with results greater than 150 days. Thus, the ratings criteria support a financial policy that mandates a minimum of 150 days of budgeted operations and maintenance expense.

It is worth noting that AW and PFM Financial Advisors were only able to identify one utility in the entire country that has an operating cash reserve financial policy with a similar requirement for maintaining cash as the policy requested by AW. Hampton Roads Sanitation District (HRSD) is a wastewater utility that is a political subdivision of the Commonwealth of Virginia. HRSD has a financial policy indicating cash on hand shall be not less than 270 days and not more than 365 days based on current and non-current cash and investments, plus any restricted cash and investments, if available for general system purposes.[10] Given the combined obligations of Financial Policy 16 and the proposed Financial Policy 12 would result in a ***minimum*** requirement of 365 days for AW's water utility, and HRSD's financial policy implies a ***maximum*** of 365 days, in NewGen's assessment even the one utility in the nation that AW and PFM Financial Advisors can identify in an attempt to justify their proposed revision to Financial Policy 12 has a policy that is less onerous than what AW has proposed.

As part of its justification for increasing cash reserves, AW has referenced the financial strain it suffered during the drought that stretched through 2015. However, although a prolonged drought could reoccur, the financial impact on AW is expected to be less significant given the increase in fixed revenues and the new, lower baseline for water consumption reflective of the current Conservation Stage watering restrictions limiting automatic irrigation to once per week. AW's water fixed charge revenue was approximately 11% of water revenue in 2012[11] but, as of the 2018 Rate Study, AW now targets recovering approximately 25% of water revenue from fixed charges.[12] Thus, the proportion of water revenue that would be impacted by reduced water sales would be meaningfully less now, reducing the financial impact. Further, given the watering restrictions that were implemented as a result of the prolonged drought, and the changes in customer behavior that resulted (including investments in low-flow fixtures, xeriscaping landscaping and, in extreme cases, investments by some residents in private water wells to avoid watering

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[10] Hampton Roads Sanitation District, Commission Adopted Policy, Financial Policy, item 3.1.1, effective July 1, 2018.

[11] Response to question number 922 submitted by Lanetta Cooper through the Rate Study website during the 2018 rate review.

[12] Public Involvement Committee meeting on January 31, 2017 (at approximately 24 minutes, 10 seconds from the start)

restrictions), the current level of water consumption would be expected to be more stable in the event of more significant watering restrictions in response to a future drought. S&P has noted the reduced cash flow volatility associated with seasonality and weather conditions in its assessment of AW.[13]

Finally, AW has not presented the results of (nor, to NewGen's knowledge, conducted) a financial reserves study that supports a higher target based on the unique risks or financial obligations of AW or its current operating environment. For these reasons, NewGen finds no compelling support for the proposed change to Financial Policy 12. At best, the ratings criteria seem to support a financial policy that mandates a minimum of 150 days of budgeted operations and maintenance expense. This is consistent with the highest score on this criteria from the S&P Rating Criteria and, even though this represents the low end of the Moody's Rating Methodology for a 'Aa' credit rating, the existence of the WRSR lessens the need to establish a minimum of more than 150 days within Financial Policy 12.

### Capital Project Review by Boards and Commissions (Financial Policy 8)

Financial Policy 8 currently states selected capital improvement projects that are located in the Drinking Water Protection Zone (DWPZ) will be identified and submitted to the Water and Wastewater Commission, Resource Management Commission, Environmental Board, Planning Commission, and the Zoning and Platting Commission. These Boards and Commissions are to review, obtain input, evaluate, and make recommendations on inclusion of the projects in AW's capital spending plan.

AW has requested that the list of Boards and Commissions that are tasked with reviewing and advising on selected capital projects located in the DWPZ be reduced down to just the Water and Wastewater Commission. This change would still allow for public involvement and input but reduce the administrative burden on AW. AW's justification for this request seems reasonable and NewGen does not oppose the proposed change.

## Conclusions

Given that AW is able to achieve and maintain its target 'AA' credit rating with its existing financial policies, there does not seem to be a compelling need to change AW's financial policies. However, NewGen does not oppose the proposed changes to Financial Policies 5, 10, and 8, as the proposed changes largely align with the internal policies AW has set for itself and relevant credit ratings criteria as justification. NewGen does find the proposed change to Financial Policy 12 to be unsupported by the ratings criteria (or any other compelling rationale or study). NewGen recommends that if Financial Policy 12 is to be changed it be amended to target a more reasonable, moderate level of operating cash reserves, such as 150 days.

It is also worth mentioning in the context of potential changes to AW's financial policies, that the credit ratings agencies also consider affordability as part of their assessment. Thus, to the extent the changes in financial policies result in higher rates for customers, in addition to this being a potential burden on ratepayers, this may work at odds with AW's affordability goals and its assessment of affordability by the credit rating agencies. Affordability has been cited by credit rating agencies as a potential weakness in the past[14] and concerns regarding affordability should be given substantial consideration and balanced against AW's proposed changes.

[13] S&P Global Ratings, Ratings Direct, Summary: Austin, Texas; Water/Sewer, October 8, 2020, page 5.

[14] Fitch Ratings, New York, Press Release on May 19, 2014, https://www.fitchratings.com/site/pr/830710