MINUTES
NORTHEAST OHIO REGIONAL SEWER DISTRICT
FINANCE COMMITTEE
MARCH 2, 2015

The meeting of the Finance Committee of the Northeast Ohio Regional Sewer District began at 10:00 a.m.

I. Roll Call

PRESENT: S. Dumas
D. Brown
R. Stefanik

A quorum was in attendance.

II. Approval of Minutes

MOTION – Mr. Brown moved and Mayor Stefanik seconded that the minutes of the March 4, 2014, Finance Committee meeting be approved. Without objection, the motion carried unanimously.

III. 2015 Budget Review

BUDGET PREPARATION PROCESS

Jennifer Demmerle, Chief Financial Officer, stated that the budget process begins in October when budget center heads are asked to submit their requests within 4% of their adopted budget from the previous year. The rates support this level of spending based on the rate increases.

The 27 budget centers submitted their budget requests which totaled $130 million to the Finance Department for a line-by-line internal review. The internal review committee was comprised of CFO Demmerle, Director of Human Resources, Douglas Dykes, CEO Ciaccia and Chief Operating Officer (COO) Kellie Rotunno. The committee meets with each budget center head that requested more than 4% and each department that had new personnel requests.

Ms. Dumas inquired if there was a different percentage increase between operations and personnel. CFO Demmerle advised that it was 4% across the board but personnel was separated if there are new staffing requests.

Ms. Dumas inquired wage increases are built into the 4% increase on the personnel budget. CFO Demmerle stated that it is 4% across the board and staff factors in a 2% wage increase, so they have 2% to work within their personnel and operating expenses.

CFO Demmerle explained that once staff meets with the budget center heads adjustments are made and presented to the Board. She noted that the budget is $120 million rather than the $130 million requested. The budget is discussed in more detail during the Finance Committee and any recommended changes are made before a request for adoption by the full Board at the next Board meeting. The budget must be adopted by March 31.

Ms. Dumas asked for a description of the criteria for new employees. CFO Demmerle explained that staff examines new positions while considering core operations and what type of work must done balanced with department workload. Lastly, it must work within the budget.

This year staff has a goal to perform a staffing analysis to determine the optimal staffing level for each department. The goal of the study is to acquire additional information regarding workload hours.

Ms. Dumas inquired whether the staffing study will be performed internally. CFO Demmerle advised that staff intends to conduct the study internally but may bring in external assistance with experience.

CFO Demmerle advised that there are four components to the budget. The first component is operating revenue. Staff projects close to $243 million in operating revenue, which is a 12.5% increase. The previous year's actual figure is used as the baseline. However, last year's actual came in well ahead of budget because of a slight increase in consumption rather than the budgeted 4% decrease.

The budget for operating expenses increases by 1.8% with less capitalized labor. Capital expenditures are projected to be $50 million more due to the larger construction projects awarded the last few years.

Debt service is projected to be $90 million, which is an increase of $12 million because the 2013 bond issue capitalized a couple years' worth of interest and those payments are kicking in this year.

Ms. Dumas questioned whether the 2015 projected revenue includes rate increases. CFO Demmerle advised that it anticipates this year's rate increase.

Ms. Dumas questioned whether there is a rate increase for 2015? CFO Demmerle advised that the increase will be11% on average. The rate schedule is a 5-year schedule that increases each year. The current rate schedule ends in 2016. A rate study will be conducted this year for the period of 2017 through 2021.

Ms. Dumas inquired whether the debt service anticipates an additional issuance of debt in 2015. CFO Demmerle responded that there is not because they just issued a bond at the end of 2014; the next projected issuance is not until the beginning of 2017.

Continuing the report, CFO Demmerle advised that operating revenue is $243 million, which is a 4% increase over last year's actual. 99% of operating revenue is from user fees. Revenue was projected using an 11% average rate increase that factored a 3% decrease in consumption and 3% uncollectible.

The budgeting process also examines staffing levels. This year there were 750 budgeted employees as opposed to last year's 730. Since 2012 there has been a significant increase in staffing primarily due to the implementation of the Stormwater Management Program (SMP), which has since been suspended. An additional 10 employees were hired for the SMP in the budget for 2013.

Program management consultants were being phased out, which resulted in hiring 10 in Engineering to take over those responsibilities. The Green Ambassador Program was implemented in 2014 with a staff of 9.

Vacated positions decreased from 2013 to 2014 as a maintenance training program was implemented with 20 individuals and hired two trainers.

CFO Demmerle stated that this year there are 17 new personnel requests, including 2 managers for the Renewable Energy Facility (REF), 5 in Engineering and the increased flow monitoring and EPA regulations have made it necessary for an additional 4 in Sewer System and Maintenance Operations.

Ms. Dumas questioned whether the SMP personnel that came on board in 2013 were a partial staffing ramp up. CEO Ciaccia advised that when the program was suspended they opted not to release the employees because they want to retain them when the program resumes. There has been plenty of work for them in the meantime as it relates to Titles III and IV of the Code of Regulations.

Mr. Brown asked what changes to the regulatory requirements that resulted in the additional staff. CFO Demmerle advised that there is additional flow monitoring to perform. CEO Ciaccia explained that with the consent order and projects the District must complete, there are many monitoring obligations to prove they are performing as the EPA would like.

COO Rotunno stated that Project Clean Lake and CSO projects impact the District's budget in terms of capital expenses in design. Staff is starting to understand the economic impact of the monitoring costs once construction is complete and moves into maintenance and demonstrating that the CSO problem was addressed. Those costs will escalate as each construction project concludes and will be a long-term impact to the operating budget.

Mr. Greenland stated that in addition to the consent decree the District received a National Pollutant Discharge Elimination System (NPDES) permit from the Ohio EPA in 2014 for the first time since 1997. That permit requires more monitoring, specific CSO locations with permanent monitoring and additional water quality analyses on the streams.

Mr. Brown inquired whether the monitoring is for quality or quantity. Frank Greenland, Director of Watershed Programs, indicated that it is for both. Staff will be on the streams periodically over the next five years for the consent decree and NPDES permit monitoring. The CSO monitoring is for flow and activations at least 20 CSOs.

Mr. Brown questioned whether it is to make sure they are not overflowing more than the requirement. Mr. Greenland advised that in areas where CSO projects have been completed and others where they have not, it is to check facilities planning information and for use in public notification of CSO occurrences.

Moving back to personnel, CFO Demmerle advised that sometimes retirements are anticipated and replacements are brought on before the employee's departure. Other positions are sometimes left vacant. Therefore, the budgeted personnel is sometimes inflated.

Operating expenses are budgeted at $120.5 million, which is a 10% increase. The majority of the increase is salaries and benefits. It is based on total budgeted personnel, there may be some people on disability and some open positions are not filled. There is also an additional $3.4 million in contractual services.

Salaries and benefits are 51% of the budget. Staff factored in a 2% wage increase, which is $950,000. New positions comprise $800,000 and there are 32 open positions for slightly over $1 million. There are also $1 million budgeted for people on disability that is budgeted but not spent.

Mayor Stefanik inquired regarding the employees' share of healthcare costs. Director of Human Resources, Douglas Dykes, advised that it is 12% for a family and 15% for an employee plus one. The cost is 20% for an employee-only union member. There are three unions.

Ms. Dumas inquired whether the unions are all under contract, to which Mr. Dykes replied they are all in contract, but two have expired. During the next Board Meeting the Board will be presented with one of the union contracts. Negotiations still must commence with the security union.

Mayor Stefanik inquired whether staff budgeted for a 2% increase. CFO Demmerle affirmed that the 2% was across the board. Ms. Dumas questioned whether benefits were premium-based, which Mr. Dykes affirmed.

CFO Demmerle advised that the next major expense category is utilities, which is 12% of the budget. Electricity costs are consistent with previous years of $11 million, while there was an 18% rate increase in electricity rates. Natural gas continued to decrease to $2 million from $4 million 5 years ago. Some savings have been realized from locking natural gas rates in 2013 and the REF.

Mr. Brown inquired how many pump stations the District has. Ray Weeden, Director of Operations & Maintenance, advised that there are a total of eight pump stations.

CFO Demmerle explained that professional services make up 5% of the budget with $6.6 million, the main components are $1.4 million in general engineering services, half of that amount is for the asset management implementation program; $800,000 is budgeted for professional service support for the REF; and $250,000 to hire a consultant to assist with the rate study. Moving to Information Technology (IT), $600,000 is budgeted for assessments. Staff would like to hire a consultant to assess how the IT governance committee is working. Staff is also looking for additional Oracle support to help with programming on e-procurement. We are also looking to assess the wireless network.

Mr. Brown questioned whether there is an IT strategic plan. Humberto Sanchez, Director of IT, advised that a plan was developed a few years ago.

Mr. Brown speculated that IT may be looking to update its strategic plan and requested an update for the Board as to how that process will work. They need to understand how efforts are being coordinated within the District to make sure technology is complementary of the programs. Mr. Sanchez explained that staff did not have a specific line item this year for a review of the plan, but did for 2016.

Mr. Brown stated that it would be beneficial to look at some level of business intelligence to have a good idea at the executive level how well metrics are being met. Mr. Sanchez stated that there is an assessment budgeted for this year around business intelligence.

CEO Ciaccia advised that such topics are regularly discussed through the IT governance committee, which consists of himself, COO Rotunno, CFO Demmerle, Mr. Sanchez and Ron Czerski, Deputy Director of Operations & Maintenance. He agreed regarding forming a new strategic plan.

CFO Demmerle advised that the next major expense category is contractual services. $19 million has been budgeted, which is a $4 million increase. $8 million of the $19 million is for collection fees to billing agents. $2 million is budgeted for green infrastructure and operating support sponsorships and an additional $1 million for REF maintenance services.

Ms. Dumas inquired whether the upward climb of contractual services is attributed to more capital construction as there has been a constant incline since 2011. CFO Demmerle explained that collection fees are the biggest expense, with a huge increase in 2013. Contractual services increased again in 2014 by $500,000 because we have a watersheds operating support sponsorship program that is new to the District that we haven't done before. CEO Ciaccia added that this year the budget includes a couple new contracts for the REF on which the Board has already acted.

Moving to the final major expense category, CFO Demmerle stated that chemicals were under $2 million in 2013, but has increased over $3 million in 2014 because of $1.5 million for polymer which is a new chemical cost for the REF.

Mr. Brown referenced the last Board meeting that when he recalled during the previous rate increases, there was an understanding that funding needed for the plants was comparable to capital expenditures on the other major programs. He wanted to make sure the District was moving towards modernizing, upgrading and keeping current on the older parts of the system. CEO Ciaccia stated that annual expenditures and other pertinent information in terms of updates are tracked and that a healthy amount of funding goes into renewal and replacement.

COO Rotunno explained that staff is managing plant assets utilizing asset management principals. Plant needs are addressed through asset management because they are identified as high-risk. Projects that rank highly are being replaced in the timeline within the budget of the current rate structure. The plants are an integral part of how staff develops the capital program and capital spending. They are addressed in order of urgency and importance of need. All plant needs are nominated and included as part of the capital plan annually.

Mr. Brown stated that the other issue would be other pipe infrastructure in the system. Changes in rainfall patterns have eaten up capacity and there are concerns with interceptors. COO Rotunno advised that staff has condition assessment data in terms of structural integrity. The hydraulic capacity of the system and what level of service to maintain in the interceptors is a high-level discussion to have in the future.

CFO Demmerle advised that the capital budget includes plans to award 28 contracts: 16 in professional design, 10 in construction and 3 in green infrastructure. The total value is $172 million.

The large scheduled contracts for professional services include an automation program management for $25 million, the Doan Valley Storage Tunnel design for $13 million and the Westerly storage tunnel for $18 million. The large scheduled contracts for construction include a main substation replacement for $11 million and the MACT compliance project for $10 million.

Ms. Dumas requested a quick definition of automation program management. James Bunsey, Director of Engineering & Construction, explained that it is a replacement program within the treatment plants. The District has been replacing outdated technology over the last 7 to 10 years. However, they have not been replaced as quickly as necessary. About two-thirds of the technology still needs to be replaced. Technology is changing so quickly that they need to be replaced sooner because they are so obsolete that replacement parts cannot be purchased for the existing units.

Mr. Brown stated that it would be beneficial when going through design for major programs to have an understanding what a construction target might look like so communities know when they might see construction and relief.

CFO Demmerle advised that $264 million is budgeted for capital projects based on cash flow over the next five years. This year includes spending 89% on CSO Long-Term Control Plan projects and plant improvement projects.

The large projects hitting cash flow this year include the conclusion of the Euclid Creek Tunnel project, which is $24 million, the Dugway West Interceptor Relief Sewer Project for $24 million and the Dugway storage tunnel, which is $15 million. Plant improvements include $47 million for the 400 MGD secondary capacity improvement project at Easterly.

CEO Ciaccia stated that non-CSO renewal replacement projects total about $96.6 million. The District is very close to where it would want to be even if it did not have the CSO control program.

CFO Demmerle advised that other capital disbursements this year include $3.4 million for IT, including $1.5 million for computer hardware for our AV upgrades to GJM and EMSC. Expenditures for computer software include implementing a customer information management system to track calls and a GIS integration system. The projects go through the governance committee before implementation.

Mr. Brown stated that it would also be beneficial to understand the thinking behind the projects that impact the community and the ability for residents to access project information online. Utilizing as many communication tools as possible to connect with customers is important.

CFO Demmerle advised that the last component of capital disbursements is minor capital, which is anything over $5,000 that budget centers request. A large component of minor capital is building improvements. There is $4 million in planned building improvements – renovation of the George J. McMonagle Administration Building to rearrange floor space and the energy conservation management project at EMSC for $2 million.

Mr. Brown noted that there had been discussion previously regarding renting office space but it was determined that GJM could be optimized. He questioned if that was the project in question. CEO Ciaccia affirmed.

CFO Demmerle stated that there is $613 million available for capital projects, which will last through the first quarter of 2017. The District recently did a bond issue at the end of 2014 and some remains from the 2013 bond issue.

Overall, there is $423 million in bond issues. Staff also has $53 million coming in from the loan program, and a capital account to pay cash for projects. The current balance of that account is about $102 million.

$20 million will be generated in new cash from rate increases. Last year the District did well in terms of revenue while expenses were low, which created a surplus. As a result, $15 million was transferred to support the capital program.

Ms. Dumas inquired regarding the difference between pay-go and District funds. CFO Demmerle explained that District funds are what remain in the capital account. Pay-go, which is $20 million, is in addition to funds in the capital account. Those funds will be generated this year based on the rate increases. Staff prefers to separate it to show what is in the account and what will be added to it.

CFO Demmerle stated that the bond issue will primarily support the Easterly Tunnel Dewatering Pump Station, the Dugway West Interceptor Relief Sewer and the Easterly Secondary Capacity Improvement Project.

In terms of loans, $30 million of the $53 million coming in will go to support the Dugway West Interceptor Relief Sewer project. Everything else that is not earmarked for bonds gets paid through District funds, pay-go or transfers.

Moving to debt service, CFO Demmerle explained that when staff prepares the budget they make sure to meet all coverage required by rate covenants in the trust agreement. This year, based on $243 million in total revenue and $111 million in operating expenses, there will be $132 million remaining to support debt service coverage.

Staff maintains goals of 1.25 times for bonds, which equates to $42 million for debt service on bonds. This year, they meet coverage by 3.15 times. Debt service on all debt, which is bonds and loans, is projected at $90 million in debt service. Net revenues are 1.46 times that debt service, which is well-above the goal of 1.05.

Mr. Brown suggested a future discussion regarding the best way to meet the District's needs in terms of debt service coverage. The District is three or four times over what it needs and will be spending some of it, but a balance will need to be struck regarding what is required to be spent on system improvements versus rates as the next 5-year period. CFO Demmerle stated that this year it is three times the coverage but does not stay there in the 10-year plan.

CEO Ciaccia stated that the real focus is on all debt, which is still healthy. The financial plan will be prominent during the rate study and decisions will be made regarding how close to come to the goal of 1.05.

CFO Demmerle stated that the rating agencies have criteria where they primarily focus and ratings emanate from the debt service coverage. For a rating such as the District's, they consider debt service coverage of 1.3 times all debt. Should the District go to 1.05, she could not guarantee keeping the good rating. They will be cognizant of that when doing the 10-year plan.

CFO Demmerle advised that every year the 10-year financial plan is updated during the budget process. The components of the plan are anticipated operating expenses for the next ten years and cash flow for capital improvement program. Staff put together a financing plan on what the projected debt service will look like in ten years. Another aspect is to project rate increases and how much revenue will be generated from them while considering the customer impact from quarterly bills and staying within internal financial metrics.

Operating expenses are projected using the previous year's actual as a baseline and escalates based on historical data or what is known to be needed in the future. This year's average increase is a little over 5%. Historically, it has been 3.5%. She explained that the larger increase is due to an increase in chemicals and shifting maintenance services for the REF into Operations. Personnel increases were kept to 2%.

Mayor Stefanik asked if the 2% includes wages and benefits. CFO Demmerle advised that the 2% increase is for wages. Benefits have an 8% escalation every year. Mayor Stefanik inquired whether the benefits increase 8% every year, which CFO Demmerle affirmed from a financial planning standpoint.

Moving to the Capital Improvement Program, CFO Demmerle advised that cash flow for the next 10 years is $2.4 billion. $1.6 billion is for CSO long-term control plan projects. There is a spike in cash flow during the period of 2017 to 2021. By 2021, four of the seven tunnels will be in construction or completed. The fifth will begin construction at the end of 2021.

CFO Demmerle refers to the chart of projected annual debt service based on the financing plan to support the $2.4 billion capital improvement plan. Currently outstanding we have $1.1 billion and anticipate based on the financing plan on bonds and loans, we plan to issue another $1.1 billion in the next ten years. Debt service escalates to $170 million by 2024.

Ms. Dumas stated that the 10-year plan is very aggressive and necessary, but the District's customers are facing costs that quadruple over a 9-year period to support it. They need some federal support.

CEO Ciaccia agreed that the presentation was sobering, especially looking at the level of debt service. However, this commitment to debt represents an investment in very long-term assets. They do not use debt to support operating whatsoever. We are not buying vehicles or short-term assets with our debt.

CEO Ciaccia stated that the entire burden of the project should not be on this generation. The rate increases that will be needed to support it will quadruple over time. That is the commitment the customers have to bear. Staff will always pursue funding through the federal government or other means but the prospect remains very unlikely. We did get $11 million from President Obama's stimulus program when it was available; however, for a program like this, it doesn't move the needle very far.

Mr. Brown stated that the discussion centered on affordability and the program does not seem affordable, particularly in the latter years -- spending hundreds of millions of dollars without a significant return on investment environmentally. It begs the question when dealing with the U.S. EPA what reasonable people should expect and the responsibility for passing it on to ratepayers. He has not seen anyone own the issue other than at the local level.

Returning to the subject of the budget, Ms. Dumas stated that the operational budget is conservative in nature; a 2% rise in wages each year is reasonable. However, the $2.5 billion mandate that has to be expended over the next 10-year period and what that translates to in terms of rates and debt service is concerning.

CEO Ciaccia stated that it certainly concerns him. Arguing the effectiveness of the program and where the benefits and costs intersect is legitimate. How projects are prioritized is a legitimate subject, too. District staff intends to raise those subjects with the federal and state governments. An aspect of the impending rate study will revisit the question of affordability for the region as it relates to what was negotiated. Some ratepayers cannot afford this program; however, there are many people who can afford it and they must find a way to address those who cannot.

Staff does not wish to argue for a lower level of CSO control but may wish to request more time to carry out the program. One of the reasons the District does not invest significantly in advocacy is because there is very little likelihood of receiving funding.

Mayor Stefanik questioned if now is a time to discuss a change in Washington, D.C. with the recent changes in party control of Congress. No one wants to pay more whether they can afford it or not. He continued to state that this will be a big issue in 10 years; he does not wish to push the issue down the road.

Ms. Dumas stated that there the Board does not dispute the necessity of the program because no one wants sewage in their basement or flooding. However, there may be a responsible way of having longer to comply with the regulations. The presentation contained concerning figures, such as $245 million anticipated revenue in 2015 and $408 million in 2024, which is only 9 years away. That is a huge increase in revenue and necessary because debt service will increase from $90 million to $168 million.

CEO Ciaccia stated that he appreciates the discussion and it will be ongoing as the rate study is conducted. However, even the possibility of a time extension in terms of CSO control brings about issues. Money would be saved during the most immediate years but the cost of the program may increase through escalation.

CEO Ciaccia advised that prior to entering the consent decree the District began projects to curb CSOs because of escalation costs. The District must comply with regulations because the Clean Water Act is sitting out there, and unless Congress wants to repeal it, the EPA has no choice but to carry out its duties and enforce its regulations.

Additionally, The American Society of Civil Engineers continually rates wastewater infrastructure "D+" because the nation is so far behind in terms of infrastructure maintenance. And when we argue the affordability issue in general terms, we'll never catch up, because we are then going to set rates based on the lowest common denominator and never catch up. Mayor Stefanik agreed that infrastructure has been neglected the past 30 to 40 years.

Referring to several slides on the screen, CFO Demmerle stated that debt service coverage issued during the next 10 years drops below two times for senior lien coverage and to 1.3 times above for all debt coverage. The projected rate structure will shift more costs from the volumetric rate to the fixed fee. 60% of flow the District treats does not run through the meters and is attributed to inflow and infiltration. The rate increase for the average customer will average 8.5%.

CFO Demmerle explained that the figures under discussion are based on 100% of planned cash flow for the Capital Program. Through value engineering last year staff saved $37 million. Historically, cash flow spent is 77 to 80%. Staff stays within certain internal metrics that the rating agencies look at in order to keep our AA+ rating. One metric we do pay attention to is our total debt to net Property, Plant & Equipment (PP&E). You can see it spikes up every time we issue a bond, then once those assets come online, the percentage goes down. We try to stay under 60%.

Moving to informational items, CFO Demmerle advised that staff informs the Finance Committee of budget transfers, or any line item that was above $100,000 and the reason for the transfers. In addition, referring to the fourth quarter investment report, the District has $642 million invested, the majority of which is from the bond issue of December 2014 in the amount of $300 million. The average return year-to-date on investments was 0.48%, as interest rates have not been favorable.

Concluding the presentation, CFO Demmerle stated that the budget will be presented to the full Board at its next meeting if there are no changes to the budget.

Mayor Stefanik questioned whether the District should reconsider the amount it spends on lobbyists. CEO Ciaccia advised that in addition to the District lobbyist the organization is a member of the National Association of Clean Water Agencies, which does the primary lobbying as an industry.

They have been active on this issue, but funding has come off the table in Congress right now. He has recently considered advocating for the federal government to begin funding affordability programs, which has garnered some interest amongst industry peers. However, they do not expect to get much support for that program from the Republican delegation; it may generate some discussion if there is enough support from the Democratic delegation.

CEO Ciaccia explained that there is a movement to communicate the value of water, because the discussion of infrastructure usually revolves around roads and bridges. In Cuyahoga County, the District One Public Works Integrating Committee primarily funds projects generated from taxes. The District is not on the radar because it is user fee-based.

IV. Adjournment

Ms. Dumas adjourned the meeting at 11:23 a.m.

Sharon Dumas

Sharon Dumas, Chair
Finance Committee
Northeast Ohio Regional Sewer District