Presentation on Revenue Requirements

Government Finance Officers of Texas

Prepared by:
Bob McLain
McLain Decision Support Systems
1932 Robin Ln
Flower Mound, TX 75028
214-488-8808, bob@mclaindss.com
Revenue Requirements

What factors impact revenues required from rates?

- Number of customers served;
- Customer water use (average consumption per meter billed);
  - Impact of weather;
  - Impact of water restriction policies
- Price elasticity;
- Conservation;
- One-time revenue items;
- Interest rates;
- Capital financing needs;
- Changes to tax laws;
- Inflation;
- Other changes in operating and economic conditions;
- Rate changes!
Two Approaches

CASH NEEDS APPROACH
- O&M Expenses
- Depreciation Expense
- Return on rate base
- Taxes and/or payments to general fund;
  - Reimbursement of administrative charges;
  - Payment-in-lieu-of franchise fees;
  - Payment in-lieu-of-ad valorem taxes.

UTILITY APPROACH
- O&M Expenses;
- Annual debt principal & interest payments;
- Funding of a renewal, rehabilitation, & replacement fund, equal to annual depreciation expense;
- Reimbursement of administrative charges;
- Payment-in-lieu-of franchise fees;
- Payment in-lieu-of ad valorem taxes.
Depreciation Expense

- Depreciation expense is a real part of the cost of running a utility.

Depreciation expense is the loss in value of the infrastructure, vehicles, and equipment.

The funding of this cost-component provides the utility with funds that are available as a source of system replacements, improvements, and expansions.
Rate base is defined to be the value of the assets on which the utility is entitled to earn a return;

The return to the City should be similar to other enterprises with similar risks;

It is proper to include an allowance in the working capital and construction work in progress (CWIP);
Issues to Consider

- Non-rate revenue offsets:
  - Transfers from other funds;
  - Connection revenues (in a fast-growing city, this can be a substantial source of revenue);
  - Impact fees (in Texas, these funds can only be used a particular way - in a fast-growing city, this can be a substantial source of revenue);
  - Interest (minor in recent years, but sometimes can be substantial).
Issues to Consider (continued)

- **Operating reserves:**
  - In Texas, many cities sell 40-45% of their water the last 2-3 months of their fiscal year;
  - Typically, Transfers from other funds;
  - Connection revenues (in a fast-growing city, this can be a substantial source of revenue);
  - Impact fees (in Texas, these funds can only be used a particular way - in a fast-growing city, this can be a substantial source of revenue);
  - Interest (minor in recent years, but sometimes can be substantial).
Concluding Comments

• Typically, if I have to use the “Utility Approach”, I will also use the “Cash-Needs Approach”.

• Ask any City Manager, and they want to know how much money they have to spend on a cash basis – it’s your job to keep him informed. They understand the “Cash-Needs Approach”.