ORANGE WATER AND SEWER AUTHORITY

A public, non-profit agency providing water, sewer and reclaimed water services to the Carrboro-Chapel Hill community.

MEMORANDUM

TO: **Finance Committee**
Heather Payne (Chair)
Quinton Harper
Dave Moreau
Amy Witsil
John Young (*ex-officio*)

THROUGH: Ed Kerwin

FROM: Stephen Winters, CPA

DATE: December 5, 2014

SUBJECT: Finance Committee Meeting – December 11, 2014

The Finance Committee will meet on Thursday, December 11, 2014, at 4:00 PM in the OWASA Boardroom. The agenda will be:

- Review and discuss staff's proposed process for hiring a firm to conduct the independent audit of OWASA's Fiscal Year 2015 financial statements.

  Committee Action Requested: Provide feedback regarding the proposed process and recommend to the Board that staff proceed.

- Discuss the adequacy of the reserves called for in our Financial Management Policy.

  Committee Action Requested: Review and discuss information and provide guidance to staff regarding next steps.

Stephen Winters, CPA
Director of Finance and Customer Service

cc: Board of Directors
Ed Kerwin
Bob Epting

Information for Proposed Independent Auditor Selection Process
December 11, 2014

One of the Board's responsibilities is to appoint the organization's independent auditor. For the last four fiscal years, our independent financial audit has been performed by Martin, Starnes and Associates. In the spring of 2013, the Board of Directors asked staff to plan to issue a Request for Proposals (RFP) for audit services for the audit of our FY 2015 financial statements. The following outlines staff's proposed process for assisting the Board in fulfilling this responsibility. This process is similar to the one used 2011 when OWASA last solicited audit engagement proposals.

Issue a RFP using the following methods:

1. Post on NC Department of Administration's Interactive Purchasing System
    a. Web based
    b. Accessible to anyone including HUBSCO registered vendors
2. Advertise in *Greater Diversity News*
3. Post for distribution with the NC Institute of Minority Economic Development (Durham). We anticipate that the institute will publicize it through:
    a. Their Plan and Resource Center
    b. United States Department of Commerce Minority Business Development Agency web based outlet

We plan to ask responding firms to submit two packages of information; one will contain the firm's qualifications and one will include proposed fees. We will evaluate and rank responding firms based on their qualifications before reviewing what they propose charging for their services. We plan to ask that responses be submitted to us within four weeks from the date the RFP is issued.

We will identify the firms we believe to be the best candidates to perform our annual audit based on the following key criteria:

1. Expertise
2. Relevant experience as evidenced by the firm's client list / references and individual engagement team member's experience and expertise
3. Demonstrated commitment to winning our engagement (level of interest in working with OWASA)
4. Location (based in North Carolina)

We anticipate conducting in-person panel interviews with a small group of "finalists." In 2011, our interview panel consisted of members of OWASA's staff and the Finance Director from the Town of Chapel Hill. Twenty-six firms submitted proposals and four were interviewed. Information about the four finalists' qualifications and fees was provided to the Board along with the interview panel's recommendation.

Committee Action Requested

Provide feedback regarding the proposed process and recommend to the Board that staff proceed.

Background

At its meeting on September 22, 2014, the Finance Committee discussed two topics regarding our financial reserves. The first was about our plans for the amount of reserves that currently exceeds the minimum targets set-forth in our Financial Management Policy. Staff explained that it anticipates that the amount by which our current reserves exceeds the minimum requirements is expected to be expended on capital improvements projects over the next two years. The committee determined that no further action is necessary.

The second topic was about whether the level of reserves established by our Financial Management Policy is appropriate to sustain the organization financially. In general, the committee expressed support for maintaining the existing three reserve funds. However, in order to assess whether the balances in the accounts are appropriate for financial sustainability (e.g. neither too large nor too small), the committee wants to analyze scenario-based financial modeling to further evaluate risks and vulnerabilities.

A Case for a Reserve Policy

Based on interactions with UNC's School of Government and other utilities across North Carolina and the U.S., not many organizations similar to OWASA have a Board-adopted policy on reserves. On several occasions, we have been asked to contribute to articles and presentations about our Financial Management Policy.

To add context to our discussion, the following is an excerpt from an article published in the November 2014 American Water Works Association Journal. The authors state:

> "The reality of uncertain water demand, increasing supply costs, large capital costs inherent in providing water service, and potential liabilities from system failures faced by water enterprises illustrates the importance of adopting reserve policies that are specifically tailored to each utility.
>
> Adopting a formal reserve policy can provide a number of potential benefits. A reserve policy can help ensure that adequate cash is available to meet working capital needs, an appropriate level of capital investments is funded with cash rather than debt, and adequate resources are available to cope with fiscal emergencies such as revenue shortfalls from droughts, asset failures, or natural disasters. It also provides guidelines for sound financial management by promoting a long-term emphasis on maintaining financial sufficiency and mitigating financial risks associated with revenue instability, volatile capital costs, and emergencies. Additionally, adopting and adhering to a sustainable reserve policy enhance financial management transparency, which improves public confidence and elected officials' credibility and helps achieve or maintain stronger credit ratings for future debt issues. There are a variety of components to consider when determining the financial health of an enterprise utility, but two main indicators are of particular importance: debt-service coverage and liquidity."

As you may recall from previous discussions, feedback we have received from the ratings agencies indicates that our policies on debt-service coverage and liquidity, and our adherence to those policies, have been keys to maintaining our "AA+" bond ratings and being considered sound financially.

Analysis of Current Policy

As we have discussed, our Financial Management Policy calls for three reserves as summarized in the table below.

Name of Reserve	Minimum Balance	Approximate Target Balance as of FY 2015 Budget
Rate/Revenue Stabilization Fund	5% of projected annual water and sewer revenue	$1,700,000
Capital Improvements Reserve Fund	2% of annual depreciated capital costs	$6,000,000
Working Capital	The greater of 33% of annual operating expense budget or 20% of the succeeding three years' CIP budget	$8,700,000
Total		**$16,400,000**

Days Cash On Hand

At the fully funded level of $16.4 million, the balance equates to 302 days of operating expenses, or "days cash on hand." For perspective, according to Fitch Ratings, municipal utilities could be considered strong if days cash on hand were 365 or more, whereas one with only 180 days cash on hand would be considered midrange. However, it is important to remember that days cash on hand is just one component of an entity's financial profile.

Sensitivity Analysis

The following table indicates the financial impact of various potential scenarios that could result in the need to utilize reserve funds.

Scenario	Estimated Financial Impact ($)
Loss of revenue due to an 10% reduction in water and sewer revenue [1]	(3,500,000) [2]
5% loss of water and sewer revenue	(1,700,000) [2]
Operating expenses are 10% over budget	(1,980,000) [2]
Electricity expense is 20% over budget	(375,000) [2]
Chemicals expense is 20% over budget	(385,000) [2]
Health insurance expense is 20% over budget	(275,000) [2]
Maintenance expense is 20% over budget	(570,000) [2]
Minimum cost of a catastrophic loss of an elevated water storage tank	(3,000,000)
Destruction of large gravity sewer aerial creek crossing	(250,000)
Major issue with one of our dams (for example, in FY 2013 an unexpected gate repair was almost $1 million)	(1,000,000)
Loss of the ability to bill customers and receive payments for services for one month	(2,900,000) [2]
Construct temporary pipeline to Haw River in case of severe water shortage	(2,000,000) [3]

[1] The largest single-year reduction in water and sewer revenue OWASA has experienced since inception was 11% which occurred from 2002 to 2003. This reduction occurred in spite of a rate increase of 6.25%. However, drought surcharges were not yet implemented. On an average million gallons per day basis, water sales dropped by 7.5% from 2008 to 2009. But due to drought surcharges and a rate increase of 9.75%, revenue increased by $700,000.

[2] Calculations are based on FY 2015 budget information.

[3] When last contemplated seven years ago, cost estimates for a temporary Haw River pipeline were between $1 and $8 million depending on the duration of the need and other factors.

Some of the scenarios listed above may be less likely to happen than others but each have the potential to occur. Obviously, one can identify many additional scenarios that could lead to a reduction in cash flowing into the organization or an increase in cash flowing out of the organization. However, the result of any of these types of scenarios is less cash on hand.

If one or more of the scenarios listed above occur at a time when we do not have adequate reserves, we would have to take steps to mitigate the related impact on cash available. Mitigating steps could include one or a combination of the following:

- Increase rates
- Reduce operating expenses
- Reduce capital improvement expenditures
- Increase borrowing

Taking these steps could have adverse impacts including:

- Customer affordability
- Our ability to properly maintain our assets which could affect the level of service we deliver
- Our ability to improve and rehabilitate system assets which could also affect level of service
- Borrowing costs
- Stakeholder confidence

The issue to address is whether our current reserve policy is sufficient to provide the resources needed to sustain the organization financially. Based on our research, there is no standard approach to setting reserve levels. The article quoted above mentions "the importance of adopting reserve policies that are specifically tailored to each utility."

A few questions that may help in analyzing the appropriateness of our reserve policy include:

If we encounter one or more of the potential scenarios listed above, will our reserves provide sufficient cash to:

- Meet working capital needs
- Fund an appropriate level of capital investments with cash rather than debt
- Deal with fiscal emergencies such as revenue shortfalls from droughts, asset failures, or natural disasters
- Sustain our bond ratings

Staff Recommendation

Staff believes that our reserve policy is appropriate to sustain the organization financially and recommends leaving existing reserve parameters in place.

Committee Action Requested

Review and discuss information and provide guidance to staff regarding next steps.