FINANCIAL CAPACITY HANDOUT SERIES

- Empowering Your Water System with Financial Capacity
- Budgeting Basics
- The Budget Process
- A Sample Budget – In 5 Easy Steps

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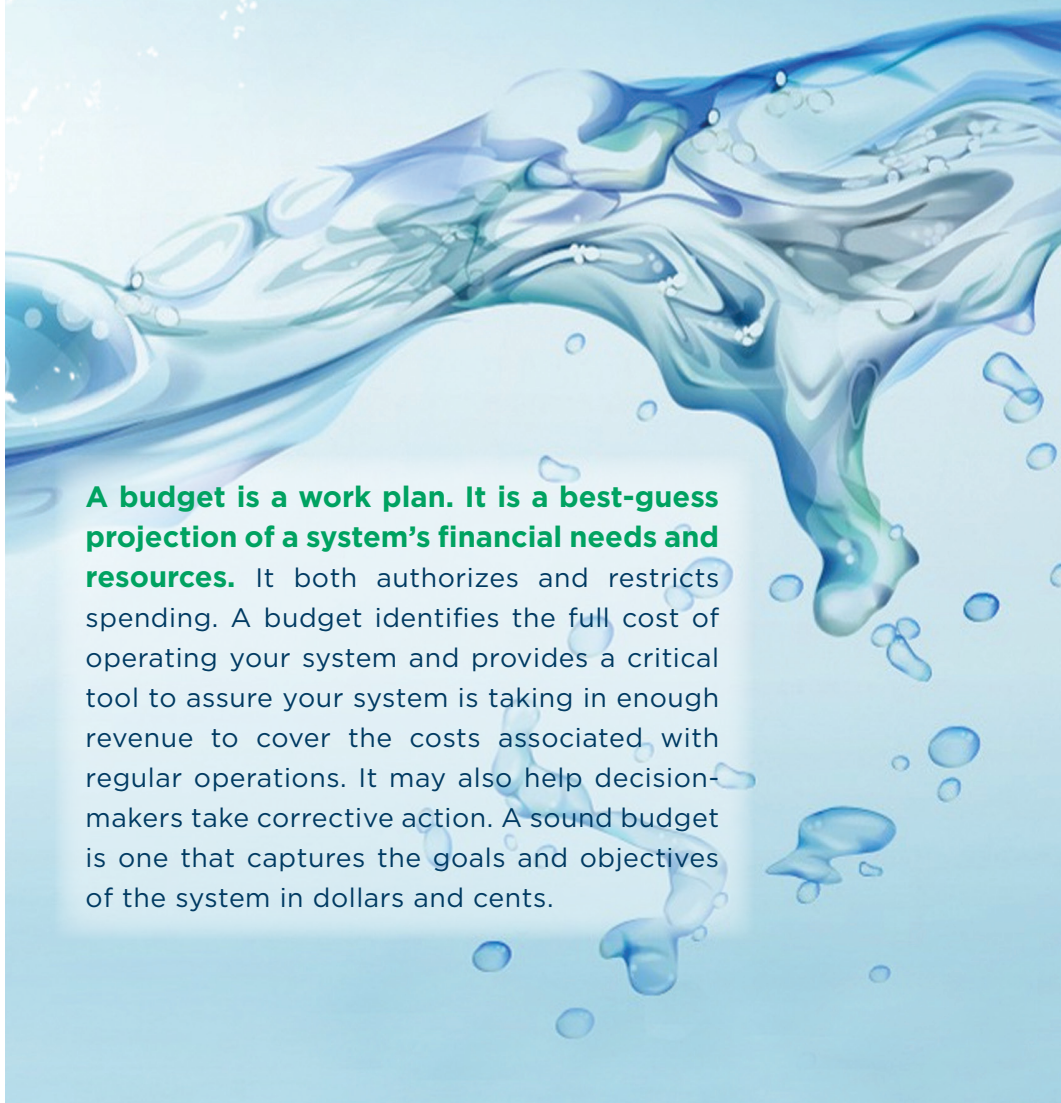
BUDGETING BASICS



A budget is a work plan. It is a best-guess projection of a system's financial needs and resources. It both authorizes and restricts spending. A budget identifies the full cost of operating your system and provides a critical tool to assure your system is taking in enough revenue to cover the costs associated with regular operations. It may also help decision-makers take corrective action. A sound budget is one that captures the goals and objectives of the system in dollars and cents.

— THERE ARE FOUR BASIC STEPS INVOLVED IN GOOD BUDGET PREPARATION —

1 - ESTIMATING ANNUAL OPERATING EXPENSES 2 - ESTIMATING NEEDED RESERVES
3 - IDENTIFYING REVENUES NEEDED TO COVER EXPENDITURES PLUS RESERVES 4 - BALANCING & USING THE BUDGET

STEP 1: EXPENSES

The first task is to define all expenses required to deliver safe, high-quality water on a sustainable basis. Different from your home budget, you want to define your costs first and income second. There are numerous ways to categorize expenses related to your system. It is important to develop a list of cost categories that make sense to you, the utility decision makers (e.g., board of directors), and your customers. Some common expenses include: wages; utilities; sampling; repairs; transportation; office supplies; rent; insurance; licenses; training; taxes; debt service. These expenses are either fixed, or variable.

FIXED COSTS are costs that must be recovered even if the service is not used. Fixed costs are usually recovered from each customer on an equal basis through the use of a minimum monthly service fee. Examples include insurance or debt repayment.

The method for identifying all or part of some expenses as fixed costs includes determining to what extent each of the line item expenses in your budget benefits every customer of the system regardless of their level of service. This is a determination that each system has to make for itself.

VARIABLE COSTS are expenses that are directly related to how much water you pump, treat, store and sell. Examples of variable expenses include electrical power, chemicals and a percentage of salaries. To recover variable costs, your water rate structure will need a "usage charge" also called a "consumption" or "commodity charge", which is the cost of water per 1,000 gallons.

STEP 2: RESERVES

Setting aside reserves can mean the difference between a system that is self-sustaining and one that may fall apart or become financially unstable during a small emergency. If your utility does not have reserve accounts, establish them as soon as possible. Ultimately, the question of how much funds a system will want to reserve is up to the utility's decision making body. The following are descriptions of reserves to consider establishing and the 'rule of thumb' for estimating adequate amounts to set aside

DEBT SERVICE RESERVE
If money was borrowed to build your system, chances are the system agreed to place money into a Debt Service Reserve account until an agreed upon dollar amount is reached. A Debt Service Reserve is in addition to a loan repayment.

EMERGENCY RESERVE
An emergency reserve is cash set aside for unplanned major maintenance or equipment failure. Some specialists suggest setting aside enough cash to cover the cost of replacing the most "vulnerable component" of your system.

OPERATING RESERVE
An operating reserve compensates for cash flow variations. A 45 day (approximately 6 weeks) operating reserve is a frequently used industry norm.

CAPITAL IMPROVEMENT RESERVE
A capital improvement reserve is for system rehabilitation, long-term equipment replacement, system expansion, and equipment/components, as well as 'on-hand cash' for expansion and new projects. Your system's decision making body should determine the appropriate planning horizon for your system. Utility systems that save for equipment replacement and new projects 10 to 12 years in the future are doing an excellent job of managing their assets.

STEP 3: REVENUES

The third task is to determine what revenues the utility generates. There are two primary revenue categories, operating and non-operating.

OPERATING REVENUE INCLUDES:
- Income from monthly service fees
- Income from water and/or wastewater sales (commodity rate)

For most systems, income from the monthly service fees is the most reliable source of revenue because they're based on historical information.

NON-OPERATING REVENUE INCLUDES:
- Interest on checking and reserve accounts
- Meter deposits
- Connection fees
- Late payments, penalties and reconnection fees

STEP 4: BALANCING THE BUDGET AND ACTUALLY USING IT

The budget balancing process compares estimated revenues against estimated expenses. The amount of operating revenue - sales of water and monthly fees - should equal the total annual costs – fixed and variable costs, and the annual reserve contribution.

After you balance the budget, you must regularly review the budget throughout the year – at least quarterly – to assure your estimated costs match your actual costs. Your ongoing vigilance assures your self-sustaining water system will have enough resources to operate next year and for generations to come.

Remember, the budget document is the key element in developing financial capacity. Developing a budget requires four steps: estimating expenses, estimating reserves, identifying revenues, and finally balancing the budget.