Mayor – Sandy Sanders

Acting City Administrator – Jeff Dingman

City Clerk – Sherri Gard

Board of Directors

Ward 1 – Keith D. Lau
Ward 2 – Andre' Good
Ward 3 – Mike Lorenz
Ward 4 – George Catsavis
At Large Position 5 – Tracy Pennartz
At Large Position 6 – Kevin Settle
At Large Position 7 – Don Hutchings

AGENDA

Fort Smith Board of Directors

STUDY SESSION

September 8, 2015 ~ 12:00 Noon

Fort Smith Public Library Community Room

3201 Rogers Avenue

CALL TO ORDER

1. Annual review of Board Best Practices document

2. Presentation of Utility Financial Policies / System Development charges for Water and Sewer System Improvements

3. Discussion regarding wholesale water contracts

4. Review preliminary agenda for the September 15, 2015 regular meeting

ADJOURN

Memo

To: Honorable Mayor & Members of the Board of Directors

From: Jeff Dingman, Acting City Administrator

Date: 9/3/2015

Re: Annual Review: Board Best Practices Document

Attached for your information is Resolution No. R-118-14 and the "City of Fort Smith Board Best Practices" document, adopted September 2, 2014. The resolution stipulates that the document shall be reviewed by the Board at least on an annual basis. Such review is included on your Study Session agenda for September 8.

The Board Best Practices document is designed to provide guidance for the Board and City Administration in conducting the city's business and interacting with each other. It states a code of ethics, a code of conduct, and it summarizes procedures while making reference to the appropriate sections of state law and the municipal code.

The annual review of this document is to serve as an opportunity for Board members and staff to revisit the document and verify that the actions of all are being conducted in such a way as to reflect to values and intentions stated in the document. As this is the first annual review of the document since its adoption, staff does not recommend any changes to the document at this time. If any Board member wishes to change the document, this annual review would be the appropriate place to start that discussion.

Please contact me if you have questions regarding this agenda item.

RESOLUTION NO. R-118-14

A RESOLUTION ADOPTING BOARD BEST PRACTICES

BE IT RESOLVED by the Board of Directors of the City of Fort Smith, Arkansas that:

The Board Best Practices attached hereto as Exhibit A is hereby adopted. The board shall review the document annually, and more frequently if needed.

This Resolution passed this 2nd day of September, 2014.

Mayor

ATTEST:

City Clerk

APPROVED AS TO FORM:

No Publication Required

CITY OF FORT SMITH
BOARD BEST PRACTICES

Adopted by Resolution No. R-118-14

September 2, 2014

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INTRODUCTION

The responsibilities of modern government depend upon having procedures which help a community function effectively in the current atmosphere of complex laws, rules and regulations. This board best practices document is intended to refine and expand those initial rules of self-government. Creation of the document was identified by the City Board as a priority during a strategic planning retreat in summer 2013.

The board best practices document is a valuable resource for Fort Smith, the City's citizens, the City Board and City administration as all continue to work together for responsive, effective, and efficient local government. The members of the City Board and City administration should be familiar with the contents of this document and keep it close at hand.

Section 1: USE OF THIS DOCUMENT

This board best practices document is designed to provide guidance for the Board and City Administration. It is not to be considered as restrictions or expansions of Board authority. This document is not intended to be an amendment or substitute for state laws, city ordinances, case law, or other authority. Because this document is designed to assist the Board and not to provide substantive rules affecting constituents, it is expressly stated that this document does not constitute land use regulations, official controls, "appearance of fairness rules", public hearing rules or other substantive rules binding upon or to be used by or relied upon by members of the public.

Section 2: STATEMENT OF VALUES

It is hereby the practice of the City to establish the values stated in this Section 2 as core values of City governance. City leaders listen to the community in a way that fully represents the community's interests and goals. Board and staff should make the maximum effort to collaborate, seeking consensus as far as possible. Board members should individually, and collectively, demonstrate the ability to lead and reason together. City leaders exhibit respect for the professionalism and ethical conduct of the City Administrator and staff; and the City Administrator and staff exhibit the same respect and professionalism for the Mayor and City Board. Leaders strive to achieve sustainable outcomes in City policies and administration, with sustainable bottom lines for the community, environment, and for City finances and the local economy. Holding public office is synonymous with public trust. A public officer's relationship with the public is that of a fiduciary. The public expects the utmost of integrity, honesty, and fairness in their dealings with public officials.

Section 3: RESPONSIBILITIES OF MAYOR, VICE MAYOR, AND BOARD MEMBERS

The roles and responsibilities of the Mayor, Vice, Mayor, and Board members are as follows. These are in addition to those enumerated throughout the Fort Smith Municipal Code and Arkansas statutes 14-48-101 et. seq. In the event of a conflict, the state statutes and municipal code shall govern.

3.1 Mayor

- Acts as the official head of the city for all ceremonial purposes.
- Selects substitute for City representation when Mayor can't attend.

- Issues proclamations.
- Supervise the preparation of Board meeting agendas by the City Clerk.
- Chairs Board meetings.
- Maintains order, decorum, and the fair and equitable treatment of all speakers at board meetings.
- Keeps discussion and questions focused on the specific agenda item under consideration.
- Recognizes citizens who wish to comment at public meetings.
- Signs documents on behalf of the City.
- Has no vote at board meetings, but may veto actions passed by the board (except personnel items).
- Recognized by the Governor for purposes of military law.

3.2 Vice Mayor

The Vice Mayor is elected by the Board at the first regular Board meeting in January of odd-numbered years following the seating of board members elected in the preceding November General Election. The Vice Mayor serves a 2-year term, and may serve multiple terms without limitation. In the event of a vacancy, the board shall elect a new Vice Mayor to serve the remainder of the unexpired term. The Vice Mayor may be removed by a majority vote of the Board members.

- Performs the duties of Mayor if the Mayor is absent or otherwise unable to perform his/her duties.
- If presiding at a Board meeting, the Vice Mayor retains his/her right to vote on matters before the Board.
- Represents the City at ceremonial functions at the request of the Mayor.

3.3 Board Members' Responsibilities

All members of the Board of Directors have equal votes. No Board member has more power than any other Board member, and all should be treated with equal respect. Board members should:

- Fully participate in City Board meetings and other public forums while demonstrating respect, kindness, consideration, and courtesy to others.
- Prepare in advance of Board meetings and be familiar with topics on the agenda.
- Represent the City at ceremonial functions at the request of the Mayor.
- Be respectful of other people's time. Stay focused and act efficiently during public meetings.
- Serve as a model of leadership and civility to the community.
- Inspire public confidence in Fort Smith government.
- Keep the community informed on municipal affairs.
- Encourage communications between citizens and the Board.
- Ensure the diverse interests of the community are represented.
- Be mindful of limited resources and avoid requests for unnecessary information in recognition of the limitations of staff time and resources.

Section 4: CODE OF ETHICS

Board members should be mindful of the need for neutrality and impartiality, rendering equal service to all and to extend the same treatment each would want to receive himself/herself. They should abstain from deliberations and voting when and only when a conflict of interest exists in accordance with the City's business ethics policy, section II. Board members should make decisions based on the merits of the issue with attention to due process and citizen participation. They should be knowledgeable and develop an understanding of local, state and national governmental guidance, directives, regulations and ordinances pertaining to a Board member's office. Members of the board should maintain the utmost standards of personal integrity, truthfulness, honesty and fairness in carrying out public duties; avoid improprieties in roles as public servants including the appearance of impropriety; and never use city position or powers for improper personal gain. Board members should maintain and respect the confidentiality of private and confidential information. Avoid personal gain by the misuse of confidential information. Members of the board shouldn't condone any unethical or illegal activity.

Section 5: CODE OF CONDUCT

Practice civility and decorum in discussions and debate. Difficult questions, tough challenges to a particular point of view, and criticism of ideas and information are legitimate elements of a free democracy in action. However, participants shouldn't make belligerent, personal, derogatory, impertinent, slanderous, threatening, abusive or disparaging comments. Shouting or physical actions that could be construed as threatening won't be tolerated.

Section 6: BOARD DECISION-MAKING PROCESS

6.1 Board Meetings Will Be Efficient and Businesslike

The information exchange, review, deliberation and vetting of issues during prior study sessions enables Board business meetings to be expeditious for the benefit of those who have business pending before the Board. The presiding officer's role, especially at the regular meetings, is to keep the Board business focused and expeditious. Board members, staff, and citizens should discuss only the topic before the Board so as not to become distracted by irrelevant discussion.

6.2 Maintain a Policy Focus

The Board's major policy focus will be on the intended long-term impacts outside the operating organization, not on the administrative or programmatic means of attaining those effects. Ends policies should define what is to be accomplished in terms of benefits, recipients, and their relative priorities. The Board should emphasize strategic rather than short-term issues, policy rather than single events, and group rather than individual decisions. Members should make decisions and recommendations based upon research and facts involving staff and stakeholders which considers the goals, impacts and the best interest of the greatest number of those affected.

6.3 Staff Reports

The City Administrator and staff shall provide the Mayor and Board with briefing reports which clearly and concisely state the issue(s), identify options and provide analysis of the advantages, disadvantages, and likely outcomes of each option, and make recommendations.

6.4 Effective Decision Making Requires Finality

Effective decision making results in finality and "moving on". While it's important to deliberate in many voices, the Board must govern with one voice.

6.5 Make No Promises on Behalf of the Board

Board members shall never overtly or implicitly promise a Board action, or to promise City staff will do something specific (issue a permit, fix a pothole, adjust a water bill, etc.). Only decisions of the Board acting as a body are binding.

Section 7: LEGAL COUNSEL AND LITIGATION

The City Attorney provides legal advice to the Board, City Administrator, and staff to the extent their interests coincide with the City's. The City Attorney should not be requested to provide research, advice, or counsel on matters unrelated to the City's direct legal interests. The Mayor and members of the Board are encouraged to make requests for legal advice through the City Administrator. This document doesn't prohibit the Mayor and Board members from having direct access to the City Attorney. Once an individual or organization has filed a legal proceeding against the City or threatened to do so, no Board member shall engage in discussions or other communications with such individual (or the officers or directors of the organization) or their legal counsel about the subject of the lawsuit without first disclosing the intent to do so to the Board.

Section 8: PUBLIC PARTICIPATION

Citizens are encouraged to participate at regular and special board meetings. Before the Board deliberates and votes on matters, citizens will have an opportunity to comment on the matters. A citizen wishing to comment on a matter which is not on a meeting agenda may do so at the town hall meeting. More specific procedures for public participation are in Section 2-37 of the Fort Smith Municipal Code.

Section 9: OPEN, TRANSPARENT GOVERNMENT

All meetings of the City Board must be open and public in accordance with the Arkansas Freedom of Information Act (Arkansas Statute 25-19-101 et. seq.). Deliberations and decisions of the board should be made so that the public has opportunity to view the performance of its elected officials. The Board may convene in executive session as provided by law. Members of the Board should avoid unintended meetings about city business which may occur in-person, by telephone, or interactive e-mail discussion.

Section 10: FILLING VACANCIES ON THE BOARD OF DIRECTORS BY APPOINTMENT

Once the Board has determined there is a vacant seat on the Board, the Board shall act in accordance with state law (Arkansas Statute 14-48-115) and as expeditiously as possible to fill the vacancy. If the Board shall fill the vacancy, the Board shall publicly solicit applications/statements of interest from qualified citizens. Based on the number of applications received, the Board shall establish a process for screening and interviewing applicants. The Board shall not be obligated to interview all applicants, particularly if there is a large number.

Section 11: EXECUTIVE SESSION DISCUSSIONS

Discussions held in executive session are to remain confidential and should never be discussed with anyone except those who were present during the executive session discussion. Any notes taken during executive session discussions should be treated with the same confidentiality. There shall be no audio or video recordings of executive sessions.

Section 12: ENDORSEMENT OF CANDIDATES

Board members shall have the right to endorse candidates for all Board seats and for other elected offices. It is prohibited for anyone to make endorsements of candidates during Board meetings or other official City meetings.

Section 13: BOARD MEETING AGENDA PROCESS

Items may be placed on board meeting agendas in accordance with the processes outlined in Section 2-31 of the Fort Smith Municipal Code. During a study session, two or more directors may place an item on the agenda for a regular Board meeting. After a study session but at least 48 hours before the meeting, four directors may place an item on the agenda for the next regular meeting. An item requiring immediate action may be placed on the meeting agenda only with the concurrence of all seven directors. An item placed on a meeting agenda may be removed by four or more directors by giving notice to the City Clerk prior to the date of the meeting.

Section 14: BOARD MEETING TYPES AND PROCEDURES

The Board of Directors conducts regular meetings, special meetings, study session meetings, executive sessions, town hall meetings, neighborhood ward meetings, retreats, budget review meetings, and brain storming meetings. The procedures for conducting meetings are outlined in Chapter 2, Article II of the Fort Smith Municipal Code.

Section 15: TRAINING AND PROFESSIONAL DEVELOPMENT FOR BOARD MEMBERS

Board members are encouraged to attend training events that are beneficial to the performance of their elective duties. Such events may be found at conferences of the Arkansas Municipal League, the National League of Cities, and other similar organizations. Attendance at such events is subject to funding availability in the Board's budget.

Section 16: TRAVEL AUTHORIZATIONS

16.1 Need for Travel

The Mayor and Board members will sometimes find it necessary to travel to conduct city business. Travel paid with public funds shall be for purposes directly related to the conduct of official city business and for which the elected official's presence is necessary.

16.2 Authorized Expenses

Expenses for official travel shall be for purposes and uses only as permitted by the City's travel policy which may be found in Section III of the City's Human Resources Policies. Reimbursement amounts shall be in accordance with established allowances for meals, lodging, mileage, etc. Travel expenses for spouses or others accompanying the elected official shall be the sole responsibility of the elected official.

Section 17: RELATIONSHIP BETWEEN BOARD, CITY ADMINISTRATOR, AND STAFF

17.1 Cooperation

Cooperation and mutual respect are essential from each individual for the good of the community. Staff should not be intimidated or manipulated by a Board member's individual comments or actions.

17.2 Informal Communications Encouraged

Individual members of the Board are encouraged to interact informally and casually with City staff for the purpose of gathering information, following up on routine constituent service requests, obtaining progress reports on policies and programs, and providing information to staff. Such informal contacts can serve to promote better understanding of specific City functions and services.

17.3 Limit Contact to Specific City Staff

Questions of City staff and requests for additional background information should be directed only to the City Administrator, Deputy City Administrator, City Attorney, Internal Auditor, and department heads. Requests for information which require a substantial work effort should be made to the City Administrator or Deputy City Administrator rather than to the department head. Requests for follow-up, directions, or action to staff should be made only through the City Administrator or Deputy City Administrator. Requests of the Internal Auditor may be made directly to that official without the need to coordinate with the City Administrator. When in doubt about what staff contact is appropriate, Board members should ask the City Administrator or Deputy City Administrator for assistance.

17.4 Avoid Administrative Functions

Board members shall not attempt to influence City staff on employment decisions, awarding contracts, purchasing decisions, selecting consultants, or issuing City licenses and permits.

17.5 Solicitation of Political Support from City Employees

Board members shouldn't solicit any type of political support (financial contributions, display of posters or yard signs, name on list of supporters, etc.) from City employees. City employees may, as private citizens with constitutional rights, support political candidates. All political activities must occur away from City workplaces, without the use of any City resources, and never during an employee's work time.

Section 18: ORIENTATION OF NEW BOARD MEMBERS

The City Administrator shall provide each newly elected Board member with appropriate orientation services, preferably before the member takes office. Such orientation should include, but not necessarily be limited to, the following:

The Board Best Practices Document	Board Meeting Procedures
Agenda Preparation	Freedom of Information Act
Contacts/Making Requests of Staff	Code of Business Conduct

Tours of City Facilities

Section 19: COMMUNICATION WITH BOARDS, COMMISSIONS, AND COMMITTEES

Any comments by a City Board member at a board, commission, or committee meeting should be clearly made as individual opinion and not as a representation of the feelings of the entire City Board. It is inappropriate for a City Board member to contact a member of a board, commission, or committee to lobby on behalf of an individual, business, or developer. It is acceptable for City Board members to contact members of boards, commissions, or committees in order to seek clarification of a position taken by the board, commission, or committee.

INTER-OFFICE MEMO

TO: Jeff Dingman, Acting City Administrator **DATE:** September 3, 2015

FROM: Steve Parke, Director of Utilities

SUBJECT: Utility Financial Policies / System Development Charges for Water and Sewer System Improvements

Utility financial policies typically address reserve funds, infrastructure renewal and replacement funding targets, debt financing policies, system development charges and long-term financial planning. In June 2014 Burns & McDonnell and staff presented the initial work in the development of formal financial policies for the water and wastewater utilities as recommended by the efficiency study. Because of the complexity introduced by the Consent Decree requirements and the inter-relationship of some policies and targets a more thorough evaluation of the impact of these policies is ongoing using the water and sewer rate models. Following this evaluation, some of the proposed policies may be further refined and an implementation plan proposed to balance the implementation of policies with rate impact or other potential consequences.

The development of the financial policies is now ready for the Board's review. Since the time of the initial presentation the Board has also requested that the system development charges (or impact fees) be reviewed in more detail. Representatives from Burns & McDonnell and staff will be present at the Board's September 8 study session to present the financial policies, to discuss system development charges and to address questions from the Board. A copy of the Utility Financial Policies report is attached.

Should you or members of the Board have any questions at this time, please let me know.

attachment

Burns & McDonnell
SINCE 1898

Report on the

Utility Financial Policies

City of Fort Smith, Arkansas

Project No. 75670

September 2015

Utility Financial Policies

prepared for

City of Fort Smith, Arkansas
Utility Department

September 2015

Project No. 75670

prepared by

Burns & McDonnell Engineering Company, Inc.
Kansas City, Missouri

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LIST OF ABBREVIATIONS

Abbreviation	Term/Phrase/Name
ABT	Additional Bonds Test
AWWA	American Water Works Association
BMcD	Burns & McDonnell
CAFR	City of Fort Smith Comprehensive Annual Financial Report
CCF	One Hundred Cubic Feet
CIP	Capital Improvement Program
Department	Fort Smith Utility Department
EPA	Environmental Protection Agency
O&M	Operating & Maintenance
SDC	System Development Charge
WEF	Water Environment Federation

1.0 EXECUTIVE SUMMARY

1.1 Purpose and Approach

In February 2013, the "Water and Sewer Operations Efficiency Study" (the Efficiency Study) was published and provided, among other things, recommendations to develop and adopt formal financial policies for the water and sewer utilities. This Utility Financial Policies report has been prepared for the Fort Smith Utility Department (the Department) to document and describe several policies to be considered by the City of Fort Smith. Taken as a whole, these recommended policies address the spirit and nature of the recommendations made in the Efficiency Study. Overall, the proposed policies will improve the overall financial strength and stability of the Department.

This document is intended to summarize the potential policies under consideration and provide a basis for discussion with the City's Board, staff, and other stakeholders as appropriate to obtain further input and direction into the policy development. Using this feedback, the policies will be evaluated during the ongoing rate study to assess the potential impact associated with implementation. The overall approach used to develop the proposed policies is illustrated below in Figure 1-1.

Figure 1-1: Policy Development Approach

The Introduction Section 2.0 of this report provides additional background and an overview of the policy development process. Section 3.0 Proposed Financial Policies documents the policies and the rationale behind them; where possible, a high level impact assessment is provided. An impact assessment will be also provided in the rate study work to be completed in 2015.

The remainder of this Executive Summary summarizes the proposed policies.

1.2 Proposed Policies

Included herein are the proposed policies for the City of Fort Smith Utilities Department. Details regarding the rationale behind specific policies and considerations made during their development are found in subsequent sections of this report. Because of the complexity of Consent Decree requirements and the inter-relationship of some policies and targets (e.g. improvements in debt service coverage will provide funds that may be used for reserves), a more thorough evaluation of the impact of these policies is ongoing that uses the water and sewer financial planning and rate models. Following this evaluation,

some of the proposed policies may be refined and a plan for implementation proposed to balance policy implementation with rate impact and other potential consequences.

Rules governing the flow of funds, the use of funds, and certain reserves are set forth in existing bond covenants. The proposed policies have been crafted to complement these requirements. Nothing in this document should be interpreted to be in conflict with or undermine existing bond covenants, which take precedence over all proposed policies contained herein.

1.2.1 Proposed Policy: Revenue-Funded Capital

The Utility Department will annually provide cash funding from the Water and Sewer Fund for the Capital Improvement Program at a minimum level equal to the prior year's annual depreciation expense. CIP spending may include fleet and equipment replacement, system renewal and replacement, and other capital projects. The amount of annual cash funding shall be at least equal to the amount of the prior year's depreciation expense. The amount of annual cash funding will be determined by the Utility Director during the annual budgeting and CIP planning process and subject to Board approval.

1.2.2 Proposed Policy: Targeted Debt Service Coverage Levels

The Department will provide through its annually approved budget the Net Revenues necessary to produce a planned debt service requirement that achieves a minimum debt service coverage level of 1.40 times annual debt service as reported in the latest CAFR. In the event actual annual debt service coverage reported in the CAFR is below the minimum threshold of 1.40 times annual debt service, the Utility Director will produce a financial plan in the next budget cycle that provides revenue or expense adjustments or a combination of revenue and expense adjustments necessary to restore coverage to 1.40 times annual debt service within 3 budget years after the shortage was initially reported.

1.2.3 Proposed Policy: Debt Service as a Percent of Revenue Stream

The Department will include debt service as a percentage of revenue stream analysis subject to Board Approval as a component of the debt issuance process.

1.2.4 Proposed Policy: System Development Charges

System development charges shall be periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries and in compliance with Arkansas State Statues. The intent of these charges will be to reasonably recover costs of growth-related backbone facilities allocated to increases in the number growth of customers. Charges will be designed so that the water and sewer systems will not subsidize the other.

1.2.5 Proposed Policy: Facility Charges

Facility charges may be developed to recover costs incurred to provide water or sewer service to a specific area. Facility charges shall be periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries and in compliance with Arkansas State Statues. The intent of these charges will be to reasonably recover costs of facilities allocated to a geographic area. Charges will be designed so that so the water and sewer systems will not subsidize the other.

1.2.6 Proposed Policy: Connection Charges

Connection charges shall be developed and periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries. The intent of these charges will be to reasonably recover costs of installing water and sewer service lines and facilities that provide services to customers' properties. Charges will be designed so that the water and sewer systems will not subsidize the other.

1.2.7 Proposed Policy: Rate Methodology

Rates for water and sewer billing shall be developed and periodically reviewed at least every five (5) years using a cost of service methodology generally accepted in the water and sewer industries. The intent of the rates will be to reasonably recover costs allocated to each customer class from the respective customer class, fund the water and sewer systems so neither system subsidizes the other, and support the goals and objectives of the water and sewer systems.

1.2.8 Proposed Policy: Affordability Assessment

The Department shall include affordability analysis as a component of the ratemaking process and performance of the Consent Decree.

1.2.9 Proposed Policy: Billing Collections

The water and sewer customer bills shall become past due if not paid within 15 days after the billing date. When past due, a penalty shall be added to the account in the amount of 10 percent of the past month's current billed amount, and a past due and shutoff notice will be mailed to the customer's address of record. Services for bills not paid within 30 days after the billing date are subject to suspension of service and may be turned off until the account is paid in full.

1.2.10 Proposed Policy: Billing Corrections

The City shall make water and sewer billing corrections to customers' bills and/or accounts to correct errors that occurred within the past three (3) years as a result of one or more of the following:

- The meter was misread.
- The water and/or sewer usage was inaccurately estimated when an actual meter reading was not used.
- The water meter, sewer meter, meter reading system, billing system, and/or accounting system did not operate properly.

Corrections shall be calculated as the difference between the erroneous usage and the corrected usage. The corrected meter reading shall be recorded on the customer's account when identified and shall be used so that the usage billed and usage subsequently billed shall be calculated using the corrected meter reading. Customer charges shall not be changed independently of meter readings. Meter readings will not be held over until the actual usage catches up to the erroneous meter reading.

In the event that the correction increases or decreases the usage so that the resulting change in either water or sewer charges exceeds the lesser of four (4) times the average water or sewer bill for that service point over the previous twelve months or $1,000, approval of the correction will require the Finance Department to escalate the matter to the Utility Director or designated representative for approval within five (5) business days from the date of escalation.

1.2.11 Proposed Policy: Billing Forgiveness

Credits to water and sewer utility bills may be granted to customers to account for water leaks fixed by plumbing repairs, filling swimming pools, and billing corrections. Credits may be applied to customer accounts subject to the following conditions.

- Except for adjustments that result due to billing corrections, a service point is eligible for a water leak credit to water charges for not more than two (2) months, provided a water leak credit was not posted to the account in the most recent 12 month period. Similarly, except for adjustments that result due to billing corrections, a service point is eligible for a credit to sewer charges for not more than two (2) months related to water leakage, provided a sewer credit related to water leakage was not posted to the account in the most recent 12 month period. In addition, an account is eligible for a credit to sewer charges for one (1) month related to filling a swimming pool each calendar year.
- In the event of a billing correction, a service point is eligible for a water credit to water charges and sewer credit to sewer charges for any charges added due to a billing correction.
- Each water credit is subject to a maximum of either four (4) times the average monthly water charges or $1,000, whichever is less. Similarly, each sewer credit is subject to a maximum of either four (4) times the average monthly sewer charges or $1,000, whichever is less.

- Credits applied to billed water volumes may not lower the billed volume for any month of service below its most recently 12 month average or 6 CCF, whichever is higher
- Credits applied to billed sewer volumes may not lower the billed volume for any month of service below its most recently designated winter average or six (6) CCF, whichever is higher.
- The customer must provide the City with written proof that the leak was fixed by plumbing repairs for a leak credit to be considered by the City.

In the event a proposed credit exceeds these conditions, approval of the credit will require the Finance Department to escalate the matter to the Utility Director or designated representative for approval within five (5) business days from the date of escalation. The Utility Director or designated representative may approve a water and sewer credits as follows:

- A maximum water credit of $1,000 plus 50 percent of the billed water amount greater than $1,000, not to exceed $5,000 total credit for water.
- A maximum sewer credit of $1,000 plus 50 percent of the billed sewer amount greater than $1,000, not to exceed $5,000 total credit for sewer.

If the proposed credit is denied by the Utility Director or designated representative, the decision may be appealed by the customer to the City Administrator or designated representative, within 10 business days from the date of the decision made by the Utility Director or designated representative.

1.2.12 Proposed Policy: Winter Averaging for Residential Sewer Bills

Billable volumes for residential sewer customers during the April, May, June, July, August, September and October billing cycles will be determined based on the most recent evaluation of winter period water consumption, defined as the average monthly water usage during the immediate preceding November, December, January, February and March billing cycles at the same service point. The monthly billable volume for each residential account will be established as either actual water usage or the winter average calculated usage, whichever is lower for the applicable month. If a residential sewer customer does not have a winter period water consumption, for example an account initiated after the start of the winter period, the billable volume during the months of April, May, June, July, August, September and October will be either actual water usage or 6 CCF whichever is lower..

1.2.13 Proposed Policy: Service Charges

Service charges shall be developed and periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries. The intent of these charges will be to reasonably

assess charges to customers who use particular services related to water or sewer services. Charges will be listed in a table of service charges subject to Board approval and maintained by the Department.

1.2.14 Proposed Policy: Water and Sewer Fund (Revenue Fund)

The Department will maintain a reserve balance of a minimum of 33 percent (120 days) to 49 percent (180 days) of the annual operation and maintenance expenses for liquidity and emergencies. Balances will be made available to fund ongoing operation and maintenance costs, and fund emergency operations or unforeseen events. If the end of year Water and Sewer Revenue Fund balance is calculated to be less than 120 days or more than 180 days, the Utility Director will provide a financial plan to the Board to restore this fund balance to the targeted range within three (3) budget years after the variance was initially reported.

1.2.15 Proposed Policy: Fleet and Equipment Replacement Reserve

The Department will establish and maintain a Fleet and Equipment Replacement Reserve (FERR) to be funded annually by a deposit equal to the prior year's equipment depreciation expense. Such deposits will be considered a portion of the transfers from the Revenue Fund to provide revenue funding for capital expenditures. Assets classifiable as fleet or mobile equipment are eligible for funding from the FERR. No minimum balance is required to be maintained in the FERR. If funding provided by the annual deposit exceeds the current year's fleet and mobile equipment purchases, available balances will carry forward to subsequent years. If funding provided by the annual deposit and any other available balance within the FERR is not sufficient to fully fund the current year's fleet and mobile equipment purchases, the Department will secure additional capital improvement funding consistent with current utility practice. If the balance available in this reserve exceeds fleet and mobile equipment spending identified in the CIP, additional deposits to this reserve may be suspended until the balance in this reserve does not exceed fleet and mobile equipment spending identified in the CIP.

1.2.16 Proposed Policy: Water/Sewer Capital Improvement Fund

The Department will maintain reserves in the Water/Sewer Capital Improvement Fund to provide funding for the capital improvement program. An annual deposit from the Revenue Fund will be proposed by the Department and subject to Board approval that, together with deposits to the Depreciation Fund and Fleet and Equipment Replacement Reserve, amount to a minimum of the prior year's depreciation expense. All assets of the Department are eligible for funding from the Water/Sewer Capital Improvement Fund reserves. No minimum balance is required to be maintained in the Water/Sewer Capital Improvement Fund reserves. If available funding exceeds the current year's capital expenditures, available balances will carry forward for use during subsequent years. If balances are not sufficient to fully fund the current

year's capital expenditures, the Department will secure additional capital improvement funding consistent with current utility practice. If the balance available in the Water/Sewer Capital Improvement Fund exceeds infrastructure, facility, and resource capital spending identified in the CIP, additional deposits to this fund may be suspended until the balance in this fund does not exceed infrastructure, facility, and resource capital spending identified in the CIP.

1.2.17 Proposed Policy: Depreciation Fund

The Department will maintain reserves in the Depreciation Fund to fulfill bond covenants and to provide funding for investment in fixed assets. An annual deposit from the Revenue Fund will be proposed by the Department and subject to Board approval that, together with deposits to the Water/Sewer Capital Improvement Fund and Fleet and Equipment Replacement Reserve, amount to a minimum of the prior year's depreciation expense. No minimum balance is required to be maintained in the Depreciation Fund in excess of that fulfilling the bond requirement. If balances are not sufficient to fully fund the current year's capital expenditures, the Department will secure additional capital improvement funding consistent with current utility practice. If the balance available in the Depreciation Fund exceeds capital spending as identified in the CIP, additional deposits to this fund may be suspended until the balance in this fund does not exceed capital spending identified in the CIP.

2.0 INTRODUCTION

2.1 Overview

The mission of the Fort Smith Utility Department (the Department) is "to ensure the sustained delivery of quality water and sewer services that promote health, safety, and quality of life for all customers." Development and adoption of financial policies will support the Department in the pursuit of its mission in several ways:

- Fulfill the mission with focus that
  - Ensures sustained delivery of quality water and sewer services
  - Promotes health, safety and quality of life
  - Provides excellent service to customers
  - Complies with the Consent Decree requirements
  - Creates value through operational excellence
  - Ensures long-term regional success
- Provide liquidity to adequately fund operating and capital costs
- Mitigate the risk of financial stress caused by
  - Revenue shortfalls due to weather anomalies
  - Sudden increases in commodity costs
  - Avoidable regulatory and Consent Decree penalties
  - Cost of major equipment failure or fixed asset failure
  - Unexpected expenses due to civil disorder, catastrophes, or other emergencies
- Better position the utility to fund capital projects that are necessary to comply with regulatory requirements and liabilities associated with aging infrastructure and future system growth
- Assist in the compliance with existing bond covenants, and position the Department more favorably for ratings reviews associated with future debt issuance thereby lowering the cost of borrowing money
- Enhance the stability in user rates and charges by minimizing the severity of rate shock that can result if inherent risks noted above are realized

The development of financial policies will also assist the Department in addressing certain recommendations that resulted from the "Water and Sewer Operations Efficiency Study" (the Efficiency Study) published during February 2013. The Efficiency Study identified several options regarding financial management that collectively were intended to strengthen the Department's financial resiliency. Furthermore, the financial policies will help to enhance the Department's long-term financial stability and

its ability to reasonably maintain stable rates. Unless otherwise noted, the policies are applicable to both the Water and Sewer Systems.

2.2 Project Approach

The overall approach used to develop the proposed policies is illustrated below in Figure 2-1. The approach began with an assessment of current policies and practices in certain strategic areas.

Figure 2-1: Policy Development Approach

These strategic areas were identified in a variety of ways, including input from Department management and staff; recommendations from the Efficiency Study; observations from prior financial planning and rate projects; consideration of Consent Decree requirements; review of financial performance and material variance drivers; and other techniques. Current policies and practices were identified. BMcD then worked with Department staff to develop financial policy concepts to either further strengthen existing policies or establish new policies as needed. Input in the development of these policy concepts was obtained from multiple perspectives, as shown in Figure 2-2.

Figure 2-2: Policy Development Perspectives Considered

Multiple perspectives were considered as policy concepts were formulated. The degree to which the proposed policies address Department concerns, align with industry best practices either from the perspective of BMcD or the City's Financial Advisor, align with the priority recommendations of the Efficiency Study, assist in compliance with Consent Decree requirements, and recognize City policies and practice was considered.

Where possible, targets for the policies were identified, and current Department compliance with these targets was evaluated. To the extent a policy target was not currently met, a high level impact on existing revenues was calculated to provide context regarding the potential adjustment necessary to achieve desired policy targets. Because of the complexity of Consent Decree requirements and the inter-relationship of some policies and targets (e.g. improvements in debt service coverage will provide funds that may be used for reserves), a more thorough evaluation of the impact of these policies is ongoing that uses the water and sewer financial planning and rate models. Following this evaluation, some of the proposed policies may be refined and a plan for implementation proposed to balance policy implementation with rate impact and other potential consequences.

This document is intended to summarize the policies under consideration and provide a basis for discussion with the City's Board, staff, and other stakeholders as appropriate to obtain further input and direction into the policy development.

Rules governing the flow of funds, the use of funds, and certain reserves are set forth in existing bond covenants. The proposed policies have been crafted to complement these requirements. Nothing in this document should be interpreted to be in conflict with or undermine existing bond covenants, which take precedence over all proposed policies contained herein.

2.3 Statement of Limitations

In the preparation of this report, BMcD used the information provided by Fort Smith and additional third parties to make certain assumptions with respect to conditions that may exist in the future. While BMcD believes the assumptions made are reasonable for the purposes of this report, we make no representation that the conditions assumed will occur. BMcD has also relied on the information provided to us without independent verification and cannot guarantee its accuracy or completeness. Therefore, to the extent that actual future conditions differ from those assumed in the Study or from the information provided to us, the actual results may vary from those projected.

3.0 PROPOSED FINANCIAL POLICIES

3.1 Introduction

In this report, proposed policies have been aggregated into three general groups, described as follows:

- Capital Funding Policies: Policies that guide the funding of capital projects and management of debt
- Rate and Service Charge Policies: Polices that guide the administration of user charges
- Reserve Fund Policies: Policies that establish specific reserves and targeted balances

This section of the report will discuss each general policy group, and detail specific proposed policy recommendations within each group. Groups were determined based on similarities in the underlying policy's purpose. However, policies can be interrelated on different levels both within groups and across groups.

Rules governing the flow of funds, the use of funds, and certain reserves are set forth in existing bond covenants. The proposed policies have been crafted to complement these requirements. Nothing in this document should be interpreted to be in conflict with or undermine existing bond covenants, which take precedence over all proposed policies contained herein.

3.2 Capital Funding Policies

3.2.1 Background

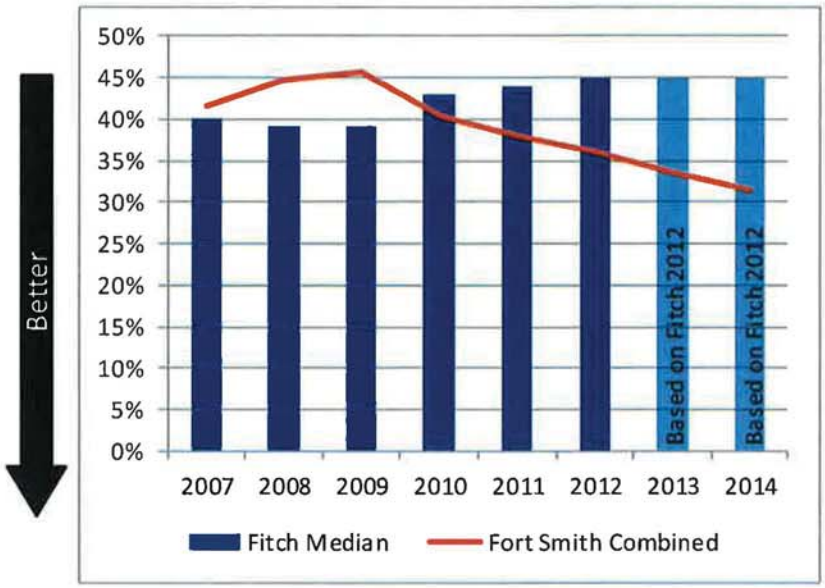
As a municipal utility the Department is charged with operating and managing water and sewer utility systems with a net book value in excess of $514 million as of December 31, 2014. Water and sewer utilities are capitally intensive enterprises requiring significant investment in above and below ground infrastructure. The need for further investment in the system can be caused by many factors, including the addition of system capacity to accommodate growth, the enhancement of the system's capabilities to meet Consent Decree requirements and increasing regulatory requirements, the renewal and replacement of aging assets that are approaching the end of their useful lives, and the desire to improve operating efficiency.

Generally speaking, a capital investment plan can easily surpass the ability of the utility to fund the improvements in its entirety. In such cases, planning and project prioritization are needed to assist in the alignment of the sources and uses of capital funds. Funding for capital projects typically includes available balances, revenues from user charges, the issuance of long term debt, state revolving loans, or

less frequently, grant funding. Fort Smith has used both revenue-backed debt instruments and sales and use taxes funded debt to finance projects for the water and sewer systems. Funding can also be derived from system development charges, facility charges, and connection charges assessed to new connections as they are added to the system.

Historically, the issuance of debt has represented a significant portion of the Department's capital funding approach. One measure frequently used to evaluate the reasonableness of the outstanding utility debt level is to compare outstanding debt to the value of the fixed assets of the system. Figure 3-1 shows the trend in the relationship between debt and net plant (defined as original cost less depreciation of fixed assets) for the Department. This ratio is compared against results published by Fitch Ratings for municipal water and sewer systems. Fitch discontinued publicly releasing annual medians after 2012, opting to require a subscription to its research service to access this information at substantial cost. For the purposes of this report, Fitch medians are estimated for 2013 and 2014 based on 2012 results.

Figure 3-1: Fort Smith Utility Debt to Net Plant



As shown in Figure 3-1, the level of debt outstanding for Fort Smith's water and sewer utilities was relatively high from 2007 through 2009, but has been on an improving trend in more recent years. Improvements in this ratio can be achieved through providing more pay-as-you-go funding sources such as revenues from user charges, system development charges and facility charges. Improvements can also be achieved through use of alternative funding sources such as taxes.

The Department currently does not have a policy regarding the level of funding to be provided from debt

or other sources. The risk in relying too heavily on debt issuance to fund capital improvements is that a utility can become over-leveraged and suffer erosion of system equity, which could signal increased riskiness of the Department's debt to the municipal bond investor. Lower bond ratings and higher cost of issuing future debt could result, and drive the need for additional rate increases. Furthermore, over-reliance on debt as a capital funding mechanism can place pressure on debt service coverage.

Minimum debt service coverage levels are usually established by utility revenue bond covenants. For Fort Smith, existing debt covenants define annual debt service coverage as:

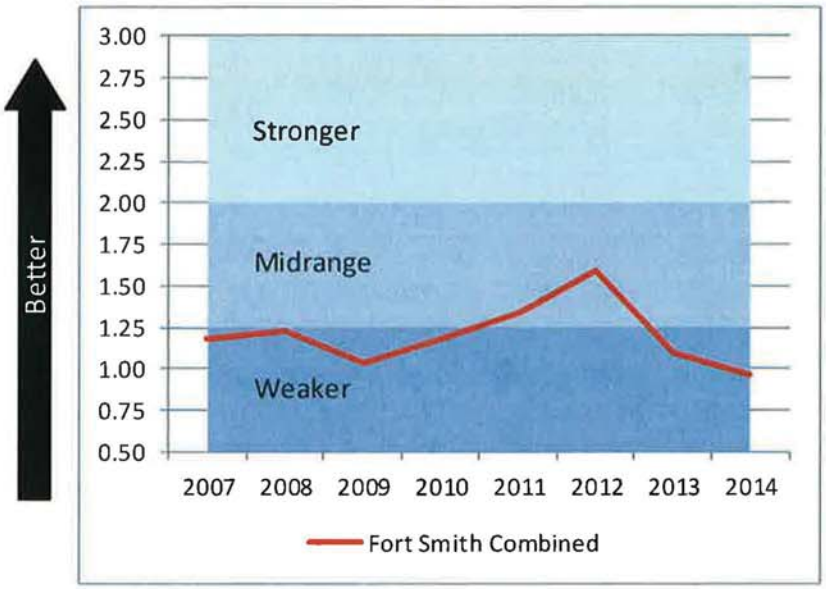
[Maximum Annual Principal and Interest payable on all Revenue Bonds] / [_Net Revenues] = Annual Debt Service Coverage

Net Revenues are defined as gross revenues less the amounts required to pay the costs of operations, maintenance and repair of the utility systems excluding depreciation, interest and amortization expenses. For Fort Smith, the minimum annual debt service coverage required by covenants is 1.10 times annual debt service. Fort Smith also has an additional bonds test (ABT) that is required to be met in the event additional parity revenue bonds are issued. The ABT requires debt service coverage of 1.25 times average debt service in the most immediately prior year or 1.30 times average debt service for the next projected year. The next projected year allows for adjustments for any increase in rates that may have been adopted and any new debt service payments. The additional bonds coverage test is only applied as a condition of issuing additional parity debt. Figure 3-2 shows the trend in the Department's annual debt service coverage in recent years, compared to Fitch Ratings' stratification of weaker, midrange, and stronger performance for municipal water and sewer utilities.

As shown in Figure 3-2, debt service coverage for Fort Smith has eroded substantially since 2012. Debt service coverage in 2014 was 0.97 times, below the minimum revenue bond requirement of 1.10 times.

While the Department is obligated by covenant to maintain a minimum debt service coverage threshold, the Department does not have a formal policy regarding targeted debt service coverage. Based on BMcD's experience, it is recommended that debt service coverage targets be established at a level higher than the minimum as a component of the utility's financial plan. By targeting a level of debt service coverage in excess of the absolute minimum required, a utility is much better positioned to handle unexpected variances (such as abnormally low revenues due to weather conditions). Additionally, rating agencies look favorably on debt service coverage levels that are consistently higher than absolute minimum requirements.

Figure 3-2: Fort Smith Utility Debt Service Coverage



System development charges (also known as impact fees) represent one possible source of revenue for funding projects that are required to support growth in customers and increased capacity in the systems. System development charges (SDCs) differ from connection charges and facility charges. Connection charges are designed to fund the costs of physically installing customer connections and service lines to the customer's property from the local water distribution system or sewer collection system. Facility charges are intended to recover the costs of extending the local water distribution system or sewer collection system that provide services to specific subdivisions or service areas, such as the existing Rye Hill elevated service plane fee. In contrast, system development charges are intended to fund growth-related backbone facilities shared by virtually all retail customers, such as treatment plants, large water transmission mains, large sewer interceptor lines, sewer flow equalization facilities, sewer outfall lines, and water source development.

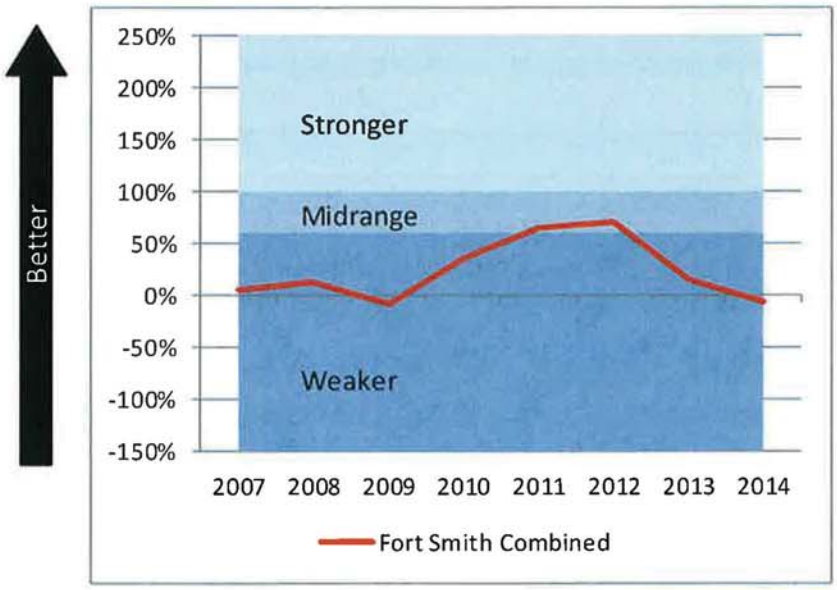
While the Department does assess charges to specific service areas to cover the cost of extending service to that service area (i.e., facility charges), it does not currently assess system development charges to recover the cost of capacity investment in backbone facilities. The determination of system development charges is governed by the State of Arkansas by Arkansas Code 14-56-103. For a variety of reasons, BMcD does not recommend implementing system development charges at this time, but does recommend developing a policy to systematically evaluate SDCs every five (5) years as conditions change.

Figure 3-3 shows annual depreciation expense as a percentage of free cash flow. This measure examines a utility's ability to generate cash in excess of operating costs and debt service, sufficient enough to meet

the level of annual depreciation expense. At the heart of this concept is that a prudent utility should be able to produce enough cash to reinvest in its system equal to annual depreciation. Fitch Ratings reserves its "Stronger" designation for utilities able to generate cash in excess of depreciation annually.

As shown in Figure 3-3, depreciation as a percentage of free cash flow has eroded substantially since 2012. As noted previously the results in several figures within this report are inter-related.

Figure 3-3: Fort Smith Utility Depreciation as a Percentage of Free Cash Flow



3.2.2 Proposed Policy: Revenue-Funded Capital

It is recommended that the Department adopt a policy regarding the cash funding of future capital improvement program (CIP) projects to provide revenue funded capital at a level consistent with the prior year's annual depreciation expense as reported on the Department's audited financial statements. The proposed policy may read as follows:

The Utility Department will annually provide cash funding from the Water and Sewer Fund for the Capital Improvement Program at a minimum level equal to the prior year's annual depreciation expense. CIP spending may include fleet and equipment replacement, system renewal and replacement, and other capital projects. The amount of annual cash funding shall be at least equal to the amount of the prior year's depreciation expense. The amount of annual cash funding will be determined by the Utility Director during the annual budgeting and CIP planning process and subject to Board approval.

3.2.3 Proposed Policy: Targeted Debt Service Coverage Levels

As noted previously the Department is generally obligated to provide annual debt service coverage at a minimum level of 1.10 times annual debt service. The ABT is more restrictive and requires coverage of 1.25 times average debt service in the prior year or 1.30 times average debt service in the next year (2). The additional bonds coverage test is only applied as a condition of issuing additional parity debt. However, in an environment where future revenue bond issues are likely, prudent planning should provide for the fulfillment of the more stringent requirements of the ABT. It is recommended that the Department adopt a policy to achieve an annual debt service target of 1.40 times annual debt service levels (1). The proposed policy may read as follows:

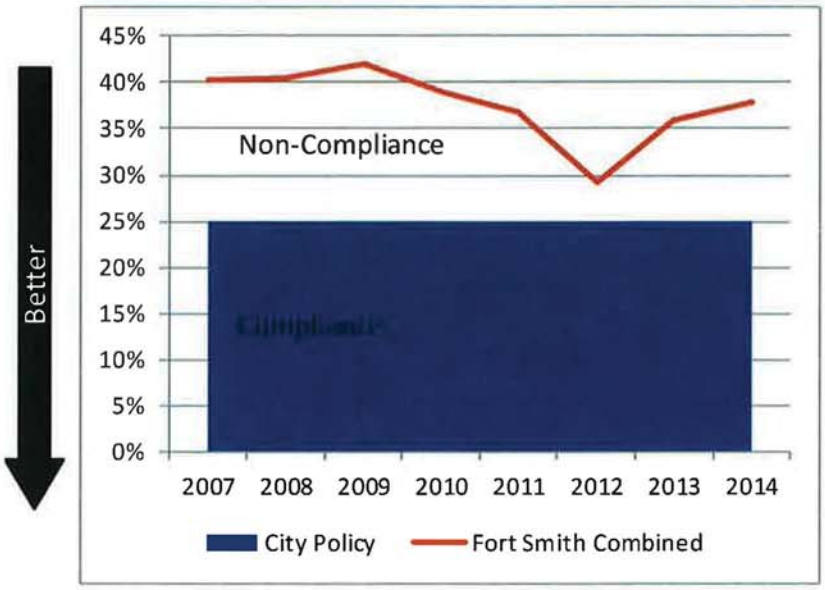
The Department will provide through its annually approved budget the Net Revenues necessary to produce a planned debt service requirement that achieves a minimum debt service coverage level of 1.40 times annual debt service as reported in the latest CAFR. In the event actual annual debt service coverage reported in the CAFR is below the minimum threshold of 1.40 times annual debt service, the Utility Director will produce a financial plan in the next budget cycle that provides revenue or expense adjustments or a combination of revenue and expense adjustments necessary to restore coverage to 1.40 times annual debt service within 3 budget years after the shortage was initially reported.

Setting an annual debt service coverage minimum target of 1.40 times annual debt service positions the utility to more easily pass the ABT threshold; is consistent with rating agency preferences as demonstrated in Figure 3-2 and confirmed with the City's financial advisor; and will assist in providing revenue streams that may be applied toward the revenue-funded capital policy described in Section 3.2.2, thereby mitigating the impact of that policy. In 2014, debt service coverage was below the annual required level of 1.10 times. Sewer revenue increases were adopted for implementation in 2015 through 2017 which should improve overall coverage levels. However, future revenue adjustments may be necessary to reach a threshold of 1.40 times.

3.2.4 Proposed Policy: Debt Service as a Percentage of Revenue Stream

The City currently maintains a policy that debt service should not exceed 25 percent of the related revenue stream. This policy is likely intended to prevent the utility or other City operations from becoming overly burdened with debt. As shown in Figure 3-4, the Department has been out of compliance with this policy in recent history.

Figure 3-4: Fort Smith Utility Debt as a Percentage of Operating Revenue



For the utilities, the clarity of this policy is clouded by the use of alternative funding strategies such as sales tax revenues. Also, utilities in general tend to be highly capitally intensive and are influenced by factors such as needed reinvestment in aging infrastructure, increasingly stringent regulatory compliance requirements, Consent Decree requirements for many sewer utilities, and the need to balance the impact all of these issues have on customer bills. As such, a Department financial plan is likely to differ significantly from general fund departments, particularly in the use of debt to fund capital improvements. Considering the proposed utility policies to revenue fund a portion of the CIP based on depreciation expense and to maintain a minimum annual debt service coverage level of 1.40 times, the likelihood of future compliance with this policy is expected to improve but is not guaranteed. Setting a firm ratio requirement of debt service to revenue stream can result in customer rates higher than would have otherwise been required for regulatory or bond covenant compliance. It is recommended that debt service as a percentage of the revenue stream be tracked and reported periodically by the Department, discussed as part of debt issuance process, and used for informational purposes only. The proposed policy may read as follows:

The Department will include debt service as a percentage of revenue stream analysis subject to Board Approval as a component of the debt issuance process.

3.2.5 Proposed Policy: System Development Charges

As noted in Section 3.2.1, system development charges (or impact fees) represent one possible source of revenue for funding projects that are required to support growth in customers and related increases in

capacity of the utility systems. Currently growth-related costs are comingled with other costs of the water and sewer systems and theoretically recovered through water and sewer user rates. In the design of system development charges (SDCs), the water and sewer costs associated with growth and related system expansion are discretely identified, and the charges are applied to new customers as they join the system. Such charges cannot be arbitrarily set, and must reasonably be related to the cost and level of service provided. Generally speaking, system development charge revenues can only be used to pay for growth-related projects. In this way, system development charges align the cost of growth and related system expansion more directly with new customer development.

The key policy consideration is whether the cost of new infrastructure should be recovered from new customers joining the system, or if it should be funded through rate revenues, which is the current utility practice.

The State of Arkansas enables municipal utilities to charge system development charges under Arkansas Code 14-56-103. BMcD recommends against implementing SDCs at this time, for a variety of reasons.

- The vast majority of CIP planned in the next five (5) years is not designed to create additional capacity to accommodate growth. Rather, the CIP is geared toward renewal and replacement or regulatory compliance. Such projects are generally not candidates for SDC cost recovery.
- Implementing and managing SDCs requires increased administrative effort, particularly with respect to the following:
  - Creation of separate funds solely for the deposit and use of SDC revenues
  - Determination of a particular project's eligibility for SDC funding
  - Tracking of receipt of SDC funds compared to applicable expenditures
  - A requirement to refund portions of SDC receipts to customers if proceeds are not spent within seven (7) years
- In recent years, Fort Smith has not experienced considerable growth in utility customers, and this trend is currently projected to continue for the near future. Assuming 125 new customers per year and an average $2,500 SDC, potential SDC revenue totals approximately $312,000 per year, an amount that will not provide sizeable funding for CIP nor materially impact user charge rate increases.

Based on these considerations, BMcD does not recommend SDCs for the Department now. However, conditions may change over time, particularly if the Department's capital plan begins to identify more growth-related projects that increase capacity in backbone components of the water or sewer systems. Therefore BMcD does recommend evaluating SDC implementation at least every five (5) years.

A policy regarding system development charges may be structured as follows:

System development charges shall be periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries and in compliance with Arkansas State Statues. The intent of these charges will be to reasonably recover costs of growth-related backbone facilities allocated to increases in the number growth of customers. Charges will be designed so that the water and sewer systems will not subsidize the other.

3.2.6 Proposed Policy: Facility Charges

Some systems use facility charges to recover costs of water or sewer facilities that provide service to a specific service area or geographic area within the system. Such areas might require storage tanks and pumping facilities exclusively for providing water or sewer service to that area. These facilities are generally required to extend service to specific areas and do not involve backbone facilities that are shared or used by most retail connections on the systems.

The Department currently charges an additional connection fee for any user who connects to the water system within the Rye Hill elevated service plane.

A policy regarding development charges may be structured as follows:

Facility charges may be developed to recover costs incurred to provide water or sewer service to a specific area. Facility charges shall be periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries and in compliance with Arkansas State Statues. The intent of these charges will be to reasonably recover costs of facilities allocated to a geographic area. Charges will be designed so that so the water and sewer systems will not subsidize the other.

3.2.7 Proposed Policy: Connection Charges

The costs of constructing water and sewer service lines and facilities to connect properties to the water or sewer system are often recovered through connection charges. These costs typically include the materials and labor associated with extending the service mains to customer premises and installing metering equipment.

A policy regarding connection charges may be structured as follows:

Connection charges shall be developed and periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries. The intent of these charges will be to reasonably recover costs of installing water and sewer service lines and facilities that provide services to

customers' properties. Charges will be designed so that the water and sewer systems will not subsidize the other.

3.3 Rate and Service Charge Policies

3.3.1 Background

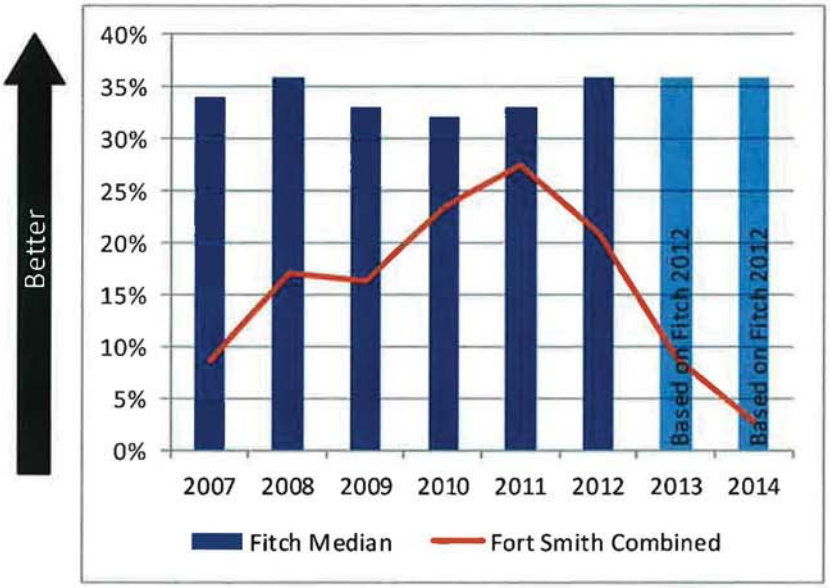
User charges must be sufficient to provide adequate funding for operating and capital needs, meet debt service requirements, and maintain sufficient reserves. The Department's planning horizon for user charges is five (5) years. A five (5) year plan is prepared and, to the extent revenue adjustments are necessary, proposed rates are developed and presented to the Board for approval. Rate approvals are typically provided by the Board for one (1) to three (3) years. Subsequent adjustments, if necessary over the three (3) years, are intended to be evaluated before the initial approval term has expired. This process is planned to be repeated every three (3) years to refresh the plan for known or anticipated changes. The current process has resulted in the adoption of revenue increases periodically, but not always regularly.

Plans are developed specifically for the water utility and the sewer utility. Rates are designed to recover the costs associated with each utility's respective financial plans. Within the plans, forecasts are made for direct costs of operating each utility and the indirect costs of support provided by the City. Some of the direct and indirect cost centers that provide service to the Department benefit both the water and the sewer utility. For those cost centers, allocation factors are used to identify the portion applicable to either the water or sewer utility. These water and sewer allocation factors are updated periodically, with the most recent update at the end of 2014. Overall financial reporting for the Department is consolidated to reflect the combined water and sewer performance.

During the evaluation of the five (5) year plan, typical bills are calculated to illustrate changes in bills for various Fort Smith customer classifications resulting from proposed rate adjustments. Comparisons are made to neighboring utilities for regional benchmarking typical customer classes. The concept of evaluating affordability was noted in the Efficiency Study as another way to indicate the reasonableness of proposed rates.

From a utility enterprise point of view, one indicator of the sufficiency of revenues (beyond coverage and reserve levels) is annual operating margin and annual cash flow. Figure 3-5 shows the trend in operating margin for Fort Smith compared to the Fitch Ratings median result.

Figure 3-5: Fort Smith Utility Operating Margin



Operating margin is defined as operating income divided by total operating revenues. In comparison to the Fitch Ratings median, Fort Smith has consistently been lower and most recently on a declining trend. Generally speaking, the trend in operating margin shown in Figure 3-5 correlates to the trend in debt service coverage shown previously in Figure 3-2 and depreciation expense as a percentage of free cash flow shown in Figure 3-3.

Several policies regarding rate and financial management are proposed herein. These policies are designed to support improvement of the Department's financial performance.

3.3.2 Proposed Policy: Rate Methodology

Receiving revenues in a manner that is equitable for customers at levels that adequately fund both the water and sewer utilities is important to sustain water and sewer services. Cost of service methodologies generally accepted in the water and sewer industries are intended to set user charges and rates that reasonably recover the cost of serving customers from the respective customers and achieve the objectives of the water and sewer systems. It is proposed that Fort Smith consider continuing using the cost of service methodology in setting water rates and adopt this methodology for setting sewer rates.

The Department generally proposes three-year (3-year) rate plans to the Board for their consideration and approval. Implementing systematic rate adjustments at regular intervals helps mitigate the risk of rate shock. BMcD is of the opinion that the current approach that adopts multi-year rate adjustments is reasonable.

A policy regarding rate methodology may be structured as follows:

Rates for water and sewer billing shall be developed and periodically reviewed at least every five (5) years using a cost of service methodology generally accepted in the water and sewer industries. The intent of the rates will be to reasonably recover costs allocated to each customer class from the respective customer class, fund the water and sewer systems so neither system subsidizes the other, and support the goals and objectives of the water and sewer systems.

3.3.3 Proposed Policy: Affordability Assessment

During the Efficiency Study, the concept of including an affordability assessment was raised for consideration and use in the ratemaking process. The concept involves comparing the Median Household Income (MHI) for Fort Smith to the existing and proposed typical bill for a residential household. According to the Affordability Assessment Tool for Federal Water Mandates, published in 2013 for the United States Conference of Mayors, the AWWA and the WEF, it is "commonly inferred that the EPA would consider a combined annual water and sewer bill of less than 4.5 percent of MHI to be affordable (2.5 percent for water, plus 2 percent for sewer services)." The concept of affordability was included in the Consent Decree that was lodged January 2, 2015. The time extension clause allows the City to submit a financial capability assessment on or before January 2, 2021 for an extension if the residential sewer costs exceed 2.5 percent of the MHI. It is worthwhile to assess affordability in consideration of the Consent Decree time extension clause and to provide affordability indicators in the information provided to the Board (1). However, BMcD does not recommend adopting formal targets and actions resulting from the affordability assessment, because the Department has no control over trends in MHI. Rather, it is recommended that affordability be monitored for a possible Consent Decree time extension, discussed as part of the rate-making process and used for informational purposes. Such a policy may be structured as follows:

The Department shall include affordability analysis as a component of the ratemaking process and performance of the Consent Decree.

3.3.4 Proposed Policy: Billing Collections

Generally speaking, improvements in the collection of revenues from customers that lead to either reduced uncollectable revenue or faster receipt of revenue will lower the utility's costs and improve working capital. A shorter and more effective collection process will help lower uncollectable bills and lower operating costs. Utility billing and collection activities are managed by the City of Fort Smith Finance Department, with responsibility for invoice preparation and issuance, collection, and customer

care. Presently, customer bills for water and sewer services are due and payable prior to midnight of the fifteenth (15th) day following the billing date. Days receivables for 2013 was 41.9 days and for 2014 was 41.8 days. Revenue recognition directly impacts the cash flow of the utilities. Thirteen other utility service providers were surveyed in the greater Fort Smith area for comparison to the City's current practices. The results are provided in Table 3-1.

Table 3-1: Regional Utility Billing Practices

	Others			City of Fort Smith
	Minimum	Maximum	Average	
Billing Frequency	Monthly	Monthly	Monthly	Monthly
Days after billing that bills become past due	7	25	17	22
Days after billing that service is shut off for non-payment	14	32	26	62

The survey results suggest that Fort Smith's current practice of waiting 62 days after billing to shut off service is longer than other utilities in the region. Other service providers shut off service on an unpaid bill 14 days to 32 days after the bills are mailed. The average is 26 days. The City shuts off service on unpaid bills 62 days after the bills are mailed – more than twice the average. Since billing occurs after utility services are provided, the City's customers can receive services for three (3) months without paying their bills before service is terminated. If this period were to be reduced, it is anticipated that slow paying customers would bring their accounts current at a faster rate improving liquidity and days outstanding ratios. If a bill is truly uncollectable, reducing the number of days to shut off would effectively lower the uncollectable amount. It is recommended that this period be reduced. Such a policy may be structured as follows:

The water and sewer customer bills shall become past due if not paid within 15 days after the billing date. When past due, a penalty shall be added to the account in the amount of 10 percent of the past month's current billed amount, and a past due and shutoff notice will be mailed to the customer's address of record. Services for bills not paid within 30 days after the billing date are subject to suspension of service and may be turned off until the account is paid in full.

3.3.5 Proposed Policy: Billing Corrections

The City may make corrections to bills and customer accounts for errors in reading meters, processing

bills, and posting payments. These corrections might occur during the billing process or after bills have been generated. Currently, corrections are sometimes recorded as corrections to customer accounts and at other times recorded as adjustments depending on when the entry is posted as related to billing cycles. Also, meter reading corrections are occasionally not made so that the usage may catch up to the actual meter reading. Consequently, billing corrections are not reported separately from adjustments and occasionally not recorded. It is recommended that corrections be identifiable and reported separately from adjustments that forgive charges that were billed to customers. Furthermore, corrections should be recorded when identified.

Finally, it is recommended that some threshold be established for approval of correction adjustments. In the event that the proposed adjustment exceeds this threshold, additional approval will be required to approve the adjustment. This concept is proposed to provide enhanced control over corrections processing and assure needed meter reading and billing process improvements are identified and implemented as those needs arise.

A policy to address correcting errors may be structured as follows:

The City shall make water and sewer billing corrections to customers' bills and/or accounts to correct errors that occurred within the past three (3) years as a result of one or more of the following:

- *The meter was misread.*
- *The water and/or sewer usage was inaccurately estimated when an actual meter reading was not used.*
- *The water meter, sewer meter, meter reading system, billing system, and/or accounting system did not operate properly.*

Corrections shall be calculated as the difference between the erroneous usage and the corrected usage. The corrected meter reading shall be recorded on the customer's account when identified and shall be used so that the usage billed and usage subsequently billed shall be calculated using the corrected meter reading. Customer charges shall not be changed independently of meter readings. Meter readings will not be held over until the actual usage catches up to the erroneous meter reading.

In the event that the correction increases or decreases the usage so that the resulting change in either water or sewer charges exceeds the lesser of four (4) times the average water or sewer bill for that service point over the previous twelve months or $1,000, approval of the correction will require the Finance Department to escalate the matter to the Utility Director or designated representative for

approval within five (5) business days from the date of escalation.

3.3.6 Proposed Policy: Billing Forgiveness

Through the customer service operations managed by the City of Fort Smith, customers may obtain credits that effectively reduce billed revenues for utility services. The need for these credits can be caused by various legitimate issues including water leaks, filling swimming pools, good will, or other matters. The total annual amount of credit granted to utility customers has varied from approximately $495,000 to $720,000 annually during the past six (6) years. Presently customers are eligible for up to three (3) credit adjustments per year.

Current practices for customer billing adjustment do not involve the Utility Department and are managed and approved entirely by the Finance Department. Occasionally the credits are substantial, and taken as a whole, may adversely impact the financial results of the utilities. A policy is proposed to introduce the Department Director (or assigned delegate) to approve the granting of credits if the credit exceeds certain thresholds and to allow billing adjustments during a three-year (3-year) period if a billing correction occurs. Such a policy may be structured as follows:

Credits to water and sewer utility bills may be granted to customers to account for water leaks fixed by plumbing repairs, filling swimming pools, and billing corrections. Credits may be applied to customer accounts subject to the following conditions.

- *Except for adjustments that result due to billing corrections, a service point is eligible for a water leak credit to water charges for not more than two (2) months, provided a water leak credit was not posted to the account in the most recent 12 month period. Similarly, except for adjustments that result due to billing corrections, a service point is eligible for a credit to sewer charges for not more than two (2) months related to water leakage, provided a sewer credit related to water leakage was not posted to the account in the most recent 12 month period. In addition, an account is eligible for a credit to sewer charges for one (1) month related to filling a swimming pool each calendar year.*
- *In the event of a billing correction, a service point is eligible for a water credit to water charges and sewer credit to sewer charges for any charges added due to a billing correction.*
- *Each water credit is subject to a maximum of either four (4) times the average monthly water charges or $1,000, whichever is less. Similarly, each sewer credit is subject to a maximum of either four (4) times the average monthly sewer charges or $1,000, whichever is less.*
- *Credits applied to billed water volumes may not lower the billed volume for any month of service below its most recently 12 month average or 6 CCF, whichever is higher.*

- *Credits applied to billed sewer volumes may not lower the billed volume for any month of service below its most recently designated winter average or six (6) CCF, whichever is higher.*
- *The customer must provide the City with written proof that the leak was fixed by plumbing repairs for a leak credit to be considered by the City.*

In the event a proposed credit exceeds these conditions, approval of the credit will require the Finance Department to escalate the matter to the Utility Director or designated representative for approval within five (5) business days from the date of escalation. The Utility Director or designated representative may approve a water and sewer credits as follows:

- *A maximum water credit of $1,000 plus 50 percent of the billed water amount greater than $1,000, not to exceed $5,000 total credit for water.*
- *A maximum sewer credit of $1,000 plus 50 percent of the billed sewer amount greater than $1,000, not to exceed $5,000 total credit for sewer.*

If the proposed credit is denied by the Utility Director or designated representative, the decision may be appealed by the customer to the City Administrator or designated representative, within 10 business days from the date of the decision made by the Utility Director or designated representative.

Because this policy involves the Utility Department and other City departments, further discussion is recommended with the Finance Department to evaluate requested procedural changes and collaborate on process controls that enhance quality control and maintain superior customer service.

3.3.7 Proposed Policy: Winter Averaging for Residential Sewer Bills

Because sewer discharge is not typically directly metered, a reasonable basis for estimating contributed (or billed) sewer volumes must be made. Within the sewer utility industry, the most frequent methods for estimating contributed sewer volumes are either 100 percent of the actual water used or calculation of winter water used. A less common method includes using a fixed percentage of actual water use (for instance, 80 percent of water use in a given month equals estimated sewer volume). The National Association of Clean Water Agencies (NACWA) publishes a detailed survey of sewer utilities which examines, among many other variables, the types of approaches used to estimate single-family contributed sewer volumes. According to the most recent NACWA survey published during 2011, 50 percent of survey respondents indicated using 100 percent metered water as the sewer billing basis, while 45 percent reported using winter water as the basis. Other approaches, including a fixed percentage of water use, were responsible for the remaining 5 percent. For non-residential customers, water use is typically the basis for estimating contributed sewer volumes.

The Department presently bases residential contributed volume for the period of April through October on

each account's most recent winter billing period of November through March. Billed sewer volumes during months outside of the winter billing period are set at the lesser of the current month's water use or the most recent winter billing period. From a ratemaking point of view, a change in the definition of the winter billing period should be revenue neutral for the utility system. For instance, if the definition of the winter period is changed, and overall billable volume declines, rates will need to be adjusted upward to provide the same revenue stream to cover the same revenue requirements. Changes in the definition of the winter period are designed to be revenue neutral for the system; however individual accounts could pay more or less based on the definition and their respective billable flow. Therefore the equitability of cost recovery can be impacted when winter period definitions are adjusted. Because of this, care should be taken in defining the winter period to derive an equitable approach to determining contributed flow. Some utilities choose to evaluate changes in winter period definition during the conduct of rate studies.

Another policy consideration is the treatment of residential accounts with sprinkler systems that have only one meter serving both the single family home as well as the sprinkler system. In the event sprinkler usage occurs in November or March, such use could presumably be captured in the winter period calculation as it is currently defined. From a practical standpoint, sprinkler use is likely limited for most residential customers in November or March under normal climatic conditions, especially when compared against the hot and dry summer months. BMcD recommends treating all residential customers similarly in the determination of winter period use. Alternately, a customer with a sprinkler system could choose to have an additional meter installed at their expense to determine the quantity of water used specifically in their sprinkler system. Such quantities would not be subject to sewer charges.

BMcD is of the opinion that the current winter period determination as practiced by the Department is reasonable, and therefore BMcD does not recommend changes to the winter period definition in the proposed policy. However we recommend evaluating seasonal trends in monthly billed water volumes for the residential class during the upcoming rate study, and consider changes if warranted. While the Department may consider evaluating the adequacy of the winter period definition from time to time, BMcD does not recommend developing a formal policy setting parameters for the frequency of such analyses. The Department should initiate such an evaluation if a shift in customer usage characteristics is detected, or if it is determined a large percentage of requested billing adjustments are based on issues with the winter period definition. A policy is proposed to clarify how winter average should be applied to residential accounts. Such a policy may be structured as follows:

Billable volumes for residential sewer customers during the April, May, June, July, August, September and October billing cycles will be determined based on the most recent evaluation of winter period water

consumption, defined as the average monthly water usage during the immediate preceding November, December, January, February and March billing cycles at the same service point. The monthly billable volume for each residential account will be established as either actual water usage or the winter average calculated usage, whichever is lower for the applicable month. If a residential sewer customer does not have a winter period water consumption, for example an account initiated after the start of the winter period, the billable volume during the months of April, May, June, July, August, September and October will be either actual water usage or 6 CCF whichever is lower.

3.3.8 Proposed Policy: Service Charges

Many water and sewer utilities assess service charges for ancillary services related to water or sewer services. These charges could include turn-on and turn-off fees, pipeline tapping fees, leak detection fees, meter re-read fees, and meter tampering fees. The intent of such charges is to match charges to the customers who use a particular service rather than collecting those costs through water and sewer rates.

The City of Fort Smith currently has service charges for reinstatement of service after a turn-off for nonpayment of a bill or for a returned check, reinstatement of service after normal business hours, setting a fire hydrant meter, processing pretreatment applications, industrial waste monitoring and inspection, collecting and analyzing samples, and reviewing and responding to accidental sewer discharges.

A policy is proposed to provide a schedule of service charges. A policy regarding service charges may be structured as follows:

Service charges shall be developed and periodically reviewed at least every five (5) years using principles generally accepted in the water and sewer industries. The intent of these charges will be to reasonably assess charges to customers who use particular services related to water or sewer services. Charges will be listed in a table of service charges subject to Board approval and maintained by the Department.

3.4 Reserve Policies

3.4.1 Background

In the Introduction Section of this report, it was noted that the development and adoption of financial policies will support the Department in the pursuit of its mission in several ways:

- Fulfill the mission with focus
  - Ensure sustained delivery of quality water and sewer services
  - Promote health, safety and quality of life

  - Provide excellent service to customers
  - Create value through operational excellence
  - Ensure long-term regional success
- Provide liquidity to adequately fund operating and capital costs
- Mitigate the risk of financial stress caused by
  - Revenue shortfalls due to weather anomalies
  - Sudden increases in commodity costs
  - Cost of major equipment failure or fixed asset failure
  - Unexpected expenses due to civil disorder, catastrophes, or other emergencies
- Better position the utility to fund capital projects that are necessary to comply with regulatory requirements and liabilities associated with aging infrastructure and future system growth
- Assist in the compliance with existing bond covenants, and position the Department more favorably for ratings reviews associated with future debt issuance thereby lowering the cost of borrowing money
- Enhance the stability in user rates and charges by minimizing the severity of rate shock that can result if inherent risks noted above are realized

Establishing and maintaining appropriate reserves represents a fundamental component of prudent utility management, and all of the factors listed above are readily addressed through reserve management. The Department currently maintains several funds or groups of funds for utility use, as detailed in Table 3-2.

Of the funds noted in Table 3-2, the assets or balances available in all but the Water and Sewer Fund are restricted in the sense that the application of those funds may only be for the expressed purpose of the fund. After obligations for the other funds are satisfied, balances available in the Water and Sewer Fund are unrestricted, in the sense that they may be used for any lawful utility purpose. Obligations for other funds are defined in the existing bond covenants.

Table 3-2: Existing Reserve Funds

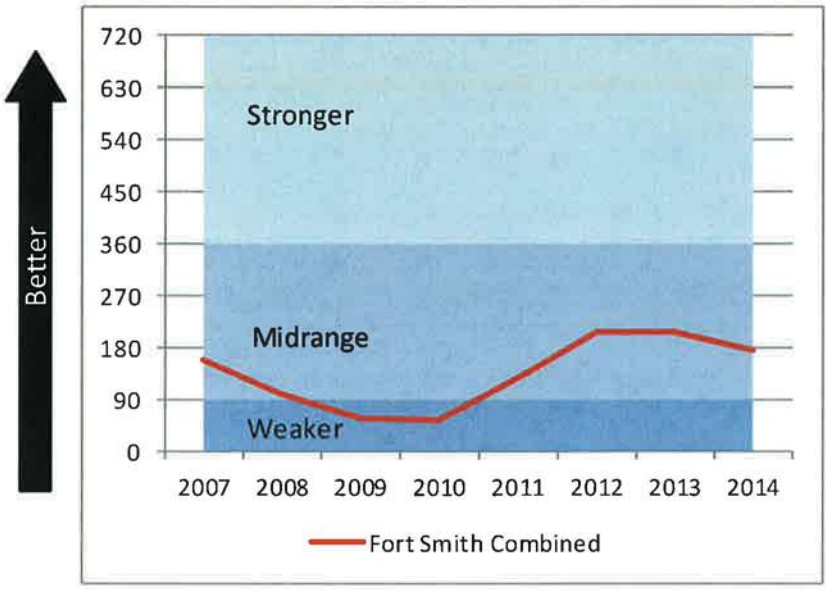
Fund	Purpose	Minimum Balance Required
Water and Sewer Fund (Revenue Fund)	Provide operating liquidity and mitigate risk	Target of 15% of O&M
Water and Sewer Revenue Bond Construction Fund(s)	Funding source for bond-financed CIP projects; holds deposits from applicable bond sales	None
Water and Sewer Revenue Bond Fund and Debt Service Reserve	Payment of principal, interest, and trustee fees, and Bond covenant requirement, lesser of (1) 10% bond proceeds; (2) max annual debt service; or (3) 125% annual average debt service.	Monthly transfers of 1/6 next interest installment, 1/12 principal installment, and trustee's fees
Water and Sewer Depreciation Fund	Bond covenant requirement to be used for asset replacement made necessary by depreciation of the system.	$500,000

An examination of the Department's financial statements will provide insight into the overall reserve position and is a key indicator for bond rating agencies. Figure 3-6 depicts Fort Smith's days cash on hand in comparison to Fitch Ratings' stratification of weaker, midrange, and stronger performance. For this chart, days cash on hand is computed as:

[Cash + Short Term Investments] / [Total Operating Expenses - Depreciation] x 365 Days = Days Cash On Hand

Across all utility funds, Fort Smith held about 176 days of cash on hand at the end of 2014, declining from 2012 levels. As noted earlier in this report, most indicators for Fort Smith evaluated in this report have eroded since 2012. At 176 days, the reserve only falls within the midrange performance stratification. To achieve "stronger" performance from Fitch Ratings' perspective, total cash on hand would need to approximate one (1) year or more of operating expenses.

Figure 3-6: Fort Smith Utility Days Cash on Hand



Policy considerations for reserves are noted in the remainder of this section of the report. These policies are designed to provide a clear basis for reserve funds, their use of funds, and where applicable their recommended minimums.

3.4.2 Water and Sewer Fund (Revenue Fund)

In the process of setting Sewer rates following adoption of the Consent Decree, the Board considered an operating reserve target of about 73 days of operating expenses (0.20 * 365 days). This revised target was an improvement over the prior 55 day / 15 percent target used previously by the Department. Operating reserves are frequently stated in terms of "days" of operating expenses as the primary purpose of operating reserves is to provide funding for ongoing operations and mitigate associated risk. Policies and practices vary widely across the industry, but the minimum operating reserve targets usually set are 60 to 90 days. As evidenced in Figure 3-6, from Fitch Ratings' perspective, the municipal bond market prefers balances in excess of 90 days.

Municipal utilities, like any enterprise, require a certain amount of liquidity to operate efficiently. Working capital bridges the timing difference between revenues received and expenses paid. By the time a customer receives a bill, the operating costs associated with providing water and sewer service such as labor and commodity costs have already been incurred. If working capital is not sufficient, financial stability can deteriorate. From BMcD's perspective, this is one reason why Fitch Ratings would consider operating reserve balances less than 90 days as weaker. Reserve levels must first be sufficient to reflect the timing differential between when the cost of providing service is incurred and when payment for this

service is ultimately received.

Additionally, municipal utilities are exposed to risks that can materially disrupt financial performance. In one extreme example, the Sewerage and Water Board of New Orleans lost over 30 percent of its revenue stream following Hurricane Katrina. While Fort Smith's hurricane risk is not comparable with New Orleans, tornado, earthquake, flooding, ice or wind storms, fires or other catastrophic disasters all represent potential risks. Risk is also present in the form of material equipment or other asset failure, sudden increases in costs associated with commodities such as natural gas or chemicals, and security, among others. Maintaining appropriate reserve balances in the Revenue Fund provides financial stability and can help mitigate the risk associated with unforeseen events.

BMcD recommends a minimum target balance of 120 days O&M, or approximately 33 percent of budgeted O&M costs to meet liquidity and provide a level of reserve for emergency purposes. The proposed 120 days minimum O&M reserve is based on an allotment of 90 days for working capital reserve (about 25 percent of O&M) plus 30 days emergency reserve (about an additional 8 percent). The working capital reserve target of 90 days is consistent with the reserve recommendation in the Efficiency Study. An overall target of 120 days further mitigates risk, and is more consistent with municipal bond market expectations demonstrated in Figure 3-6. In the event an unanticipated issue causes reserves to be drawn below the minimum 120-day balance, we recommend the Department commit to developing a plan to restore balances within three (3) budget years after the shortage was initially reported. With a minimum operating reserve of 120 days, the Department will be better positioned for favorable bond ratings and the financial stability of the system will increase over the long term. As a result, the increase days of cash may reduce the cost of borrowing future money.

The Department may also consider establishing a maximum threshold for reserves in the Water and Sewer Fund. It is proposed that a maximum reserve balance of 180 days be set to establish an overall range of 120 to 180 days of O&M for reserve purposes. In the event reserves exceed the 180 day balance, we recommend the Department develop a plan to restore balances to the targeted range within 3 budget years after the overage was initially reported.

A proposed reserve policy for the Water and Sewer Revenue Fund can be structured as follows:

The Department will maintain a reserve balance of a minimum of 33 percent (120 days) to 49 percent (180 days) of the annual operation and maintenance expenses for liquidity and emergencies. Balances will be made available to fund ongoing operation and maintenance costs, and fund emergency operations or unforeseen events. If the end of year Water and Sewer Revenue Fund balance is calculated to be less

than 120 days or more than 180 days, the Utility Director will provide a financial plan to the Board to restore this fund balance to the targeted range within three (3) budget years after the variance was initially reported.

3.4.3 Fleet and Equipment Replacement Reserve

The Fleet and Equipment Replacement Reserve represents a new account established for the purpose of pooling available revenue transfers from the Water and Sewer Fund (see Section 3.2.2 Revenue-Financed Capital) as a funding source for fleet and mobile equipment replacement (1). Assets classifiable as fleet or mobile equipment within the Department's fixed asset records qualify for funding from the Fleet and Equipment Replacement Reserve. It is recommended that deposits to this reserve equal the Department's equipment depreciation and represent a portion of the revenues available for cash funding of equipment described in Section 3.2.2 of this report (and not be considered incremental to the transfers described in that policy statement). As such, a portion of revenue-financed capital will be explicitly directed to the shorter-lived assets of the Department, which are most effectively paid out of current revenues. No minimum balance is required for this reserve. If fleet and mobile equipment spending exceeds the balance available in this reserve, the Department will identify alternative funding sources as part of the annual financial planning and budget cycle. If the balance available in this reserve exceeds fleet and mobile equipment spending identified in the CIP, additional deposits to this reserve may be suspended until the balance in this reserve does not exceeds fleet and mobile equipment spending identified in the CIP.

A proposed policy for the Fleet and Equipment Replacement Reserve can be structured as follows:

The Department will establish and maintain a Fleet and Equipment Replacement Reserve (FERR) to be funded annually by a deposit equal to the prior year's equipment depreciation expense. Such deposits will be considered a portion of the transfers from the Revenue Fund to provide revenue funding for capital expenditures. Assets classifiable as fleet or mobile equipment are eligible for funding from the FERR. No minimum balance is required to be maintained in the FERR. If funding provided by the annual deposit exceeds the current year's fleet and mobile equipment purchases, available balances will carry forward to subsequent years. If funding provided by the annual deposit and any other available balance within the FERR is not sufficient to fully fund the current year's fleet and mobile equipment purchases, the Department will secure additional capital improvement funding consistent with current utility practice. If the balance available in this reserve exceeds fleet and mobile equipment spending identified in the CIP, additional deposits to this reserve may be suspended until the balance in this reserve does not exceed fleet and mobile equipment spending identified in the CIP.

3.4.4 Water/Sewer Capital Improvement Fund

The capital funds represent a group of funds established for the purpose of funding capital improvement projects for the Department. Examples of these capital improvement projects include infrastructure related to water supply, treatment, and transmission for the water system, and sewer interceptor and treatment for the sewer system. Existing Bond Construction Funds are created to receive deposits from applicable bond sales and use those funds in accordance with bond covenants. It is anticipated that an additional capital reserve should be created called the Water/Sewer Capital Improvement Fund to receive annual transfers proposed in Section 3.2.2 from the Revenue Fund. Balances available in the Water/Sewer Capital Improvement Fund may be applied to any infrastructure, facility, and resource capital project approved as a part of the Capital Improvement Program (CIP). Annual revenue transfers will provide a funding source for the capital projects (1). No minimum balance is required for this fund. If infrastructure, facility, and resource capital improvement spending exceeds the balance available in the Water/Sewer Capital Improvement Fund, the Department will identify alternative funding sources as part of the annual financial planning and budget cycle. If the balance available in the Water/Sewer Capital Improvement Fund exceeds infrastructure, facility, and resource capital spending identified in the CIP, additional deposits to this fund may be suspended until the balance in this fund does not exceed infrastructure, facility, and resource capital spending identified in the CIP.

The amount of monies transferred to the Capital Improvement Fund may vary year to year based on decisions made by the Department and approved by the Board as part of the annual budgeting and CIP planning process. However, the total amount of monies available to fund capital projects in a given year among the transfers to the Water/Sewer Capital Improvement Fund, the Depreciation Fund, and the Fleet and Equipment Replacement Reserve shall at a minimum amount to the prior year's annual depreciation expense as proposed in Section 3.2.2.

A proposed policy for the Water/Sewer Capital Improvement Fund can be structured as follows:

The Department will maintain reserves in the Water/Sewer Capital Improvement Fund to provide funding for the capital improvement program. An annual deposit from the Revenue Fund will be proposed by the Department and subject to Board approval that, together with deposits to the Depreciation Fund and Fleet and Equipment Replacement Reserve, amount to a minimum of the prior year's depreciation expense. All assets of the Department are eligible for funding from the Water/Sewer Capital Improvement Fund reserves. No minimum balance is required to be maintained in the Water/Sewer Capital Improvement Fund reserves. If available funding exceeds the current year's capital expenditures, available balances will carry forward for use during subsequent years. If balances are not sufficient to

fully fund the current year's capital expenditures, the Department will secure additional capital improvement funding consistent with current utility practice. If the balance available in the Water/Sewer Capital Improvement Fund exceeds infrastructure, facility, and resource capital spending identified in the CIP, additional deposits to this fund may be suspended until the balance in this fund does not exceed infrastructure, facility, and resource capital spending identified in the CIP.

3.4.5 Depreciation Fund

In accordance with existing bond covenants, the Department is required to maintain a balance of $500,000 until the applicable bonds mature. As of December 31, 2014, the City has accumulated $1,400,000 in the Water and Sewer Depreciation Fund for asset replacement. The 2015 Budget transfers an additional $450,000 to the Depreciation Fund. With an annual depreciation amount of $11,861,667 in 2014, a Depreciation Fund transfer of $450,000 is sufficient to provide about 4 percent of annual depreciation funding for one year. The Efficiency Study recommended the utility pursue a policy to provide revenue funding for capital projects equal to the amount of value lost in annual depreciation.

The amount of monies transferred to the Depreciation Fund may vary year to year based on decisions made by the Department and approved by the Board as part of the annual budgeting and capital planning process. However, the total amount of monies available to fund capital projects in a given year among the transfers to the Water/Sewer Capital Improvement Fund, the Depreciation Fund, and the Fleet and Equipment Replacement Reserve shall at a minimum amount to the prior year's annual depreciation expense as proposed in Section 3.2.2. If the balance available in the Depreciation Fund exceeds capital spending identified in the CIP, additional deposits to this fund may be suspended until the balance in this fund does not exceed capital spending identified in the CIP.

No minimum balance is required for this fund. Projects funded by balances in the Depreciation Fund must be renewal and replacement projects that have been identified and approved within the CIP. Beyond the minimum bond covenant requirement of $500,000, no minimum balance is required for this fund. If capital improvement spending for assets exceeds the balance available in the fund, the Department will identify alternative funding sources as part of the annual financial planning and budget cycle.

A proposed policy for the Depreciation Fund can be structured as follows:

The Department will maintain reserves in the Depreciation Fund to fulfill bond covenants and to provide funding for investment in fixed assets. An annual deposit from the Revenue Fund will be proposed by the Department and subject to Board approval that, together with deposits to the Water/Sewer Capital Improvement Fund and Fleet and Equipment Replacement Reserve, amount to a minimum of the prior

year's depreciation expense. No minimum balance is required to be maintained in the Depreciation Fund in excess of that fulfilling the bond requirement. If balances are not sufficient to fully fund the current year's capital expenditures, the Department will secure additional capital improvement funding consistent with current utility practice. If the balance available in the Depreciation Fund exceeds capital spending as identified in the CIP, additional deposits to this fund may be suspended until the balance in this fund does not exceed capital spending identified in the CIP.

3.4.6 Summary of Reserve Funds and Policy Changes

Table 3-3 summarizes the reserve funds impacted by the recommendations in this report. The Revenue Fund is an existing fund with recommendations to increase the reserve level and to increase revenue financed capital. The Equipment Replacement and Capital Funds are new.

Table 3-3: Summary of Recommended Funds with Policy Adjustments (1)

Fund or Account	Purpose	Efficiency Study Recommendation	Proposed Balance Range	Required Deposits To/From
Water and Sewer Fund (Revenue Fund)	Provide operating liquidity and mitigate risk	25% or 90 Days of Current O&M	33% to 49% of O&M / 120 -180 Days	Minimum of prior year's depreciation to FERR, Capital Improvement Fund, and Depreciation Fund
Fleet and Equipment Replacement Reserve	Funding source for fleet and mobile equipment replacement	Annual Equipment Depreciation	No Minimum Requirement; Maximum as Approved by Board in CIP	Annual Equipment Depreciation(1) from Revenue Fund
Water/Sewer Capital Improvement Fund	Funding source for CIP	Annual Revenue Funded Capital Projects	No Minimum Requirement; Maximum as Approved by Board in CIP	Portion of prior year's annual depreciation from Revenue Fund
Water and Sewer Depreciation Fund	Bond covenant requirement and funding source for CIP asset replacement made necessary by depreciation of the system.	Annual Infrastructure Depreciation	$500,000 Minimum; Maximum as Approved by Board in CIP	Portion of prior year's annual depreciation from Revenue Fund

Table 3-4 summarizes the existing reserve funds that are not impacted by the recommendations in this report.

Table 3-4: Summary of Existing Reserve Funds with No Recommended Changes (1)

Fund or Account	Purpose	Minimum Balance Requirement
Water and Sewer Revenue Bond Construction Fund(s)	Funding source for bond-financed CIP projects; holds deposits from applicable bond sales	None
Water and Sewer Revenue Bond Fund and Debt Reserve (Bond Fund)	Payment of principal, interest, and trustee fees. Bond covenant requirement, lesser of (1) 10% bond proceeds; (2) max annual debt service; or (3) 125% annual average debt service.	Monthly transfers of 1/6 next interest installment, 1/12 principal installment, and trustee's fees

4.0 REFERENCES

1. **HDR Engineering, Inc.** *City of Fort Smith Water and Sewer Operations Efficiency Study: Final Report.* Kansas City : HDR Engineering, Inc., 2013. pp. 99-101.
2. **Stephens Inc.** $7,330,000 City of Fort Smith, Arkansas Water and Sewer Revenue Bonds Series 2005B. [Official Bond Statement]. Little Rock, Arkansas : s.n., December 1, 2005. p. 16.

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INTER-OFFICE MEMO

TO: Jeff Dingman, Acting City Administrator **DATE:** September 3, 2015

FROM: Steve Parke, Director of Utilities

SUBJECT: Wholesale Water Users

The city currently has 13 wholesale water customers. Of these 13 customers, Fort Chaffee is the oldest with a Government water service contract to support military operations beginning in 1941. The Town of Mountainburg is the oldest of the municipal or private water user associations with its water service beginning in 1956. Fort Smith acknowledged the concept of a contract water sales relationship with Mountainburg in 1935, when in exchange for Mountainburg granting Fort Smith permission to route its water transmission line from the original Lake Fort Smith water supply through the town's street right-of-ways, agreed to sell water to Mountainburg if it ever developed a public water system.

Prior to 1983, Fort Smith's water rates for outside of city water customers varied from applying a factor of 1.33 to the in-city water rate for an outside-of-city customer as allowed by state statues to setting rates which were designed to recover costs above those needed for the water system. In 1983, the city's wholesale users sued the city alleging the water rate charged to them was improper. The formal settlement agreement entered with the court dismissed the lawsuit based upon Fort Smith's agreement to utilize the cost allocations as determined through a cost-of-service methodology. Although the time period set for the settlement agreement mandates has expired, Fort Smith has continued to use the American Water Works Association cost-of-service principals for rate setting purposes. It should be noted that Van Buren's contract receives additional considerations with the inclusion of true-up provisions.

The attached exhibit lists the city's current 13 wholesale/contract water customers along with other information about those accounts such as the initial year of service, contract status (current or lapsed) and type of service (surplus or firm supply). Six users have current contracts, one is currently negotiating for a new contract and six have lapsed. The wholesale user surplus user status prevents them from entering into contracts which require minimum purchase volumes or binding time periods which would be secured with buy-out provisions for early termination, so the lapsed contracts do not introduce additional risk to Fort Smith. The presence of a contract is most beneficial to the wholesale user as it establishes water volumes available to them during a defined period, their ability to obtain loans for construction of improvements, and their other normal business protections. In absence of a long term contract the wholesale users' exposure to risk increases. Fort Smith's risk of cost recovery is reduced during revenue bond repayment periods if wholesale users purchase the water volumes anticipated with their contract. In our geographic setting, there is no other viable, or more cost effective, alternate water supply available so the risk of stranded costs is minimal. However, in order to not let the minimal risk of stranded costs to go unaddressed, our current rate study is analyzing the risk of potential stranded costs for system improvements which include capacity for regional growth and will recommend a higher water rate for wholesale users with lapsed contracts to address that impact.

Fort Smith has a minimal risk during periods of financing water system improvements utilizing revenue bonds as repayment of those bonds depends solely on the system's revenues. Should a wholesale user leave our system during a bond repayment period we may be exposed to some stranded costs. However, in our geographic setting, there is no other viable, or more cost effective, alternate water supply available. Even though it is a minimal risk, our current water rate development work is analyzing the risk of potential stranded costs for system improvements which include capacity for regional growth and will recommend a higher water rate for wholesale users with lapsed contracts to eliminate that impact.

Should you or members of the Board have any questions, please let me know.

attachment

Wholesale User	Initial Contract	Last Contract	Term	Expiration	Status	Type of Service	Comments
Arkoma Municipal Authority	1973	2013	20 years	2033	Current	Surplus User	
Barling, City of	1969	2002	30 years	2032	Current	Firm Supply	
Cedarville Water Users Association	1980	1994	10 years	2004	Lapsed	Surplus User	
Central Water Users Association	2006	2006	20 years	2026	Current	Surplus User	
Chester, Town of	1980	1980	20 years	2000	Lapsed	Surplus User	
CMTC Utility Branch (Fort Chaffee)	1941	Amended 1985	N/A	N/A	Current	Special	
Concord Water Users Association	1984	1994	10 years	2004	Lapsed	Surplus User	
Franklin-Sebastian Public Water Authority	2009	2009	20 years	2029	Current	Surplus User	
Highway 71 Water Users Association	1972	2000	5 years	2005	Lapsed	Surplus User	Currently negotiating
Mountainburg, City of	1956	1956	3 years	1959	Lapsed	Surplus User	
Rural Water District No. 7	1967	1993	10 years	2003	Lapsed	Surplus User	
Van Buren, City of	1975	2001	24 years	2027	Current	Firm Supply	
Winslow, City of	1984	1984	5 years	1989	Lapsed	Surplus User	