City and Borough of Sitka Finance Department

Memo

Thru: Mark Gorman, Municipal Administrator

To: Mayor Matthew Hunter and Members of the Assembly

From: Jay Sweeney, Chief Finance and Administrative Officer

Date: March 14, 2017

Re: FY2018 Budget Special Meeting on March 16, 2017

The second FY2018 budget special meeting is scheduled for March 16th and will focus on Sitka's eight enterprise funds. To prepare for this special meeting, I would like to highlight, from my perspective as Chief Financial and Administrative Officer, the key issues relating to these particular funds.

Enterprise Funds differ from the General Fund in several important ways, and these differences are the areas in which Assembly overview is most critical. Key differences in enterprise funds are (1) that they are established to operate as a business; (2) they levy user fees for the provision of some service, normally utility services; and, (3) user fees are established by the Assembly at rates necessary to generate cash flow sufficient to pay for ongoing operating expenses and to accomplish long-term fiscal and infrastructure plans which are critically linked.

Given the key differences, I encourage the Assembly to focus on and examine the following broad areas:

(1) What is the cash flow the enterprise fund is generating currently, and, what cash flow is it projected to generate in FY2018? Examine the cash flow from operations, which is operating less operating expenses excluding depreciation. This cash flow is critical as it forms the resource necessary to pay debt service and increase working capital for the future cost of infrastructure. If cash flow is too meager and does not allow for working capital to build to levels identified in fiscal plans, then infrastructure decisions will need to be delayed or revised, or, higher than anticipated levels of debt taken on in the future.

(2) What is the proposal for increasing user fees? User fees should be examined annually for adjustment in relation to inflation. Collective bargain agreements increase operating costs as bargained wage increases become effective; not adjusting user fees in relation to programmatic expense increases has a direct impact on reducing operating cash flow. Proposed user fee increases above inflationary adjustments need to be examined as to their necessity to generate the cash flow required to fund capital infrastructure plans. If political affordability concerns impact user fee increase decisions, then close examination of the proposed capital infrastructure plan is required.

(3) What is the long term capital infrastructure plan for at least the next decade comprised of? What is being proposed for construction and what is the plan to pay for it? Each enterprise fund's capital construction plan, and the funding decisions imbedded in it, have a direct impact on user fees. Again, if political affordability issues cause concern over potential user fee

increases, the re-examination of the capital infrastructure plan and/or examination of operating costs is required.

(4) If the proposed budget is fully executed, what will the resultant financial position of the enterprise fund be? For each enterprise fund, staff has prepared a document entitled "Pro Forma Financial Projection". It is located at the end of each enterprise fund's budget section. I strongly encourage Assembly members to examine this document as it is a one-page encapsulation of each fund's proposed financial performance and position for the budget year. This document projects where working capital for each fund will be at the end of the fiscal year, both designated for capital projects and undesignated. Is it enough? Is it growing?

Critical issues in Sitka's individual enterprise funds.

Electric Fund

A user fee increase that will approximate 15% for most users is built into the budget. Staff feels that this user fee is the minimum that will allow for achievement of bond coverages for debt coverage, barring any unforeseen or unanticipated consumption decreases or expenses. The Pro forma financial projection for the Electric Fund, on page 119, forecasts the debt coverage ratio to be the minimum 1.25%. The proposed budget for the Electric Fund will generate operating cash flow of $158,692. Proposed new capital expenditures are $3,300,000 and are detailed on page 118. As operating cash flow is insufficient to finance proposed new expenditures, working capital will be used as the source for funding the proposed improvements. Unspent bond proceeds from the final 2014 electric revenue bond issue are proposed as the source, as opposed to undesignated working capital.

It important that the infrastructure plan for this utility be reviewed in conjunction with the budget, as critical infrastructure repairs are required over the next decade and the bare minimum of working capital is projected to be generated to pay for them. Additional bonding is not a viable option, given the current high level of debt and debt-to-equity ratio in excess of 50%. The capital infrastructure plan has risk associated with it and that risk should be reviewed.

Water Fund

A 3% user fee increase is being proposed annually from 2018 through 2020, then 3.7% annually through 2026 and inflationary increases thereafter. The proposed annual increases are directly tied to the capital required to finance the long-term infrastructure plan. The Water Fund long-term capital infrastructure plan projects low-interest DEC loans being taken out every year going forward as the source of funding to pay for planned improvements; the reason for this is that insufficient undesignated working capital exists, and will not be generated, to pay for such improvements outright without debt. The Pro forma financial projection for the Water Fund, on page 129, shows that the Fund will generate operating cash flow of $342,192. Proposed new capital expenditures from working capital are $245,000 and are detailed on page 127. In addition, additional contingent capital improvements of $19,337,722 are listed on page 128. In FY2018, the DeGroff Utilities and Street Improvements project and the South Lake/West DeGroff Water Projects are planned (they are a portion of the contingent projects listed on Page 128); funding for these projects is planned to come from $1,398,403 in loans and $500,000 in grants.

As with the Electric Fund, it is important that the infrastructure plan for this utility be reviewed in conjunction with the budget, as critical infrastructure repairs are required over the next decade and the bare minimum of working capital is projected to be generated to pay for them. Extensive use of low interest loans from the State of Alaska is planned as the funding source. To obtain these loans, it is critical that the Water Fund generate acceptable levels of cash flow from operations, and, that the capital structure of the Fund not become too leveraged (as measured by the debt-to-equity ratio). The Fiscal Plan for the Water Fund projects its financial condition through the next decade and provided the basis for sustained user fee increases.

Wastewater Fund
A 4.5% user fee increase is being proposed annually for 2018 and 2019; an increase of 6% in 2020; 2.9% in 2021; 3.5% in 2022; 4.3% in 2023 and 2024, then 2.8% annually thereafter. As with the Water Fund, the proposed annual increases are directly tied to the capital required to finance the long-term infrastructure plan. The Wastewater Fund long-term capital infrastructure plan also projects low-interest DEC loans being taken out every year going forward as the source of funding to pay for planned improvements; the reason for this is that insufficient undesignated working capital exists, and will not be generated, to pay for such improvements outright without debt. The Pro forma financial projection for the Wastewater Fund, on page 139, shows that the Fund will generate operating cash flow of $468,055. Proposed new capital expenditures from working capital are $691,000 and are detailed on page 138. Also, additional contingent capital improvements of $10,044,761 are listed on page 138. In FY2018, the DeGroff Utilities and Street Improvements and the South Lake/West DeGroff Sewer projects are planned (they are a portion of the contingent projects listed on Page 128); funding for these projects is planned to come from $1,662,391 in loans and $500,000 in grants.

As with the Electric and Water Funds, It important that the infrastructure plan for this utility be reviewed in conjunction with the budget, as critical infrastructure repairs are required over the next decade and the bare minimum of working capital is projected to be generated to pay for them. Extensive use of low interest loans from the State of Alaska is planned as the funding source. To obtain these loans, it is critical that the Water Fund generate acceptable levels of cash flow from operations, and, that the capital structure of the Fund not become too leveraged (as measured by the debt-to-equity ratio). The Fiscal Plan for the Water Fund projects its financial condition through the next decade and provided the basis for sustained user fee increases.

Solid Waste Fund
A 2.07% user fee increase is being proposed for the Solid Waste Fund in FY2018. The current solid waste collection contracts provide for an annual inflationary adjustment to contractual charges. Thus, to keep the Solid Waste Fund solvent, annual inflationary adjustments to user fees must be considered. The Pro forma financial projection for the Solid Waste Fund, on page 148, shows that the Fund will generate operating cash flow of $194,904. Proposed new capital expenditures from working capital are $500,000 and are detailed on page 147. As the amount of cash flow projected to be generated is less than the cost of the biosolids expansion, undesignated working capital will be used as the source for funding the project. As a result, total working capital for the fund is anticipated to decline to $569,390 at the end of FY2018, see page 148.

Harbor Fund
A 6% user fee increase is being proposed for the Harbor Fund in FY2018. As has been presented to the Assembly in the past, the Harbor Fund has the most daunting challenge in terms of funding capital improvements given the high cost and the relatively modest amount of working capital in the Fund. Major improvements in the amount of $31,532,636 are scheduled for the 2033 to 2037 time frame and include the replacement of Eliason Harbor, the Boat Grid, and the Crescent Harbor High Load Dock. In all, renovations of $74,897,000 are planned through 2056 to keep the harbor system maintained in its present state. Minimal funding is available from the State of Alaska or Federal government in the form of grants to pay for these improvements; most projects have a maximum funding level of $5,000,000 from the State of Alaska. As a result, sustained user fee increases are required in the Harbor Fund through 2035 to generate sufficient cash flow to pay for some improvements and pay for the debt service for others which require bonding. It is critical to understand and acknowledge that the only ways to moderate sustainer user fee increases are to either (1) delay improvements to later years, risking failure, or (2) not replace the infrastructure, removing it from the system. Hard choices lie ahead.

The Pro forma financial projection for the Harbor Fund, on page 157, shows that the Fund will generate operating cash flow of $862,461. No new capital expenditures from working capital are proposed. Contingent capital improvements of $17,300,000 are listed on page 156; these include Phase 1 of the Crescent Harbor project and the Eliason Harbor Electric project. Both projects are dependent on receiving harbor matching grants from the State of Alaska, and, on the issuance of additional harbor revenue bonds. The issuance of $8,000,000 in harbor revenue bonds is tentatively planned for FY2019.

Airport Terminal Fund

The Pro forma financial projection for the Airport Terminal Fund, on page 165, shows that the Fund will generate operating cash flow of $354,199. A substantial contributor to this cash flow will be the planned receipt of Passenger Facility Charges. The Municipality is proposing to apply for the authority to collect Passenger Facility Charges to fund an Airport Terminal Enhancement Project. The remodeling of the airport terminal is critical to meet the operating requirements of air carriers and major users. No new capital expenditures from working capital are proposed; however, contingent capital improvements of $4,000,000 are listed on page 164. If authority to collect Passenger Facility Charges is obtained, the Municipality would look to issue airport terminal revenue bonds to finance the improvements and use Passenger Facility Charges as the revenue stream to pay for debt service.

Marine Service Center

The Pro forma financial projection for the Airport Terminal Fund, on page 173, shows that the Fund will generate operating cash flow of $131,160. No new capital expenditures from working capital are proposed.

Gary Paxton Industrial Park

The Pro forma financial projection for the Gary Paxton Industrial Park (GPIP), on page 181, shows that the Fund will generate operating cash flow of $8,712. The Park will undergo a transformation in operations with the completion of the new dock. Completion of the dock will bring planned new revenue streams in the form of moorage, wharfage, and storage fees; these fees have been built into the budget based on projections from the GPIP Board of Directors.