nFRONT CONSULTING LLC
Power Industry Planners • Analysts • Advisors

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Edward J. Bielarski
General Manager
Gainesville Regional Utilities

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Dear Mr. Bielarski:

Subject: **GRU General Fund Transfer Policy Review**

Upon receipt of your email of January 25, the nFront Consulting project team asked me to review the work nFront Consulting has done on this project and work with them and GRU to address the concerns raised in your email.

Task 4 of our Scope of Services referred to in your email specifically provides for nFront Consulting to "develop alternative General Fund Transfer ("GFT" or "transfer") mechanisms based on a formula that **balances** General Government's need for certainty of funding, with GRU's ability to sustainably fund the GFT over an extended amount of time" as stated in Attachment 3 of our Contract with GRU (emphasis added). Attachment 3 further elaborates on the competing considerations we are to consider as follows:

1. GRU's recent financial results and projections reflect financial constraints in adequately covering the payment without debt restructurings or reductions in reserves.
2. General Government relies on the payment to remain the same and/or increase to adequately fund the forementioned City services.

We performed the assignment working with a team of five City and GRU representatives. At each step of the process, all information we developed was shared with those representatives from which we obtained substantial direction. In addition, the City Manager and you participated in some of the calls toward the completion of the assignment.

Having reviewed the Final Report dated January 25, I am very comfortable we have indeed fulfilled our obligation to assess and develop alternative mechanisms that in our professional judgement reasonably balance the above competing objectives. We have also addressed the impacts of potential variances in those mechanisms and concluded variations could also be reasonable depending on the priorities of the City and GRU. The nFront Consulting project team includes professionals with the experience and knowledge necessary to analyze the factors involved and reach sound conclusions. I also have that experience and knowledge. Therefore, I am very comfortable we have not breached our obligations to the City and GRU. However, we also understand that our balance of those considerations has not yet produced a mechanism that meets with your expectations. Hopefully, the following explanations and suggestions will be helpful in moving us toward the most appropriate GFT mechanism and level.

1. **Existing GFT Amounts and Determination Method:**

GRU's transfer to the City's General Fund in the last two years has been fixed at $38.3 million per year. The current level of transfer as a percentage of GRU's utility system revenue is less than for Lakeland, OUC, and Tallahassee and more than for JEA, but all 5 of the large municipal systems transfer an amount that represents 8% to 10% of total utility revenue. This metric indicates the level of the transfer is not materially out of line with a level deemed reasonable by other utilities and City governments in our State. A lower transfer level may allow GRU to use the greater level of funds retained within GRU to strengthen GRU's financial standing and thereby lessen upward pressure of rates over the long term, which are higher for the electric system than the rates charged by other electric utilities in Florida.

Of significant concern to us is the current transfer level has not been tied to a formula such that it would vary with GRU rate levels, costs, or debt service, all of which the City ultimately impacts.

2. **Proposed Mechanism:**

To balance the competing considerations discussed above, nFront Consulting concluded the new mechanism should result in a $2.3 million lower annual transfer level of approximately $36 million based on the current budget. While this lower level would adversely impact the City's budget, according to GRU's budget projections, GRU's cash balances[1] would increase on the order of $6 million by the end of FY2023, assuming all planned rate increases GRU has included in the budget projections are ultimately authorized by the City and the new mechanism is implemented for FY2021.

nFront Consulting also developed a formula for determining the actual transfer level each year based on GRU's Net Revenue in the prior year, which for this purpose was defined as revenue including transfers from (to) rate stabilization, less operating expenses, and less senior lien debt service, leveraging the UPIF contribution computation provided for in GRU's Bond Resolution. By setting the transfer amount in this manner, should the City not authorize planned rate increases or mandate programs not now in GRU's budget that further increase GRU's costs without also authorizing higher rates to cover those costs, the reduction in the GFT will absorb 41% of the financial impact of those decisions. Moreover, because Net Revenue is determined after deducting debt service, if GRU issues additional debt to fund working capital or plant investments, the additional debt service incurred would result in a lower transfer to the City unless the City also approves rate increases to fully recover from customers the increase in debt service that would result from that financing activity.

For example, the following table assumes GRU's planned rate increases for FY2022 and FY2023 are deferred until FY2024. Note, that over the two years of deferral, GRU's revenues would be approximately $21 million lower cumulatively, but the transfer also would be lower by approximately $8.6 million, which would dampen the impact on GRU's cash reserve balance to approximately $12.4 million.

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[1] The primary metric used to assess whether an option would adversely impact GRU's financial standing was total cash reserve balances. nFront Consulting evaluated 9 alternative mechanisms.

Assuming Budgeted Rate Increases for FY2022-FY2023 are Deferred to FY2024 ($000)

Description	FY2022	FY2023	FY2024	Total FY2022-FY2024	Pcnt of Rev Diff
Revenue Shortfall	6,987	14,064	0	21,050	
Reduction in GFT v. Planned Level	0	2,865	5,766	8,631	41%
Net Reduction in GRU Reserves	6,987	11,199	(5,766)	12,420	59%

The formulary approach proposed should result in productive collaboration between GRU and the City about budget impacts of rate level and other decisions because finances of the City and GRU would both be impacted by the decisions to be made. In other words, the mechanism should better align City and GRU financial considerations.

In identifying the mechanism we concluded would achieve the best balance, in addition to considering the impact on GRU, nFront Consulting gave significant weight to the need to minimize the abrupt reduction in transfer to the City and provide a mechanism under which the City could expect a relatively stable level of transfer in the future. However, the transfer is stable only GRU's rates are adjusted as needed to properly recover GRU's revenue requirements from its customers.

As you can see from the above, nFront Consulting clearly did develop multiple mechanisms that balance the competing considerations we were asked to consider, as promised in our Contract with GRU, and did identify the mechanism nFront Consulting concluded struck the best balance. However, as recognized earlier in this letter, you have significant concerns about at least three areas of our assessments and conclusions which are discussed below. While substantial information is provided below, it would be best to have a more complete discussion about these points with you and the entire team we have been interacting with from the City and GRU. Hopefully, the following information will facilitate that discussion.

1. **Impact of the 2019 Restructuring:**

   If the mechanism we found best balances the competing objective were to be implemented, for each dollar of annual debt service reduction from the 2019 restructuring, GRU's cash reserves would improve, all other things being equal, by 59 cents each year. So, the majority of the debt service savings realized from the restructuring authorized by the City would in fact work to improve GRU's cash position.

   Nonetheless, if the City and GRU have agreed to impute a higher level of debt service to be used in the GFT formula so 100% of the debt service reduction achieved would improve GRU's cash position, the transfer computation could reflect that agreement[2]. Doing so would result in the transfer being approximately $4 million lower per year than without that adjustment in the near term.

   nFront Consulting did not in any way include in the transfer computation any portion of the proceeds of the restructuring bonds, adjust the formula or data to cause savings from the

[2] It would be unusual in our experience to impute debt service for any net income-based computation, but it could be done if the City and GRU agree to do so.

restructuring to increase the transfer[3], or suggest the City and GRU reduce utility rates to pass through the lower debt service to customers. nFront Consulting simply used projected actual debt service requirements in determining the Net Revenue that included the effects of the 2019 restructuring.

2. **Treatment of Rate Stabilization Fund Deposits and Withdrawals:**

   The formula nFront Consulting concluded was the best balance assumes Net Revenue will be determined including transfers from (and to) the rate stabilization fund ("RSF"), as is the case in the UPIF contribution computation specified in GRU's Bond Resolution. You indicate GRU prefers Net Revenue be imputed without transfers from (to) rate stabilization.

   Because RSF deposits and withdrawals normally would be budgeted as needed to better align revenue and expenses on an annual basis, using a Net Revenue value that is increased by RSF withdrawals and reduced by RSF deposits can be expected to provide a more stable GFT amount. Nonetheless, we also concluded making an adjustment to Net Revenue to subtract the effect of RSF withdrawals or add back RSF deposits as you propose can reasonably be done if the City and GRU agree. The effect of this change on the GFT level would be minimal over the next few years but become more significant in the 2025 timeframe. Making this change would have the benefit of reducing use of RSF balances by GRU in future years but also would make the transfer amount less stable.

   More specifically, over the next three years, excluding RSF impacts from net income as you propose would be projected to reduce the transfer to the General Fund by a total of $1.2 million (cumulatively over the entire period, not annually), all other things being equal.

   nFront Consulting understands that longer term projections indicate large rate stabilization withdrawals are projected to occur beginning in FY2025 unless other adjustments are made to GRU's cost and revenue structure. For each $10 million of withdrawal made in a year but excluded from the Net Revenue computation, the transfer to the City would be approximately $4.1 million lower for that year than under the mechanism nFront Consulting concluded best balanced the competing considerations.

   Overall, we considered both methods and identified the method that would result in more stable transfer amounts to the City. But, as stated on Slide 27 of our Final Report, "[a] reasonable variation to [the method proposed by nFront Consulting] would be to remove RSF activity from the calculation [as you propose], which would improve Ability to Fund but reduce Certainty of Funding."

3. **Fund Transfer Level in relation to GRU Earnings:**

   Under the proposed mechanism, the transfer to the general fund would be 41% of Net Revenue as determined by the Bond Resolution. Net Revenue for FY2019, determined per GRU's Bond Resolution income statement, was approximately $80 million. Of that $80 million, approximately 50% would be transferred to the UPIF leaving approximately $40 million, of which $35 million could be transferred to the City. Accordingly, that level of transfer can be funded by the cash

[3] We used actual debt service from GRU's budget projections in our computations. It is our understanding the debt service levels from that source are lower because of the 2019 restructuring.

generated from revenues in a year, based on a net income analysis that recognizes revenue and expenses as specified in GRU's Bond Resolution

However, you expressed a significant concern the amount of the transfer would be more than the net income shown on GRU's GAAP income statement resulting in a negative change in position. Because GAAP allocates to each year the original investment in assets through depreciation rather than principal payments on debt, there can be material differences in the timing of cost recognition under GAAP and Bond Resolution income statements. For instance, in 2019, GRU's GAAP income statement shows depreciation and interest expense to total approximately $159 million. In the same year, debt service (i.e., principal payments plus interest expense) on the Bond Resolution-based income statement totals approximately $91 million, or $68 million less. The GAAP income statement shows net income of approximately $25 million, or $55 million less than the $80 million of Net Revenue determined using the Bond Resolution statement and actual debt service. The two net income or revenue numbers can largely[4] be reconciled by the difference in depreciation and principal component of debt service. This timing difference in cost recognition on the two types of statements is typical for municipal entities.

nFront Consulting determined Net Revenue in a manner consistent with the Bond Resolution, UPIF computation, revenue requirement studies used to set rates, and coverage analyses typically prepared by GRU and rating agencies. By doing so, Net Revenue was determined net of the cash required to fund principal and interest for the year. By contrast, the GAAP statement deducts depreciation and amortization expense, which is a non-cash expression of the allocation of GRU's assets, usually on a level basis over the expected useful life of property being depreciated or amortized. GRU's principal payment schedule is not level, is now lower than depreciation, and increases over time. Over the life of GRU's assets and debt repayment periods the principal retired must total to an amount similar[5] to cumulative depreciation, generally speaking, so at some point in the future principal will increase significantly relative to depreciation.

nFront Consulting recognizes the 2019 GAAP income statement indicates GRU cannot fund a $35 million transfer to the City without the statement also showing a negative change in position for the year. It is important to consider that the negative change in GRU's financial position on its GAAP income statement is occurring because rates are not high enough to cover annual depreciation even though rates are high enough to cover debt service for the year.

If determining the transfer amount such that GAAP statements would not show a negative change in position is determined to be of the highest importance to the City and GRU, then the City and

[4] The are other much less significant differences than the timing differences addressed in this paragraph.

[5] The debt principal outstanding and investment are typically different for numerous reasons, but according to GRU's balance sheet are close in magnitude as of the end of 2019.

GRU should agree to a lower transfer and to determine the transfer based primarily on data from the GAAP income statement.[6]

Should GRU and the City decide to tie the computation of the transfer amount to net income on the GAAP statement, GRU should consider that, at some future point, GAAP-basis Net Revenue may well be higher than the cash-based Bond Resolution Net Revenue because at some point annual principal payments would be expected to exceed annual depreciation if the debt associated with GRU's assets is to be retired. At that time, if the transfer is still made based on a non-cash Net Revenue metric, the conflict will be that the cash-based Bond Resolution Net Revenue metric will show the transfer should be lower or cash generated after deducting expenses from revenue in the year will not be sufficient for debt service, the UPIF deposit, and the GFT and therefore GRU's cash balances will be reduced.

According to GRU's 2019 financial statements, GRU's debt service obligations are scheduled to increase by approximately $7 million after FY2024 on average for each year in the FY2025 through FY2029 period. If GRU's rates are increased to cover that increase in revenue requirements, and assuming the mechanism is based on Net Revenue per the Bond Resolution as concluded by nFront Consulting, the transfer to the City will remain relatively stable and net income determined under the GAAP income statement would significantly increase, all other things being equal. However, if GRU's rates are not increased to cover that additional revenue requirement, the transfer would be lowered by approximately $2.9 million each year (i.e., 41% of that $7 million) and the GAAP basis net income would *not* improve.

nFront Consulting has worked to fully meet all obligations under our Contract with GRU. We have performed our work promptly and diligently both in accordance with the applicable professional standards currently recognized by consultants performing similar assignments and consistent with the agreed upon Scope of Services. Further, we have applied our judgement and experience to prepare useful analyses and provide input to the City and GRU that we believe reasonably and prudently balance competing considerations. Accordingly, there is no basis for GRU to conclude nFront Consulting has breached our Contract with GRU.

nFront Consulting stands ready to continue to work diligently with GRU and the City to further explain our work and conclusions. Ultimately, the City and GRU must work together to agree to a mutually acceptable transfer amount and determination mechanism. The mechanisms and information developed by nFront Consulting is intended to be used in that process but not to dictate the outcome of that effort. We recognize there may be multiple solutions that reasonably balance those objectives. We have identified the solution we conclude best balances the competing objectives. But, the solution nFront Consulting concluded works best is not the only reasonable approach. nFront Consulting is prepared to provide further assistance with that process upon the request of the City and GRU.

[6] Alternatively, the proposed Bond Resolution statement-based mechanism could be used, and payment of more than the minimum amount of debt service due could be budgeted, which would then reduce the transfer to the City (unless covered by higher revenues) and would also accelerate reduction of outstanding debt.

Respectfully Submitted,

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Cc.
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