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Enhancing Your Utility's Long-Term Financial Sustainability & Resilience through Cash Reserves.

Personal financial advisors often recommend that families should have enough money in an emergency fund to cover at least three to six months of living expenses. Corporations such as Microsoft, General Electric and Home Depot maintain excess operating funds for their own business reasons. Why should water utilities be any different?

Quite frankly, they aren't different. In fact, emergency funds or utility cash reserves for a water utility are required to meet the operational, maintenance and capital needs of the utility while providing a necessary service 24 hours a day, every day of the year. Here, we'll review operating reserves. Capital reserves, debt service and rate stabilization reserves will be discussed in a future article. It is recommended that water utilities establish either formal or informal financial policies regarding utility cash reserves.

Operating Reserves

Having an adequate level of operating reserves improves a water utility's ability to respond to seasonal fluctuations in revenues brought on by droughts or significant rain events, mitigate potential risks such as major emergency repairs or natural disasters, as well as provide working capital needs. Revenue-backed debt includes bond covenants often requiring a minimum required operating reserve that must be maintained by the utility.

A few of the key considerations are discussed below for setting the appropriate level of operating reserves for your utility. Please bear in mind that some of the considerations listed may not apply if a utility has developed other specific reserves (namely Capital Reserves, Debt Service Reserves, or Rate Stabilization Reserves).

Credit Rating Objectives. Operating reserves that are not restricted are a key consideration that credit rating analysts utilize when determining a utility's bond rating. Each rating agency has its own criteria for credit rating evaluations. Generally speaking, the greater the amount of unrestricted operating reserves for a utility, then the greater the opportunity for a higher credit rating (and thus lower interest costs).

Availability of Other Reserves. Many utilities maintain several specific reserves (Capital, Debt Service and Rate Stabilization) that can be used to mitigate financial challenges. The existence of these other reserves need to be considered when determining the size of your utility's operating reserves.

Non-Utility Resources. The level of operating reserves could be affected by resources available outside your utility in emergency conditions such as general fund cash for publicly-owned water utilities or cash from affiliate entities for investor-owned utilities.

Bond Requirements. Bond covenants often require minimum levels of operating reserves that must be maintained in addition to debt service reserves.

Insurance Requirements. Insurance policies often require that reserves be held by the utility, and these reduce the level of operating reserves needed as a result of emergencies.

Rate Structure. The use of conservation rates (revenues generated by higher usage blocks are at risk of not materializing) and pass-through rates (recovery of raw water costs) affect the level of needed operating reserves. In addition, the more revenue generated from volumetric rates as opposed to fixed components affects the level of operating reserves needed.

Customer Usage Variability/Seasonal Cash Flow. Changes in customer usage brought on by weather, conservation, and economic factors affect the level of operating reserves for the utility.

Billing Frequency. Utilities utilizing a lower frequency of billing (bi-monthly or quarterly versus monthly billing cycles) should consider higher levels of operating reserves since expense incurrence leads revenue collection by greater dollar amounts.

Strength of Bill Collection Policies. A utility with stronger collection policies would need a lower level of Operating Reserves due to lower levels of receivables and past due accounts.

System Size. Financial risk and economic changes have a more dramatic effect on smaller utilities so they would need a higher relative level of operating reserves.

Age of System and Customer Concentration. Older utility systems have a greater likelihood of unplanned emergency repairs and those with an increased customer concentration (a small number of customers that generate a majority of the revenues) cause the utility to have a higher level of risk (and thus higher levels of operating reserves needed) than newer systems and utilities with less customer concentration.

Use of Contingencies. Utilities that budget for contingencies may affect the level of operating reserves needed.

Metrics for Evaluating Operating Reserves

The metrics commonly used by utilities for evaluating the level of operating reserves are: Days (or months) of operating expenses, a specific dollar amount, or a percentage of revenues. Each utility selects the best metric for its given circumstances.

The following are the minimum recommendations for utilities cited from several organizations:

- **Water Environment Federation (WEF):** One to three months of operating costs depending on instability of revenues and expenses.
- **International City/County Management Association (ICMA):** One to two months of expenses depending on size, challenges faced, and the availability of special reserves.
- **Government Finance Officers Association (GFOA):** No less than 45 days of annual operating expenses including depreciation expense.

Each utility is unique and operates under a special set of circumstances that must be considered when selecting the type of cash reserves and the corresponding policies to best meet the utility's objectives and requirements. A utility should consider adopting a formal reserve policy to help guide and govern the decision maker's actions while providing greater clarity to the investment community. Having a formal policy must always be weighed against informal policies as there are benefits from greater flexibility with an informal policy.

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*Editor's Note:

This article provides a summary of the recent AWWA Rates & Charges Committee report, "Cash Reserve Policy Guidelines," and the Journal AWWA article titled Utility Cash Reserves from April 2018. The "Cash Reserve Policy Guidelines" report provides a more comprehensive review of reserve policy considerations, as well as case studies providing examples of various reserve policies from utilities across the United States. Click here for more information.

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