5 KEYS

to Setting Water and Sewer Rates

By Bill Brickey and Keith Szymanski

In many communities, the only "business-type activities" (as they're referred to by us accountants) are water and sewer operations. It can be challenging for rate-setters to change their mindset as they go from budgeting their governmental funds to projecting operations of what should be a self-sustaining enterprise within a governmental entity. Setting water and sewer rates should be a deliberate, annual process that includes the following key steps:

1. Understand Your Objectives

Some of the objectives are obvious. Water and sewer funds should generate enough cash to cover operating costs, pay debt service, and make necessary capital improvements, but paying the bills and keeping the water flowing are just the basics. Rate-setters should also consider how much cash should be held in reserves—more on this in a bit. To the extent possible, rate-setters should also seek to limit the variability in the rate increases passed on to customers. While it's almost impossible to make everyone happy, most customers can understand the need for reasonable and steady increases in rates from year to year. What's more likely to draw an outcry is a dramatic spike in rates after multiple years of little or no increases.

2. Understand Your Operating Costs and What Drives Them

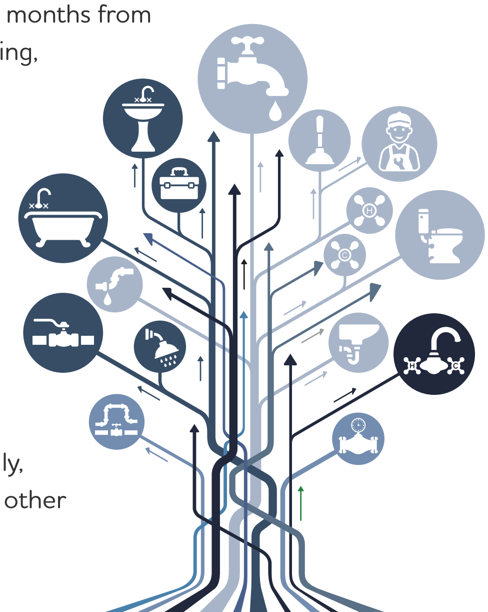
For the most part, all systems have the same categories of operating expenses: the actual cost of water and sewage treatment, operations, maintenance, and administrative costs. It is one thing to know the costs, but another to understand what drives them. Are they fixed each year or variable based on sales? Are we in a mature community in which consumption is decreasing as homes become more efficient or is development adding new users to our system? How much will a dry summer impact the system compared to one with a lot of rain? It is important to break down the costs and consider the answers to these questions before beginning to consider changes in rates. The more variation in consumption, the greater the need to maintain adequate working capital reserves to cover fixed costs if consumption does not meet expectations.

3. Consider Other Cash Outflows

After evaluating your costs, it is necessary to consider those cash outlay items that don't show up on a system's income statement because they only impact the balance sheet: debt service principal payments and capital improvement outlays. Debt service principal requirements are relatively easy to project using amortization schedules. For capital improvements, we recommend creating a plan that covers the next five to 10 years and details the needed purchases for equipment and vehicles as well as infrastructure projects. Once the future needs are known, determine whether they will be paid in cash or funded with debt. If paid from cash reserves, begin planning for them now in order to ensure enough is on hand at the time the purchase will be made.

4. Establish Adequate Reserves

As alluded to before, there's more to maintaining a fiscally healthy water and sewer system than simply being able to pay the bills. A strong system also maintains an adequate amount of cash on hand for operations and emergencies. There is no working capital reserve amount that is right for every system, but a common benchmark is 60 to 120 days of operating costs. Most systems have to pay providers monthly and employees twice monthly whereas collections from customers can lag many months from the date of usage, to billing, to ultimate collection. For an emergency replacement reserve, it is recommended to have 1–2 percent of the net book value of capital assets (net book value equals original cost less accumulated depreciation). Additionally, some systems may have other



required reserves based on debt agreements or orders from the Environmental Protection Agency. When setting rates, it's important to consider not only cash outflows, but also amounts that should be kept on hand. Rate-setters should also be careful not to accumulate excessive reserves. For the most part, today's customers should only be asked to pay for today's costs (plus reasonable additions to reserves).

5. Develop a Multi-Year Tool

Clearly there is a lot that goes into setting water and sewer rates. In order to accumulate the information and evaluate the future needs of the system, we recommend creating a multiyear forecast that incorporates all of the items mentioned above. It should be a "living document" that is updated to reflect changes in facts or assumptions. While it may not be necessary to share all of the details with those responsible for approving the rates, they should understand and agree with the key inputs and assumptions. Finally, it should be an objective of the forecast to have the necessary reserves on hand at the end of a number of years. The rate increases needed to achieve those reserves can be smoothed over all years as long as adequate cash is available for operations at all times.

We hope these five keys will be helpful the next time your community begins the process of setting water and sewer rates.

The Bolt Decision

In *Bolt v City of Lansing*, the Michigan Supreme Court developed a test for user charges. In order to avoid classification as a tax, a user charge must "serve a regulatory purpose rather than a revenue-raising purpose."

Rates and charges must also bear a direct relation to the cost of providing the service to the ratepayer. A fee designed to raise revenue for general public services in addition to covering the cost of providing the service which is the subject of the fee is actually a tax. A fee designed to raise revenue from a broad range of users of a system to pay the cost of an improvement to a discrete part of the system which will benefit only a smaller group of users may also be considered a tax.

Revenues derived from user charges (or assessments) must be segregated from other municipal funds and applied solely to the expenses of providing the service or the improvement. The expenses of providing the service may include some indirect costs of providing the service.

(Excerpt, CH 22: Special Assessments and User Charges, Handbook for Municipal Officials, MML, 2015.)

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