

FLOMATIC® VALVES

TAKE CONTROL

Flomatic® pilot-operated control valves are built in compliance with AWWA C530 standard. NSF/ANSI 61 approved, our control valves are available in a full port globe style, reduced port globe style, or angle style configurations.

Flomatic control valves are manufactured in accordance with the American Iron and Steel Act (AIS)* for the planning, design, and construction of water infrastructure improvements nationwide.

Take control of pressurized pipeline systems with Flomatic's extensive line of pilot operated control valves:

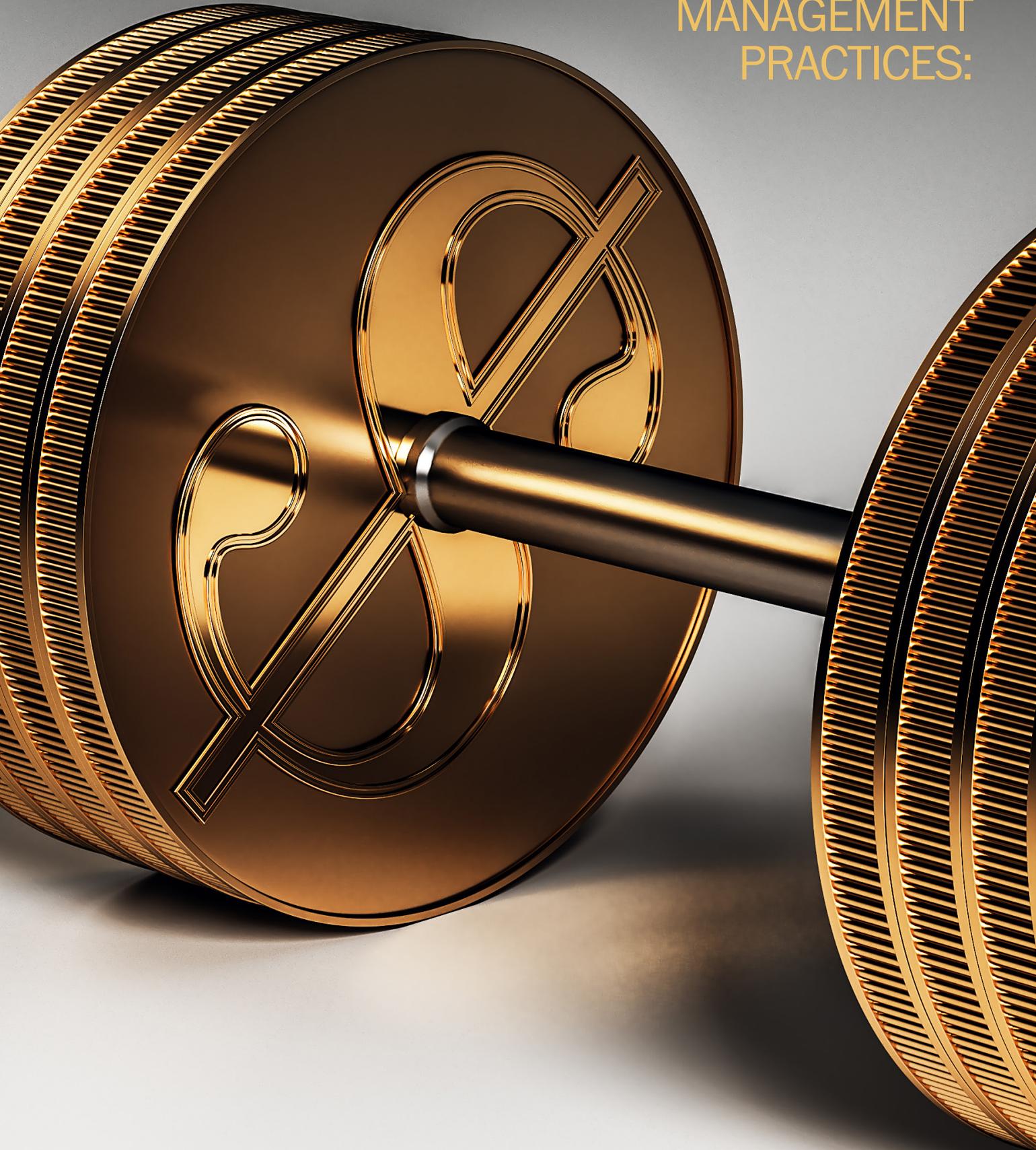
- ✓ Pressure-Reducing
- ✓ Altitude
- ✓ Back-Pressure Sustaining
- ✓ Surge Arrestor
- ✓ Pump Control
- ✓ Pilot-Operated Float
- ✓ Solenoid Control
- ✓ Flow Control
- ✓ Hydraulic Check Valve

*Consult factory. Must specify AIS requirements at time of order

(800) 833 - 2040
WWW.FLOMATIC.COM
15 PRUYN'S ISLAND DR
GLENS FALLS, NY 12801



UTILITY BEST MANAGEMENT PRACTICES:



Strong Adopted Financial Management Policies

Bryan A. Mantz and Angie Flores

Key Takeaways

A financial management policy document that has been adopted by the governing body is a valuable planning tool for guiding a utility's financial decisions and how a utility deals with the unexpected.

A financial management policy document should contain its purpose, financial targets, goals and objectives, and clear definitions of terms. Utility managers can decide which additional elements are appropriate.

Any personnel who play a role in managing a utility should be involved in developing its financial policies.

Layout imagery by Andrey Tolkachev/Shutterstock.com



A utility's financial management policies support its mission and can help ensure long-term stability and operational reliability when unexpected problems arise. Comprehensive financial management policies—ideally organized in a single, cohesive document—can also guide future investments and rate decisions.

Since every utility has its own unique operations and service characteristics, there is no “one size fits all” for financial policies. Some utilities have ready access to water and a stable customer base. In contrast, others have more expensive water sources and/or customers with significant variances in yearly demand. A utility with higher operating risks may need to incorporate stronger financial metrics into its policies.

A utility's governing body should adopt a financial policy document that details the utility's approach to financial management, or at least the major parts. Regardless of its size and whether it has outstanding debt or contemplates debt financing, every utility should have adopted financial management policies in place, because they document how a utility plans to reach its financial goals and support its mission. Strategically, financial policies should also describe how a utility balances cost recovery and affordability issues.

When a utility tries to secure debt financing, credit rating agencies or lenders will likely request a copy of the adopted financial management policies, and having such a document is considered a best management practice as it helps the utility with its financial planning and promotes its sustainability. Certain aspects of a utility's financial plan can also bolster its credit rating, and rating agencies especially want to see an uninterrupted revenue stream for debt service. The credit rating of some utilities was upgraded shortly after they adopted clear financial management policies. However, some utilities have received a lower financial management score in their credit rating because of a lack of formalized financial policies. A utility's financial policies may be included as part of the local government's overall financial management policies. A sample first page of a financial management policy document is shown in Figure 1. Utilities

can borrow language from the financial management policy documents of other utilities, some of which may be found via an online search (they might not need to start from scratch).

Financial management policies can have several elements, and the local government can decide which are appropriate for the utility; potential elements are described in this article.

Because financial management policies should reflect a utility's mission, they should be developed by all departments responsible for the utility management (e.g., public works, finance, local government manager or administrator). If a utility has a municipal advisor and/or rate consultant, these professionals should also be involved to help ensure that the elements of the financial policies are feasible and conform with the utility's best financial management practices. This article provides guidance to utility managers who are developing financial management policies for their organization or for those looking to improve or update their existing policies.

Financial Targets

All water utilities face revenue volatility due to forces beyond their control, especially the weather and cost increases from third-party providers, and they may experience higher levels of revenue uncertainty, depending on their fixed- versus variable-rate revenue distribution. In considering financial policies, local governments can look to various industry best practices, including AWWA's benchmarking surveys and, in the United States, guidance developed by the Government Financial Officers Association. In addition, rating criteria scorecards developed by bond rating agencies (Moody's, Fitch, and Standard & Poor's) can be used to evaluate a utility's financial metrics.

When developing financial policies, utility managers should consider how third-party evaluators will assess the utility's creditworthiness. A stronger credit rating, which indicates lower implied financial risk, can help a utility secure lower interest rates for debt financing. Minimizing the cost of capital helps keep user rates lower over the long term.

Rating criteria are constantly evolving, but credit rating agencies use key financial ratios when evaluating a utility's business. Table 1 lists financial ratios that a utility may want to consider addressing in its financial policies. A utility's financial management policies should explicitly establish a target cash position and debt service coverage.

When developing or updating financial policies, utility managers should consider the utility's existing position, its dependence on debt, and its ability to meet financial

Regardless of its size and whether it has outstanding debt or contemplates debt financing, every utility should have adopted financial management policies in place.

Sample First Page of Financial Management Policy Document

**FINANCIAL MANAGEMENT POLICIES
FOR THE
CITY OF _____
WATER AND WASTEWATER ENTERPRISE FUND**

ADOPTED BY THE CITY COUNCIL ON _____, 2022

Contents

GENERAL.....	1
POLICY OBJECTIVES.....	2
DEFINITIONS.....	2
FINANCIAL POLICIES.....	6
Credit Rating Policy.....	7
Fund Balance Policies.....	7
<i>Cash Reserves Policies</i>	7
<i>Fund Balance Policies—Other</i>	8
Debt Coverage Policy.....	9
Operating Budget Policy.....	10
Capital Budget Policy.....	10
Rate and Financial Plan Review Policy.....	10
Impact Fee Policies.....	11
UPDATES TO FINANCIAL POLICIES.....	12

GENERAL

The City of _____, (the “City”) recognizes that one of the keys to the long-term sound financial management of the City’s water and wastewater enterprise fund (the “Enterprise Fund” or the “System”) is the adoption of formal fiscal policies associated with the financial management and creditworthiness of the System (the “Financial Policies”). This view is supported by bond rating agencies, investors, and the Government Finance Officers Association. The Financial Policies are primarily intended to help protect the financial resources of the Enterprise Fund through:

- Formal adoption of industry-recognized best practices for utility financial management;
- Guiding the managers of the Enterprise Fund in the financial planning cycle and decision-making process;
- Establishing appropriate levels of operating and capital cash reserves, and providing available funds for emergencies and extraordinary expenditures;

Figure 1

Common Financial Ratios in Utility Financial Policies

Ratio	Description
<p>All-in debt service coverage</p> $\frac{\text{current revenues} - \text{current expenses (does not include noncash expenses)}}{\text{annual debt service payments}}$	<p>A way to measure a utility's ability to repay current debt obligations, this ratio is operating income (current revenue less current expenses) divided by the annual debt service payments (principal and interest). Current expenses for coverage purposes do not typically include noncash expenses, such as depreciation. The debt service payments include both senior lien and subordinate lien obligations. As of the date of this article, a utility with a stronger financial profile may have an all-in debt service coverage of 200%.</p>
<p>Days cash on hand</p> $\frac{\text{unrestricted cash on hand}}{([\text{operating expenses} - \text{noncash expenses}] \div 365 \text{ days})}$	<p>The number of days a utility can continue to pay its operating and maintenance expenses (not including depreciation and amortization) with the current cash it has available. As of the date of this article, rating agencies look favorably (AA-rated) on utilities with a minimum of 170 days cash on hand (Fitch 2021).</p>
<p>Days working capital</p> $\frac{\text{working capital} \times 365 \text{ days}}{\text{revenue}}$	<p>Indicates the relatively liquid portion of the utility's capital, which constitutes a margin or buffer for meeting debt obligations.</p>
<p>Debt ratio or debt capacity</p> $\frac{\text{outstanding principal amount of debt}}{\text{net fixed assets}}$	<p>Measures the debt leverage of assets and can indicate the capacity for additional debt. Calculated using the following formula: outstanding principal amount of debt compared with the net fixed assets or utility plant investment of the system. Net fixed assets reflect the gross fixed assets minus depreciation.</p>

Table 1

targets. In addition, utilities should consider projections of revenues and costs when evaluating their ability to meet financial targets. If a utility's financial metrics are not optimal, its financial policies could specify incremental steps to increase the financial targets over time (e.g., 150% all-in debt service coverage target in fiscal years [FYs] 2022 and 2023; 175% in FYs 2024 and 2025; and 200% in FY 2026 and beyond). If financial targets are not met in a given year, a utility's financial policies should specify the time frame for improving its financial position to meet the targets (e.g., three years).

Elements of a Financial Management Policy Document

The following elements should be included in every utility's financial management policy document.

Purpose

Rate and financial policies commonly provide direction for planning purposes, but other purposes include managing risk and establishing internal controls, standards, and best management practices. It is easier to communicate the need for rate increases to the

governing body and customers when the increases are linked to the financial policies' purpose and associated goals of delivering a continuous supply of safe, affordable water to customers.

Financial Goals and Objectives

A utility's financial management policies should clearly define its goals and objectives, such as the following:

- Formally adopting industry-recognized best practices for utility financial management
- Guiding the enterprise fund and its managers in the financial planning cycle and decision-making process
- Establishing appropriate levels of operating and capital cash reserves and providing available funds for emergencies and extraordinary expenditures
- Developing a process to evaluate financing solutions and fund necessary capital improvements efficiently
- Reducing the cost of debt by providing a framework for the utility to achieve and maintain a strong credit rating
- Maintaining reasonable and justified levels of rates, fees, and charges to cover all costs and promote the long-term sustainability of the utility

Common Terms

Providing clear definitions helps readers understand the terms commonly used in financial policies. For example, the term *operating expenses* for debt service coverage purposes does not typically include depreciation and amortization expenses (noncash expenses) or the payment of interest expense on outstanding debt. Also, for coverage purposes, “gross revenues” usually excludes property and cash contributions, grants, and system development charges (often referred to as “impact fees” or “capacity charges”). Given virtually unlimited financing options, “pledged revenues” sometimes includes revenue streams outside of utility operations (e.g., taxes).

Types of Financial Management Policies

At a minimum, a utility’s financial management policies should describe its targets for cash reserves and debt service coverage. However, many other areas should be considered to ensure the policies can effectively meet a utility’s needs.

Cash Reserves

Cash reserves provide a measure of protection from uncertainty and unforeseen financial events. Emerging trends in the water industry include establishing additional reserves to address revenue stability concerns. AWWA’s position is that utilities should establish cash reserve policies and adopt cash reserve policy statements. AWWA’s policies on cash reserves are available on the AWWA website (www.awwa.org).

Some water utilities face decreasing consumption due to supply constraints that lead to voluntary or mandatory usage reductions, resulting in lower per capita use. The reserves maintained by a water utility to address revenue instability should correlate to the potential volatility of rate revenues. It may be appropriate for some utilities to have larger reserves if there is a higher likelihood their operations may be substantially affected by forces beyond their control (e.g., increases in wholesale service rates from a water provider). Improving a utility’s cash position and having “rainy day” funds are good ways to upgrade its credit rating. An overall objective could be to maintain unrestricted cash equal to at least 365 days of cash on hand, which is the historical rating agency standard for a utility with a stronger financial profile, as of the date of this article.

Policies can be developed for different types of operating and capital reserves. For reserves set aside for future expenditures, utilities may consider designating them as restricted in financial statements to avoid the impression that the utility has excessive cash. It is also recommended that the reserves be clearly defined so that future use is limited to the intended purpose.

Operating Reserves

A utility’s financial management policies should establish an operating cash reserves target to provide short-term liquidity for general utility purposes. Operating reserves help the utility cover costs during the cyclicalities of collections and revenue shortfalls. Operating reserves often range between three and nine months of operating expenses or operating revenues; in general, a greater cash cushion implies less financial risk in evaluating a utility’s creditworthiness.

Operating reserves can also provide the ability to phase in rate adjustments, and some utilities create separate rate or revenue stabilization funds specifically to manage rate adjustments. It is important to distinguish between a rate stabilization fund that simply consists of additional cash reserves and a rate stabilization fund created by a bond resolution or ordinance as a debt service coverage management tool. With the latter, any deposit into the rate stabilization fund may represent deferred revenue recognition and may not be included in coverage calculations for the year in which the deposit is made. Similarly, any withdrawal from the fund may be recognized as revenue for coverage purposes.

Capital Reserves

These reserves will be used for capital improvements in the future and can be restricted or unrestricted. A portion of the capital reserves may represent restricted accruals for specific future expenditures.

A utility should maintain minimum capital reserves at least equal to the previous year’s depreciation expense (possibly adjusted for inflation factors). With this level of capital reserves, the utility is positioned to address the next year’s wear and tear on the utility system. As discussed subsequently, a utility’s level of capital reserves ideally should link to its asset management plan.

Debt

Debt Service Coverage

Utilities often have minimum debt service coverage requirements associated with debt financing. The addition of coverage requirements gives protections to

Certain aspects of a utility’s financial plan can also bolster its credit rating, and rating agencies especially want to see an uninterrupted revenue stream for debt service.

bondholders and, depending on the coverage met by utilities, can potentially improve the utility's credit rating and reduce the interest rate the utility must pay. Utilities should ideally set their coverage target at an amount higher than the minimum to generate cash to fund pay-as-you-go capital needs and be less dependent on debt financing—i.e., balanced debt risk. A policy target higher than what is required by the covenants also provides a cushion to avoid any covenant violations in years when revenues decrease significantly.

If a utility considers a financing vehicle with balloon indebtedness, with which a significant amount (e.g., 25% or more) of the original principal amount matures in a single fiscal year, it should address how the coverage requirement will be addressed. For example, a utility's rate covenant might specify that balloon indebtedness for coverage purposes should be determined assuming it is amortized over a certain period (e.g., 20 years) on an approximately level annual debt-service basis.

Debt Capacity

A debt capacity policy can help prevent a utility from becoming overly leveraged—i.e., taking on too much debt. Utility systems carrying large amounts of debt are less able to reduce costs if demand shrinks, and it is more challenging to achieve higher debt service coverage.

A utility's debt capacity policy could state that the outstanding principal amount of debt compared with the system's net fixed assets or utility plant investment will not exceed a certain percentage. Utilities with stronger financial profiles typically aim to keep their debt ratios less than 50% under most conditions.

The utility life cycle significantly affects the need for debt financing. Growth-oriented utilities that must build infrastructure in advance of growth may be more reliant on debt financing than mature utilities with high-capacity utilization. As with most areas of a utility's financial policies, if its debt coverage target is not met, the financial management policy document should have a time frame for correcting the deficiency.

Utilities should ideally set their coverage target at an amount higher than the minimum to generate cash to fund pay-as-you-go capital needs and be less dependent on debt financing.

Debt Refunding

Utilities may consider adding guidance on how they will issue debt obligations to refund outstanding debt when market conditions indicate a certain percentage of present value savings or when other management considerations, as recommended by the utility's financial advisors, indicate a refund is appropriate.

Bond Rating

A utility can have a financial policy stating it will strive to maintain a certain bond/credit rating, such as AA or better.

Accounting Policies

Budget

Utilities often state their formal policies regarding budgeting practices, some of which may be required by state statutes. These policies often express how the utility's annual operating budget will

- structurally balance revenues to meet ongoing expenses.
- reflect rates set at levels intended to support the direct and indirect costs of the system, with the intent to provide the lowest reasonable rates over time (not necessarily the lowest fees and user charges during the current fiscal year) and at a level necessary to ensure adequate system maintenance and operation.
- reflect the utility's financial management policies and include amounts necessary to maintain the required operating and capital reserves.
- address when and how amendments to the budget can and will occur.

Investment

A utility's financial policies can include specific guidance for managing its investment portfolio. For example, the portfolio could be managed to achieve, in order of priority,

- safety of capital,
- sufficient liquidity to meet disbursement schedules, and
- rate of return at least equal to the return on a comparably maturing US Treasury bill.

The investment policy could also state that the utility will not make any investments with a long-term issuer rating lower than "A" or equivalent from the credit rating agencies at the time of purchase.

General Fund Transfer Policies

A best management practice per credit rating agencies is to limit non-enterprise-related transfers to the general fund (i.e., the local government's primary operating fund). Similarly, the utility as an enterprise fund should not be

As with most areas of a utility's financial policies, if its debt coverage target is not met, the financial management policy document should have a time frame for correcting the deficiency.

subsidized by the general fund. A substantial amount of capital—often secured through debt financing—is required to provide utility services. As such, it is important to reinvest in the utility system.

If revenues after payment of all required expenditures and transfers must remain in the utility fund and can be used only for purposes related to the utility system, the utility fund is considered to be “closed.” With an “open” fund, surplus utility revenues can be used for any legal purposes of the local government. Master bond resolutions typically indicate (usually in a “Disposition of Revenues” section) whether a utility fund is open or closed. Rating agencies prefer utility funds to be closed because there is more assurance that renewal and replacement needs will be addressed promptly and without political interference.

Capital Policies

Capital Reinvestment

Utilities are capital-intensive businesses, and regular reinvestment in water system assets like pipelines, pump stations, and treatment plants is critical for service sustainability. Bond resolutions or ordinances often contain covenants under which the issuer agrees to make annual deposits—typically based on a percentage of revenues—to a renewal and replacement (R&R) fund.

Typically, it makes sense for utilities to deposit more than the minimum required into their R&R funds. While the percentage-of-revenues basis for R&R deposits is common, there are other approaches.

Depreciation Expense

As a utility's asset values decline as a result of normal wear and tear, it makes sense to deposit an amount equal to the reduction in value into the R&R fund. Some utilities have adopted a financial policy that sets the minimum annual deposit into the R&R fund to equal the prior year's depreciation expense, possibly adjusted for inflation factors.

Asset Management Plan

A best management practice for utilities is to develop asset replacement schedules. Utilities can accrue funds over multiple years on the basis of when assets are projected to need replacement and estimated replacement costs, considering inflationary factors. During the year of replacement, a utility would then have sufficient cash to renew or replace its asset(s). Linking annual R&R fund deposits to an asset management plan is perhaps the ideal approach.

Project Funding

A utility's financial policies can specify what types of projects will be cash funded or debt financed. For example, a utility might use cash to fund renewal and replacement capital projects and assets with estimated useful lives of 10 years or less. Renewal, replacement, extension, regulatory, and expansion capital projects and assets with longer useful lives might be funded through debt or cash financing, depending on prevailing economic conditions.

Rate Policies

Rate Review

With changes in capital needs, regulatory requirements, customer demand, and other factors, financial and rate plans can quickly become outdated. Annual reviews of a utility's rates are appropriate to ensure that, if rate increases are necessary, they will be phased in over time, and the resulting changes to customers' bills will be minimized. Regularly reviewing and updating a utility's rate structure allows it to better plan for future capital expenditures and adequately cover those costs.

Rate review policies often require annual reviews by the utility staff and formal rate studies every two to three years to ensure compliance with the utility's financial management policies.

Automatic Rate Adjustments

Automatic rate increases are considered a utility best management practice and are favored by credit rating agencies. From a financial risk standpoint, regular rate increases provide more assurance that rates will keep up with a utility's costs, and these are even more important during times of increasing or high inflation. If financial projections are submitted as part of securing debt financing, the rating agencies will want to know if all rate adjustments needed to support the debt have been adopted.

Automatic rate increases sometimes include pass-through rate increases from wholesale water

providers and electric companies. Utilities typically have limited control over such costs, but they are often a substantial portion of utility operating expenses.

With proper communication, local governing bodies are generally supportive of small, regular rate increases over time. For more information on automatic rate adjustment policies, see the *Journal AWWA* article titled “Automatic Rate, Fee, and Charge Increases for Water Utilities,” published in March 2021.

System Development Charges or Impact Fees

State and local laws are constantly evolving, so utilities should understand their specific options for system development charges (SDCs):

- Accounting practices for SDCs
- Limitations on the spending of SDCs
- The amounts by which SDCs can be increased in a given year
- Notification requirements

SDC policies incorporated in a utility’s financial management policy document should address the most up-to-date legal requirements.

Other Rate Policies

Many other rate policies can be incorporated into a utility’s financial management policy document:

- Current rate-setting methodology
- Fixed-charge cost recovery policy
- Inactive account policies, such as whether customers should be responsible for paying base charges when they turn off their service
- Disconnect/reconnect policies
- Mandatory connection policies
- Late fees
- Outside-municipality surcharges
- Rate or financial covenants included in the utility’s master bond resolution/ordinance

Financial Policy Updates

A utility can have a financial policy specifying how often its financial management policies will be reviewed (e.g., every three years). The financial policies can be adjusted on the basis of revised credit rating criteria, changes in utility system financial performance, and other utility management considerations.

A Vital Planning Tool

Adopting clear and sound financial management policies—ideally organized in a single, cohesive document—is vital for utility planning, and it can facilitate management and communication with customers. The guidance provided in this article should be

useful for utility managers as they develop or improve their organizations’ financial policies. 📌

Acknowledgment

The content of this article was reviewed by members of AWWA’s Finance, Accounting, and Management Controls (FAMC) Committee and the Publications Subcommittee, which is a joint effort of AWWA’s Rates and Charges and FAMC Committees. The authors greatly appreciate the valuable feedback received from the reviewers: Ann Bui, Black & Veatch; Christine Gray, the City of Westminster, Colo.; Michael Maker, NewGen Strategies & Solutions; John Mastracchio, Raftelis; Seena Mostafavipour; Jason Mumm, FCS Group; Usha Sharma, Denver Water; and Stephanie Stanley, Highlands Ranch Metro District, Colo.

About the Authors



Bryan A. Mantz is the president of GovRates; bmantz@govrates.com.

Angie Flores is a senior manager with Raftelis.

<https://doi.org/10.1002/awwa.1881>

Reference

Fitch Ratings. 2021. *U.S. Water and Sewer Rating Criteria*. www.fitchratings.com/research/us-public-finance/us-water-sewer-rating-criteria-18-03-2021

AWWA Resources

- Utility Tips for Maintaining Financial Resilience During and After a Pandemic. Karnovitz A, Johns G, Kiefer JC. 2021. *Journal AWWA*. 113:4:24. <https://doi.org/10.1002/awwa.1707>
- Affordability Assessments: Policy Recommendations for USEPA. Mastracchio J, Raucher R, Rothstein EP, et al. 2020. *Journal AWWA*. 112:6:20. <https://doi.org/10.1002/awwa.1515>
- Tucson Examines the Rate Impacts of Increased Water Efficiency and Finds Customer Savings. Rupprecht C, Allen MM, Mayer P. 2020. *Journal AWWA*. 112:1:32. <https://doi.org/10.1002/awwa.1429>
- Align Municipal Procurement Practices With Asset Management and Sustainability Goals. Moore R, Stroebel TJ. 2021. *Opflow*. 47:6:8. <https://doi.org/10.1002/opfl.1556>

These resources have been supplied by *Journal AWWA* staff. For information on these and other AWWA resources, visit www.awwa.org.