

# MILWAUKEE WATER WORKS

RESEARCH AND ANALYSIS SECTION - LEGISLATIVE REFERENCE BUREAU

EXECUTIVE SUMMARY: 2011 PROPOSED BUDGET

HEARING DATE: OCTOBER 22, 2010

1. **Revenue Shortfall:** Revenues for 2010 could fall \$15 million short of projections because of delays in approval of the department's rate increase application to the Public Service Commission ("PSC").
2. **Curtailed 2010 Spending:** The Water Works has delayed capital spending \$10 to \$11 million during 2010 and throttled back on O&M spending by approximately \$3.4 million to make ends meet in light of its revenue shortfall.
3. **Deficits and Cash Reserves:** The Water Works ran deficits in each of the 3 years from 2007 to 2009 – including capital spending which was entirely self-funded - in the aggregate of \$23.3 million, and depleted unencumbered cash reserves by \$24.6 in the same period.
4. **Payments to the City:** The Water Works paid the City \$29 million for services during 2009, including \$9.5 million in PILOT for the use of City real estate.
5. **Surplus Earnings Payment:** The Water Works will pay the City \$3,000,000 in surplus earnings in 2010, but this surplus earnings payment has been eliminated in the Proposed 2011 Budget.
6. **Cash Reserves:** Unencumbered cash reserves at the beginning of 2010 were \$6.6 million. The Water Works was unable to provide the department's cash balance for this analysis.
7. **Liquidity:** Estimates of cash reserves needed for full liquidity range from \$10 to \$19 million.
8. **Garbage Cart Billing:** The Water Works will be unable to include any new fee for additional garbage carts on the water bill until the second quarter of 2011 because the department will not complete a major software upgrade – currently in progress – until February, 2011.

## Profit & Loss – The Nature of an Enterprise Fund

Although the Water Works submits an O&M budget for Council approval, implying the Water Works is supported by City funding, the Water Works is actually self-supporting – essentially an independent business. No funding flows from the City to the Water Works, but quite the contrary, the Water Works pays the City. In 2009, for instance, Water Works paid the City \$19.5 million for services provided by the City, plus \$9.5 million in PILOT payments for the use of City real estate – a total of \$29 million. In 2010, Water Works is also budgeted to pay the City \$3,000,000 in surplus earnings.

The following chart (FIGURE 1) is a highly simplified summary of operations in recent years to help conceptualize the decline in Water Works' cash reserves.

Gross Profit is simply the amount revenues exceed operating costs. The Deficits in the 5 years shown represent the amount total expenditures for the department's O&M

operations and capital improvements exceed revenues. These Deficits represent “losses” which must be financed with cash reserves. The string of Deficits from 2007 to 2009 indicates Water Works had to withdraw approximately \$23 million from its cash reserves to remain solvent.

At no time has the independent status of the Water Works been more striking than in 2010 operations. The Water Works has throttled back dramatically on operations and capital spending in 2010 because the department is cash-starved – and Water Works is cash-starved because revenues for 2010 are at least \$15 million, and perhaps \$18 million, below estimates – the result of protracted delays in approval of the department's PSC rate increase application. 2010's cash crunch is exacerbated by the fact cash reserves have been drained in recent years to finance operations and capital spending.

FIGURE 1

Water Works - Net Surplus/(Deficit) 5-year Comparison					
	'07 Actual	'08 Actual	'09 Actual	'10 Budget	'11 Proposed
Revenues	\$79,744,297	\$75,513,033	\$76,939,308	\$90,462,000	\$94,124,000
Operating Costs	67,252,804	66,165,760	69,575,284	82,802,804	77,629,906
Gross Profit	12,491,493	9,347,273	7,364,024	7,659,196	16,494,094
Net Capital Costs	(15,411,049)	(17,842,608)	(19,256,986)	(19,630,000)	(20,245,000)
Net Surplus/(Deficit)	(\$2,919,556)	(\$8,495,335)	(\$11,892,962)	(\$11,970,804)	(\$3,750,906)

Assuming the shortfall in 2010 revenues is at the low end and only \$15 million, 2010's projected deficit - losses - loom to nearly \$27 million. The department's unencumbered cash reserves at the beginning of the year were approximately \$6.5 – far short of the needed financing if budgeted operations and capital spending remained status quo.

## Cash – 2010 Operations

The Water Works reacted to the dramatic overestimation of 2010 revenues like any independent business faced with a revenue shortfall and moved to cut both 2010's O&M operating costs and capital improvements spending.

**FIGURE 2** below chronicles the decline of the department's unencumbered cash reserves in recent years which more or less matches the deficits shown in **FIGURE 1**.

**FIGURE 2**

<b>Cash Decline</b>	
Beginning 2007	\$31,174,400
'07 Withdrawals	(2,635,585)
Beginning 2008	28,538,815
'08 Withdrawals	(9,641,983)
Beginning 2009	18,896,832
'09 Withdrawals	(12,332,270)
Beginning 2010	\$6,564,562

The department has cut 2010 capital spending – mostly water main replacements – by \$10 to \$11 million – approximately half the capital spending budgeted. Operating spending is expected to come in approximately \$3.4 million below budget as the department delays equipment purchases (\$1.5 million), reduces overtime (\$900,000) and caps DPW's cosmetic "fix-up" paving of water main repair sites – saving another \$1,000,000. All department personnel have been directed to restrain and delay

spending whenever possible. The department hopes these economy measures will do the trick, and has been assure the City will float the department a loan to finance modest shortfalls.

A potential 2010 shortfall will in part be subsidized by a favorable bond instrument issued midyear. Water Works was authorized in 2008 to borrow \$12.5 million to purchase a Backup Power system. The department bought the system this year, but because the supplier had excess inventory, the department saved \$4 million on generators – and that "extra" \$4 million is available to finance possible 2010 deficits.

## Liquidity

Some sources suggest the Water Works should have 3-months of operating expenses – roughly \$19 million – in cash reserves to be fully liquid. Some say \$10 million would suffice, and the LRB calculates 70 days of receivables or about \$14 million. Unencumbered cash at the beginning of the 2010 was \$6.6 million, and the Water Works was unable to provide the department's cash balance for this analysis.

## 2011 Budget - Recuperation

2011 seems to be the year Water Works starts putting its fiscal house in order. The 2010 Proposed Budget assumes the new, higher water rates applied for by Water Works in September, 2009, will be approved and in full force for 2011. Revenues are projected up \$3,662,000 over 2010's overestimated revenues, suggesting 2011 revenues will likely be \$18,662,000 more that actual 2010 revenues. At the same time, the 2011 Proposed O&M cuts spending over \$5 million – mostly by eliminating the \$3 million in surplus earnings the Water Works is slated to pay the City in 2010.

**FIGURE 3** (below) tracks the budget changes for 2011.

**FIGURE 3**

<b>2011 Budget Changes</b>	
<b>Prior Year Budgets</b>	
2009 Actual Expenses	\$69,575,284
2010 Adopted Budget	\$82,802,804
<b>Wages &amp; Fringe Benefits</b>	
Base Salary	230,121
Fringe Benefits	432,481
Total Changes	\$662,602
<b>Operating Expenses</b>	
Construction Supplies	(361,000)
Infrastructure Services	(940,000)
Other	182,000
Total Changes	(\$1,119,000)
<b>Equipment Purchases</b>	
Computer Peripherals	(232,000)
Industrial Trucks/Vehicles	(1,696,000)
Other	(355,500)
Total Changes	(\$2,283,500)
<b>Special Funds</b>	
Debt Service	1,173,000
Pension Contribution	(606,000)
Surplus Earnings Transfer	(3,000,000)
Total Changes	(\$2,433,000)
TL Changes Proposed	(\$5,172,898)
2011 Proposed Budget	\$77,629,906

By maximizing revenues and minimizing O&M spending, the Water Works seems to be rejuvenating its balance sheet. With net capital improvement expenditures of \$20,245,000, **FIGURE 1** shows 2011 will end with a modest deficit of \$3,750,906. Water Works plans to borrow \$4,045,000 to cover this shortfall, depositing the unused \$294,094 in cash to begin building the department's cash reserves.

## Surplus Earnings

Water Works will pay the City \$3,000,000 in surplus earnings in 2010, but no surplus earnings payment is budgeted for 2011.

The Common Council may appropriate surplus earnings from the Water Works provided sufficient surplus earnings remain to pay one year of debt service on outstanding bonds. By recognizing the \$3,000,000 of surplus earnings as revenue in the 2010 Budget, the City was obliged to appropriate it so long as the Water Works reserves for debt service – which it does. By eliminating the surplus earnings payment to the City from Water Works' 2011 budget, the City can, but is not obliged to, appropriate any earning surplus in 2011 in excess of debt service.

## Other Budget Changes of Note

Other 2011 Proposed Budget changes of note not highlighted in **FIGURE 3** are:

- Meter Services and Field Operations payroll is down over \$700,000 as a result of staffing changes made possible by consolidating repair crews at the department's Tower facility.
- Energy was down \$300,000 in the Requested Budget due to improved operating practices – but came in \$169,000 over 2010's budget level after the department was notified of a 13.7% increase in 2011 utility rates. The Water Works does not hedge contracts for utility purchases.
- Information Technology Services is down \$1.2 million because the department is completing an extensive upgrade customer service software package in February, 2011.

- Water Works' PILOT increases steady each year. 2010 PILOT is projected at \$10,440,000, and 2011 is projected to up \$860,000 to \$11,300,000.

## Rate Case – Revenue Shortfall

The Water Works expected its rate increase application – submitted in September, 2009, - to be granted by the PSC by April, 2010. Instead, the rate increase has not been granted as of this analysis, and there is a good chance it will not be granted until January, 2011 – causing a revenue shortfall of at least \$15 million from 2010 projections.

The delay in this rate case is primarily due to the Water Works' wholesale customers – cities which buy water from Milwaukee and resell it to their residents – which have vehemently lodged their objections to the PSC.

The Water Works requested a blended rate increase of 28.5% for its Milwaukee retail customers and 36% for its wholesale customers. The goal was to achieve a rate of return as defined by the PSC of 5.2%. The PSC's target rate of return for the Water Works is 7.5%. The Water Works' rate of return has been steadily declining in recent years from 1.97% in 2007 to 0.97% in 2008 and in 2009 went negative at -0.69. 2010's rate of return is also expected to be negative.

The Water Works expects to be granted the rate increase. Part of the problem has been that the PSC has allocated the department's 36% overall increase for wholesale customers by individual city based on costs, so a city's individual rate change may be higher than 36%, and some cities are up-in-arms

over the size of their rate increases. Mequon's increase will be 51%, New Berlin's 40%.

These wholesale city customers also see red over the possibility of the Water Works paying the City \$3,000,000 in surplus earnings – often erroneously labeled a dividend – which they see as “subsidizing” Milwaukee. Any payment of surplus earnings was not included in the Water Works' cost structure used by the PSC as the basis for its rate-setting, but protesting wholesale city customers either do not understand this fact, or choose to ignore it.

## Garbage Cart Billing

If fees for additional garbage carts are approved, these fees will appear on residential water bills. Water Works billing software allows new fees to be readily added to the a resident's water bill, but because the Water Works is in the midst of a major software upgrade which cannot be interrupted without jeopardizing the integrity of the upgrade, and will not be completed until February, 2011, the Water Works will not be able to include the new fee on water bills until the second quarter of 2011.

The Water Works may incur additional costs as a result of adding this new fee to the water bill – a possible onetime cost to increase processing capacity to accommodate DPW's garbage cart database, and an additional handling charge per invoice if a water bill, which already contains a long list of non-water fees, increases a page in length due to the addition.

## AMR Project

The Water Works is in the second year of a 6-year project to replace all 161,000 Automatic Meter Readers in its network. This will create a “baseline” of

reliable, easy-to-read meters to ensure customers are accurately billed for water consumed. Once this baseline is established, Water Works will institute a replacement cycle based on the expected useful life of meters and batteries.

Meter replacement is budgeted for \$3.6 million in 2011 plus \$150,000 for capital spending (included in the overall O&M and capital improvements budgets). This is down from 2010's O&M budget of \$3.7 million and \$1.25 million for capital improvements.

## Capital Improvements

The proposed capital improvements budget for 2011 is up 3% per **FIGURE 4** below.

**FIGURE 4**

Capital Improvements Budget Comparison		
	'10 Budget	'11 Proposed
Water Mains	\$15,400,000	\$15,800,000
Treatment Imp.	480,000	1,875,000
Pump Facilities	3,600,000	1,650,000
Buildings & Other	550,000	1,320,000
Total	\$20,030,000	\$20,645,000

\$3,720,000 in additional capital spending was initially requested but cut from the proposed budget as detailed in **FIGURE 5** below.

**FIGURE 5**

Proposed vs. Requested	
Water Mains	(\$1,720,000)
Treatment Imp.	(350,000)
Pump Facilities	(400,000)
Buildings & Other	(1,250,000)
Total	(\$3,720,000)

## Issues of Concern

- Liquidity to operate efficiently based on cash reserves.
- Setting, establishing and maintaining appropriate cash reserves levels.
- Management of and need for future rate increases.
- Sustainability of surplus earning appropriations.
- Ways of improving Water Works' "business" management skills versus its "City department" management skills.
- Borrowing all or a portion of capital improvement expenditures.