ATTACHMENT 5

Financial Policy Review

Cash-Funding Alternatives

King County Wastewater Treatment Division

October 6, 2022

Agenda

1. Background
2. Cash-Funding Policy Alternatives
3. Evaluation Results
4. Recommendations
5. Next Steps
6. Q&A

Background

- Current practice of cash-funding 40% of the Capital Improvement Program (CIP) has helped to strengthen WTD's financial capability and limit growth in debt balances
- But a rapidly growing CIP introduces challenges to current approach
    - **Affordability:** large projected rate increases, especially in the last five years of the 2023 Adopted Rate Forecast
    - **Rate management:** rates are sensitive to changes in CIP forecasts, resulting in more volatile rate forecasts
- MWPAAC, King County Council members, Department of Natural Resources and Parks leadership, and the County's Office of Performance, Strategy and Budget (PSB) have all expressed interest in reviewing the current cash-funding practice and potential alternatives

Cash-Funding Policy Categories

- Cash-funding approaches can be grouped into three general categories

A — **Based on a percentage of capital expenditures**

WTD practice since 2017 (40% of total CIP)

B — **Anchored in concepts related to asset renewal**

Three potential alternatives

C — **Cash-funding as indirect result of debt service coverage target**

WTD practice before 2017 and not the focus of this analysis

Cash-Funding Policy Alternatives

A

- Based on a percentage of capital expenditures, generally intended to limit the utility's resulting debt ratios
  - Current practice: **40% of total CIP**
  - Alternative evaluated: **30% of total CIP**

B

- Anchored in concepts related to asset renewal/replacement, system reinvestment, or annual consumption of assets by current ratepayers
  - **Repair & Replacement:** fully cash-funding WTD's Asset Management portfolio category every year
  - **Original Cost Depreciation:** cash-funding an amount equivalent to WTD's forecasted annual depreciation
  - **Replacement Cost Depreciation:** cash-funding an amount equivalent to WTD's forecasted annual depreciation, after escalating capital assets costs to today's dollars

Summary of Evaluated Alternatives

	Alternatives*	Cash Funding Average	Sewer Rate in 2032	Reduces Sewer Rate Increases	Meets DSC 1.40x	Change in Total Interest Expense	Reduces Volatility
A	1. 40% of Total CIP (Current Practice)	40.2%	$100.33	N/A	Yes (1.59x - 1.72x)	N/A	N/A
A	2. 30% of Total CIP	30.3%	$87.23	Yes	No (1.37x - 1.60x)	$0.6 billion	No
B	3. Repair & Replacement at 100%	40.2%	$100.33	No	Yes (1.59x - 1.72x)	$0.0 billion	Some
B	4. Repair & Replacement at 80%	32.1%	$89.30	Yes	Yes (1.43x - 1.60x)	$0.5 billion	Some
B	5. Original Cost Depreciation	36.4%	$92.53	Yes	Yes (1.53x - 1.67x)	$0.2 billion	Yes
B	6. Replacement Cost Depreciation	69.4%	$129.35	No	Yes (1.66x - 2.80x)	($1.7 billion)	Yes

**Alternatives compared to current 10 year sewer rate forecast at year 10*

Policy Recommendation: Original Cost Depreciation (1/2)

Addresses affordability concerns while preserving financial strength

Current Practice

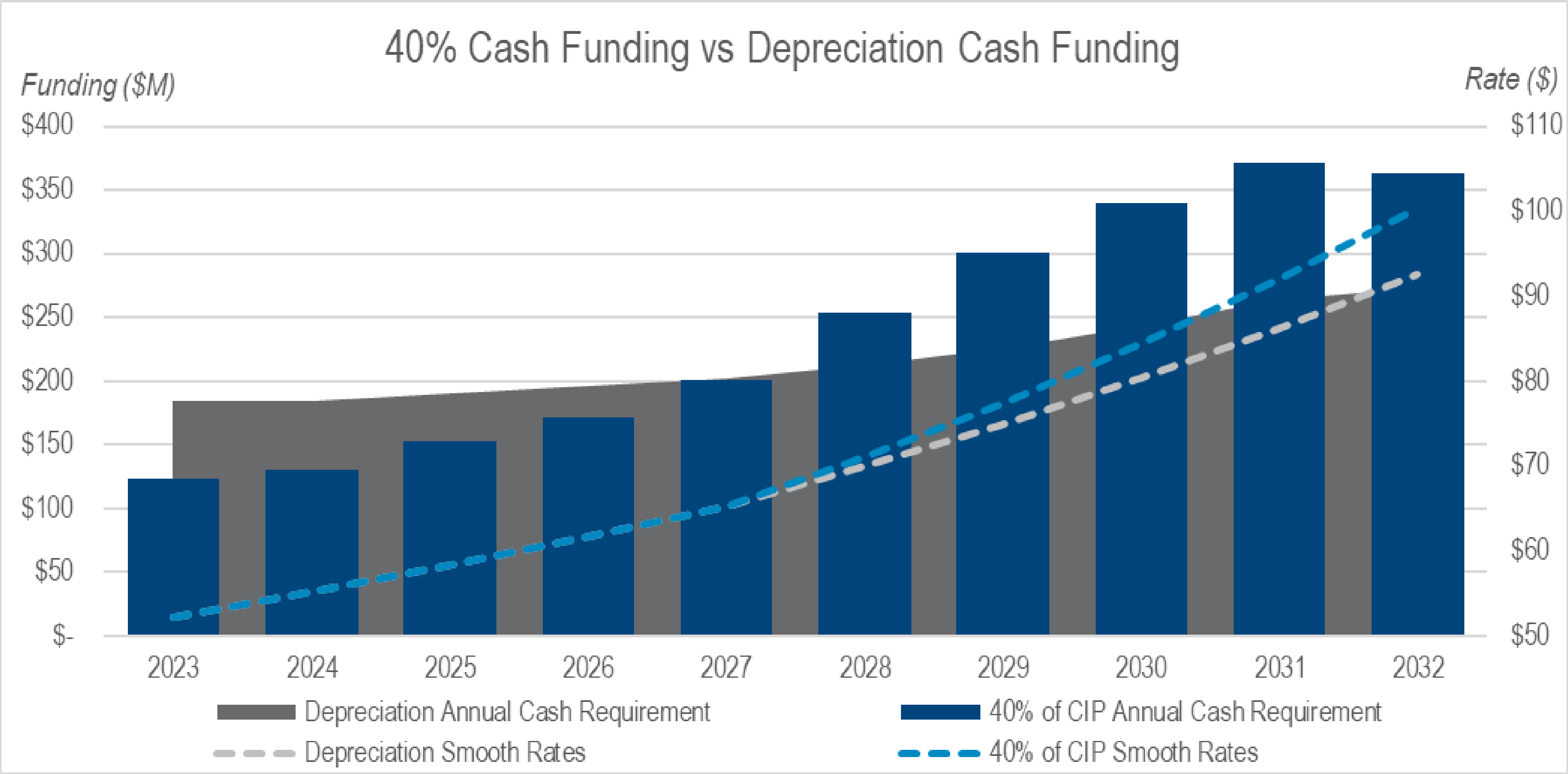
40% Cash Funding	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Rate Increase %	**5.75%**	5.75%	5.75%	5.75%	5.75%	9.00%	9.00%	9.00%	9.00%	9.00%
Monthly Sewer Rate	**$52.11**	$55.11	$58.28	$61.64	$65.19	$71.06	$77.46	$84.44	$92.04	$100.33
All-In Debt Service Coverage	1.59x	1.63x	1.64x	1.65x	1.67x	1.69x	1.72x	1.70x	1.70x	1.71x
Cash Funding									10-Year Average	40.2%

Recommended Policy

Depreciation Cash Funding	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Rate Increase %	**5.75%**	5.75%	5.75%	5.75%	5.75%	7.25%	7.25%	7.25%	7.25%	7.25%
Monthly Sewer Rate	**$52.11**	$55.11	$58.28	$61.64	$65.19	$69.92	$74.99	$80.43	$86.27	$92.53
All-In Debt Service Coverage	1.59x	1.63x	1.64x	1.65x	1.67x	1.66x	1.65x	1.59x	1.56x	1.53x
Cash Funding									10-Year Average	36.4%

Policy Recommendation: Original Cost Depreciation (2/2)

Reduces volatility in rate forecasting: revenue requirements become less sensitive to changes in CIP forecasts



Additional Recommendations: 1.40x DSC and Regular Reviews

- WTD also recommends maintaining a minimum 1.40x debt service coverage as a secondary rate-setting requirement
  - This would honor MWPAAC’s original recommendation in 2015 and signal to rating agencies that WTD is committed to maintaining strong financial metrics
  - The 1.40x coverage has been exceeded since 2016 and is projected to be achieved in all but one of the evaluated alternatives
- Lastly, WTD recommends conducting a comprehensive policy review, with contract agency participation, every five years
  - The next review would be 2027 and could result in further adjustments reflected in the 2029 rate-setting process

Next Steps

- Continue receiving feedback from MWPAAC on November 3 and December 7
- Select cash-funding alternative in December
- Implementation of new cash-funding approach to guide the 2024 sewer rate process that formally starts in February 2023

Wastewater Treatment Division
Rates, Capital, & Debt Management

Andrés Bas Moore
Financial Planning & Analysis Coordinator

Devin ViBarnes
Unit Supervisor

Appendix

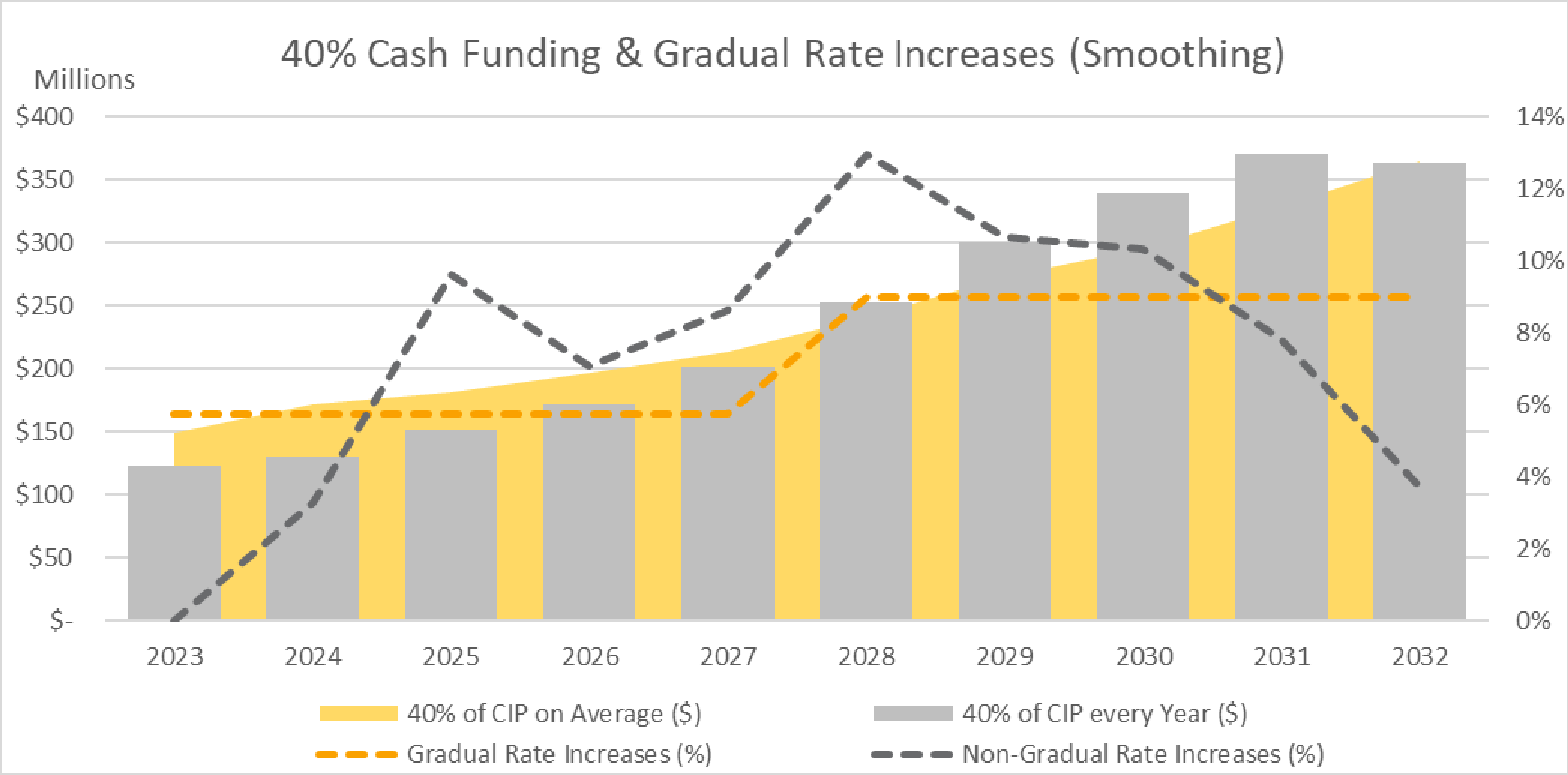
Industry and Rating Agency Perspectives on Cash Policy

- Industry publications from Water Environment Federation and American Water Works Association mostly refer to the practice of cash-funding annual repair and replacement (R&R) programs
  - Depreciation is viewed as an approximation to R&R
- Bond rating agency scoring metrics illustrate a preference for more cash-funding (lower debt-to-asset levels and high debt service coverage ratios)
  - Moody's considers WTD's debt service coverage as "satisfactory" and below sector median
  - Standard & Poor's considers WTD's debt-to-asset ratio "extremely high"
- Cash-funding policies vary considerably among peer agencies across the country depending on financial context
  - Common to rely on cash-funding percentages, debt service coverage, debt-to-asset ratios, or a combination of those
  - Sometimes minimums or targets are set low to provide more flexibility, but are easily exceeded for planning purposes

Cash-Funding & Rate Smoothing

- Cash-funding requirements tied to a rapidly growing CIP result in steep, irregular rate increases (dark grey dotted line)
- WTD “smooths” the rates by averaging the 40% cash-funding requirement over 10 years (orange dotted line)
- Near-term rates become more sensitive to changes in CIP forecasts (more “volatility”)

Annual Cash-Funding Requirements: 2023-2032 Adopted Rate Forecast



Volatility Example

- Sensitivity analysis on the right shows what would happen if CIP increases or decreases by $200 million a year after 2032 under two different cash-funding alternatives
- Under a 40% cash-funding approach, cash requirements (and rates) change in proportion to CIP growth, which can lead to rate volatility
- Under a depreciation cash-funding approach, cash requirements (and rates) change much more gradually over time but the changes last longer—there is more stability in the rates