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# Financial Viability

## Financial Planning for Water Utilities

### A Common Sense Approach



Presented by: John Julien, CPA

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“The best thing about  
having a plan, is you have  
something to change.”

Herschell Umbaugh



# Points to be Covered During this Morning's Presentation

- 1 – Simple techniques for Financial Planning for non-financial people.
- 2 – Setting the stage for a successful rate adjustment

# Five Steps to Financial Planning

- Step 1. Know where you are coming from.
  - What have revenues and expenses been for the last three years?
    - This information gives you an idea of what direction your going financially.
  - What is your current cash position?
    - Changes in cash balances are the best indication of your utility's financial condition.
      - Need to know how your cash position compares to your reserve requirements. More on this later.



# Five Steps to Financial Planning

- Step 2. Know where you are going
  - Funds needed for day-to-day operations.
  - Funds needed to pay debt obligations.
  - Funds needed for extensions and replacements.

# Five Steps to Financial Planning

- Step 3. Answer the question – Is this where we want to go?
  - Is there a better plan?
    - Can we be more efficient with operations?
    - Can we defer maintenance or investments in extensions or replacements?
    - Should we use debt to supplement pay as you go funding?
    - Do we need to increase available revenues?

# Five Steps to Financial Planning

- Step 4. Develop plan that gets you where you need to be.
  - Plan needs to have clear targets.
    - O&M Budgets
    - E&R Budgets
    - DS Budgets
  - Plan needs to have buy in from the Utility Stakeholders.
    - Utility Management
    - Elected Officials
    - Rate Payers

# Five Steps to Financial Planning

- Step 5. Constantly monitor the plan.
  - Circumstances change, does the Plan need to change as well?

# Plan for the Financial Obligations a Utility Needs to Fund

- Revenue Requirements – cash that's going out the door.

# Revenue Requirements

- Operation and Maintenance Expense
  - Normal items for operating the utility on a daily basis
    - Payroll and benefits
    - Purchased power
    - Chemicals
    - Insurance
    - Routine repairs and maintenance



# Revenue Requirements

- Debt Service
  - Principal and interest payments on outstanding debt or lease payments.

# Revenue Requirements

- Extensions and Replacements
  - Funds for major repairs or improvements that are non-recurring
    - Line extensions
    - New equipment

# Planning for Operation & Maintenance Expense – the O & M Budget

- Think Step 1- Where are you coming from?
  - What have I been spending the last several years?
  - How do I think that's going to change next year?

# Planning for Operation & Maintenance Expense – the O & M Budget

- Utilities generally do a good job of tracking operating expenses.
- Usually use Uniform Chart of Accounts.
- This provides information to:
  - Track changes in efficiencies
  - Adjust rates on a Cost of Service Basis
- Provides lots of information that could be studied when preparing a budget.



# How you analyze these accounts can range from:

- Simple

- I spent \$X last year
  - Inflation is running 4%, I'll budget \$X plus 4%
- to

- Complex

- Financial Forecasting Technique
  - Regression Analysis
  - Sensitivity Analysis

- Truth Is – Being pretty close on big things is better than very close on the small things
  
- What are the “big things”?
  - Labor
  - Labor Related
    - Pensions & Benefits
    - Taxes
  - Non-recurring maintenance
    - Tank painting
    - Pump overhauls
    - Well cleaning



# Questions you need to answer to adjust last year's costs:

- Labor
  - Any raises given?
  - Is anyone retiring?
  - Are you hiring anyone new?
- Labor related
  - How much are insurance premiums going up?
  - Is the pension contribution rate changing?
- Non-recurring maintenance
  - Did we have any major maintenance items this year we won't have next year?
  - Will we have any major maintenance items next year we didn't have this year?



# Planning for Operation & Maintenance Expense – the O & M Budget

- Doing a good job answering those questions will make you pretty close on 75%-80% of the O&M Budget.
- Rough estimates on the other 20% of the budget will still give you a pretty accurate O&M Budget.

# Planning for Debt Service

- Debt Service is another term for the principal and interest payments on a bond, or a lease payment on a lease
- If the utility has debt outstanding you should have a bond payment schedule.

ANYTOWN MUNICIPAL WATER UTILITY							
<u>SCHEDULE OF AMORTIZATION OF \$1,425,000 PRINCIPAL</u>							
<u>AMOUNT OF SEWAGE WORKS REVENUE BONDS OF 2007</u>							
Debt Service							
Payment Date	Principal Outstanding (-----In \$1,000's-----)	Principal	Interest Rate (%)	Interest	Total	Bond Year Total	
				(-----In Dollars-----)			
01/01/07	\$1,425	\$1	3.45	\$ 24,581.25	\$ 25,581.25	\$ 25,581.25	
07/01/07				24,564.00	24,564.00		
01/01/08	1,424	1	3.45	24,564.00	25,564.00	50,128.00	
07/01/08				24,546.75	24,546.75		
01/01/09	1,423	1	3.45	24,546.75	25,546.75	50,093.50	
07/01/09				24,529.50	24,529.50		
01/01/10	1,422	1	3.45	24,529.50	25,529.50	50,059.00	
07/01/10				24,512.25	24,512.25		
01/01/11	1,421	38	3.45	24,512.25	62,512.25	87,024.50	



# Planning for Extensions and Replacements

- When money runs short, Extensions and Replacements are usually the first things cut.
- Deferring investments in E&R almost always end up being more expensive.
  - “pay me now, or pay me later.”
- For these reasons, how well you plan for Extensions and Replacements will have a major impact on the success of your Financial Plan.



# Extensions & Replacements Planning

- The best plans cover 3 – 5 years
- Anticipate Surprises
  - Plans that show declining expenditures are usually too optimistic

Year 1 \$400,000

Year 2 \$425,000

Year 3 \$300,000

Year 4 \$150,000

Year 5 \$125,000



# Extensions & Replacements Planning

- Organize your written plan.
  - Show projects and expenditures by year.
  - It usually helps to organize the projects into categories.
    - By critical assets
    - By process
    - Recurring/Periodic
- Revisit the plan frequently
  - Finish one year, add the next.
  - Reprioritize as facts become clearer.

Remember: The best thing about having a plan is you have something to change.



# Evaluating Your Financial Condition

- All the planning in the world doesn't help if you don't step back and evaluate.
- Evaluating what you expect to happen in the future is more important than evaluating the past.
  - Can't change history.
  - Can change the future.
- Evaluate early and often. It takes time to create change.



# Evaluating Your Financial Condition

- Your evaluations needs to cover multiple future years.
- The evaluation process doesn't need to be complex to be effective.

# Simple Evaluation Process

## - Look at Cash

- The simplest evaluation process is to analyze cash.
  - Annual changes in cash.
  - Sufficiency of Cash Balances

# Simple Evaluation Process

## - Look at Cash

- Changes in Cash
  - Look at expected future changes in cash.
  - Look at multiple future years.
  - Doing this analysis in annual periods is sufficient unless cash is very tight.
    - Quarterly or monthly periods will be influenced by seasonal differences. (i.e. annual payment of Hydrant Rental, construction season expenditures)

## Analysis of Anticipated Changes in Cash

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Budgeted Utility Revenues	\$1,500,000	\$1,500,000	\$1,500,000
Less: Budgeted O&M Expenses	(750,000)	(775,000)	(800,000)
Less: Budgeted Debt Service Payments	<u>(500,000)</u>	<u>(500,000)</u>	<u>(500,000)</u>
Remaining Revenues	250,000	225,000	200,000
Budgeted Extension & Replacements Needs	<u>(100,000)</u>	<u>(225,000)</u>	<u>(400,000)</u>
Anticipated Changes in Cash	\$150,000	\$0	\$(200,000)

# Analysis of Anticipated Changes in Cash

- If Cash Flows are not anticipated to be sufficient.
  - Hope is not a strategy.
  - Questions you need to answer.
    - Can we cut costs?
    - Should we use debt to fund E&R to lower the annual requirement?
    - Can we raise revenues?
    - Are Fund balances sufficient to make up for the shortfall?

# Simple Evaluation Process

## - Look at Cash

### ■ Cash Balances

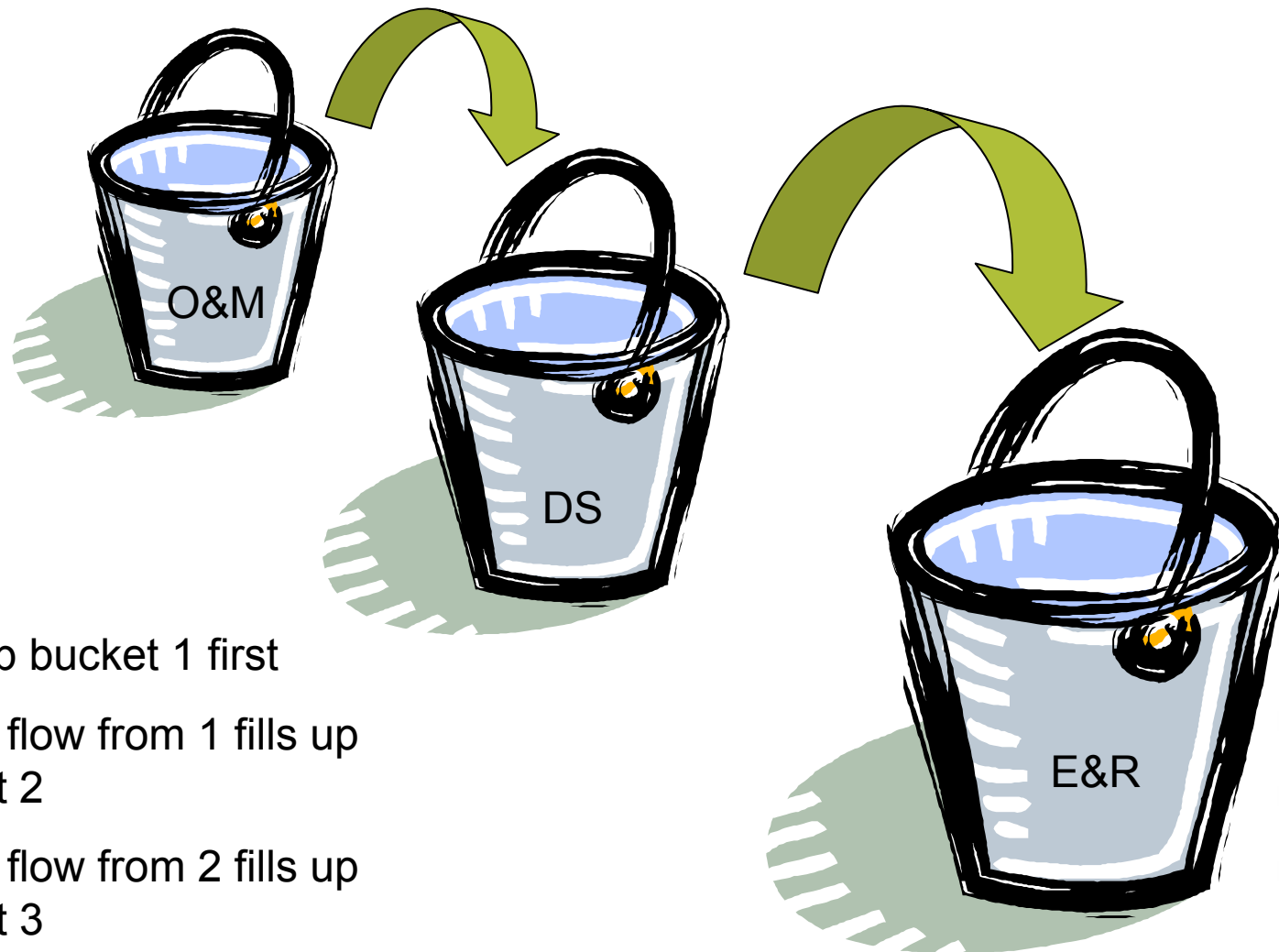
- It helps to look at historical balances as well as future balances.
- It's more important to know how much cash you have for each Revenue Requirement than total cash position.

# Cash for Each Revenue Requirement

## The “Three Bucket Approach”

- Fund for O&M – Bucket One.
- Funds for Debt Service – Bucket Two.
- Funds for Extensions and Replacements – Bucket Three.

# Three Bucket Approach



- Fill up bucket 1 first
- Over flow from 1 fills up Bucket 2
- Over flow from 2 fills up Bucket 3

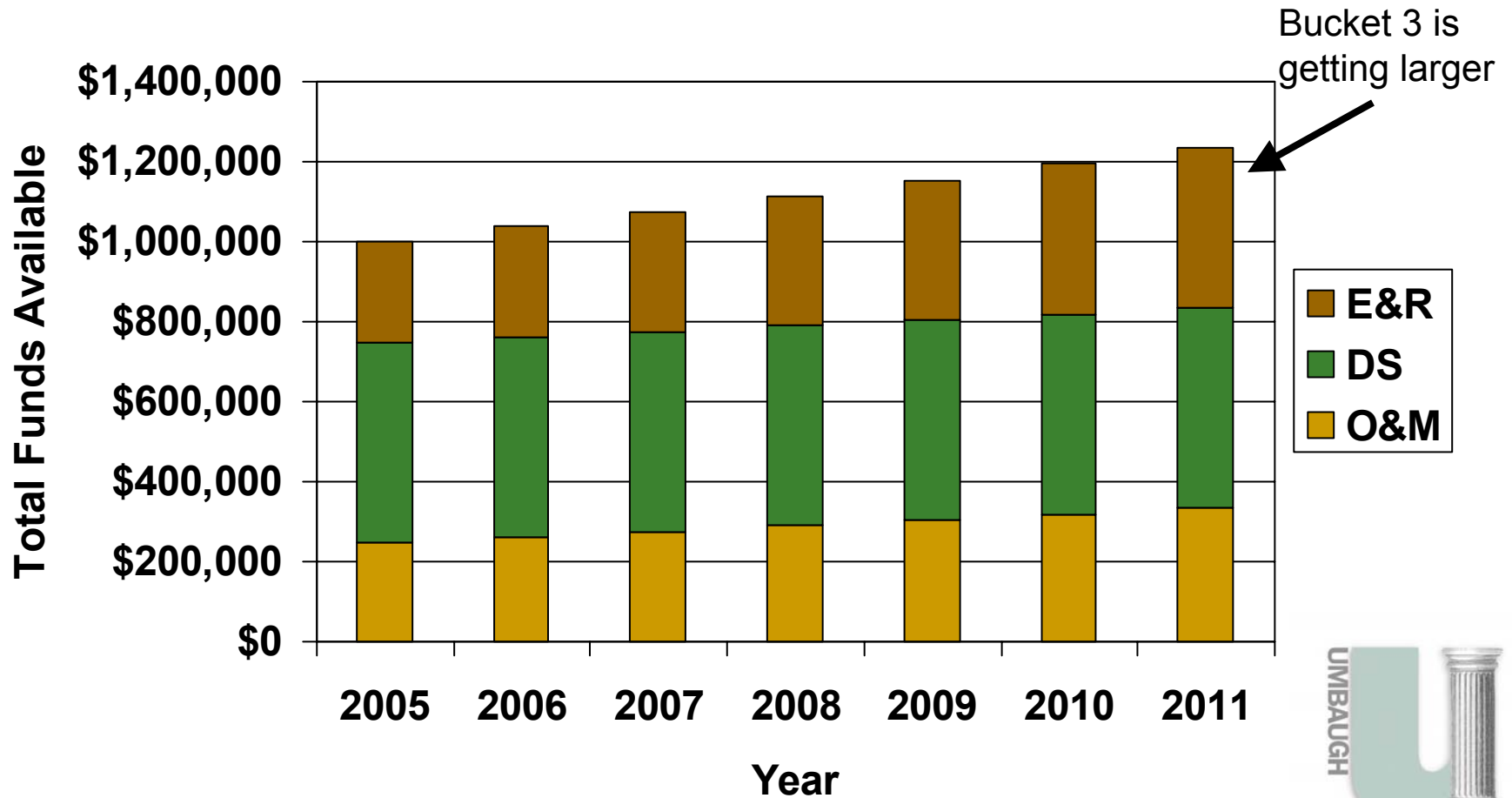
# Three Bucket Approach

- The rules for how much money should be in each bucket is usually spelled out in the Bond Ordinance.
  - General Rules
    - O&M – two months’ O&M expense.
      - Annual Budget \$1,500,000 divided by 6 = \$250,000.
    - Debt Service – the Reserve Amount plus a pro rata portion of the next payment.
      - The Reserve Amount is often equal to the Annual Payment.
      - The pro rata portion of the next payment depends on when you make your Bond payments.
        - If your next Bond Payment is on March 1, your pro rata portion of the March 1 payment on December 31 is 3/6ths.



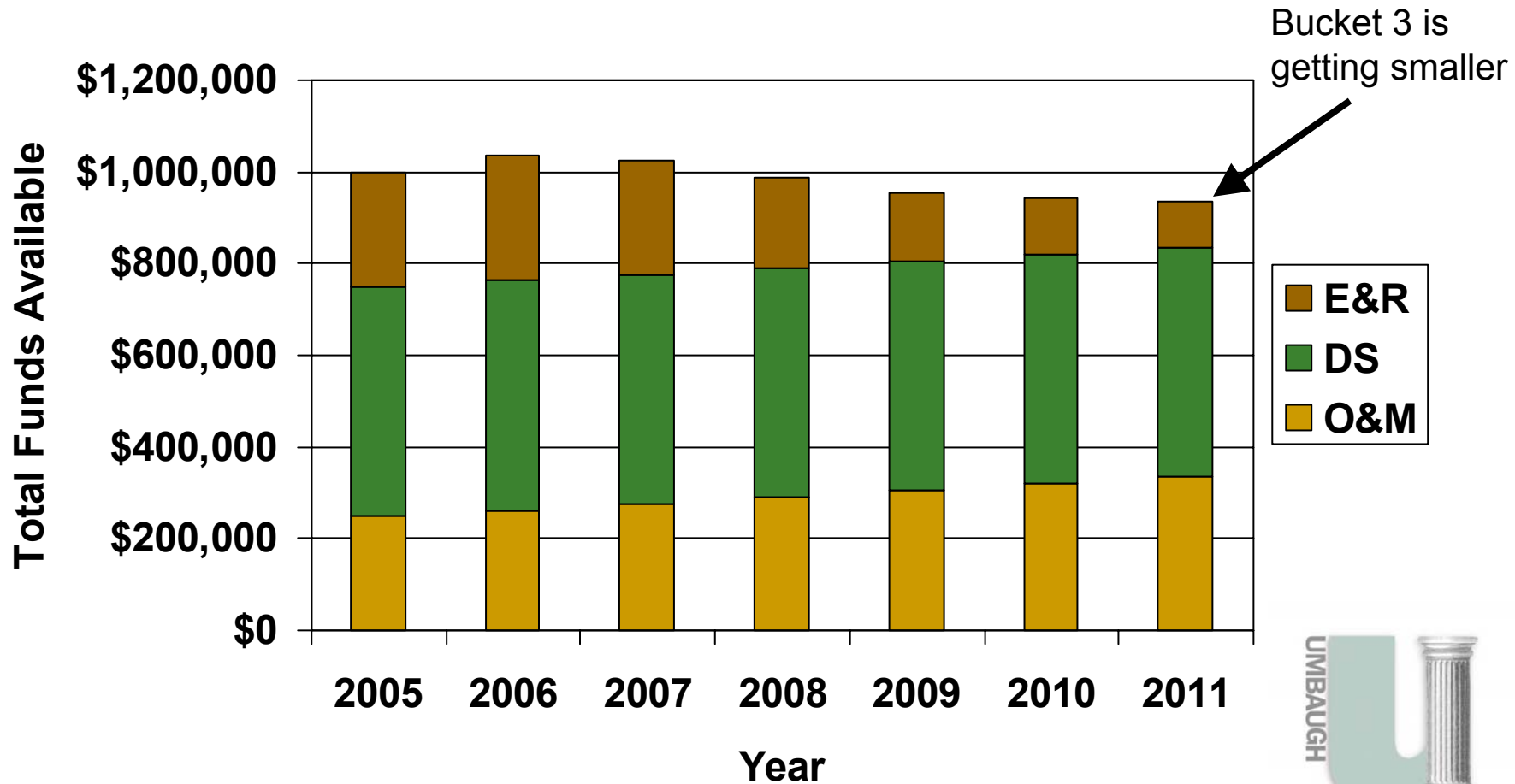
# Illustration 1

## A Utility in good financial shape



# Illustration 2

## A Utility in financial decline



# Position Yourself to Adjust Rates

- Eventually you need to increase rates. You shouldn't have to apologize for a rate increase.
- The key is to present a strong case to support the adjustment.
- Stakeholders want to know the rate increase is the final step taken, not the first step to keep the utility in sound financial shape.
  - Improve efficiencies (Not defer necessary expenses)
  - Look for other revenue sources
    - Is growth paying for growth?



# Position Yourself to Adjust Rates

- Gather the facts to support your case.
  - Document areas where performance has improved.
  - Document new challenges the utility faces.
    - New State and Federal mandates.
    - Aging workforce.
    - Aging infrastructure.
    - Contracting/expanding customer base.
- Present your rate adjustment plans early.
  - The bigger the problem, the earlier you need to discuss it.



# Position Yourself to Adjust Rates

- Remember:
  - Good planning helps avoid surprises.
  - Rate increases should be managed.
  - If you manage rates, increases can be:
    - Predictable
    - Small

# Questions?



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