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Capital Projects:

Savings or Debt?

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So what can smart utility managers do to walk this fine line between debt and savings financing? A wise strategy may be to use a combination of both debt and savings.

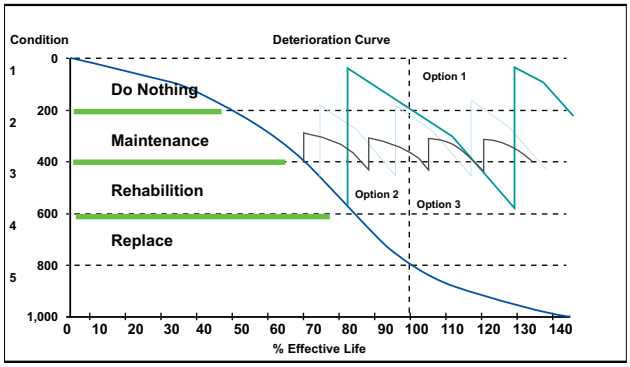
MANY UTILITIES STRUGGLE with the question of whether they should pay for capital projects with savings or debt. Although this question seems fairly straightforward at first, there are many nuances that cause this to be one of the toughest decisions many utilities managers will face. Each community has their own unique strategy based upon what their customers are willing to pay and what the political climate will tolerate.

Paying with debt

When a waterworks decides to pay for capital projects **with debt** it often means that they will delay necessary maintenance until the infrastructure (pipes, pumps, buildings, etc.) has to be completely replaced. This allows them to build a solid case for funding and also allows them time to build the reserves needed to back debt for the large project. In this scenario, if current rates only cover day-to-day operations and not substantial repairs, the rates would need to be increased to cover the new cost of debt payments. This can be a real problem when the political climate is opposed to rate increases or when the rates have already been increased to pay for debt related to past projects. In some cases the rates can become so expensive that collection of revenue from the customer's water bills becomes difficult. Many private utilities are regulated by the State Corporation Commission (SCC) and in order to raise their rates, they must navigate a SCC rate case, which takes tremendous time and effort. (Commonwealth of Virginia State Corporation Commission) Rate increases to offset debt are so difficult to obtain that many may assume private utilities would chose to finance all projects with savings instead.

Paying with savings

Paying for capital improvement projects **with savings** means the utility has access to enough cash to cover the both the routine rehabilitation projects needed to extend the life of the infrastructure and reserves to pay for larger infrastructure projects.



(Portland Water Bureau, 2016)

As the above graph indicates, small investments in infrastructure rehabilitation at the right time can extend the life of the infrastructure. This can allow the waterworks to continue to build its CIP reserves for a longer period of time since the existing equipment is lasting longer. The reality, though, is that many utilities only collect enough revenue from water bills to cover their operations cost. This provides little or no savings left to extend the life of their infrastructure by routine rehabilitation projects. It also leaves them completely dependent upon debt for the eventual replacement of this infrastructure.

Disincentives to building savings

There are often disincentives to building savings for either debt service or for cash savings to pay for repairs and improvements.

Private utilities are discouraged from maintaining savings due to tax implications. This is even more complicated for private utilities that have to get approval from the SCC prior

to increasing rates. In order to raise rates they have to hire an attorney and submit an extensive application to the SCC. It is not unusual for the SCC to negotiate for lower rate increases on the behalf of citizens, which leaves the private utility with less potential revenue with which to plan for upgrades. Unlike debt, savings are counted as part of the profits of the private utility and those savings (in excess of expenses) get taxed as corporate profits. The taxes on those profits eat into shareholder returns for publicly traded companies as well as the final sum available to put into reserves. One private utility owner indicated that his savings gets taxed at 45 percent. (Rossi, 2016) This makes it very difficult to pay for projects with savings and causes most private utilities to rely extensively on debt.

While **municipal utilities** do not share the tax implications that private utilities face, there are still disincentives in the form of increased rates for customers, the threat of the savings being raided for other political projects, and the potential for the loss of the manager's job for appearing to stock his treasure trove at the expense of the citizens. Although municipal utilities do not have to worry about taxes on savings, they have to be concerned about the customers' ability and willingness to pay the increased bills needed to build adequate savings. If the utility charges too much, it may be a hardship on their fixed income customers. There also may be customers that refuse or neglect to pay their bills when they get more expensive. This creates problems including additional expenses for collecting past-due bills as well as the absence of much-needed water revenue to pay for routine expenses. Political backlash can also be a concern. In some instances the political climate can get so heated about the topic of raising rates that utility managers are fearful of losing their jobs.

Governing boards and local politicians may not be willing to increase rates just to build the coffers of savings. It can be hard for a utility manager to justify the need for savings large enough to cover a capital improvement project. If they do begin to build the reserves, it can be re-allocated to a different group or the general fund for the municipality, which leaves the utility unable to make the needed upgrades. Utility managers can protect their savings from being raided with proper asset management and capital improvement planning. These plans identify the

state of infrastructure, list what infrastructure needs to be rehabilitated or replaced, the date this work is planned to occur, and how it will be paid for. This ties the savings directly to projects in the community, which indirectly ties it to voters that will suffer if savings is redirected to other projects or business units.

A blended strategy

A blended debt-savings strategy is often the best way through the pitfalls identified above: Save enough to pay for rehabilitation projects that extend the life of infrastructure, and save enough extra to provide collateral or bond reserves for debt needed to pay for replacement projects. This strategy would need to be tied to solid asset management and capital improvement plans that provide the evidence of their need to governing boards and customers. This will also provide protection against borrowing the utilities savings for other projects.

Summary

So what can smart utility managers do to walk this fine line between debt and savings financing? A wise strategy may be to use a combination of both debt and savings. Savings can be used to rehabilitate and extend the life of infrastructure can keep the rates lower for customers longer, and can also provide the collateral and bond reserves necessary to leverage debt for the larger projects when needed. In order to know how much savings a utility needs, it is necessary to complete an asset management and capital improvement plan that details the rehabilitation and replacement projects necessary for the utility's foreseeable future. Using this information, the manager can devise a savings and debt strategy that directly ties to these projects and the voters benefited by them. The plan may indicate that larger projects will be paid for by debt with corresponding rate increases to cover the debt payments. Just like a good trial defense for a court case, a good savings and debt strategy provides all of the evidence needed to convince the jurors, or in this case the utility board, that the strategy provides the best stewardship of their customers current and future money.

Works Cited

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