City of Marco Island, Florida

Task Force Examination of the Water and Sewer Fund

Prepared by: Water and Sewer Task Force

June 12, 2012

Acknowledgements

The report has been reviewed and accepted by the following persons. Their review and editing suggestions were greatly appreciated.

Bryant Miller Olive P.A. (Bond Counsel)
- Duane D. Draper, Shareholder & Co-Chair of Public Finance Group
- Mark G. Lawson, Shareholder & Co-Chair of Local Government Law Group
- Christopher B. Roe, Associate Attorney

Burton & Associates, Inc. (Utility Consultant)
- Andrew Burnham, Senior Vice President
- Michael Burton, President

Clerk of the Circuit Court of Collier County (performing Internal Audit function)
- Dwight E. Brock, Clerk of the Circuit Court
- Derek Johnssen, General Accounting Manager
- Allison Kearns, Internal Audit Department
- Crystal Kinzel, Director of Finance and Accounting

Fifth Third Securities, Inc. (Financial Advisor)
- John White, Vice-President-Public Finance Manager

Gray-Robinson, P.A. (City Attorney)
- Burt L. Saunders, Attorney

Mayer Hoffman McCann P.C. (Independent CPA - External Audit Firm)
- Laura Krueger Brock, Shareholder

Research and input has been provided by the following city staff members:

Water & Sewer Task Force (City Staff)
- Gretchen Baldus, IT Director
- Don Blalock, Asset Manager
- Patricia Bliss, Senior Financial Advisor
- Deputy Fire Chief Chris Byrne, Chairman
- Bob Creighton, Purchasing Manager
- Jim Lang, Customer Service Manager
- Laura Litzan, City Clerk
- Keith Shinabarger, STRP-Utility Accountant

Task Force Examination of the Water and Sewer Fund

Introduction

This document was created by City of Marco Island management and addresses the $4 million cash shortfall that was publicized as part of the Burton Revenue Sufficiency Study.

Burton Study

In December 2010, a utility rate consultant, Burton and Associates Inc. (Burton), was engaged to perform a cost of service analysis based on the M-1 model to redesign the water and sewer utility system's water and wastewater billing rate structure design. The engagement was expanded in December 2011 to include a comparison with an M-54 design model as well as a revenue sufficiency study.

While the ***cost of service rate structure design*** indicates how much each customer class should pay for their portion of the plant costs, the ***revenue sufficiency study*** ensures that the total rates charged to all customers will generate adequate revenue and satisfy the daily operating costs, long-term system outlays and the bond covenant requirements set forth in City Resolution No. 03-55 as amended (Master Bond Resolution).

One of the data items requested for the revenue sufficiency study was the cash balance for the funds that depend on the rate tables so that revenue levels for each fund can be determined. Burton was provided all bond documents including the bond covenant requirements that legally need to be satisfied by the generated revenue.

City management briefed Burton concerning pressures on various funds caused by decisions made at prior Council meetings. As part of the scope of a revenue sufficiency study, Burton would need to analyze the revenue requirements and expenditure demands for each rate-driven resource.

Burton's Revenue Sufficiency Study would need to address the following items.

- Rates would need to be set for proper bond coverage requirements. Management provided Burton historical data on bond coverage, the water and sewer's current bond ratings from the big three rating agencies, and the City's desire to maintain these bond ratings.

- The annual change in debt service as required by bond covenants as well as the cash requirements for the debt sinking funding that should have been earmarked in prior years.

- Council's retroactive decision made during the FY12 budget process that the accumulated cash of two surcharges (described in detail later) would not be allowed to provide temporary funding as an internal loan for any other fund starting in FY12. Over the last four years prior to this policy change, management had previously allowed temporary internal loans. Burton's new rates would need to phase in this elimination of the use of internal loans.

- A corollary directive by City management to minimize the use of "ledger loans" from all other sources besides the two surcharges which provide temporary funding as had been previously allowed using the pooled cash method. Likewise, this would need to be phased in by Burton.

- Setting all of the published fees in the rate tables at a proper rate or "right-sizing the surcharges" so that the accumulated money in these surcharge funds is kept to a minimum and providing appropriate rate-based revenue to cash fund the amounts required by the bond covenants.

- Burton's study would also need to address funding demands to ensure sufficient cash is received given the City's historical average of $2.5 million in Accounts Receivable each year end. This means that estimated revenues cannot just cover expenses appropriated from the operating fund. Actual cash must be received by the water and sewer operating fund on September 30th each year to cover the debt sinking fund requirement per the bond covenants.

- Burton's recommendations should address the timing and amount of new capital projects required to properly maintain and preserve the system. In addition, the recommendations should address the spending that occurred in the past due to prior Council's actions which used available resources on hand to pay for projects and delayed the issuance of debt to a future date.

- Using the aggregate fund method, the shortfalls in one area were covered by the overages in another. In past rate studies, the water and sewer aggregate operating fund was reported as having a zero cash balance even when this was not true. Thus, prior rate studies did not address the cash shortfall and rates were not adjusted as needed to recover from past spending practices.

Background history

After incorporation in 1997, the City's utility fund was used to account for the wastewater distribution system serving approximately 1,200 customer accounts with central sewer on the island.

In November 2003, the City of Marco Island acquired the local water and wastewater operations from a private provider, Florida Water Services Corporation (FWS). The City issued utility revenue bonds in 2003 to purchase the utility operations on Marco Island and at an adjacent area of unincorporated Collier County known as Marco Shores and proceeded to upgrade the neglected utility infrastructure. Currently approximately 10,000 utility accounts are served.

After the acquisition of the system, Council's position was that the existing water and sewer rates would remain constant at the tariff rates approved when FWS operated the utility and, during the first 6 years of ownership, the only increases to the water and sewer rate table were increases based on an annual inflation index. The inflation index used was the same Consumer Price Index (CPI) for social security cost of living adjustments (COLA) and not the more commonly used Florida Public Service Commission (PSC) Deflator Index. The PSC index is based upon the Gross Domestic Product Implicit Price Deflator Index and is used for utility industries because it is more heavily weighted for the inflationary changes to items such as chemicals, sludge-hauling, electricity, fuel and wages. The PSC inflation index rate is often higher than the CPI used for the average social security taxpayer reflecting the higher costs that utilities incur compared to the average taxpayer.

In 2005, the rate design was modified to establish water conservation blocks based on lot size to protect owners of larger parcels from dramatic rate increases. Additionally, the rate table was modified to charge water base fees for master meter condominiums on a per unit basis which increased revenue obtained from those property owners.

The water and sewer utility began several major multi-year capital construction projects during 2006 and City Council determined that it is in the best interest of the City to use the City's available resources during construction, thereby delaying the issuance of debt and incurring interest expenses.

Revenue received from customers is based on the rate tables (or rate tariffs) as amended by Council by resolution each year. Annually, a portion of the revenue received is used for capital improvements as required by bond covenants and a specified amount is deposited monthly to a Renewal and Replacement Fund. Since the acquisition of the system, Council has approved a voluntary annual contribution for additional capital related projects and this amount is deposited monthly into a separate Capital Reserve Fund. (Further detailed definitions of the various funds, their funding requirements and their uses are discussed later starting the in the "Fund Structure" section of this document).

The decision to provide central sewer to all properties on the island was made in 2006 and the Septic Tank Replacement Program (STRP) plan calls for the formation of 17 separate sewer assessment districts to be created over seven years. The City provided some funding in advance and allows affected property owners four repayment options for their share of the neighborhood construction and capacity costs after construction is completed. This decision has profound and significant effects as the City's debt principal and interest payments to the bank are made annually; however, some property owners will not make a payment to the City for their share of the debt payment incurred until 20 years later or on the debt's final maturity date. In some cases, payments from the property owners are due 30 years after construction or 10 years after the debt has matured and the final debt payment has been made by the City. In the meantime, the water and sewer main operating fund (WSOF) supplies the cash needed until funds are received from the property owners.

Estimates based on the intense rising housing market between 2005 and 2007 were used for decision making on the quantity, size, and turnover rate of properties within STRP districts. Since the housing bubble burst in 2007-2008, these estimates have subsequently been viewed to be unobtainable in the near term. The WSOF will continue as the source of the operating cash for these projects until the housing market projections are met. If it is deemed that a portion of these estimated revenues will never be received in the future, then Council will need to make a decision to permanently use alternative revenue sources.

In 2007, City Council adopted a series of rate surcharges on the water and sewer rates imposed only in the Marco Island service area to finance certain capital costs that were determined by the City Council to benefit the Utility System.

Specifically, the City imposed a surcharge to finance: (a) the roadway resurfacing program which is necessitated by the impacts of the STRP program and (b) the costs of reducing the neighborhood construction charges for the affected STRP property owners in the amount of $2,758 per property.

a. While road resurfacing after the completion of neighborhood construction is usually a cost borne by the special assessment district, City Council directed that these costs would be shared among all water and sewer customers in the Marco Island service area. With respect to the surcharge adopted by the City for the roadway resurfacing program, the surcharge has varied between two percent (2%) and six percent (6%) since inception in February 2007 and is currently three percent (3%) which is applied uniformly to the rates for monthly service, and was phased in over a multiple year period.

b. The surcharge to finance a portion of the neighborhood construction charges for the STRP program as adopted by the City Council is also applied to both water and sewer rates for service. The surcharge collected pays for the $2,758 per property subsidy that is given to each property within each STRP district. This subsidy to the STRP property owners is often referred to as STRP Buy Down and helps to fund a portion of the STRP plan. With respect to the surcharge adopted by the City for funding a portion of the STRP plan, the surcharge was set at eight percent (8%) in October 2007 and is currently three percent (3%) which is applied uniformly to the rates for monthly service and was fully implemented on October 1, 2007.

When the surcharges were originally added to the utility rate table, each individual rate was increased by the surcharge percentage and no other information was provided to the customer on the monthly utility bill. For example, after a combined 12% surcharge (4% road plus 8% buy down) was adopted in October 2007, a rate of $1 would be listed in the rate table as $1.12. Subsequently, the rate table and printed customer bills have changed to indicate the base rate of $1.00 and a separate line has been added to indicate the $0.12 surcharge portion.

Both surcharges are programmed to be discontinued once sufficient funds are generated in an amount sufficient to pay all the capital costs (whether incurred or financed) as identified by the City for which the surcharge applies.

The tables below show a summary of the dates and percentages adopted by Council for these two surcharges.

Summary of STRP Road Resurfacing Surcharge

Effective date	Increase or Decrease	Annual Cumulative Surcharge
February 2007	2.0%	2.0%
October 2007	2.0%	4.0%
October 2008	2.0%	6.0%
November 2011	(2.0%)	4.0%
March 2012	**(1.0%)**	**3.0%**

Summary of STRP Buy Down Surcharge

Effective date	Increase or Decrease	Annual Cumulative Surcharge
October 2007	8.0%	8.0%
March 2012	**(5.0%)**	**3.0%**

During fiscal year 2010, over $57 million in revenue bonds were issued to refund and reimburse the water and sewer utility for projects previously committed and spent as well as for supplementary new projects. Of this $57 million bond issue, $15.4 million was secured to cover a portion of both the road resurfacing projects and the costs of reducing construction charges for the neighborhood STRP that have already been incurred. Revenue collected from the Road Resurfacing and STRP Buy Down surcharges in future years will be used to repay the respective amounts borrowed for each purpose.

In addition, a Reserve Fund Insurance Policy existed when the acquisition revenue bonds were originally issued in 2003, thus no Debt Service Reserve Fund was required. Credit rating downgrades of MBIA Inc., the issuer of the reserve fund insurance policy, required that cash be provided in the Debt Service Reserve Fund to replace the policy per bond covenant requirements. This was accomplished initially through interfund loans of available cash. The interfund loans were repaid with proceeds of the Series 2009B bond issue which was subsequently refunded using the proceeds of the Series 2010B bond issue.

Fund Structure

The City uses fund accounting principles and reports a Water and Sewer Utility Enterprise Fund in its Comprehensive Annual Financial Report (CAFR). A ***fund*** is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. Fund accounting is used to ensure and demonstrate compliance with legal requirements. ***Enterprise fund accounting*** is used when the primary customers are citizens or businesses and costs that are incurred are recovered through user fees and charges.

For the City of Marco Island, the complex activity of distinctively different funds is consolidated into one Water and Sewer Enterprise Fund as shown on the financial reports. The water and sewer rate tables developed in a revenue sufficiency study can potentially impact 17 of the 53 water and sewer funds that are currently in use. The other funds were created to track the activity of the proceeds that are received when bonds are issued and the special assessment revenue that is generated from the STRP districts.

This report is limited to the rate-based funds and not the assessment-related funds.

Old Fund Structure using aggregate fund prior to 2010

Prior to 2010, the City used four funds to account for activity in the water and sewer enterprise fund that are affected by rate-based revenues (non-assessment-based revenues).

1. A separate fund was used to account for the construction projects associated with the 2003 bond proceeds.
2. A separate fund was used to account for the waste water treatment plant upgrades involving the STRP project to convert properties from septic tanks to the city's central sewer system. This fund combined the funding resources of various activities including the 17 special assessment districts, sewer impact fees, and grants as well as a rate-based revenue portion.
3. A separate fund was used to account for construction projects that eventually will be paid from future bond issues.
4. An aggregate fund (named Fund 400) was used to account for all other transactions. This aggregate fund accounted for all revenues received from all other sources not included within the first three funds and included all rate-based revenues, surcharges, impact fees and grant revenues. Likewise, all outflows and expenditures not accounted for within the first three funds, including personnel, chemicals and other operating transactions, grant eligible expenses, major and minor construction projects, and debt service payments were accounted for in this aggregate fund.

   The accounting software was unable to provide the management tools needed when a large aggregate fund is used for reporting purposes. Prior to 2009, separate spreadsheets outside of the official City financial accounting system were often maintained or created to help track the flow of various revenues and match the corresponding expenses. While this provided a trail for the revenues and expenses, the timing of the cash received and dispensed was not tracked as the entire aggregate fund had sufficient cash on hand to make payments. The use and timing of cash received versus cash dispensed is not easily detectible with the use of a very large, aggregate fund with inadequate detailed reporting software.

New Fund Structure using more-detailed funds

To increase stewardship and transparency, the aggregate fund was separated into smaller funds or sub-funds after a new Finance Director was hired in 2009. All activity of each fund is maintained on the financial accounting software and separate spreadsheets have been eliminated. The new smaller funds can be segregated by type and some types were further divided to increase accountability.

Rate-based debt is the bond issues and loans that are repaid from the revenue generated from customer utility bills issued based upon the water and sewer rate tables. The Burton Study was performed to assist the City on decisions and modifications to the water and sewer rate tables. Again, this discussion is limited to the funds that are influenced by the rate-based tables and will not include the funds that account for the activities of the special assessment-based STRP revenues and its related debt.

Of the City's 53 active water and sewer utility funds that existed at the end of FY11, seventeen (17) funds are rate-driven funds. The remaining 36 funds are either related to the construction activity from bond proceeds or the Septic Tank Replacement Program (STRP) plan and are not covered in this report.

In general terms, there are three types of water and sewer funds that can influence and be influenced by rate setting decisions – (A) bond covenant funds (10 funds), (B) impact fee funds (2 funds) and (C) the main revenue fund (WSR) (5 funds).

A. Bond Covenant Funds

Bond covenants require certain actions and calculations be performed in order to meet the required conditions or "promises" made by the City to the bank and the terms which the investors relied upon when the bonds were issued. ***Bond covenant funds*** include funds that are required due to the issuance of bonds and the funds can be further divided between debt-related and construction-related covenants.

The City maintains 9 debt-related funds and 1 construction-related bond covenant fund.

Bond covenants from the original 2003 bond issue provide that "*all Gross Revenues of the System shall, upon receipt*", be deposited and "*disposed of monthly, but not later than the 25th day of each month commencing in the month immediately following the delivery of the Series 2003 Bonds*" in the following order of priority: (a) debt sinking fund for interest and principal repayment, (b) debt service reserve fund if required in lieu of a reserve fund insurance policy, (c) debt service funds related to any subordinated debt issued, (d) the Renewal and Replacement (R&R) fund and (e) the balance may be used for any lawful purpose as provided in the bond documents.

Likewise, the bond covenants further state that the monies on deposit in the R&R Fund "*may also be used to supplement the Reserve Fund, if necessary, in order to prevent a default in the payment of the principal and interest on the Bonds.*"

The City maintains nine (9) debt-related funds that are used to track the requirements and calculations required for the rate-based debt. The rate-based debt is the Series 2003 bond, 2006 bond, 2008 bond, 2010A bond, 2010B bond, and 2011 bond issues plus two non-assessment State Revolving Fund (SRF) loans. The Series 2010A bond issue has 3 components that are accounted for in 3 separate funds. Each of the above named debt issues are maintained in individual funds which identifies the debt's sinking requirement and debt service reserve requirement as well as other activities such as amortization costs and principal and interest payments.

For the debt-related funds, bond covenants require the utility to set aside money into what is commonly called a debt sinking fund and a debt service reserve fund. Each fund has specific calculations and due date requirements. The data regarding the following bond covenant debt-related funds are extracted from the 9 debt funds.

Commingling or pooling of funds is authorized under the Master Bond Resolution, section 17 of which provides that the "*cash required to be accounted for in each of the funds and accounts described in this Section 17 may be deposited in a single bank account, provided that adequate accounting records are maintained to reflect and control the restricted allocation of the cash on deposit therein for the various purposes of such funds and accounts as herein provided. The designation and establishment of the various funds in and* *by this Resolution shall not be construed to require the establishment of any completely independent, self-balancing funds as such term is commonly defined and used in governmental accounting, but rather is intended solely to constitute an earmarking of certain revenues and assets of the System for certain purposes and to establish certain priorities for application of such revenues and assets as herein provided.*"

Debt Sinking Fund – is used to account for the bond covenant-required monthly contribution from rate revenue for the principal and interest amount of the bonds which will mature in the near future. The bond covenants require monthly cash deposits of 1/12th of the future debt service payment so that by the next maturity date, tangible cash will be available in the primary checking account in advance of the due date.

The net change in cash required to be deposited in the Debt Sinking Fund in fiscal year 2011 compared to fiscal year 2010 was an increase of $1,626,412.61 for all rate-based debt ($1,488,588.46 for bond issues and $137,824.15 for State Revolving Fund (SRF) loans).

Debt Service Reserve Fund – is used to account for the bond covenant-required cash pledged for the payment of debt service based upon each bond series' bond service requirements. Prior to 2010 this fund was not necessary because a valid insurance policy existed. Cash funding is required now due to the downgrading of the credit rating of the issuer of the reserve fund insurance policy. Cash funding is also required for the SRF loan that closed in 2011.

This Debt Service Reserve (DSR) Fund is physically deposited in a bank account separate from the City's primary checking account and as of September 30, 2011 it has accumulated $1,007,220 in excess of the required balances for the rate-based debt. These excess funds will be used in future budget years for debt service obligations.

There is 1 construction-related bond covenant fund which impacts rate-based decisions.

R&R Fund – is used to account for bond covenant required minimum contribution and moneys on deposit are to be used for "*extraordinary repairs, extensions, enlargements or additions to, or the replacement of capital assets of* *the system or emergency repairs*" or to supplement the Reserve Fund to prevent a default in the payment of utility bonds. The covenants require monthly deposits of 1/12th of "*5% of the gross revenues received during the immediately preceding fiscal year*" into the Renewal, Replacement and Improvement Fund or R&R Fund for short. Generally, no further deposits into the Renewal, Replacement and Improvement Fund are required when the amount on deposit equals or exceeds one percent (1%) of the gross book value of the fixed assets of the utility system.

B. Impact Fee Funds

There are two funds that provide information on utility impact fees. ***Impact fees*** are based upon the idea that growth should pay its own way. The fees are imposed on new development or on existing customers that increase their original usage and is used to pay for the cost to expand the existing infrastructure due to the demands that the new/revised development causes to the utility system. Burton reviewed the amount charged for impact fees as part of the study and determined that the current rates are sufficient.

1. **Water Impact Fund** – is used to account for legally restricted water impact fees collected and qualified construction projects to be paid from water impact fees.

2. **Sewer Impact Fund** – is used to account for legally restricted sewer impact fees collected and qualified construction projects to be paid from sewer impact fees. With the aggregate fund used in the past, construction projects attributable to growth and sewer impact fees were spent prior to the actual receipt of these fees. This fund's negative cash is expected to be recovered shortly based on the current collections from building permits during FY12.

   The water and sewer impact fees are referred to as "*Water System Capital Facilities Fees*" and "*Sewer System Capital Facilities Fees*," respectively, in the Master Bond Resolution which provides that money "on deposit in such funds shall be applied on or before the 26th of each month toward deficiencies in the Debt Sinking Fund, if any, and if no such deficiency exists the moneys on deposit therein may be applied toward any use allowed by law.

Moreover, the rate-backed SRF loans are secured on a subordinate basis by all utility system income or earnings received by the City (net of operation and maintenance expenses) which would include water and sewer impact fees.

C. Water and Sewer Revenue Fund (WSR)

The City maintains the accounting for its utility system's operations in the Water and Sewer Revenue Fund (WSR) which is split into 5 sub-funds. All of these sub-funds could be group together in the one main WSR as no legal requirement exists to account for the activity of these sub-funds in separate funds. The creation of these sub-funds was to improve accountability and efficiency in the Finance Department, to provide City management more detail, and to respond to inquiries made by Council, the Budget Sub-Committee, and public records requests.

Furthermore, only one sub-fund of WSR is required to have a cash account; the other sub-funds were created as a method to track the total revenue collected and the total costs expensed. For the Burton Study, the cash attributed to each sub-fund was provided to Burton which revealed the magnitude of the impact of internal loans from the WSR.

1. **Water and Sewer Operating Fund (WSOF)** (sub-fund of WSR) – is used to account for the normal cost of operations and maintenance of the system that are not accounted for in any other fund. This sub-fund is the only sub-fund that requires a cash account as the next 4 WSR sub-funds listed in this document could be legally combined with this sub-fund.

2. **Grant Fund (sub-fund of WSR)** – is used to account for grant revenue and grant eligible expenses. Historically, the City must spend its cash resources first, submit a distribution request to the grantor, and wait for the grantor to reimburse the City. This sub-fund often has a negative cash balance while waiting for receipt of grant compensation from the grantor.

3. **Capital Reserve Fund (sub-fund of WSR)** – is used to account for Council designated funding of additional construction projects to maintain and improve the water and waste water systems. Funding levels are determined during the budget process and originates from legally

available remaining rate revenue that has been collected from customers receiving monthly water and sewer utility bills. Historically, funding of the total original budgeted amount has been made monthly in 1/12th increments; however, expenses could be tracked with funding made on a periodic reimbursement basis in order to eliminate the accumulated cash in this sub-fund.

4. **STRP Buy Down Surcharge Fund (sub-fund of WSR)** – is used to account for surcharge revenue collected on utility bills and the repayment of debt service principal and interest that was incurred in order to provide a $2,758 per property subsidy to each property owner in the 17 special assessment districts. Starting in October 2007, this surcharge was set at 8 percent and as of March 20, 2012 this surcharge was reduced to 3 percent. It was scheduled so that excess funds accumulated would be sufficient to call and redeem the bonds at its earliest date in 2020 and thus save interest expenses. Historically, funding of the billed surcharge amount is made monthly when the customer bills are calculated and mailed; however, receipt of the surcharge fees shown on the bills is not due nor realistically paid to the WSOF until 25 days after the bills are mailed. In order to eliminate the accumulated cash in this sub-fund, a liability for the amount billed could be recorded, expenses tracked, and cash funding made on a periodic reimbursement basis.

5. **STRP Road Resurfacing Surcharge Fund (sub-fund of WSR)** – is used to account for surcharge revenue collected on utility bills and as of March 20, 2012 this surcharge is set at 3 percent. Construction projects for all districts have not been completed yet, thus, the funds are used for the repayment of debt service principal and interest that was incurred to cover resurfacing projects from prior years as well as pay-as-you-go financing of the current asphalt paving and bike lanes in future districts. (Note: Road resurfacing for Year 6 (Copperfield and Goldenrod) Sewer Assessment Districts has been excluded in FY12 because an alternative funding source was used.) As mentioned with the STRP Buy Down Surcharge, traditionally, funding of the billed surcharge amount is made monthly when the customer bills are determined; however, receipt of the surcharge fees from the bills is not due or realistically paid to the WSOF until 25 days after the bills are mailed. In order to eliminate the

accumulated cash in this sub-fund, a liability for the amount could be recorded, expenses tracked, and cash funding made on a periodic reimbursement basis.

Findings and other information

Traditionally, all utility systems allow temporary loans to take place within various water and sewer funds using the pooled cash method of accounting and the City permitted temporary loans within the WSR since system acquisition in 2003. During the FY12 budget process, Council indicated that any excess cash accumulated by the two surcharges should only be used for road resurfacing or STRP buy down debt service or construction and that this restriction should be retroactively applied going back to 2007. Council desired that the two surcharges be separated, backdating to 2007, and wanted to have those monies held and unused. When the accumulated, but not used, surcharge cash is not allowed to be used to provide temporary funding, then the cash of the rate-based WSOF will need to make up any funding shortfall starting in FY12.

As of FY11, the accumulated cash balance in both surcharge funds totaled $2,582,519.

Moreover, the transfer between the WSOF and the various sub-funds is made as a cash transaction each month. Bond covenants allow for the transfer to be made monthly *upon receipt* of gross revenues (*emphasis added*). Using the accrual method of accounting, revenue is recorded when the bills are generated, which does not coincide with when the cash is received. Each month there is approximately $2.5 million in accounts receivable from utility bills generated on the last day of the month but not due until the 25th day of the following month (i.e.: billing date is September 30th and due date is October 25th). Thus the cash is transferred out of the WSOF when the bills are mailed; however, the collection or *receipt* of cash into the WSOF occurs 25 days after the cash has been transferred out. In the future, the timing of the cash transfers needs to be coordinated with the timing of the cash receipts.

Furthermore, City management has ceased the use of “future bond issue” funding. The concept of ***future bond issue funding*** is that cash on hand from various sources both inside and outside of the water and sewer utility fund are used and subsequent bonds are issued to reimburse the original resources.

An example of a “future bond issue” occurred around 2010. Cash from the utility and from other funds at the City were used for many years. In 2009, temporary financing was issued to reimburse the City for approximately $17 million in accumulated expenses. Then, in April 2010, another $57 million in bonds were issued and less than $25 million was used for new projects. The majority of the bond proceeds from the 2010 bond issue were used to pay off temporary financing or to reimburse the City for additional accumulated expenses that occurred and were not covered by the temporary financing. Since 2010, City management has stopped the use of future bond issue funding. In addition, non-debt financed projects are not allowed to start until the revenue that will support the expense has been properly identified.

Cash balances of 2011 amounts shown in aggregate

Since the cash is reported in aggregate in the financial reports, negative amounts for any sub-fund are hidden and the temporary cash shortfall in the WSOF is covered by the accumulated cash in the other individual sub-funds, specifically the two surcharges and capital reserve sub-funds.

Rate-based cash balances shown in detail with 2011 amounts

The FY11 data for rate-based funds was provided to Burton for use in the Revenue Sufficiency Study.

The $4.2 million shortfall was created when each sub-fund’s balance was removed from the WSOF. This data was provided to Burton so that the WSOF’s revenue needs could be properly addressed. When the five WSR sub-funds are added back together the total balance is $207,678. A liability indicating the portion that is attributable to the sub-funds can be recorded instead of transferring cash out of WSOF.

Prior to the 2010 Burton Study, the WSOF beginning balance was shown always as a zero balance instead of its negative cash balance. This influenced the results of any rate study and effectively kept water and sewer rates at a level lower than required.

Factors that Contributed to Cash Shortfall

- Prior practice of starting rate studies by reporting a zero beginning balance when in fact the WSOF had a negative balance.
- Retroactively applied change in the use of internal loans.
- Pre-funding sub-funds when a periodic reimbursement could have been made and the cash retained within the WSOF.
- Previous use of “future bond issue” funding methods.
- Inadequate reporting capabilities of the current accounting software.
- Previous use (until 2009) of one large aggregate fund in which overages from some revenue sources helped to cover the shortage of other revenues.
- Timing of cash received from customers versus cash transferred to the miscellaneous sub-funds.
- Significant change in the amount of cash needed to cover the debt sinking fund between FY10 and FY11.
- Loss of the Reserve Fund Insurance Policy due to downgraded credit rating of issuer resulting in the requirement to fund the Reserve Fund.
- Current economic conditions inhibiting the timely flow of money from customers.
- Generous repayment terms provided to STRP property owners.
- Delays in collecting impact fees due to the housing market downturn.

Changes as a result of the Burton Study

To charge the proper rate revenue from the various sources and to build the cash balances in order to eliminate the temporary cash loans between sub-funds, Burton has three recommendations and management concurs with them. Management is also proposing three additional recommendations. The City’s auditors reviewed and concur with the recommendations that are relevant to their function. The combined list of 6 recommendations is presented here.

1. Burton recommends that the City apply rate increases as shown in the latest Burton Study results in order to generate sufficient revenue to properly operate the system and to provide capital for minor maintenance projects required to preserve the system.

2. Burton recommends that the accumulated cash from the two surcharges be permanently moved into the WSOF.

   Prior to Council's FY12 budget process decision, surcharge revenue was used to provide temporary funding on a routine basis if rate revenue was insufficient. Thus in prior years, rates for Marco Island remained at an artificially lower level than required because the surcharge money was used to provide temporary funding.

   The surcharges could have been reduced to a level to cover only their debt service payments after the respective bonds were issued in 2008 and in 2010; however, the total amount of revenue required for the bond covenants would have remained approximately the same. Thus the operating rate revenue would have been increased in order to obtain fundamentally the same dollars. The net effect to the customer would have been the same amount due on their water & sewer utility bill; the difference would have been the amount proportioned into the three funds (the 2 surcharge sub-funds and WSOF). The change would have lowered the amount accumulated in the two surcharge funds and increased the amount in WSOF.

3. Additionally, Burton suggests that Council reduce the surcharges. Council adopted the reduced surcharges in March 2012. The STRP Buy Down Surcharge can be further reduced by 1% with a corresponding increase in rates by 1% on October 1, 2012. This will minimize the amount of cash the STRP Buy Down surcharge accumulates in future years. This is similar to the explanation that was outlined in #1 from above.

4. Management recommends that the timing of the cash transfers between WSOF and the four sub-funds (Grants, Capital Reserve, Road Resurfacing Surcharge and STRP Buy Down Surcharge funds) be

modified. Burton concurs with this change and Council discussed and approved it at the Burton Study workshop on April 16, 2012.

The change would record a liability in WSOF and would allow the transfer of cash based upon the sub-funds actual requirements. Thus WSOF would retain better control of its cash resource until the Burton recommended rate modifications restore the cash balance in WSOF in approximately 4 years.

5. Management recommends that new accounting software be obtained to provide better reporting, greater transparency and more efficiency. The new software should provide a mix of detailed and summary financial management and budgetary reports and should improve the processes and internal controls of the entire City. Moreover, a formal STRP assessment-based billing and collection module should be installed as recommended by the City's external auditors, Mayer Hoffman McCann P.C., in addition to the upgrading of the utility billing module.

   Replacement of Financial Management Software is included in the FY12 Capital Improvement Project Budget and the evaluation, purchase, and installation of new software is the next major project for the Finance Department. The external auditors concur with this recommendation.

6. Finally, management recommends that Council consider creating a minimum financial reserve policy for the Water and Sewer Fund similar to the General Fund's policy. The external auditors concur with this recommendation.

   The General Fund is covered by the City's Financial Reserve Policy which indicates that the City will maintain emergency reserves of 25% of the next year's proposed General Fund operating expense budget to handle any emergencies and contingencies that arise.

   Since acquisition of the utility system, Council has consistently provided extra funding for the Water and Sewer Fund of approximately 5% to cover urgent capital projects on the expenditure side. These funds have routinely been deposited in the Capital Reserve Fund (as described earlier in this document) and subsequently spent on budgeted crucial capital projects. The recommendation is that this policy should remain in effect and Council should continue to provide this supplemental funding in future years.

In addition, Council should also consider a financial reserve policy for the Water and Sewer Fund based on working capital levels. After the balance in WSOF is restored in 3 or 4 years, a working capital policy should be enacted. ***Working capital*** is usually calculated based on current assets and current liabilities and a working capital policy creates a safeguard to meet obligations of known increases to existing expenditures and unanticipated expenses that may occur. Likewise, weather conditions (wet or dry), customer elasticity impacted by rate changes, consumer technology products that reduce water usage, and economic conditions which impact customers' ability to pay their bills on a timely basis could affect water sales and utility revenue collection.

The Government Finance Officers Association (GFOA) recommends a working capital target amount of between 45 to 90 days of annual operating expenses (including depreciation) for enterprise or utility funds. Fitch Ratings medians from 2012 indicate that the utility systems in the southeast region have a median working capital (excluding depreciation) of 343 days. A working capital reserve policy for the Water and Sewer Fund would ensure that temporary cash shortfalls caused by reduced revenue collections or by unusual expenses would be covered.

Summary

Independent audits have verified that the $4M cash shortfall in the Water and Sewer Operating Fund (WSOF) does not constitute "missing money" or even a "deficit". A combination of Council mandated accounting policy changes, prior funding decisions made during the early STRP process, and the slower current economic conditions resulted in the WSOF having a negative cash balance (a shortfall) while other sub-funds were equally over funded. All transactions and cash reallocations made by Staff were consistent with Council policy in place at the time of the transactions.

The existence of WSOF shortfall was understood and activity was tracked by the prior Finance Director (Mr. Harrison) using Excel spreadsheets. A policy of using interfund loans to correct this funding imbalance was initiated at that time.

In 2009, the new Finance Director (Ms. Bliss) implemented the record keeping to conventional standard accounting utilizing the City's Financial Management System software. During the course of the Burton Study, Ms. Bliss pointed out this shortfall to the Burton representatives who then confirmed and publicized the amounts.

In the future, prospective changes in accounting and fund structure need to be modeled and fully analyzed by staff prior to final approval and implementation by Council. Management's plan to replace the current inadequate financial reporting software will aid in providing more accurate and timely data.

Both Burton and City management have outlined the recommended steps to be taken to correct the $4M shortfall and to prevent any future occurrence. Adopting all of the rate-based recommendations closes this issue.