Hamilton County Administration

Interdepartmental Memo

Date: November 25, 2014

To: Board of County Commissioners

Cc: Christian Sigman, County Administrator
Dave Meyer, Utility Oversight Director
John Bruggen, Budget Director

From: Jeff Aluotto, Assistant County Administrator

Subject: MSD Budget and Rates for 2015

Introduction and Summary Budget Recommendation

On Wednesday, December 3rd and on Monday December 8th, the Board will conduct public hearings on MSD's proposed operating and capital budgets as well as MSD's recommended rate increase for 2015. MSD's proposal includes an operating budget of $234.2 million and a Capital Budget of $318.9 million.

The County oversight team has reviewed the MSD budget proposal, has met several times with MSD staff to review information, and is recommending an Operating Budget of approximately $216.5 million and a Capital Budget of approximately $290 million.

The 2015 Operating Budget recommendation represents:

- An approximate 1.5% increase relative to the 2014 Budget as legislated, and amended, by the Board of County Commissioners ($213.3 million).
- A 3.3% increase relative to projected MSDGC 2014 expenditures ($209.5 million)

The 2014 Recommended CIP represents:

- A 39% increase over the 2014 approved CIP ($209 million).
- A 10% decrease relative to the amount projected for 2015 in the 5 year CIP as adopted in 2014 ($322 million).

As it relates to the Operating Budget, the variance from the MSDGC request to the Administration's recommendation is driven largely by lower estimates for debt service in 2015 and targeted reductions to the Operating Budget to better align with historical trends. Lower debt

service projections comprise approximately $7 million of this amount. Given these dynamics, it is possible that an adjustment to the Administration's recommendation could occur in advance of the Board action should more information be received. Additionally, in 2015, if capital financing actions (bond sales, OWDA draws, etc.) occur at a time of the year which differs significantly from current assumptions, additional appropriations may be needed throughout the year in order to cover debt service.

When examining the requested and recommended Capital Budget figures, it should be noted that these amounts represent a plan as legislated by the Board of County Commissioners. Actual capital expenditures in a given year will include some portion of that amount as well as cash flow from projects legislated in prior years which are now in being planned and constructed.

Comparison of MSD/County 2015 Operating and Capital Budget Recommendations		
	Operating Budget	**Capital Budget**
MSD Submittal	$234.2 million	$318.9 million
County Recommendation*	$216.5 million	$290.0 million
Difference	$ 17.7 million	$ 28.9 million

*Amounts may change slightly as additional information provided by MSD is appropriately evaluated.

A detailed description of the County oversight team's review is included with this memorandum and was posted to the County's website along with MSD's budget proposal.

Rate Recommendation

MSD submitted a Revenue Requirement, Cost of Service and Rate Design Study on November 14th, 2014. The study recommends a proposed rate increase of 7% in order to continue to cover the operational costs of the sewer district, fulfil debt service payment requirements to bondholders and to maintain an adequate liquidity position to advance fund capital projects and facilitate access to the bond market. The County team has reviewed this proposal with its financial advisor and has determined that a lower increase of 5.5% is possible for 2015. This lower recommended increase is due, primarily, to the following factors:

- A reduced operating budget recommendation.
- A later timing of the 2015 revenue bond issuance, than projected by MSDGC, which will likely delay an initial principle and interest payment until 2016.
- The refunding of $267 million of MSD revenue bonds which produced a net present value savings exceeding $30 million and which will reduce debt service on outstanding revenue bonds by $1.2 million in 2015 and $2.3 million annually thereafter.
- Differing assumptions between the County and the MSDGC recommendation regarding the impact of capital legislation, contracts and projected cash flow on required reserves.

Attachment A provides an analysis of the recommended 5.5% increase in terms of debt service coverage and outstanding debt over the life of the consent decree and into future years.

It should be noted that the rate environment for MSDGC is still largely driven by the massive court-ordered wet weather capital program being undertaken and projected to last for an additional 20 years. While past discussion has referenced this capital program as a $2-$3 billion program, these references have typically been framed in 2006 dollars. On a real dollar basis, after considering inflation as well as baseline estimates for Phase 2 WWIP spending, total program costs could exceed this amount. The need to ensure liquidity to adequately finance this program and to maintain industry standard levels of debt service coverage will necessitate significant future rate increases. Additional impacts to rates could materialize to the degree project costs come in higher than projected in initial WWIP estimates.

While the precise cost of Phase 2 is not currently known, it is projected to be in the range of $2 billion and, as such, will have a significant impact on rates. The Administration's approach has been to set rates presuming those costs will total approximately $2 billion spread evenly over the years 2020 through 2036. The uncertainty over long term program costs, however, makes it very difficult to apply a strict philosophy to rate setting (i.e. It is difficult to measure the impact of various rate scenarios on program costs when a large portion of those costs are uncertain). Instead, the Administration seeks to make a recommendation which balances short term affordability concerns with longer term metrics relating to the total cost of the MSDGC capital program.

Impact of Rates on Debt Service Coverage

The table below details projected debt service coverage ratios for 2015 as referenced in MSDGC's report recommendation as well as in the 2014 Revenue Bond OS and the County's recommendation.

Debt Service Coverage	2015
MSD November 2014 Recommendation	1.95x
October 2014 OS	2.00x
County Current Recommendation	**2.23x**
County Policy	1.5x
Bond Covenant	1.25x
AA1 Credit Benchmark	1.77x

Note: Debt Service Coverage is defined as Net Revenue from Operations plus connection fee revenue and interest income divided by debt service in a given year.

Debt service coverage levels are perhaps the single most important controllable factor in determining bond pricing for an entity. This becomes even more important given the impact of debt service costs on the operating budget and, thus, rate requirements. While County Administration deems it impractical to attempt to precisely hit forecast coverage levels on an annual basis, it would recommend against a radical departure from a projected coverage level – in particular when that level was just disclosed to the financial community in the last several months. Rates and coverage levels should be set prudently, as part of a long term plan that

considers financial stability of the utility, long term program costs, and affordability to the rate payer.

Rate Equity Issues

It is apparent that rates for certain customer classes are not consistent with the cost of providing service to those classes. This is most significant in the sewer surcharge fees applied primarily to industrial/commercial users. The Administration recommended freezing these rates in 2014 and would recommend doing the same in 2015. Doing so is reflected in the Administration's recommendation.

In addition to this rather academic issue, there has been increasing general discussion on the magnitude and affordability of recent and planned future MSD rate increases. Most recently, this discussion culminated in a community meeting arranged by Communities United for Action (CUFA) in which a majority of the Board of County Commissioners participated. One outcome of that meeting was concurrence by the Board that a broad community-based effort should occur in 2015 to examine the issue of sewer rates and affordability of those rates in Hamilton County. The goal of the effort would be to examine and recommend alternatives for addressing the economic impacts of future rate increases on the broader community.

As a part of its 2015 work plan, the Administration will seek to facilitate the formation of a community task force, inclusive of a broad range of stakeholders, around this issue – not dissimilar from the task force effort currently investigating 9-1-1 funding options on the Board's behalf. Separately, yet concurrently, the Administration will be looking more deeply at the issue of affordability and where the County stands in relation to prescribed WWIP benchmarks. This issue may help to refine the Board's approach on rates, capital financing policies, and MSDGC budgets in general.

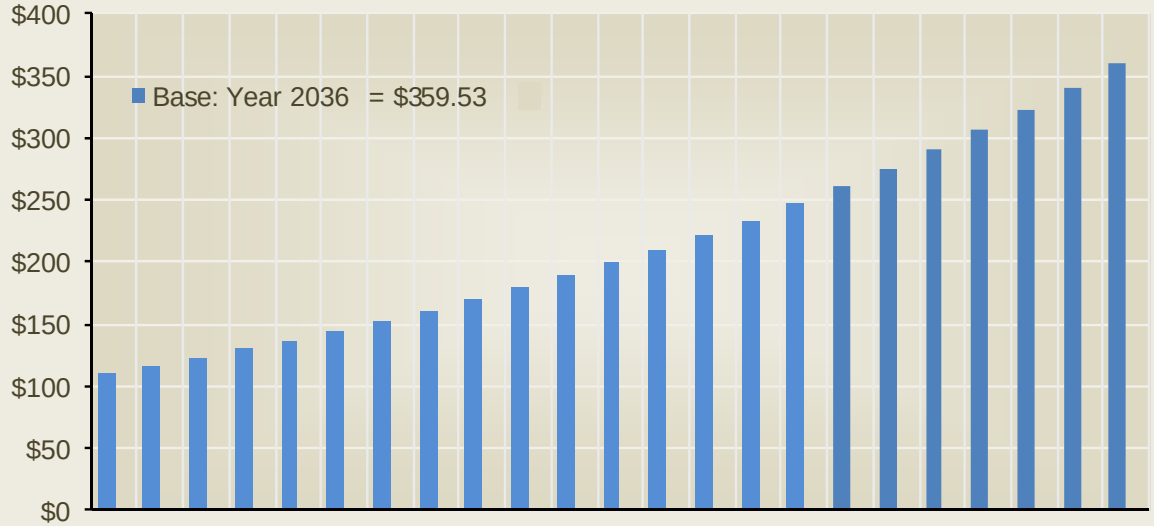
In conclusion, development of the MSDGC budget and rate recommendation is a complex effort which requires a great deal of teamwork and cooperation amongst employees at the County, City and MSDGC and across the employees of various consulting firms all of whom bring unique expertise to the table. In particular, the Administration wishes to thank the work of the County's MSD Oversight Team including Director of Utility Oversight, Dave Meyer and County Compliance Coordinator Karen Ball for their hard work in compiling these budget recommendations and to Plante Moran and Public Financial Management (PFM) for assistance with rate calculations and budget analysis. Additional thanks go to Director Tony Parrott and the staff at MSD for their work and cooperation in this process and to Pam Lemoine, at Black and Veatch Consulting, for her continued hard work in developing the MSDGC Revenue and Rate Analysis report which, each year, serves as the cornerstone of the entire rate setting process.

Establishing the Base Case

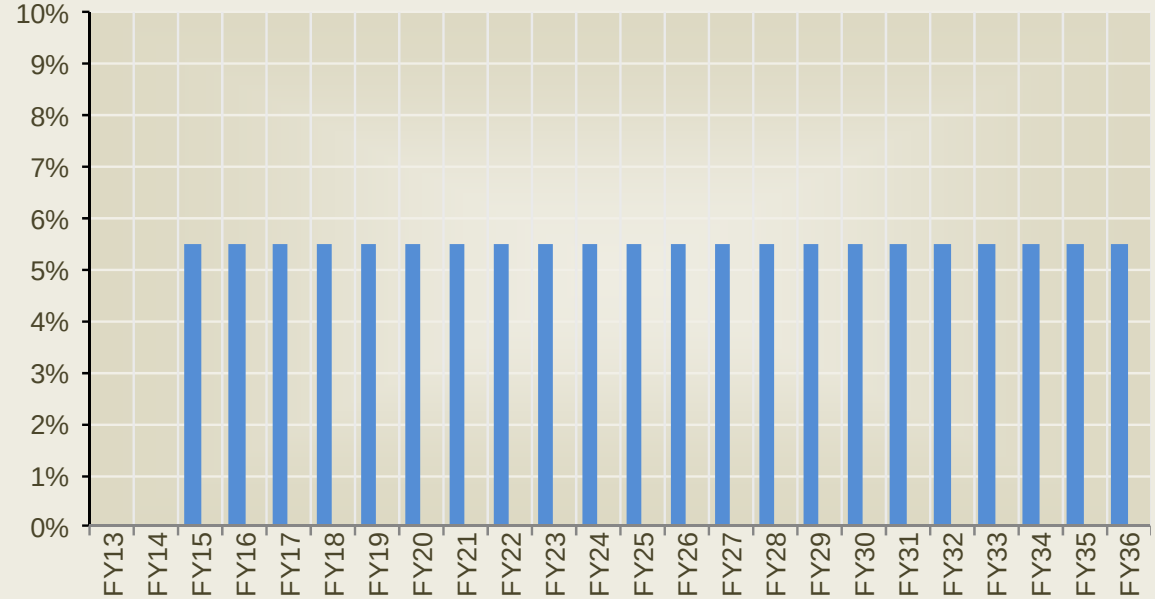
- The Base Case
  - Rate increases are flat at 5.5% per year from 2015 – 2027 when Phase 2 is complete.
  - Revenue as provided by Black and Veatch.
  - Capital and Operating Costs as provided by the County.

Rate Increases

5/8 inches (Quarterly) Minimum Charge

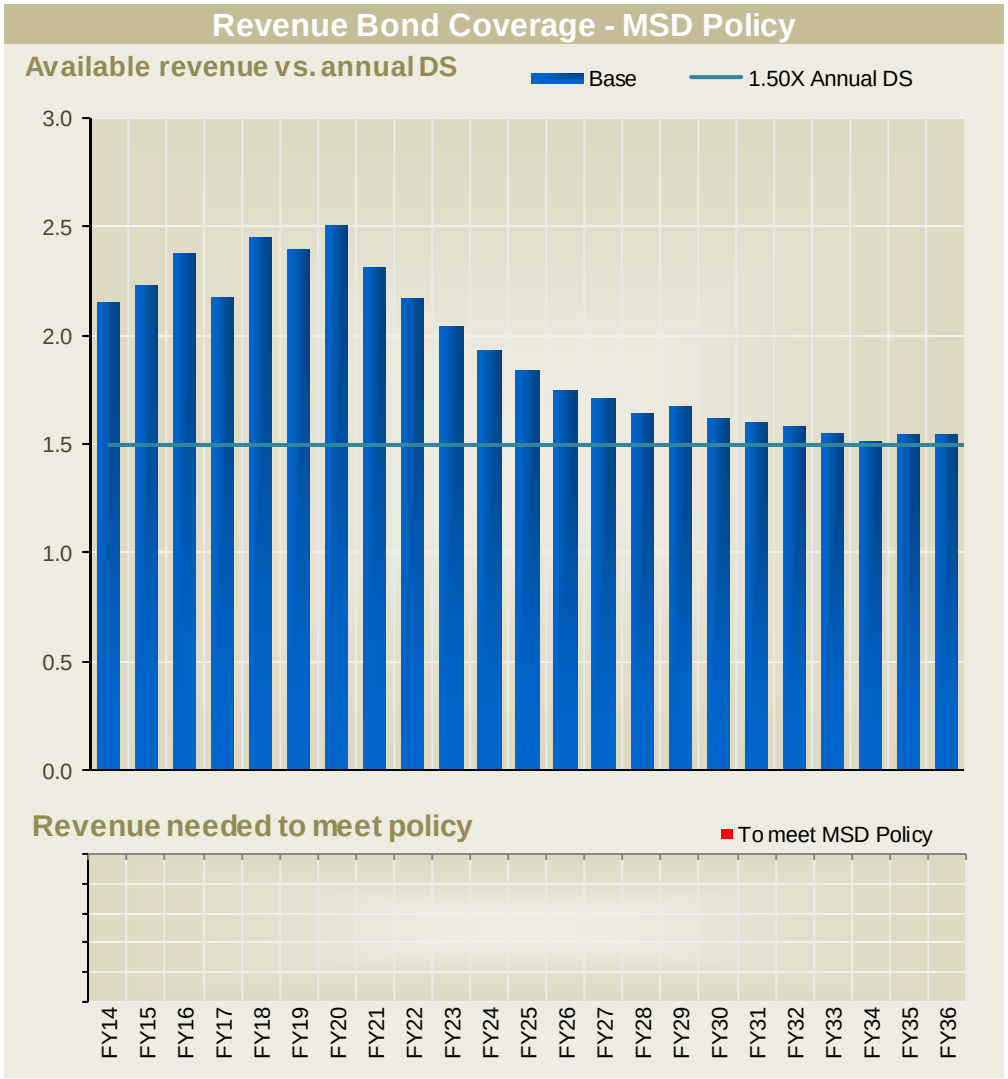


Projected rate increases



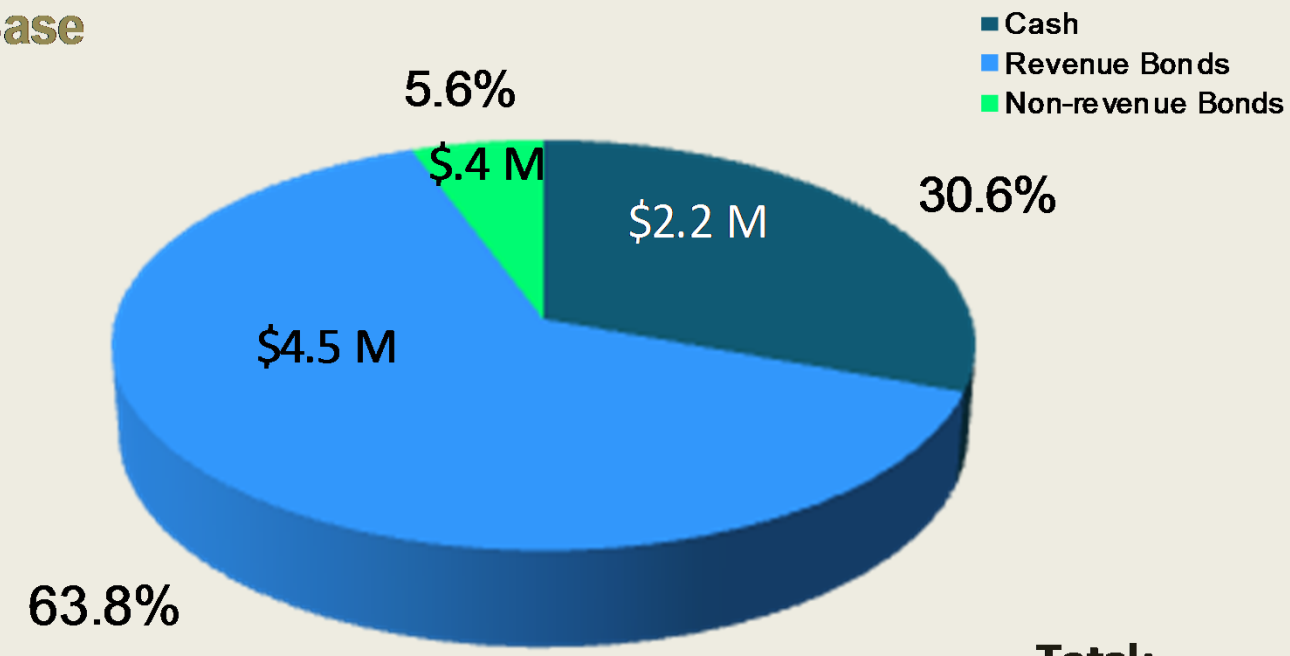
Coverage

	FY 14	FY 15	FY 16	FY 17	FY 18	FY 19	FY 20	FY 21	FY 22	FY 23	FY 24	FY 25	FY 26	FY 27	FY 28	FY 29	FY 30	FY 31	FY 32	FY 33	FY 34	FY 35	FY 36
Base	215%	223%	237%	218%	245%	239%	251%	231%	217%	204%	193%	183%	174%	171%	164%	167%	161%	159%	158%	155%	151%	154%	154%



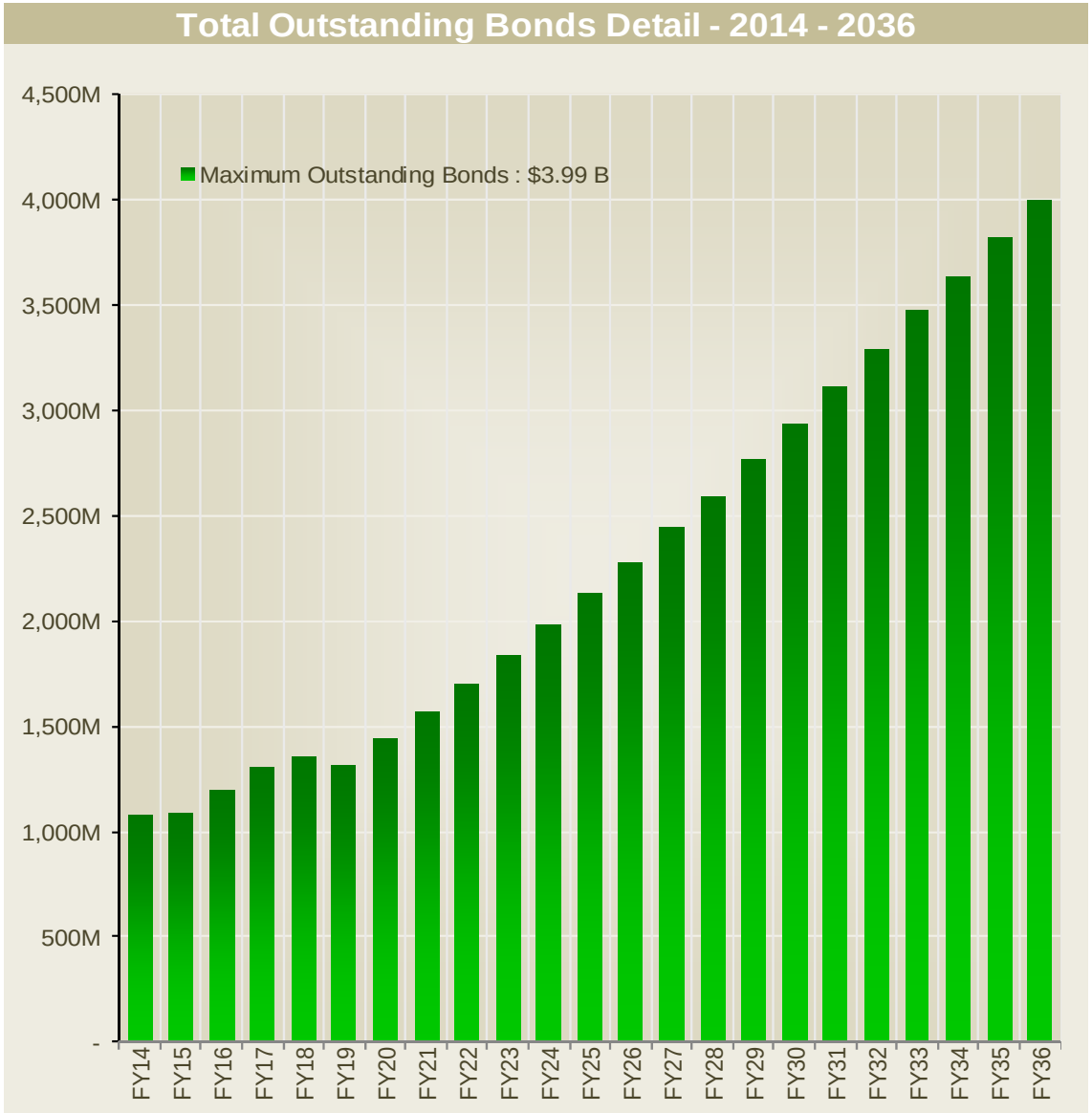
Project Funding

Total - Base

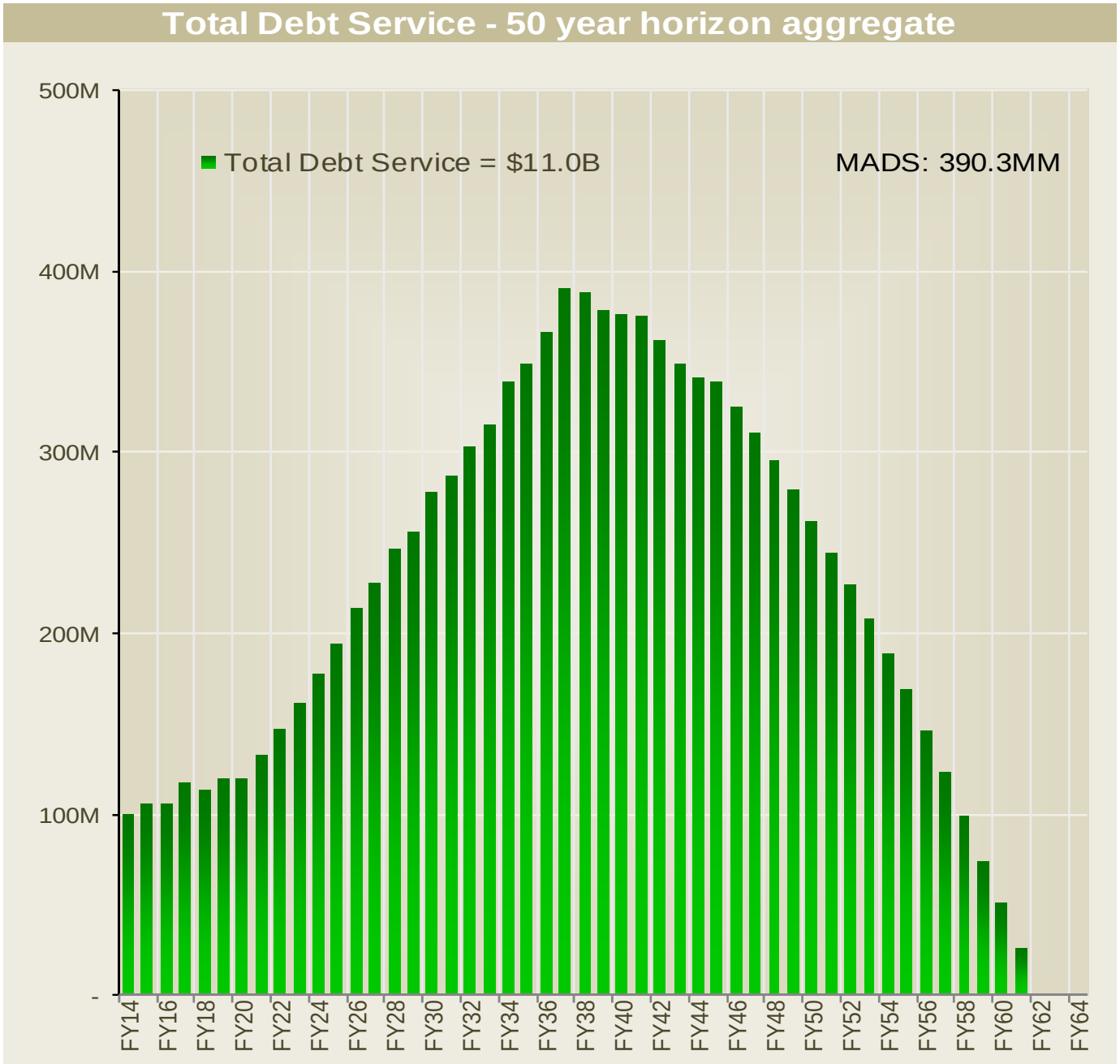


Total:
7,130,152,304

Debt Outstanding at Fiscal Year End



Includes OWDA loans ($475,000,000)


Total Debt Service - 50 year horizon aggregate
Total Debt Service = $11.0B
MADS: 390.3MM
500M
400M
300M
200M
100M
-
FY14
FY16
FY18
FY20
FY22
FY24
FY26
FY28
FY30
FY32
FY34
FY36
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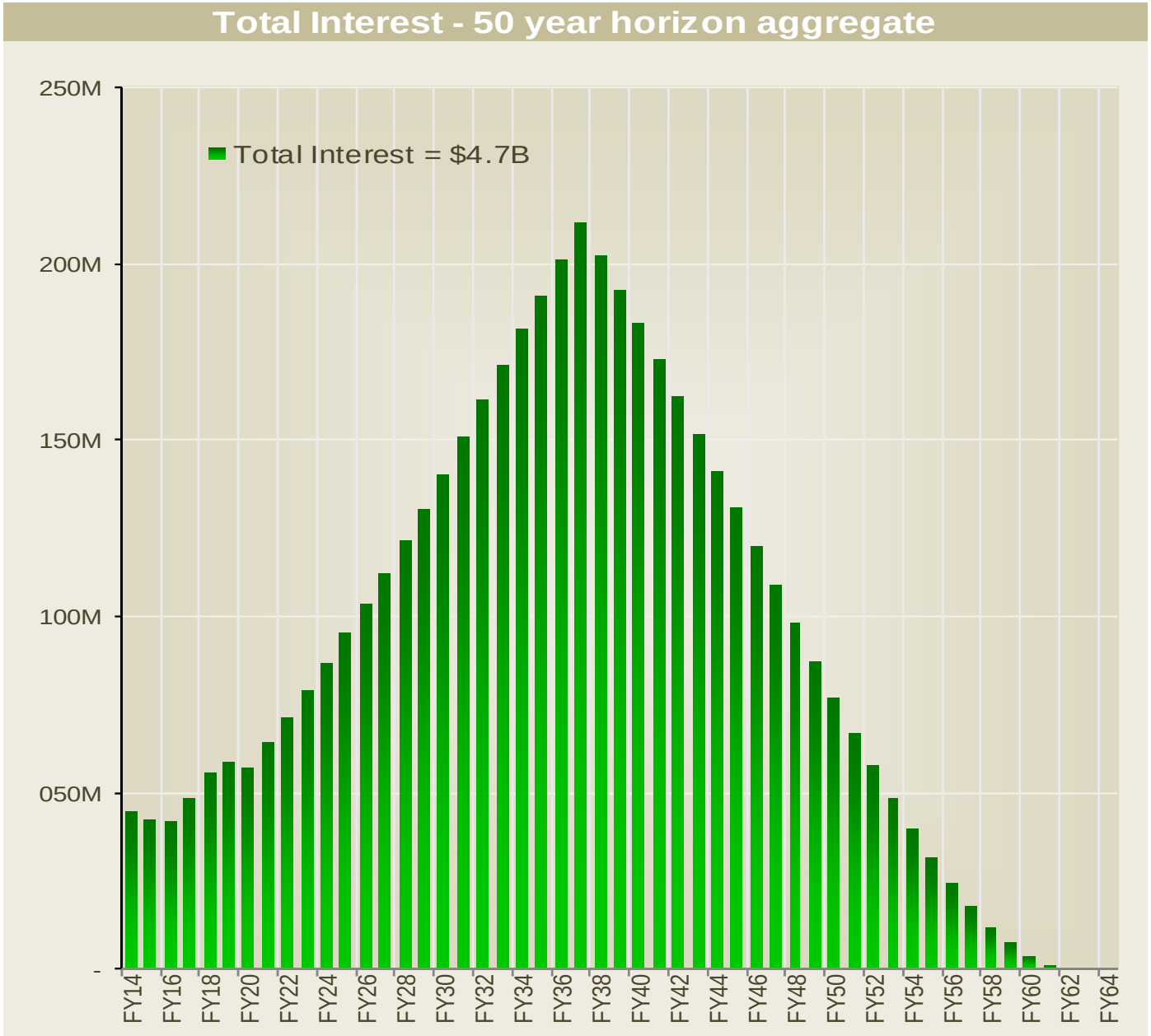
FY64


Total Interest - 50 year horizon aggregate
Total Interest = $4.7B
250M
200M
150M
100M
050M
-
FY14
FY16
FY18
FY20
FY22
FY24
FY26
FY28
FY30
FY32
FY34
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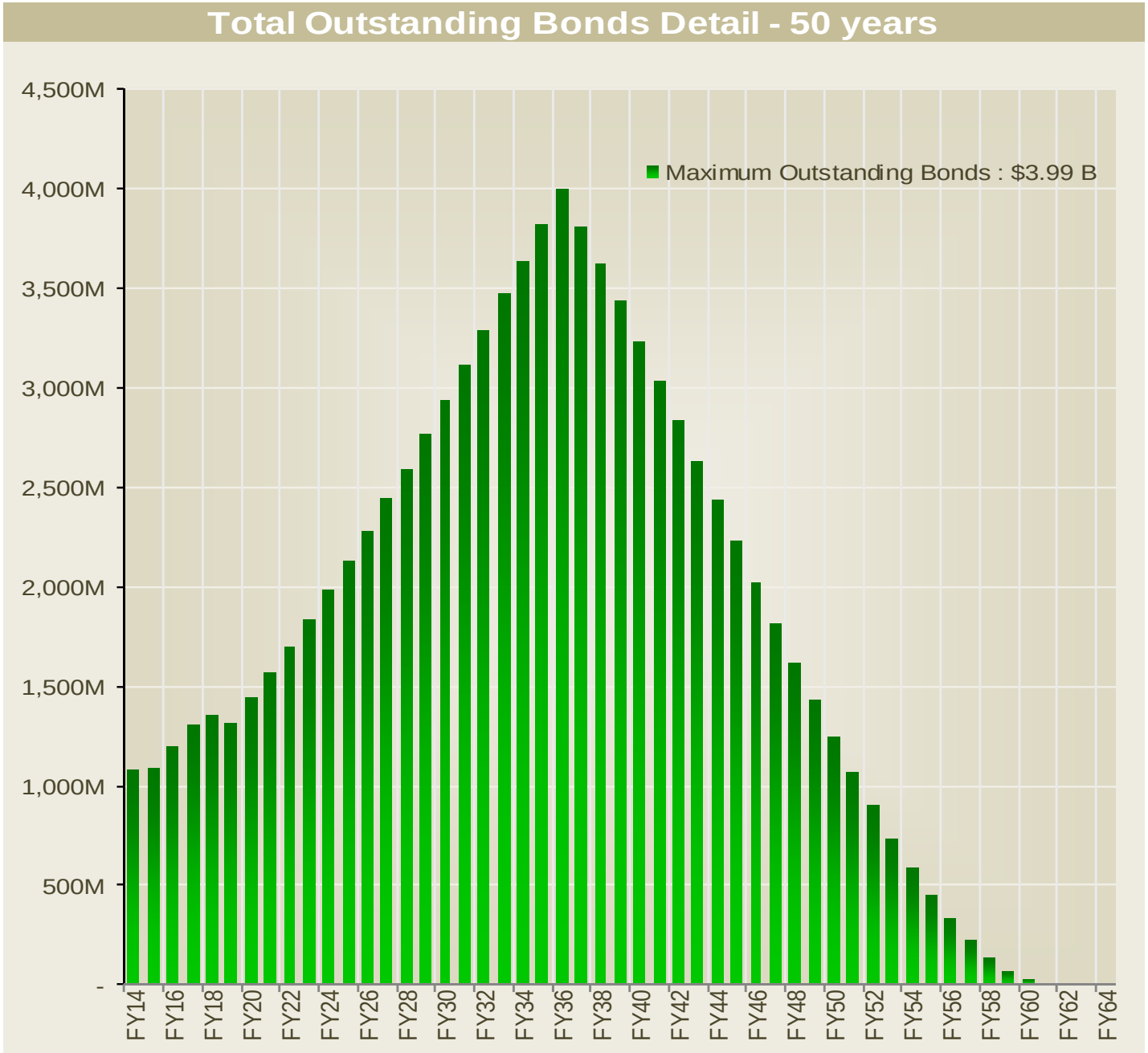
Total Outstanding Bonds Detail - 50 years
Maximum Outstanding Bonds : $3.99 B
4,500M
4,000M
3,500M
3,000M
2,500M
2,000M
1,500M
1,000M
500M
-
FY14
FY16
FY18
FY20
FY22
FY24
FY26
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FY30
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