

Developing Financial Policies To Aid in Strategic Planning and Setting Rates

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Introduction

The water utility industry is constantly changing, but there is always one constant - the need for strong financial performance to support the strategic objectives of the utility. Weak financial performance makes it difficult, if not impossible, to attain or even maintain service at an adequate level. The development of financial policies provides an important and valuable management tool for utilities to meet their strategic plans.

Developing Strategic Plans

Water utilities traditionally have not thought about strategic plans and as a result, have not developed such plans. Utilities have traditionally operated from year-to-year, and simply met challenges as they were incurred along the way. As the industry has evolved in recent years, utility management is now faced with increasingly complex regulatory issues, new competitive challenges from outside forces, and increased price sensitivity by customers. Successfully meeting these new challenges requires the ability to address each issue in an organized manner, and prioritize them into a strategic plan.

At its most basic definition, and as used within this paper, a strategic plan is an organized management plan that contains the utility's vision of a desired level of service or management objectives. It provides the utility with a roadmap focusing on specific goals and objectives.

Developing a strategic plan may sound like an extensive and complicated process. In some cases, it does not necessarily have to be extensive or complicated. Rather, a strategic plan may be as simple as a statement of key initiatives, with short statements (goals) to measure the utility's effectiveness against that initiative.

A simple example of a strategic initiative may be the following:

"The utility will protect, sustain and enhance the environmental quality of our resources. To achieve this initiative, the utility will develop and implement a cost-effective conservation program"

In the example noted above, the utility will need to take a number of steps or actions to achieve it. However, a key component of achieving any initiative of the utility is the financial position of the utility. That is, the utility will need to have sufficient financial resources available to supply the people and programs necessary to achieve the initiative. One method to help assure that the utility has the necessary financial resources available to support their strategic initiatives is to develop written financial policies. Written financial policies can aid in establishing cost-based rates, while at the same time creating an environment for long-term financial stability and adequacy of funds.

Why Establishing Written Financial Policies Is Important

One of the challenges of managing a public utility is working with a Board or City Council and determining the financial and management parameters around which the utility should be operated. On the other side, as a Board or City Council member it can sometimes be challenging to understand all the financial complexities of operating and managing a contemporary water utility. Establishing written financial policies, particularly as they relate to establishing the rates for the utility, is one way to bridge the communication gap between management and policymakers concerning this complex issue.

While written financial policies help bridge the communication gap between management and policy makers, they also provide other significant benefits. Among these are the following:

- ***Provides Management With Clear Direction*** - By developing written financial policies, the policy maker has provided to management clear direction and boundaries for the financial management of the utility. This eliminates the need for management to "guess" the policy maker's intentions or to constantly return to the policy maker to obtain direction on specific financial issues.
- ***Provides Consistent Financial Decisions*** - A set of financial policies provides uniform guidance that should result in consistent and uniform management decisions around each specific financial issue over the long-term.
- ***Provides Policy Makers With the Basis or Reasoning Behind Past Decisions*** - One of the challenges for the management of any public utility is working with an elected Board or City Council. As these elected individuals come and go, it is important that any new Board or City Council member understand the past and current financial philosophy of the remaining members. To that end, written financial policies provide the clear and written link between past and present decisions.
- ***Provides a Strong Message to the Outside Financial Community*** - Establishment of written financial policies for water utilities is not a common practice. Therefore, by establishing a comprehensive set of written financial policies, the utility is making a strong statement to the financial community that it is well-managed. When going before rating agencies, presenting a set of written financial policies will provide a very positive message on the utility's behalf.

In summary, the overall objective in establishing written financial policies is to establish clear policy direction for management. In doing so, it will create greater consistency in the overall financial performance of the utility.

Establishing Written Financial Policies

There is no specific approach or framework that must be used to establish written financial policies. However, in establishing the policies care should be taken to ensure that they are comprehensive and organized in a logical manner. At the same time, financial policies should

be flexible. Flexibility refers to the fact that most financial policies are guidelines. As an example, the utility may establish a financial policy on the types of reserves to be maintained and the recommended minimum level of the reserves. Therefore, when a reserve falls below the established minimum level, it should trigger some management action, but not necessarily a specific action stated within the policy. Management should be provided with the flexibility to determine the most appropriate course of action (e.g. wait and watch, reduce spending, increase rates, etc.). In essence, the policymaker establishes the "ends" or desired results and management is left with selecting the appropriate "means" to get there.

One way in which financial policies can be organized is in the following manner:

1. GLOBAL POLICY STATEMENT

1.1 General Policy Statement

1.1.1 Specific Policy Statement

Utilizing the above framework, the following example demonstrates the general approach.

1. FACILITIES SHALL BE MAINTAINED AT SUCH A LEVEL THAT IT PROVIDES FOR THE PUBLIC WELL-BEING AND THE SAFETY OF THE RESIDENTS

The utility's operation and maintenance (O&M) program will be maintained at a level that assures system reliability and efficiency. A well-thought out maintenance program will extend the life of the system, that will in turn reduce infrastructure costs in the long-run.

1.1 Sufficient funding shall be made available for adequate maintenance and/or replacement of capital plant and equipment

1.1.1 The utility will adequately fund costs for meeting current industry standards and regulation (e.g. Safe Drinking Water Act) in the annual financial review and budgeting process.

1.1.2 The utility will develop a 5-year capital improvement plan and update it annually.

1.1.3 The capital plan will consider all mandated capital, growth related capital and renewal/replacement capital needs.

1.1.4 The utility will make all capital improvements according to the adopted Capital Improvement Plan.

As can be seen, the basic framework for developing the financial policies should help to organize the planning process, particularly as it relates to meeting any strategic objectives the utility may have.

Types of Financial Policies To Consider

In establishing financial policies, there are a variety of areas or topics that policies can be developed around. At the very minimum, the utility must take into account, and be in compliance with any legal covenants (e.g. debt service coverage) or regulatory mandates. Therefore, in establishing a set of financial policies the starting point of the process should be

the review of any bond covenants and/or Federal/State requirements. As an example, revenue bond covenants often require the establishment and funding of certain reserves and the maintenance of rates at a sufficient level to assure meeting or exceeding debt service coverage ratios. At the same time, the utility may have certain Federal or State requirements that may appropriately be included within the financial policies. As an example, a utility may be legally required to establish "conservation-based" rates for the utility.

Most, if not all utilities, have adopted financial policies that cover policy issues such as investment policies, etc. The focus of this paper is on establishing financial policies to aid in setting rates to meet strategic plans. Therefore, the discussion below will focus only on those policies that have a direct impact on the rate setting process and meeting strategic plans.

There are a number of very basic and fundamental questions that a utility must answer in order to address their strategic plan. Among these basic questions are the following:

- ✓ Does the utility and its customers desire to have "cost-based" rates?
- ✓ Should the utility be financially operated as a "business?" If so, what are the appropriate financial and operating goals to be established for the utility (i.e. target debt service coverage ratios, reserves, service levels, etc.)?
- ✓ How should the cost of growth be paid for? Growth pays for growth? Some level of subsidy to encourage growth and economic development? The entire cost of growth should be absorbed into the existing customer base?
- ✓ What level of financial risk is the utility willing to incur? Should the utility build infrastructure in advance of growth (i.e. build it and they will come)?
- ✓ Should capital be paid for on a "pay-as-you-go" basis, or should long-term debt be used, and if so, how much and under what conditions?
- ✓ Is the utility in the business to sell as much water as possible or conserve water? Should the utility attempt to control or change a customer's consumption patterns?

Many of the questions raised above are rarely discussed from a policy perspective, let alone answered via written financial policies for the utility. Provided below are some examples of global policy statements that begin to formally address these kinds of strategic issues.

Example of Financial Policies/Guidelines to Aid in Setting Rates

These recommended financial policies and guidelines have been developed to assist the *[name of utility]* in achieving financial and rate stability from year-to-year.

In addition, these proposed policies should provide consistency in decision-making to both the *[governing body, e.g. City Council]* and utility management.

These proposed policies and guidelines should be used as a starting point in the utility's overall utility financial planning and rate setting process.

The proposed policies and guidelines listed below should be reviewed over time to determine if they are still relevant and appropriate.

1. Rates Should Be Established Utilizing a “Generally Accepted” Rate Setting Methodology.

When reviewing rates, it is important to use a methodology that is “generally accepted” in the financial and rate setting community as well as the water, sewer and storm water utility industry. This will assure a legally defensible approach as well as consistency of the analysis over time.

1.1 It is recommended the City use the following “generally accepted” approaches to establish rates for each utility.

- **Revenue requirement analysis**
- **Cost of service analysis**
- **Rate design analysis**

REVENUE REQUIREMENTS:

- 1.1.1 Revenue requirements will be established on a “cash basis” approach that will include operation & maintenance expenses, taxes/transfers, debt service (P&I) and capital improvements funded from rates.
- 1.1.2 Revenues and costs will be annually projected for a projected five-year time period.
- 1.1.3 Projections of O&M costs should include any estimated incremental O&M costs associated with future capital improvements.
- 1.1.4 The administrative transfer fee from utility enterprise funds to the General Fund is a payment for various services provided by the General Fund. The amount of each year's transfer fee shall be based on the reasonable estimated general fund costs incurred by the utility enterprise funds, of the General Fund costs.
- 1.1.5 Costs associated with mandated program requirements will be identified and included within the “cash basis” approach.
- 1.1.6 Any wholesale cost increases imposed upon the City by a water or sewer supplier/partner should be equitably passed through to the City's ratepayers at the same time such rates become effective upon the City.

COST OF SERVICE:

- 1.2.1 A cost of service study will be utilized to equitably allocate the water and sewer costs to the customer classifications of service.
- 1.2.2 The cost allocation methodology will utilize techniques that are “generally accepted” by the industry (e.g. American Water Works Association, Water Environment Federation).
- 1.2.3 The water cost of service will, at a minimum, consider the following cost components:
 - ✓ *Commodity/base costs* – those costs that vary with the total amount, or flow of water consumed by a customer over an extended period of time (e.g. electricity and chemicals)
 - ✓ *Capacity costs* – those costs that vary with maximum demand, or the maximum rates of flow to customers (e.g. sizing facilities to meet peak demands)
 - ✓ *Public fire protection costs* – those costs related to the public fire protection function (e.g. hydrants and over-sizing of mains)
 - ✓ *Customer related costs* – those costs that vary with the number of customers on the system (e.g. postage, meter maintenance expense)
 - ✓ *Revenue related costs* – those costs associated with the amount of revenue received by the utility (e.g. a gross proceeds tax, delinquent fees)
- 1.2.4 The sewer cost of service will, at a minimum, consider the following cost components:
 - ✓ *Volume costs* – those costs that vary with the total flow of wastewater contributed by a customer over an extended period of time.
 - ✓ *Strength costs* – those treatment related costs associated with the strength of wastewater (biochemical oxygen demand and suspended solids).
 - ✓ *Customer related costs* – those costs that vary with the number of customers on the system (e.g. postage, meter maintenance expense)
 - ✓ *Revenue related costs* – those costs associated with the amount of revenue received by the utility (e.g. a gross proceeds tax, delinquent fees)
- 1.2.5 The water and sewer cost of service will consider the specific circumstances and unique characteristics of the City’s systems in the cost allocation methodology.

RATE DESIGN:

- 1.3.1 User charges (rates) will be established so that operating revenues are at least equal to the direct and indirect operating costs, to include costs of administration for each individual utility.
- 1.3.2 Rate designs will be reflective of utility needs, and also reflect the greater public purpose and policy goals of the City Council (e.g. conservation, economic development, ability to pay, etc.).
- 1.3.3 Rates will recognize and attempt to incorporate a fixed charge for the up-front fixed costs associated with serving customers and a usage or volumetric charge that attempts to recover the variable costs of operating the utility.
- 1.3.4 Rates will be set at a level that recovers necessary costs, by classification, yet flexible enough to accomplish the City’s objectives (e.g. public purpose programs).
- 1.3.5 Rates should be designed to be equitable and detailed to a level to reflect the service provided (e.g., private fire protection, multi-family services, etc.).

2. The City’s Utilities Should Continue to be Managed to Attempt to Maintain Financial Stability Over Time.

The City’s utilities, like any other business, should strive to maintain financial stability over time, as it has done in the past. Financial stability is not only a prudent financial management goal; it can also minimize financial costs in the long-term (e.g. unnecessary borrowing). Above all, financial stability will provide the community with the confidence of knowing a strong, consistent management team is managing the utility.

2.1 Financial Policies and Measures Will be Developed to Measure, Manage and Achieve Financial Stability.

RESERVES:

2.1.1 The City will maintain utility reserves required by law, ordinance and bond covenant, so as to provide cash working capital for normal and ordinary operations, and also provide some insurance against economic downturns and emergencies.

2.1.2 Minimum reserve funds, excluding bond reserve funds, will be as follows:

Operating Reserves – Operating reserves are composed of Active Working Capital Cash and Operating Reserves. These reserves reflect the timing difference between billing for revenues and payment of expenses. The Operating Reserve can also be used to cover unanticipated cash operating expenses or lower than expected revenue collections. The basis for establishing a minimum total operating reserve level for each utility will be ## days of the O&M expenses for that utility. Based upon 2005 O&M levels, the minimum operating reserve for each utility is as follows:

- Water utility \$ _____
- Sewer utility \$ _____
- Storm water utility \$ _____

Catastrophe/Emergency Reserves – The catastrophe/emergency reserve is essentially to protect the City’s utilities against the financial impacts from unanticipated emergencies. It provides funding for emergency repairs or failure of essential equipment that needs to be immediately replaced. At a minimum, the contingency reserve will be set equal to \$###,### (\$###,### water/\$###,### sewer). This level of contingency/emergency reserves will be deemed sufficient to finance the required cash flow until such time that adequate emergency financing can be secured from conventional outside resources.

Capital Reserves – Capital reserves are used to fund the cash flow requirements of capital infrastructure construction. These reserves can increase and decrease significantly depending on funding sources available and the capital projects that are planned during the year. The City should, however, set a minimum funding level for each utility as follows:

Funding should be based upon the five (5) year average of the annual capital expenditures contained within the City's capital improvement plan for each utility. Based upon the 2005 – 2009 capital improvement plan, the following minimum reserves are recommended:

- Water utility \$#,###,###
- Sewer utility \$#,###,###
- Storm water utility \$###,###

Bond Reserves – Bond reserves may be legally required for specific debt issues. Bond reserves will be established in accordance with the legal covenants of the debt issue.

- 2.1.3 The City Council may establish other reserves for specific needs that are over and above the reserves noted above.
- 2.1.4 Maintenance of minimum reserves should not, on its own, trigger the need for a rate adjustment, (e.g. rates will be reviewed after two consecutive years of loss of revenue or diminishing reserves as a result of covering costs).

LIQUIDITY:

- 2.2.1 The City's utilities will maintain sufficient reserves, and of such a nature, that it maintains liquidity equal to # months of operating expenses.

CASH FLOW:

- 2.3.1 Each utility should have annual net income (total revenue less O&M, taxes, debt service and capital projects funded from rates) greater than or equal to zero (\$).

TARGET DEBT SERVICE COVERAGE:

- 2.4.1 The City should have an annual debt service coverage ratio greater than or equal to 1.## (e.g. 1.50) on all outstanding debt that carries a legal bond covenant. The City will maintain a debt service coverage ratio of 1.30 on all outstanding debt service. (Industry norm for revenue bond coverage ratio covenants is 1.25.)

CAPITAL IMPROVEMENT FUNDING FROM RATES:

- 2.5.1 On an annual basis, each utility should adequately fund through its rates an amount for capital improvement funding.
- 2.5.2 To achieve policy 2.5.1, the following minimum funding for each utility should be included within the rates, and escalated (increased) over time to reflect the impacts of inflation and replacement cost of infrastructure. [Note: generally targets an amount ≥ annual depreciation expense].
 - Water utility \$#,###,###
 - Sewer utility \$#,###,###
 - Storm water utility \$###,###
- 2.5.3 As new large capital facilities are added to the City, consideration may be given to phasing-in the rate impact of policy 2.5.1.

3. Rates Should be Stable Over Time.

Financial stability of a utility also provides rate stability. Rate stability reinforces that costs are being managed and controlled, thereby gaining customers' confidence of the management team's credibility.

3.1 Rates Should be Stable in Their Ability to Generate Sufficient Revenues, but also in the Customer's Perception of the Rate Changes from Year to Year.

- 3.1.1 Rates should be reviewed by the City, on an annual basis, to assure that they provide sufficient revenues.
- 3.1.2 Annual rate reviews will consider a five-year projected period to attempt to stabilize and minimize rates over time.
- 3.1.3 Needed rate adjustments will attempt to minimize impacts to customers by phasing-in large rate adjustments over time.
- 3.1.4 Rates should reflect pass-through components for costs that fluctuate and are not controllable by the City, such as wastewater treatment costs and energy costs.
- 3.1.5 A comprehensive rate study will be conducted by an outside party at least every 5 years in order to assess the fairness of the rates to the City's ratepayers and to ensure that the necessary revenue is available for the City's operating and capital needs.

4. The City will maintain utility facilities at a level that will provide for the public well-being and safety of the residents.

The City's operating and maintenance (O&M) program will be maintained at a level that assures system reliability and efficiency. A well thought out maintenance program will extend the life of the system that will in turn reduce infrastructure costs in the long-term.

- 4.1 Sufficient funding should be made to provide for adequate maintenance and/or replacement of capital plant and equipment. This is to protect the City's capital investment and to minimize future maintenance and replacement costs.
 - 4.1.1 The City will adequately fund costs for meeting current industry standards and regulations (e.g. Safe Drinking Water Act) in the annual financial review.
 - 4.1.2 The City will develop a 5-year capital improvement plan and update it annually. The capital improvement plan will be coordinated with the operating budget and impacts to ratepayers.
 - 4.1.3 The City will make all capital improvements according to an adopted Capital Improvement Program.
 - 4.1.4 The City's capital improvement program for each utility will consider mandated capital, growth related capital and replacement, reproduction and refurbishment capital.

5. The City will consider the impacts of rates on their customers and financial and operating needs will be balanced against the rates and financial impacts.

Utility rates are the primary communication the City has with its utility customers. Whenever possible, the City's rates should be easy to understand, stable from year-to-year and minimize the overall impacts to customers.

- 5.1 Rates will be easy to understand and the City will attempt to keep rate increases to a minimum.**
 - 5.1.1 Rates for each utility will be structured to promote understanding by the City's customers (e.g. bills that are easy to hand calculate and understand).
 - 5.1.2 Rate adjustments will be phased-in, over time, when large financial impacts to customers are anticipated (e.g. eliminate rate shock).
- 5.2 Rates will be reviewed for their overall competitiveness.**
 - 5.2.1 Any rate adjustment to a utility should consider the City's "competitiveness" with neighboring utilities.
 - 5.2.2 The "competitiveness" of the City's rates should not necessarily take precedence over prudent financial and business practices.