FINANCIAL CAPACITY BUDGET SERIES

- **Budgeting Basics**
- The Budget Process
- A Sample Budget

Financial capacity is the ability to acquire and manage sufficient funds to effectively operate and maintain your water system. This handout series is designed to help you develop a sound water system budget, which is the key element to developing financial capacity.

Oregon Health Authority

DRINKING WATER SERVICES

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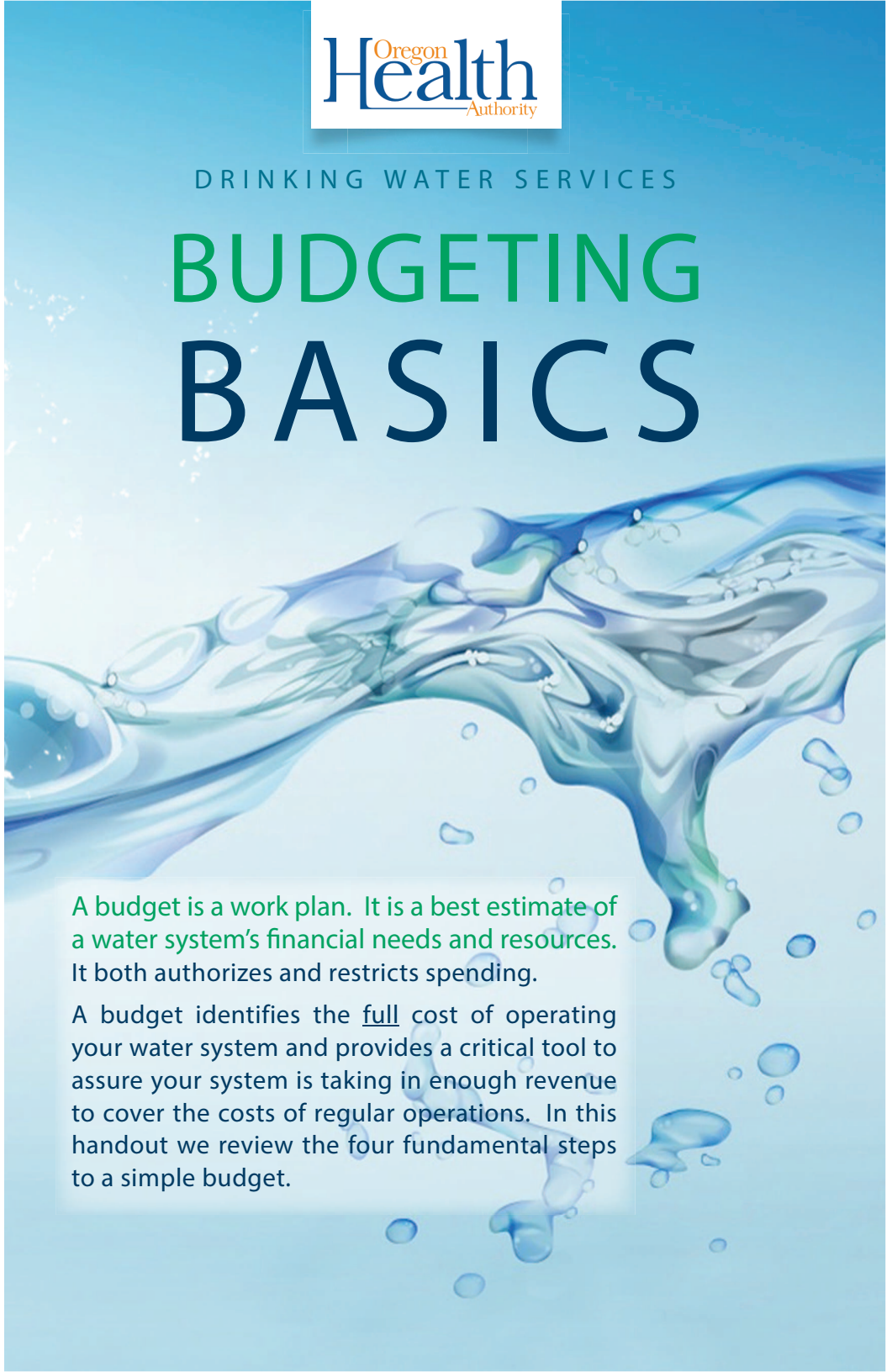
BUDGETING BASICS



A budget is a work plan. It is a best estimate of a water system's financial needs and resources. It both authorizes and restricts spending.

A budget identifies the full cost of operating your water system and provides a critical tool to assure your system is taking in enough revenue to cover the costs of regular operations. In this handout we review the four fundamental steps to a simple budget.

— 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, costs are determined first and income second. As you proceed in the budget process, if income is not adequate to cover your costs, and raising rates to cover the entire gap is not reasonable, it may be necessary to re-visit your cost estimates.

There are numerous ways to categorize expenses related to your water 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; supplies and equipment; rent; insurance; licenses; training; taxes; debt service; external services.

In your budget, it is best to divide your expenses into operating costs and capital costs. This makes it easy to compare costs to revenues.

OPERATING COSTS are expenses that are spent to perform normal water system operations, like salaries, utilities, chemicals, and transportation.

CAPITAL COSTS are spent to acquire assests, e.g., a truck or pipe, when the cost is higher than an established dollar amount and the asset has a useful life of three years or more. It may include investing in an asset to enhance or increase its life.

Note: While defining expenses, it can be useful to label them either as fixed or variable. Fixed costs are costs that must be recovered even if the service is not used (e.g., taxes or insurance). Variable costs are expenses that are directly related to how much water you pump, treat, store and sell (e.g., electricity or chemicals). This can help you in the future when analyzing your rate structure.

STEP 2: RESERVES

Setting aside reserves can mean the difference between a self-sustaining system and one that may fall apart or become financially unstable during a small emergency. If your water system does not have reserve accounts, plan on establishing them soon. Ultimately, the question of how much funds a system will want to reserve is up to the water system'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.

OPERATING RESERVE

An operating reserve compensates for cash flow variations. A 6 week operating reserve is a frequently used industry norm.

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.

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 (usually ~10% of the debt). A Debt Service Reserve provides a reserve source of payment for principal and interest in the event that revenues are unable to cover these obligations (like a rainy day fund).

CAPITAL IMPROVEMENT RESERVE

A capital improvement reserve is for system rehabilitation, long-term equipment purchase/replacement, system expansion, etc. Your system's decision making body should determine the appropriate planning horizon for your water system. Water 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 water system generates. There are two primary revenue categories, operating and non-operating. Operating revenue comes from your core activities of selling water. Non-operating revenue comes from one-time monies.

OPERATING REVENUE INCLUDES:

- Income from monthly service fees *
- Income from water sales

NON-OPERATING REVENUE INCLUDES:

- Interest on checking and reserve accounts
- Meter Installation Charges
- Connection fees and system development charges
- Late payments, penalties and reconnection fees

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

STEP 4: BALANCING THE BUDGET AND ACTUALLY USING IT

The budget balancing process compares estimated revenues against estimated expenses. The amount of revenue (operating and non-operating) should equal or exceed the total annual costs (operating and capital) plus the annual reserve contribution you set aside.

After you balance the budget, you must regularly review the budget – at least quarterly – to assure your predicted costs match your actual costs. If revenues are not keeping pace with expenditures, expenses may need to be reduced or monies may need to be taken out of reserve accounts to balance the budget. Your ongoing vigilance assures your water system will have enough resources to operate next year and for generations to come.