



To: Commissioner Nick Fish  
From: Janice Thompson, CUB Consumer Advocate  
Re: Rate Stabilization Funds

February 4, 2015

## **BACKGROUND**

In CUB testimony at the May 2014 rate hearing I briefly mentioned rate stabilization funds with the implicit purpose of notifying the City Council that it should not use these dollars inappropriately. The specific language from that testimony is provided below:

Rate Stabilization Funds in both BES and PWB have enabled avoiding utility spikes. This is standard practice within the utility industry and effective use of these funds in Portland has also been missing from recent discussions. The benefit of Rate Stabilization Funds continues and this practice should continue with strategic replenishing of these funds and prudent decisions about their future use.

The “recent discussions” reference in that testimony related to the spring 2014 campaign on the ballot measure to remove the City Council as the public utility decision making body that failed last May with a 73 percent “no” vote. Even though rate stabilization funds were not highlighted during that campaign, PWB and BES discuss use of these funds in City Council budget documents and rate stabilization is a topic monitored by the City Debt Manager.

Preliminary conversations last summer with Jim Hagerman of BES and Cecelia Huynh of PWB by CUB did not indicate a major concern with their rate stabilization funds, so this topic became one that I was going to monitor in the 2015-2016 budget. However, you asked CUB for a report you could provide the City Council on rate stabilization funds due to a *Willamette Week* article on this topic. Assessment by the Budget Advisory Committees of PWB was also requested and that group reviewed a draft of this memo.

## **RATE STABILIZATION FUND BASICS**

The *Willamette Week* article used the following definition, “A stabilization fund allows a utility to draw on the fund balance during revenue shortfalls that result from lower than expected customer consumption.”<sup>1</sup> The *Willamette Week* article, however, does not provide the context of that definition being in a discussion of the role of a stabilization fund when charging seasonal rates or rates that increase during dry periods and decrease during wet periods of a year, a dynamic not seen in Portland rates.

A more informative description is that rate stabilization fund dollars are “used to ‘smooth out’ rate increases over time when there are fluctuations in revenues and expenses.”<sup>2</sup> After “designated reserves for a rate stabilization fund” are accumulated it “can be drawn on to mitigate large impacts of prospective revenue requirements. The rate stabilization fund is used to meet a portion of the utility’s revenue requirements” and once established should be maintained.<sup>3</sup> In other words, rate

stabilization funds are built up and then drawn down, but not eliminated, in a planned and strategic manner.

Financial, economic and capital planning circumstances are not static. It is also important that financial strategies – including use of a rate stabilization fund – are able to adjust and respond to constantly evolving circumstances. For example, not as much was moved from the PWB rate stabilization fund in fiscal year 2014<sup>4</sup> as was originally planned due to higher than anticipated revenues. This kind of adjustment occurs as part of finalizing end of fiscal year accounts. It was prudent since it facilitates projection of lower future rate increases. The new utility oversight group, the Public Utility Board, should be consulted on these adjustments which, though valid, should be more transparent.

## **PORTLAND WATER BUREAU AND BUREAU OF ENVIRONMENTAL SERVICES RATE STABILIZATION FUNDS**

Rate stabilization funds are designed to build up and be drawn down. There is no industry standard for an optimal amount of a rate stabilization fund; rather the circumstances facing each utility determine the size and strategic use of a rate stabilization fund. For example, *Willamette Week* makes a flawed comparison between the rate stabilization funds of the PWB and BES. The *Willamette Week* article implies that the size of the PWB rate stabilization fund is higher than it should be because the current balance in the BES rate stabilization fund is lower. The notion that PWB and BES rate stabilization fund balances should be the same reflects a fundamental misunderstanding of the “build up and draw down” nature of these funds. Right now the BES rate stabilization fund balance may be lower than its PWB counterpart, but that has not always been the case as illustrated in the charts at the end of this memo.<sup>5</sup>

### **BES Rate Stabilization Fund**

BES has had two planned cycles of building up and drawing down its rate stabilization fund. The first began in 1987 linked to growth of the consumer base due to the Mid-County Sewer Project. In 1983 Multnomah County decided to stop providing municipal services to unincorporated areas that led to the annexation of East Portland, in large part to comply with a state environmental requirement that sewer services be provided.<sup>6</sup> The Mid-County project title reflects that the East Portland area affected is in the middle of Multnomah County. Projections of higher rates once service development charges and other revenues from this sewer service expansion ended, however, led to using revenue increases to build up the rate stabilization fund. The fund peaked at \$29.3 million in 1996 and was gradually drawn down to smooth rate increases until 2002.

Beginning in 2003, the BES rate stabilization fund balance began to be increased again and peaked at \$76.5 million in 2008. Drawing down the BES rate stabilization fund since then has smoothed rate increases linked to the construction of the Big Pipe project. This project has reduced Combined Sewer Overflows to levels mandated in an agreement with environmental regulators. For financial resiliency the BES rate stabilization fund will not be spent down to zero with a projected minimum balance goal of 8 percent of operating expenses or about \$10 million. There are planned fluctuations in future levels of the BES rate stabilization funds linked to the smoothing of annual rate increases related mostly to increased debt service on anticipated biennial bond sales.

### **PWB Rate Stabilization Account**<sup>7</sup>

The motivation for the PWB to begin building a rate stabilization fund in 2007 was anticipation of major construction costs related to complying with environmental regulations to build covered reservoirs and decommission open reservoirs in Mt. Tabor and Washington Parks. The PWB rate stabilization fund peaked in 2013 at \$32.6 million and will be drawn down to about \$5 million in

2020. This is 6.3 percent of PWB's operating budget while the \$2 million minimum target for this fund balance is 2.5 percent of PWB's operating budget. It is fiscally responsible for these PWB percentages to be lower than the 8 percent fund balance goal of BES for various reasons, but a major factor is the higher debt coverage ratio for water utility bonds due to PWB's Aaa bond rating.

### **RATE STABILIZATION FUND AND BOND RATINGS**

Bond rating agencies view use rate stabilization funds as a "financial asset," especially those funds that have a replenishment plan<sup>8</sup> and are for entities that consistently meet financial and capital improvement planning targets. The PWB Aaa bond rating is the highest in the industry while the BES Aa3/AA- bond ratings are among the best in the country. Bond rating agencies value Portland's use of rate stabilization funds because it demonstrates long-range planning and fiscal prudence on the part of the two utility bureaus.

Transfers of money from rate stabilization funds to operating budgets generally coincides with increases in debt service due to bond sales that, in turn, provide funding for capital improvements. This helps secure a good debt service coverage ratio that clearly indicates the availability of money to repay the bonds when due while also mitigating increases in future rates. Bolstering the credit quality of Portland's utility bonds benefits ratepayers since 44% of an average 2014 residential bill is applied towards paying debt service.

*Willamette Week's* suggestion that the PWB rate stabilization fund should be spent down in one year would most likely alarm the bond market and rating agencies. Any action that reduces the credit quality of Portland's utility bonds would result in increased borrowing costs and increased rates for water customers. A one-time spend down of the rate stabilization fund could provide a short-term benefit for ratepayers. That benefit, however, would be far outweighed by the risk of increased long-term costs to ratepayers due to potential damage to bond ratings and future rate spikes. For example, if the entire rate stabilization fund was used in one year there would be substantial rate increases the following year.

### **CONCLUSION**

*Willamette Week's* article seems to suggest that the rate stabilization funds for PWB and BES are somehow used as slush funds. We do not find that to be the case. The build-up of the rate stabilization funds and subsequent draw-downs are targeted, strategic and planned. They have eased the financial impact of major capital investments and also help maintain excellent utility bond ratings to ensure that ratepayers get the lowest financing costs possible.

Capital investments are the expenditures with the most significant rate impacts. Those investments are the most in need of ongoing analysis, discussion and review. Preserving the credit quality of Portland's utility bonds also help reduce costs for ratepayers. CUB is pleased to see these points reflected in the final report of the Utility Oversight Blue Ribbon Commission along with the recommendation that capital improvement planning receive significant scrutiny by the Public Utility Board. CUB also places a priority on ensuring that the appropriate projects are chosen at the right time in the right priority order.

The new Public Utility Board advisory group should also receive regular, at least annual, briefings from PWB and BES on the status of utility bonds and rate stabilization funds. Also recommended is having the city debt manager on hand during these briefings. These regular briefings would facilitate the Portland Utility Board's ability to provide input on these topics including possible adjustments in rate stabilization fund balances. CUB would plan on attending these briefings. If

they do not occur, CUB will request such briefings for our own analysis of capital improvement planning, bond debt, and strategic use of rate stabilization funds.

<sup>1</sup> *Principles of Water Rates, Fees, and Charges*, American Water Works Association manual, Sixth Edition

<sup>2</sup> Right-Sizing Reserve Funds, February, 2012, <http://efc.web.unc.edu/2013/02/12/right-sizing-reserve-funds/>

<sup>3</sup> *Principles of Water Rates, Fees, and Charges*, American Water Works Association manual, Sixth Edition

<sup>4</sup> FY 2014 means mid 2013 to mid 2014.

<sup>5</sup> Historical data from presentation to Utility Oversight Blue Ribbon Commission and more recent data from PWB FY 2015-16 proposed budget and mid-January 2015 BES data developed for the BES FY 2015-16 proposed budget

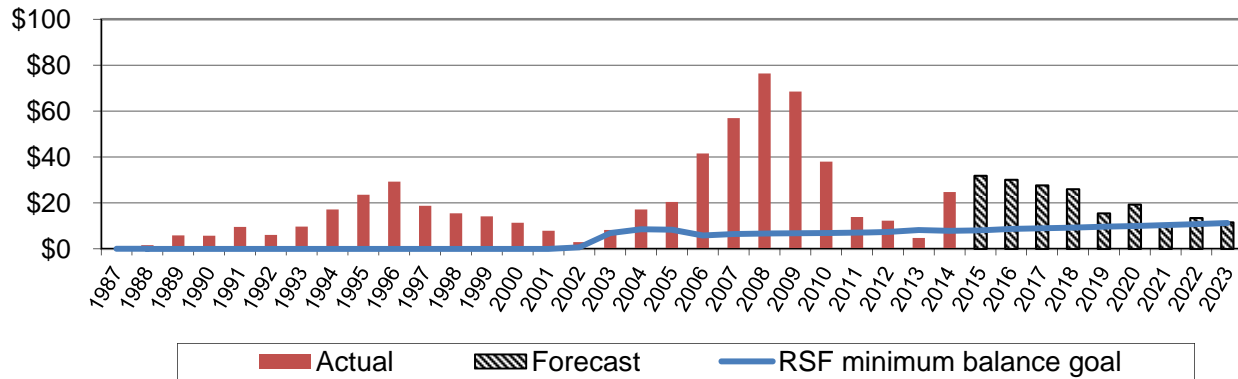
<sup>6</sup> East Portland: History of City services examined, Portland City Auditor, April 2014,

<http://www.portlandonline.com/auditor/index.cfm?c=64479&a=488003>

<sup>7</sup> Rate stabilization fund and rate stabilization account are used interchangeably, but the official title of the PWB fund is rate stabilization account.

<sup>8</sup> Rate Stabilization Reserves, 2014 Water Research Foundation, <http://efc.web.unc.edu/2014/02/11/release-of-revenue-resiliency-review-for-water-utilities/>

**BES Rate Stabilization Fund Ending Balances  
by fiscal years in millions of dollars**



**PWB Rate Stabilization Fund Ending Balances  
by fiscal years in millions of dollars**

