

Cost Recovery Policy



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Introduction

Cost recovery policies are designed to create long-term financial stability for a public utility, while ensuring that the charges for services are equitable.

Because all financial planning occurs in a dynamic environment, cost recovery policies will require periodic revision. So while this document has been formally adopted by the Mount Pleasant Waterworks Commission (MPW), the customers, Commissioners, or staff may request revision of these policies as appropriate.

Goals, Objectives, and Policies

Cost Recovery Goal

To fully and equitably recover all costs of operating, maintaining, and expanding the water and wastewater utilities from the customers of the service area while maintaining financial stability.

The mission of MPW is to provide excellent quality water and wastewater services to its customers, while meeting all State and Federal regulations. All of the costs to provide these services must be fully recovered by MPW. In addition, rates must be equitable among customer classes, and between existing and future customers. Financial stability ensures that rates remain reasonable, and that the utility's borrowing ability is maintained.

Cost Recovery Objectives

Objective 1. Maintain Bond Rating

MPW will maintain an uninsured bond rating of "AA" or better (as rated by both Moody's and Standard and Poor's) for the combined water and wastewater utilities.

Objective 2. Set Rates to Maintain Financial Stability

MPW will establish rates to meet mandatory debt service coverage ratios as required in the existing bond ordinance.

Objective 3. Maintain Minimum Fund Balances

MPW will meet or exceed minimum Fund¹ balance requirements including mandatory requirements specified in the existing bond ordinance and a minimum balance of not less than 90 days of unrestricted cash² will be maintained.

Objective 4. Maintain a Rate Stabilization Fund

MPW will maintain a Rate Stabilization Fund to minimize any fluctuations that may be caused by unanticipated revenue decreases and/or expense increases in a fiscal year.

¹ A Fund has a legal definition. It may be a single bank account or a group of accounts and may be held by MPW or by a trustee.

² This sum will equal 90/365 times the total annual operating budget, excluding debt service.



Objective 5. Maintain Equitable Charging Practices

MPW will strive for equity among customer classes and between existing and future customers when setting rates, fees, and other charges.

- *MPW will help ensure equity between existing and future customers by following a flow of funds system that indicates the sources of funds, where funds are deposited and held, and where funds are disbursed.*
- *Impact fees and other connection charges will be used for system expansion, to ensure that to the extent possible “growth pays for growth”.*
- *Costs will be controlled and the rate program will be planned such that increases in typical monthly bills will not exceed 15 percent in any given fiscal year. Exceptions will be made to this policy only as necessary to meet mandatory debt coverage ratios.*

MPW operates as a business enterprise independent of other revenue sources. The utility is managed as an enterprise fund, and prices will approximate those that would prevail in a competitive market.

Objective 6. Establish Long-Term Cost Recovery Objectives

The long-term cost recovery objectives are:

- *Cash fund renewal and replacement capital projects and assets with estimated useful lives of ten years or less.*
- *Fund renewal and replacement capital projects and assets with estimated useful lives of over ten years by using debt or cash financing, depending on prevailing economic conditions.*

It is the intent to cash fund renewal and replacement (R&R) whenever possible, while maintaining fund balances and rates, fees and charges at a reasonable level. However, for R&R of higher value, longer-life capital assets, the policy will provide for the use of debt financing if market conditions dictate that such funding would be a better solution for all customers.

Cost Recovery Policies

Cost recovery policies guide the way in which MPW conducts its programs and activities to achieve the cost recovery goal and objectives.

1. Cost Recovery Administration

Policy 1.1 Authority to Set Rates, Fees and Charges

The authority to set rates, fees, and charges rests with the elected Board of Commissioners of Mount Pleasant Waterworks (South Carolina Code 5-31-210)



***Policy 1.2 Authority to Grant Exceptions to Adopted Rates,
Fees and Charges***

The authority to grant exceptions to adopted rates, fees and charges rests with the elected Board of Commissioners of Mount Pleasant Waterworks and may be delegated to the Manager.

MPW will not provide free services nor waive adopted rates, fees or charges to any customer or group of customers because to do so is arbitrary and discriminatory. Special payment schedules based on hardship may be requested in writing to any elected member of the Board of Commissioners or the Manager. Approval of such requests will be discretionary.

Policy 1.3 Policy Review

MPW will review its cost recovery policies prior to preparation of the annual budget and revise the policy document as often as necessary to maintain consistency with actual cost recovery practices. A comprehensive, independent cost recovery review of rates, fees and charges will be conducted at least every 5 years or more frequently if deemed necessary.

Cost recovery studies will be conducted more frequently if major changes occur in: 1) cost forecasts, 2) regulations governing system operations, 3) operating technologies, or 4) customer base demographics. The independent review will, at a minimum, produce a comprehensive schedule of rates, fees and charges that reflect stated policies and provide documentation of the calculations used in designing the rates, fees and charges.

Policy 1.4 Customer Classes

The customer classification system will be reviewed prior to each cost recovery study and revised as often as necessary to promote equity.

Customers are classified into homogeneous groups to allow equitable cost allocations and fair application of charges. New customer classes will be created if customer groups with significantly different demand and usage patterns are identified. Current customer classifications for the water system are residential, commercial and irrigation; for the wastewater system are residential, commercial and all other customers.

Policy 1.5 Unified Service Area

Customers by class in all parts of the East Cooper Service Area will be treated uniformly and equitably.

In some utilities, there is a reasonable basis (predicated on cost differentials or ownership) for dividing a utility's geographic service area into smaller service areas for the purpose of applying different rates, fees and charges.



Policy 1.6 Financial Plan

MPW will update its Ten-Year Financial Plan annually, to assess the financial feasibility of planned and budgeted activities as they relate to cost recovery objectives.

Policy 1.7 Residential Equivalent Units

All customer accounts are assigned Residential Equivalent Units (REU) according to the number of REU for which impact fees have been paid.

In no event will the number of REU on an account be lowered without approval of the elected Board of Commissioners.

2. Funds Management

The term “flow of funds” refers to the binding system of money management that has been established in MPW’s existing bond ordinance. Under MPW’s flow of funds system, specific revenues must be deposited into specific funds and then applied to specific types of expenditures in order of importance to the bondholders. Any revenues remaining after these requirements have been met, or revenues from sources which were not pledged toward bond repayment, may be managed and dispersed at MPW’s discretion. Additional Funds may be created, as long as their requirements do not diminish the rights of the bondholders or conflict with the required system.

In this policy document, flow of funds refers to MPW’s total system of money management including requirements of the existing bond ordinance.

Exhibit 1 to this policy document describes the MPW flow of funds system.

Policy 2.1 Fund Disbursement

To the nearest extent practical, funds received by MPW will be used to pay for the services that benefit the customers whose payments generated those funds.

Appropriate Disbursement of Operating Revenues

Operating revenues, generated from existing customers, are used to cover operating expenses that benefit these existing customers.³

Debt service payments represent the cost of capital facilities that benefit both existing and future customers and are paid with a mixture of operating revenues and impact fees, adding equity to the cost recovery system. If impact fee revenues are unavailable for debt service, payment will come from operating revenues. Such an event would decrease equity between existing and future customers, but would protect MPW’s financial strength.

Another appropriate expenditure of operating revenues is for capital expenditures for R&R, including budgeted routine capital outlays for equipment such as automobiles, and capital projects such as reverse osmosis membrane replacement or other short-term assets.

Appropriate Disbursement of Impact Fee Revenues

Impact fee revenues will be expended only for capital items that directly benefit the future customers for which they were paid. Two types of expenditures are appropriate:

³ An exception is connection charges, which are generated from new customers, and are included in operating revenues. Because expenses involved with new connections are only incurred when new connections occur, these connection revenues and expenses are considered equal and therefore do not create an inequity with this policy.



- Direct costs of planning, designing, or constructing capital facilities that will be extended or expanded (E&E) for future customers.
- Debt service payments for capital facilities planned, designed, or constructed for future customers (Growth Cost Recovery Fund).

Appropriate Disbursement of Non-Operating Revenues

Depreciation is a real, but non-cash, expense. Each year, fixed assets become older, and at some point in time, will need R&R. To keep the cost recovery system equitable, MPW will recover the cost of the future R&R over time from the customers who will benefit from the R&R.

Appropriate Disbursement of Debt Proceeds and Grants

In most cases, disbursement of bond proceeds (restricted to specific capital projects) will be controlled by a trustee or the State Budget and Control Board. Grant funds will be disbursed for the capital projects for which they were obtained.

Policy 2.2 Minimum Fund Balance Requirements

If cash reserves fall below the objective of 90 days of unrestricted cash, MPW will make it a priority to build them back up to that level as soon as possible. Mid-year rate increases may be adopted to meet this objective.

Unrestricted cash-on-hand gives MPW flexibility in setting aside funds for the scheduled repair or replacement of capital assets with projected useful lives of ten years or less, acquiring unbudgeted but necessary items, paying for capital cost overruns, implementing small capital projects without bonding, and providing cash for emergency situations, such as a critical asset failure or hurricanes.

It is at times prudent to decrease the amount of cash-on-hand in order to defray debt, avoid or delay a bond issue by cash-funding capital projects, or prevent or lessen the need for a rate increase.

Policy 2.3 Debt Service Coverage

MPW will maintain rates to meet the coverage tests required by its bond ordinance:

Test 1

$$\frac{\text{Net Operating Revenues}(\text{Operating Revenues} - \text{Operating Expenses})}{\text{Total Debt Service}} > 1.00$$

And:

Test 2

$$\frac{\text{Net Operating Revenues} + \text{Growth Cost Recovery Fund Transfer}}{\text{Total Debt Service}} > 1.20$$

Whenever Test 1 equals 1.50 or less, MPW will take necessary corrective actions to ensure that the ratio remains at or above the mandatory level.



Policy 2.4 Rate Stabilization Fund

The Rate Stabilization Fund will be funded from savings experienced during a fiscal year through the difference of actual revenues and expenses from budgeted amounts.

The funds to be included in the Rate Stabilization Fund will be determined following the presentation of the prior years' audit report to the Board of Commissioners. The amount to be placed in the Fund will be based on the revenue and expense variances from budgeted levels experienced during the prior fiscal year and the amount previously placed in the fund. Once determined and approved by the Board of Commissioners, the amount will be transferred to the Fund within 60 days. The Board of Commissioners will review the Fund balance during the annual budget preparation process to determine if changes are needed.

Policy 2.5 Variable Rate Stabilization Fund

The Variable Rate Stabilization Fund will be funded monthly by the difference between the monthly variable bond interest rate paid and the interest rate that would have been paid if the bonds had been issued as fixed rate bonds.

Each month an amount will be paid into or extracted from the Variable Rate Stabilization Fund, which amount will be the difference between the monthly variable bond interest rate paid and the interest rate that would have been paid if the bonds had been issued as fixed rate bonds. The Board of Commissioners will review the Fund balance during the annual budget preparation process to determine if funding changes are needed.

3. Setting Rates, Fees and Charges

The basic principles MPW will use in calculating rates, fees and charges are as follows:

- All costs incurred will be considered investments of resources. These resources include the capital costs of developing facilities and capacity for providing services, the operational costs of providing services from these facilities, and the administrative costs of programs and activities related to the facilities and services provided.
- Utility services are goods and their full costs will be recovered. Rates will be reviewed annually and updated as often as necessary to fully recover costs and meet the requirements of the cost recovery policies.
- As a responsible public entity, MPW will price its services to recover costs without generating a profit over time.
- The entire pricing system will be as equitable as practicable.

Policy 3.1 Basic Facilities Charges

Water and wastewater basic facilities charges will recover an amount equal to or greater than the sum of: the annual debt service expense, annual billing and collection expense, and annual general administrative costs. They will be calculated on a per REU basis.



MPW incurs “fixed costs” for providing services to its customers, including debt service, billing and collection, and general administrative costs. Basic facilities charges are base charges that are to be paid by all customers of the utility each month, to recover these fixed costs, and provide equity to the cost recovery system.

Policy 3.2 Volumetric Rates

Water and wastewater volumetric rates will be set to recover all costs and funding requirements that are not recovered from other rates, fees and charges, including minimum fund balance requirements.

In the interest of discouraging excessive or wasteful water use and encouraging conservation of water resources, water and wastewater rate schedules include flow-based charges. Thus, the customers who use more water and generate more wastewater pay higher total charges than those who conserve water. Volumetric rates for water and wastewater are calculated and levied per 1,000 gallons of metered water per account, rounded downward to the nearest 100 gallons.

Policy 3.3 Application of Volumetric Rates

Water volumetric rates will be applied to all metered water use.

Some public utilities do not charge the water volumetric rate for lost water or metered water that was wasted due to an extraneous circumstance, such as a broken faucet. Because the utility bears the cost of water lost on the utility’s side of the meter, it is equitable for individual customers to bear the cost of water lost on the customer’s side of the meter. Thus, the customer will be held directly responsible for all metered water at his or her household or business. The wastewater volumetric rate may be waived on lost water if the customer can show that the lost water was not discharged to the wastewater system.

Policy 3.4 Excessive Use Charge

An excessive use charge⁴ will be levied on all water customer classes as follows:

- *100% of the water volumetric rate for monthly metered water usage in excess of 9,200 gallons per REU*
- *200% of the water volumetric rate for monthly metered water usage in excess of 18,400 gallons per REU*
- *300% of the water volumetric rate for monthly metered water usage in excess of 27,600 gallons per REU*

The quantity of water used to calculate excessive usage for customers with irrigation meters is based on the meter size. The current rates are shown on the MPW website.

⁴ MPW uses the term “excessive use charge” rather than “conservation rate” because this charge is a penalty for excessive water use. Unlike MPW’s other charges, the excessive use surcharge is not a cost-of-service rate.

Water conservation may be one of the most important issues facing MPW in the future. The major benefits of water conservation to the customers of MPW are:

- An adequate quantity of high-quality water will be available to all customers every day of the year.
- Demonstrating responsible use of a critical natural resource that we all share.

Without water conservation, total water demand on peak days may cause MPW to blend more water, which temporarily generates lower quality water for all customers. Unusually high demands for water increase costs, which may require water rate increases. So excessive water use by some customers creates problems for all customers. The excessive water use charge is intended to encourage efficient water use by all customers and to require customers who waste water to pay a premium.

Revenues from the excessive use charge are generated by existing customers and will be utilized and disbursed as all other operating revenue. The excessive use charge is not currently being applied to wastewater service.

Policy 3.5 Connection Charges

Water and wastewater connection charges will be levied on the owners of new structures and will recover the full costs of system connections. Connection charges will include:

- *A water connection fee to recover the costs of labor, equipment, water meter and other materials required for water service connection. The water connection fee will apply to all activities associated with setting water meters, including irrigation meters.*
- *A wastewater tap fee to recover the costs of labor, equipment and materials required for MPW to make any tap into the wastewater system. .*
- *A wastewater tap inspection fee to recover the costs for inspection and approval of any third party tap into the wastewater system, and a wastewater tap re-inspection fee for repeating this service, if necessary.*
- *A wastewater maintenance fee to recover the long-term R&R costs of maintaining gravity wastewater systems.*

Connection charges are considered operating revenues, and expenses associated with these services are considered operating expenses, according to generally accepted accounting principles. Revenues generated from the wastewater maintenance fee will be transferred to the R&R Fund annually.



Policy 3.6 Impact Fees

Impact fees will recover major capital costs associated with expanding water and wastewater service facilities, including but not limited to water treatment plants, storage facilities, pumps and distribution mains, wastewater collection, transmission, storage and treatment facilities, and other capital equipment.

- *Impact fees will be updated at least every 5 years in order to maintain equity to both existing and future customers.*
- *Impact fees will recover the costs of both the excess capacity in existing capital facilities, and new facilities planned specifically for growth.*
- *The impact fee cost basis will be the original costs (without deducting depreciation) and planned costs discounted over through build out.*
- *Impact fees will recover to the extent possible interest expense on outstanding and anticipated extension and expansion project debt discounted through build out.*
- *A “double payment credit” will be deducted from the impact fee to prevent future customers from paying for debt-financed capacity in both their impact fee and their monthly rates.*

Impact fees are charges assessed against new development to recover part of the capital costs of expanding the water and wastewater infrastructure to serve them. Considered as a capital-recovery charge, impact fees allow recovery of the capital costs of developing the new service directly from the customers who will benefit from the service.

Policy 3.7 Miscellaneous Charges

Miscellaneous charges will recover the full cost of labor and expenses required to provide ancillary services from the individuals who receive benefit for these ancillary services.

Miscellaneous charges will be levied only when: 1) a customer or customer group can be identified; 2) the activity produces a significant cost that is not common to all customers; and 3) the cost can be identified and related to the activity. Miscellaneous charges will not be levied to recover general overhead costs or for services that are beneficial to the system as a whole or to a relatively large group of customers.

Although miscellaneous charges are not necessarily based on cost recovery principles, and include penalties to discourage certain actions, they enable MPW to more closely match revenues with costs and thus enhance the fairness of the cost recovery policy.



EXHIBIT 1

Flow of Funds System

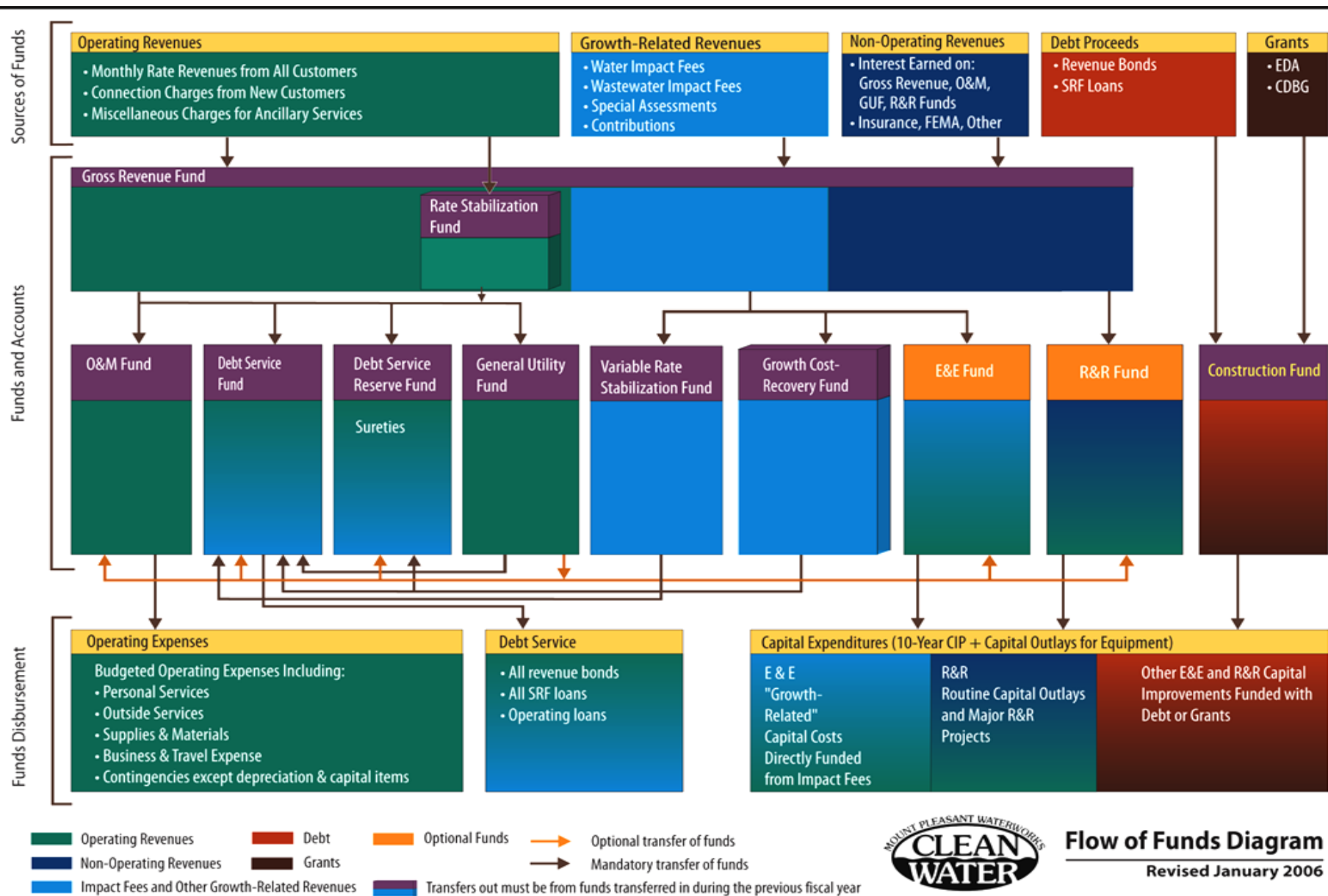
MPW's flow of funds system to meet the requirements of the existing bond ordinance includes the following funds.

- *General Revenue Fund*
- *General Utility Fund*
- *Growth Cost Recovery Fund*
- *E&E Fund*
- *R&R Fund*

The chart on the following page illustrates the current flow of funds system. Colors are used in the figure to indicate the flow of funds requirements as well as “what pays for what.”

- The five major sources of funds available to MPW, the Funds and accounts into which those funds flow, and the appropriate types of expenditures for each of those sources of funds are illustrated with colors:
 - Green indicates operating revenues primarily generated from existing customers
 - Light Blue indicates impact fees generated from and for future customers
 - Dark Blue indicates non-operating revenues primarily generated from existing customers' investments¹
 - Red indicates debt proceeds from lenders for specific projects for existing or future customers
 - Brown indicates grants or special funds from governmental agencies for specific projects for existing or future customers
- Title blocks for sources of funds and types of fund disbursement have a gold background. The colors of the title blocks and labels of the Funds and accounts indicate the origin of the specific Fund:
 - Purple title boxes indicate Funds and Accounts required under the existing Bond Ordinance
 - Orange title boxes indicate Funds that will not be mandatory under existing bond ordinance, but are being voluntarily established by MPW to improve equity between existing and future customers and ensure that “growth pays for growth”

¹ Non-operating revenues are to be transferred directly to the R&R Fund because it is the intention to apply these revenues in this manner in the fund management program outlined in this policy document.



Flow of Funds Diagram
Revised January 2006

Impact Fee Revenues from Future Customers

Impact fees are payments made by homebuilders or developers to pay for capital facilities for future customers. Case law requires that impact fee revenues be expended for the direct benefit of the future customers for whom they were paid. Thus, the flow of impact fee funds is kept separate from other revenues.

Impact fees are separated into water and wastewater accounts. The Growth Cost Recovery Fund is a fund into which a specific portion of all impact fees received during the fiscal year will be deposited. This portion will be the percentage of the facilities, developed for the benefit of future customers that have been financed with debt proceeds.

Transfers of impact fees have two constraints:

- (1) After transfers from the Impact Fee Accounts into the Growth Cost Recovery Fund have been made, the funds will be restricted to payment of debt service, debt service reserves, or defeasance of debt.
- (2) Funds transferred out of the Growth Cost Recovery Fund to the Debt Service Fund will have been received and transferred into the Growth Cost Recovery Fund during previous fiscal years.²

The Growth Cost Recovery Fund will provide two benefits to the customers of MPW:

- Because the portion of impact fees that will be applied to debt service will be from impact fees previously paid, bondholders will have more security.
- Equity between existing and future customers will be improved. Future customers will be protected by ensuring that no more than a fair share of their impact fees is applied to debt service. Equity to existing customers can be improved by funding part of the annual debt service requirement at the beginning of each year with impact fees, thus unencumbering part of the operating revenues for uses that more directly benefit these customers.

All impact fee revenues that are not transferred into the Growth Cost Recovery Fund will be transferred to the E&E Fund and spent directly on capital projects for the benefit of future customers.

Non-Operating Revenues Fund R&R Projects

Non-operating revenues include interest earned and other miscellaneous sources of revenues, such as insurance reimbursements, that are not generated from the normal operations.

The primary sources of non-operating revenues are interest earned on the account balances in the Gross Revenue Fund, the O&M Fund, the General Utility Fund, and the R&R Fund³. Non-operating revenues are not a steady source of revenue because the amount received depends upon

² This multi-year planning process for the Growth Cost Recovery Fund is illustrated with a 3 – dimensional box to indicate that there is time lag of at least 1 year between transfers in and transfers out.

³ Interest earned on impact fee-related accounts and the Construction Fund are restricted to the same types of application and uses as other monies in those Funds and accounts and are therefore not considered non-operating revenues for policy-making purposes.



the total amount of money invested at a given time, the interest rate at which it is invested, and other extraneous circumstances.

Because the definition of non-operating revenues excludes interest earned on impact fees and construction funds, most non-operating revenues are generated from earnings on funds that were created by existing customers.⁴ Therefore, the most appropriate expenditure for non-operating revenues is for R&R of capital outlays or facilities that benefit existing customers. In the flow of funds diagram, non-operating revenues are dedicated to R&R expenditures.

Debt Proceeds and Grants Benefit All Customers

Debt proceeds and grants are sources of funds provided by lenders or public agencies that are restricted to expenditure on specific capital projects, regardless of the intended beneficiary. MPW's rapid rate of growth and demand for new facilities, coupled with R&R projects, has necessitated incurrence of debt. Additional debt probably will be required to implement through build-out.

Operating Revenues from Existing Customers

Operating revenues are MPW's primary source of funds. These revenues come from monthly use charges including basic facilities charges, volumetric rates for water and wastewater, water and wastewater connection charges for new customers, and miscellaneous charges for ancillary services.

The bond ordinance requires that these revenues be deposited into the General Revenue Fund. These funds are transferred out of the General Revenue Fund to other Funds and accounts in order of importance to the bond holders:

- A sum sufficient to cover O&M expenses is transferred to the O&M Fund.
- An amount equivalent to the revenues received in excess of the budgeted level and expenses not incurred during the fiscal year as budgeted, and that will not rollover to the subsequent year, will be transferred to the Rate Stabilization Fund. The fund will be funded up to a predetermined amount based on the experience from the prior fiscal year and the amount currently in the fund.

Twice each year, 5 days before the debt service payment is due, the funds that have been set aside for debt service payment are transferred into Debt Service Fund.

- If the Debt Service Reserve Fund contains less than enough money to make a full year's debt service payment, the remaining operating revenues are transferred into these accounts. Monies from this fund are transferred out only to the Debt Service Fund to correct a shortfall in that Fund or to make the last debt service payment.
- Any funds remaining after these requirements have been met are unrestricted and may be transferred into other Funds or accounts of the utility as long as the minimum balance of 90 days unrestricted cash is maintained.

⁴ An exception would be made for any insurance reimbursement for damage to a facility fully or partially intended for future customers