PROPOSED
Herron Island Water System Financial Policies
as of March 2011

If the vote to retain and operate the HMC water system should pass, the proposed financial policies and water issues are discussed below. This document is a proposal only and not final.

Water System Utility

First, for accounting purposes only, a Water System Utility will be formed and fully owned by HMC. The utility would be a self-balancing entity where water-related costs are supported entirely by water related revenues, thus assuring members that the water system neither subsidizes nor is subsidized by general assessments. Any loan made to the water system is, however, a loan secured by all HMC assets and is thus the ultimate responsibility of HMC members.

Utility Connections

The water system utility will consist of connections each having a water meter, a shut-off valve and a tie to a member's water line. The basis for cost distribution will be the total number of connections to the water distribution system with a minimum of one connection per assessable unit. Members with multiple lots making up an assessable unit will be able to subscribe to additional connections if they desire. This will then increase the basis for cost distribution.

As with all general assessments where the needed budget is divided among the assessable units minus units that are known to be long term delinquent, the connection base for the Water System Utility will be the connections minus those connections for expected delinquencies. At present, the number of projected delinquencies is 6.

Elements for Water System Revenues
The water utility revenues will come from three areas:

1. Capital Cost Recovery (loan payment)
2. Reserve Contributions (major repairs, operational reserves, and loan reserves)
3. Payment of Operational Expenses (reading meters, testing, minor repairs)

To keep water affordable, Washington State Department of Health has set an indicator which shows that basic water charges over 1.5% of Pierce County Median Income ($54/mo) will cause an undue burden on consumers.

Capital Cost Recovery

The capital cost recovery will be the expected replacement and upgrade construction costs divided by the number of connections (HMC lots and expected delinquencies are not counted in this number). This amount may be paid as a one-time up-front payment or by participating in an HMC loan from the USDA or private bank. For example: If the cost of construction is $2,500,000 and the number of connections is 390, then the up-front payment would be $6,410. Should the members vote to employ the USDA loan at an estimated 3.375% interest rate over 40 years, the monthly bill for connections not paid up-front would be $25.00. The total of these payments over the 40 years would be $12,000. If the loan is from a private bank it will have a shorter term and higher interest rate, the payment amount will be greater. Naturally, if the actual cost of construction comes in lower, the amounts will be less. The ongoing monthly utility bill for capital cost recovery will only apply to those connections that elect not to pay their portion up-front. It will be an HMC objective that the level of this bill will never change over the life of the loan for all members. This means that once a connection is made part of the loan for capital cost recovery, the obligation to make payments for the loan does not change regardless of ownership of the property.

After the term of the loan (40 years in the case of the USDA loan, or 20 years in the case of a commercial loan), the capital cost portion of the bill per connection goes away. Neither loan has a prepayment penalty but a total prepayment of the loan would require all financing members to agree to pay their total remaining balance. To do an individual prepayment would require a re-financing to keep other member's payments the same.

Water Utility Reserves

The water utility will have reserves to cover one-year operational expenses, loan reserves, and a replacement reserve fund sufficient to replace any reasonable set of upgrades of pumps, well, controls, hydrants, tanks, meters, distribution pipe and valves. There will be a reserve buffer for loan payments in case of delinquencies not resolved in the normal HMC process for recovery. These reserve funds will be built over time and be part of the monthly cost for each connection. The reserve contributions can vary over time with changing costs for replacement and time frames needed. These reserve contributions can also be suspended if the level of needed reserves estimated is reached. The reserves for operational expenses are to account for potential variations in water usage revenues and changing operational costs. This is an accepted practice by most Utilities and is encouraged by the State.

HMC is estimating a $7.00 per month per connection reserve contribution amount.

Operational Expenses

The operational expenses will be covered by fees billed as a base fee and an escalating rate based on water usage fee. Water Use Efficiency Rules require three levels of usage rates to encourage conservation and safe water availability. Fees will cover all the management costs for the utility including labor, billing, meter reading, system maintenance and repair, testing, reporting, and accounting. These operational costs are not new to the HMC Water System. Currently HMC contracts with Washington Water Service Company to perform some of these functions, paid from member assessments. With the new HMC Water System Utility, we will continue to contract for professional management of the system with certified personnel.

The annual operational expenses for the system are estimated to be about $50,000 (Currently about $39,500) and would be recovered through flat rate fee billed for the first year only. This flat rate fee is less than or similar to other public water utilities. The current water portion of the annual assessment including reserves (in 2011 about $153 per assessable unit) will be removed from the general HMC budget.

For the budget year during construction, HMC would budget about $50,000 annually. This will cover operations, base fee and water usage together with reserves and would equal a flat rate of $17.50 to $20.00 per month, per connection. During the first year of operation information will be gathered to establish base, reserves and water usage rates for the budget year following construction.

Water Bills

It is suggested that the water utility bill be mailed quarterly. Since water usage is very important to members, we will be working to provide member's monthly usage readings on-line. The Water System Utility will read meters monthly and get a baseline of use. Because of State Water use Efficiency requirements, HMC must promote conservation and allow members to monitor usage for their connection. Please note: promoting conservation also carries the direct system benefits of reducing electricity consumption and wear and tear on mechanical components of the system, lowering short and long term costs for everyone.
SAMPLE WATER BILL

First Year Active Connection:
Proposed Bill: Capital Cost Payment – if financed
Flat Rate Fee

Following Year Active Connection:
Proposed Bill: Capital Cost Payment – if financed
Reserve Contribution
Base Fee
Water usage charges

Issues ("What ifs")

Avoid water usage billing: Any connection that does not want to be billed for water usage will have the following two options:

1. Each connection will have a meter which will allow manual shut off. No use - no water usage bill.
2. Members may request management to place their connection on in-active status and have a lock placed on their meter. Fee may be charged for this service.

Non-payment of Water Bill: If a member does not pay the water bill: Since the utility is wholly owned by HMC and any loan is an HMC loan backed by HMC assets, all members are responsible for payment of the loan. A member who does not pay the water utility bill becomes delinquent just like not paying their assessment. The process employed by HMC for delinquent members is followed and results in a lien against the property and possible foreclosure. There are some members that are long-term delinquent so the assessment approach is to decrease the assessment base to account for these. The same approach will be used for the water utility connection base. That is, the connection base for the three elements of the utility bill will be reduced to account for known delinquent members. Thus, all members share the burden of costs associated with delinquent members. All members also benefit from costs recovered from sales of properties or payment of liens on properties of delinquent members. If costs are not recovered from the liens and if the property is not sold and reverts to HMC, then the water bill from the delinquent member must be paid out of water system loan reserves if the number of connections falls below the number used in calculating all the cost distributions.

Contiguous Lots Divided Following Construction: When an assessable unit of contiguous lots is divided and the member did not elect to have a connection to the second portion of the assessable unit. That is, the member wants to add a water connection at a later time and did not contribute to the capital cost recovery, base fees, and did not contribute to the reserve build up. The suggested approach would be to charge a late comers fee which is the actual installation costs including labor for the connection plus a connection fee equal to the amount the member would have paid if he had elected to have the second connection at the beginning of the project. This is common practice with public and private utilities. That connection fee would be the annual capital cost recovery, base fee, and reserve contributions times the number of years since the establishment of the water utility. The connection base would then be increased with the result that capital costs revenues would exceed that needed. It is suggested that the increased revenue be put into reserves thus lowering the contributions needed from all members in the future.

HMC Owned Parcels: HMC facility lots will have metered connections at North Beach Park, Goodpastor Park, the Community Center and Office, Island Side Ferry Dock, Community Garden Lot, Water Department Lot, South Beach Park, and Nature Park. These connections will not be included in the cost distribution base as they are owned by all members. For all HMC lots that might be sold no connection will be established and no cost will be added to the base for cost distribution. If at a later time the lot is sold andthe new owner becomes part of the connection base of the water utility and is responsible for an active connection and the subsequent payments. If the new owner wishes to activate the water connection and if no payments have been made toward the water system from the lot, the owner will be assessed a late comers fee which will be the actual costs of the connection plus all the payments for capital cost recovery and reserves dating back to when the water system started. Like the case above, new revenues will be added to the reserves thus lowering the costs for all existing members. The methods proposed result in the sharing of increases or decreases in the connection base over all members regardless of whether they elected to pay up-front or participate in the loan.

Fees Do Not Cover Operational Costs: If the base fees and water usage fees do not cover the operational costs due to water system management cost increases or reduced water usage: then, as with any utility, the rates would have to change to cover costs. The rates could actually go down if water usage increases or costs are less than estimated. The utility is a non-profit (also a non-loss) entity so rates have to be adjusted periodically to cover costs that arise. The operational reserves will be used to keep the rates from changing except over the long term.

When a Member sells their Property: If a lot containing a connection is sold: The obligation to participate and pay water rates in the water system and to continue loan payments goes to the new owner. This obligation is independent of whether the lot becomes part of an existing assessable unit or remains a separate assessable unit. That is, the connection base for billing does not change and does not impact payments by existing members.

Commercial Loan

The same process would be followed if a commercial loan were used in place of the USDA loan. The interest rate and term would change the level of capital cost recovery but not the concept. Also, since the commercial loan would likely fund only 80% of the capital costs, then a special assessment per connection might be needed. If the number of members that elect to pay up-front results in the needed amount for the down payment, then the remainder of the members participating in the loan would not have to pay anything up-front. If the number paying up-front does not result in the estimated 20%, then each member participating in the HMC loan would have would be assessed their portion of the "down payment" to make up the difference.

NOTES:

The financial policies listed above are proposed and not final and may be changed following engineering and legal review.

All numbers presented above are examples based on estimates and will change depending on actual costs.

Estimates include contingencies in an attempt to cover unknown costs.

There is no prepayment penalty for HMC for either USDA or Commercial loans.

Construction could take place IN LATE summer or in the early fall of 2011

Important: Following construction completion, when all costs are finalized, members will have the ONE-TIME OPPORTUNITY to choose between the full payment "up-front" option or the full-term financing option for their share of the capital costs.

YELLOW HIGHLIGHTED TEXT INDICATES CHANGES MADE 3/6/11