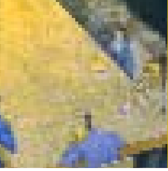


The Finance Director's Role in Helping Public Enterprises Look their Best

By Bryan A. Mantz

Finance directors of public enterprises face special challenges; developing expertise in financial best management practices will help them keep the enterprise operationally and financially sustainable while minimizing user rate increases over the long term.

Many directors of public enterprises such as public utilities and solid waste management have limited or no formal training in accounting and finance. Their backgrounds are often in engineering or operations, so they typically rely on financial professionals either within their department or in the local government's finance department for advice on financial issues. In many municipalities, customer service and billing for the enterprise is managed by the finance department. To excel in their positions, therefore, public finance directors use knowledge and skill sets in all the major business disciplines — accounting, finance, management/operations and marketing.

RAISING RATES

In most cases, public enterprises are intended to be self-supporting. They should normally be managed much like a business, with their expenditures recovered primarily through charges to users. This means that rate increases are sometimes required, often when:

- User rate revenues are lower than previously anticipated because of economic conditions or weather patterns.
- Operating expenses are higher than previously anticipated, often due to circumstances beyond the local government's control (e.g., energy, chemical and fuel prices, construction materials.).
- Substantial capital investment is needed to prepare for growth in the service area, to address renewal and replacement requirements of the existing infrastructure, or to comply with new regulatory requirements.
- The governing body has decided to initiate or increase transfers from the enterprise fund to the general fund.

There never seems to be a "right time" to request an increase in user rates — the economy is in a recession, or elections are on the horizon. The finance director needs to work closely with the enterprise staff to develop a rate case that will make the enterprise look its best to the governing body, the public, and third parties such as the rating agencies that evaluate the creditworthiness of the enterprise.

To properly assist the enterprise in developing a strong rate case, the finance director needs a fundamental knowledge of best management practices that are applicable to the enterprise, especially financial practices. Best management practices can help keep the enterprise operationally and financially sustainable while minimizing user rate increases over the long term. A credit/bond rating is an assessment of risk, and a well-managed

enterprise has less implied risk, which can translate to higher credit ratings and lower interest rates and borrowing costs on debt financings.

User rates should be competitive and affordable. A user rate comparison is a valuable tool (see Exhibit 1) in "selling" rate increases to governing bodies. If the rates are higher than those of neighboring governments, there should be a valid explanation (e.g., differences in service area characteristics). Well-managed enterprises don't always have the lowest rates; enterprises with lower rates might be experiencing operating losses or failing to perform needed renewals and replacements on existing infrastructure.

Many industry references discuss best management practices, including publications from the three major credit rating agencies, Moody's, Standard and Poor's, and Fitch Ratings. Rating agencies routinely release publications that discuss the best management practices they consider when evaluating an enterprise. Some of these key practices are discussed below.

BUSINESS PLAN

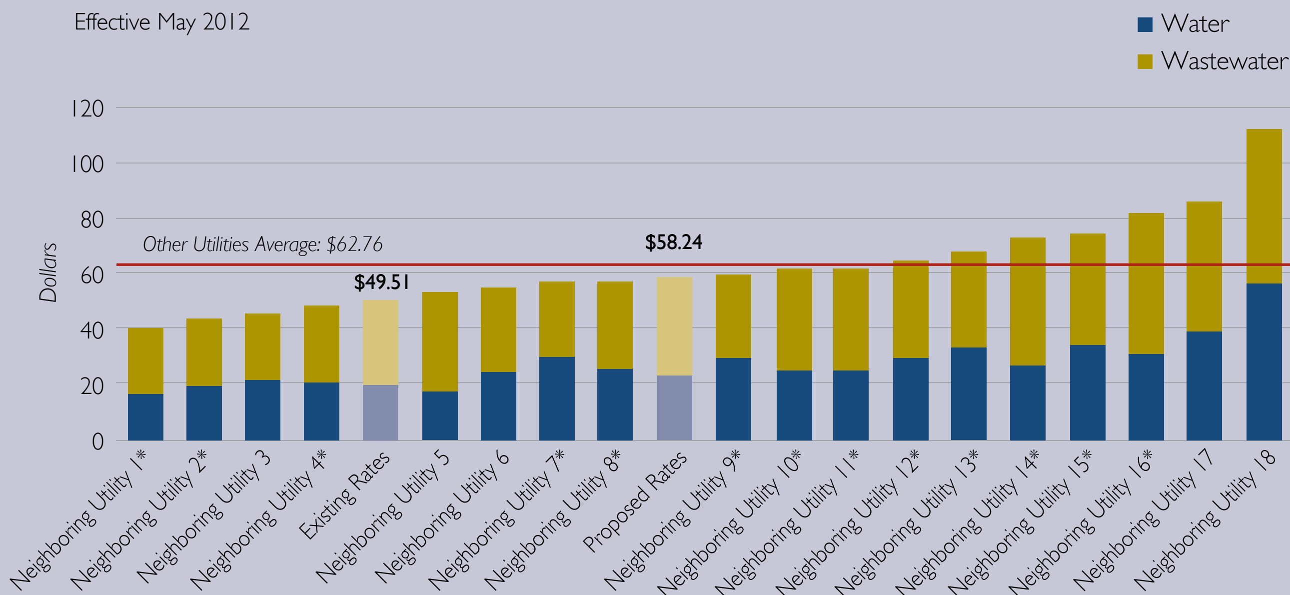
The enterprise should have business principles or a business plan approved by the governing body. Long-range planning is a proactive approach to managing the enterprise. Rating agencies often request copies of written planning documents because enterprises that plan ahead and have contingency plans may have less financial risk. The finance director should help the enterprise develop appropriate business principles and a long-term plan, as these items will affect management decisions.

The enterprise should also attempt to build a long-term written history of operational and financial information and key performance indicators, as history usually provides a good foundation for forecasting. The more years of history, the better the trend analysis.

Limit non-utility-related transfers from the enterprise to the local government's general fund. Since there is often a perception that it is easier to increase user

Exhibit 1: Sample User Rate Comparison

Comparison of Monthly Charges for Combined Water and Wastewater Service for Single Family Residential Customers Using 5,000 Gallons



**Utilities: i) involved in rate study; ii) are planning to conduct rate study; or iii) will implement rate revision or price index/pass-through adjustment within twelve months*

rates than property tax millage rates, local governments sometimes initiate or increase the enterprise's transfers to the general fund to help cover funding deficits, especially during recessionary times. Rating agencies prefer for enterprises to have limited exposure to the financial operations of the general government, such that enterprise revenues can be relied on to operate and improve the enterprise. If there are transfers to the general fund, the organization's policies should limit their scope and growth. The flow of funds provisions of outstanding debt obligations may require that any revenues collected by the enterprise must remain within the enterprise fund (i.e., a closed-loop system). With this requirement, the only way to make a transfer from the enterprise fund to the general fund may be to treat the transfer as an operating expense, which would negatively affect the enterprise's debt service coverage.

CAPITAL PROGRAM

The capital program should have an appropriate mix of debt versus pay-as-you-go financing. Capital planning is an important component of a long-range plan. An organization needs a capital program that meets the community's needs, can be realistically executed within the given timeframe, and is fundable and affordable. Developing a capital project prioritization ranking system can help in isolating critical projects from projects that could be deferred.

Consider historical and projected percentages of capacity use when evaluating expansions. Capacity planning is a process of balancing risks. The risk from an engineering standpoint is that the enterprise might not have enough capacity to meet the service area needs, so the most conservative approach would be to use a higher population estimate, ensuring sufficient capacity in case of a growth trend. From a financial perspective, however, the growth expectation should be lower to provide reasonable assurance that revenue would be sufficient to meet expenditure needs. The key risk from a financial standpoint is building too much capacity too far in advance of new growth, forcing the organization to increase user rates to pay for the underutilized or unused capacity (e.g., debt service on the capital costs of the capacity and fixed operating expenses to maintain such capacity).

Exhibit 2: Examples of Utility Renewal and Replacement Needs

Routine, ongoing capital needs should be funded on a pay-as-you-go basis, while the enterprise could consider debt financing for major capital projects. Funding all capital needs on a pay-as-you-go basis would result in the lowest user rates over the long-term, but is often not practical because of the sizeable amount of cash required by large capital projects. Debt financing can offer several advantages. For one, the annual cash flow is reduced to the level of debt service over the term of the debt. Also, the recovery of the capital project costs can be spread over the life of the debt instrument to match asset use (e.g., 30-year repayment schedule, 30-year asset service life), which can be more fair to ratepayers.

Moreover, if the enterprise has implemented growth-related fees such as impact fees, debt financing might allow more time for "growth to pay for growth." Any impact fees collected can be used to pay for growth-related capital projects or growth-related debt service, thereby lessening the cost burden for existing users who had to fund the growth-related infrastructure in advance of growth.

While debt financing has advantages, issuing too much debt can lead to additional pressures to raise user rates to meet debt service coverage requirements. This situation often leads to high user rates and a "cash rich, coverage poor" financial position (which could possibly be remedied by retiring some of the outstanding debt).

The enterprise should fund renewal and replacement needs annually. Unfunded renewal and replacement needs on aging infrastructure are a big problem in the United States (see

Exhibit 3: Simplified Sample Renewal and Replacement Schedule

Preparation Year: 2012

Description	Estimated Replacement Cost [1]	Percent to Be Cash-Funded [2]	Amount to Be Cash-Funded	Asset Service Life (Years)	Annual Funding Amount [3]	In-Service Year	Replacement Year
Asset 1	$1,000,000	50	$500,000	30	$16,667	1986	2016
Asset 2	25,000,000	25	6,250,000	30	208,333	2002	2032
Asset 3	6,000,000	25	1,500,000	30	50,000	2007	2037
Asset 4	50,000	100	50,000	10	5,000	2007	2017
Asset 5	25,000	100	25,000	5	5,000	2010	2015
Asset 6	5,000	100	5,000	5	1,000	2009	2014
Asset 7	3,100,000	25	775,000	30	25,833	1983	2013
Asset 8	400,000	50	200,000	15	13,333	2007	2022
Asset 9	250,000	50	125,000	10	12,500	2010	2020
Asset 10	12,500	100	12,500	5	2,500	2011	2016
Total	$35,842,500		$9,442,500		$340,167		

Renewal and Replacement Fund Balance (Assumes No Interest Earnings)

	Fiscal Year Ending September 30,				
Description	**2012**	**2013**	**2014**	**2015**	**2016**
Starting Balance	$3,648,000	$3,988,167	$3,553,333	$3,888,500	$4,203,667
Annual Contributions	340,167	340,167	340,167	340,167	340,167
Additional Contributions [4]	0	0	0	0	0
Expenditures (Cash)	0	775,000	5,000	25,000	512,500
Ending Balance	$3,988,167	$3,553,333	$3,888,500	$4,203,667	$4,031,333

Footnotes:

[1] Includes allowance of 3% per year construction cost inflation.

[2] Remainder to be funded from debt-financing or alternative funding source.

[3] Annual transfer to be funded from user rates.

[4] Includes additional contributions required to address funding deficiencies.

Exhibit 2 for images). The multi-year capital program should incorporate a schedule of renewals and replacements derived from the: estimated remaining service lives of enterprise assets in service; estimated replacement costs; and, if applicable, a systems condition report prepared for the utility system (see Exhibit 3).

User rates are typically established by considering the enterprise's cash needs; non-cash items such as depreciation and amortization are not included as revenue requirements. If user rates are established to fund sufficient "below-the-line" transfers for renewals, replacements, upgrades, and betterments, the enterprise should still be able to show positive income after accounting for the depreciation expense. However, it is not uncommon for financial statements to reflect higher depreciation expenses because of a mismatch between the depreciation periods and the asset lives (e.g., water transmission main with 50-year asset life being depreciated over 30 years).

PERFORMANCE STANDARDS

The financial targets of the enterprise should be consistent with the prudent industry performance standards that have been approved by the governing body. Rating agencies indicate key financial targets and ratios that they consider during the rating process. In its Water and Sewer Revenue Bond Rating Guidelines, Fitch Ratings offers the following for debt service coverage and working capital cash balances: "For utilities in the most stable operating environments with a suitably diverse and healthy service area economy, 1.5x annual coverage, with consistently maintained unrestricted financial liquidity of at least 90 days of operating revenues, could be sufficient for AA or higher ratings. For utilities with substantial growth, compliance demands, or significant annual volatility in revenues or expenditures, greater financial flexibility may be necessary."[1]

This guidance could apply to most enterprise funds. With respect to debt service coverage, the most important ratio is the all-in debt service coverage, or net revenues divided by total annual debt service (senior lien and subordinate lien payments added together). Impact fees are not usually included as a component of net revenues. Therefore, if the enterprise meets all financial targets without considering impact fees, the enterprise is prepared for the cyclical nature of impact fees and other growth-related fees.

> The finance director should help the enterprise staff develop financial targets and monitor financial performance.

The enterprise should maintain adequate cash reserves for working capital, asset replacement, rate stabilization, landfill closure (for solid waste management enterprises), and other purposes. The 2012 median Fitch key ratio of "days cash on hand," is "current unrestricted cash and investments plus any restricted cash and investments (if available for general system purposes), divided by operating expenditures minus depreciation, divided by 365 for 420, 309, and 195 days for AAA-, AA-, and A-rated water and wastewater utilities, respectively."[2]

The finance director should help the enterprise staff develop financial targets and monitor financial performance. If increases are centered on meeting targets that are laid out in a formal ordinance or resolution, the enterprise may be able to secure rate increases more easily. Once again, rating agencies prefer adopted policies and often request copies.

REGULATORY COMPLIANCE

The enterprise must remain in regulatory compliance. Federal and state environmental and other laws and regulations can drive the need for additional capital investment. Non-compliance can lead to a shutdown of enterprise operations, consent orders, fines, and lower credit ratings.

The finance director should assist the enterprise in compiling operational data that could indicate problems that might lead to future compliance issues. For instance, utilities should monitor the unbilled water percentage, or the difference between finished water produced (or purchased) and water billed to system customers. Generally, well-managed systems have unbilled water percentages of 10 percent or less. A high unbilled water percentage could signify system water leaks or water usage (possibly unauthorized) that should have been billed but was not.

For wastewater systems, the difference between wastewater billed and wastewater treated can often be explained by the user rate structure, as wastewater is billed based on metered water flow, not all of which returns to the wastewater system (e.g., irrigation). However, a significant difference can sometimes indicate an inflow or infil-

tration problem. Inflow and infiltration, which are two ways that water gets into a wastewater system when it is not supposed to, are not uncommon in older wastewater systems.

COMMUNICATION

Build support through ongoing communication with governing bodies. The director of the public enterprise should team up with the finance director to routinely educate members of governing bodies and communicate with them about enterprise operational and financial issues. Inviting the governing body members to tour the enterprise facilities can be a component of the educational process. Showing pictures at public meetings (such as those in Exhibit 2) can be an effective communication tool, as can presenting actual samples, if discussing renewal and replacement needs (e.g., sample section of a highly corroded water main recently replaced by the utility). If the governing bodies are fully informed about enterprise issues in advance, they are more likely to take action when there is a request to increase user rates. Before a public meeting to make a formal rate increase request, it can be helpful to meet one-on-one with members of the governing bodies to reiterate the issues that make the increase necessary.

Rating agencies look favorably on a history of governing bodies' raising user rates when needed. If user rates need to be increased before a bond issue, it is advisable for the governing bodies to adopt all rate increases required during the forecast period (e.g., next five years). When meeting with representatives from rating agencies, it can sometimes be helpful to have members of the governing body present to express their support for the enterprise operation.

CONCLUSIONS

A finance director who has expertise in financial best management practices for enterprises such as utilities can be instrumental in ensuring that the business is operating as it should to meet the long-term interests of customers. The finance director, as a crucial member of the enterprise management team, can play a pivotal role in helping the enterprise look its best. ❚

Notes

1. Water and Sewer Revenue Bond Rating Guidelines, Fitch Ratings, 2007.
2. 2012 Water and Sewer Medians, Fitch Ratings, 2012.

This article also uses material from the following:

Bryan A. Mantz, "Utility Transfers to the General Fund: What Is Reasonable, Fair, and Legal" (Scheduled for publication in October 2012 edition of *Journal AWWA*).

Bryan A. Mantz, "Optimal Debt Management Practices for Local Government Enterprises," *Journal of Government Financial Management*, fall 2012.

Bryan A. Mantz and Henry L. Thomas, "Utility Impact Fees: Practices and Challenges" *Journal AWWA* 104:4. 2012.

Bryan A. Mantz and Robert J. Ori, "Utility Rates and the Political Environment," *Journal AWWA* 103:8. 2011. Winner of the 2012 AWWA Management & Leadership Division Best Paper Award.

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