

TFG
THE FOSTER GROUP

P.O. BOX 26282
LEAWOOD, KS 66225
TEL: (913) 345-1410
FAX: (913) 345-1640

THE FOSTER GROUP, LLC
BART FOSTER, PRESIDENT
CELL: (913) 530-6240
BFOSTER@FOSTERGROUPLLC.COM

MEMORANDUM

FY 2021 Budget Schedules
Update

January 14, 2020

To: Nicolette Bateson

From: Bart Foster

This memorandum has been prepared to address two questions regarding the preliminary FY 2021 budget schedules presented at the December 19, 2019 Audit Committee meeting. Together with the accompanying exhibits, this discussion is designed to provide clarity on:

- The calculation of budgeted investment earnings for FY 2021 compared to FY 2020;
- How the budgeted revenue requirement for “operating reserve requirement” is calculated.

Investment Earnings

The budget process for estimating investment earnings has traditionally been quite simple. The financial forecast prepared as part of the budget establishes estimated year end balances in the various Funds dictated by the Master Bond Ordinance (“MBO”). The budget process applies an estimated average earnings rate to the year-end balance in each fund. Earnings on the Construction Bond Funds are required to remain in those funds, and are therefore not eligible to be treated as revenues.

The calculations for budget FYs 2020 and 2021 investment earnings are shown in Exhibit 1 to this memorandum. The “balance for investment earnings” figures shown on Line 1 are simply the year end balances in revenue generated funds, as set forth in Lines 4 through 26 of the table. Applying estimated average earnings rates on Line 2 yields the estimated investment earnings on Line 3.

Based on information provided by GLWA Treasury and PFM, an interest rate of 2.5% was used for the FY 2020 Budget, reflecting estimated earning potential at the time. The corresponding figure for the FY 2021 Budget is 1.5%. This lower rate is the principal cause for the “negative variance” in budgeted investment earnings for FY 2021. The Water figures are also impacted by a lower overall estimated fund balance, as Improvement and Extension (“I&E”) are applied to finance capital improvement projects.

Operating Reserve Requirements

The other open question relates to the decrease in amounts budgeted for the Water operating reserve revenue requirement. GLWA is required by the MBO to maintain at least 30 days of budgeted O&M in the O&M Fund. It is also required by the Trust Agreement supporting the MBO to deposit the next month's O&M requirements into that fund on the first day of the month. So in essence the minimum required balance in the O&M Fund is 60 days of budgeted expenditures. For purposes of financial planning and forecasting, GLWA has established a target balance in this Fund of 120 days of operating expense, effectively to establish an "operating reserve", which works in tandem with the I&E Funds to provide liquidity to the utilities.

Exhibit 2 illustrates the calculation of the budgeted revenue requirements necessary to maintain the operating reserve at the 120 day level. In simplest terms, an increase in budgeted O&M would lead to a corresponding increase in the operating reserve budget requirement. However, there are some complexities in recent budget developments that complicate the matter.

The original FY 2020 Budget request for the Water System included an increase of almost 10% in operating expenses, and a corresponding 10% increase in the operating reserve requirement – which would require a \$3.976 million contribution during the FY 2020 budget year. During the review process, the O&M budget was reduced by \$2 million at the request of the Board. However that was the only element of the budget that was adjusted. All other revenue requirements were held constant, including the operating reserve requirement.

A similar nuance is apparent with the FY 2021 Water budgeted amounts. The original budget target established in November assumed a 2.0% increase in O&M expense, and a corresponding 2.0% in the reserve requirement. Subsequently the preliminary O&M budget was revised to reflect a 4.3% O&M increase. However we did not initially modify the budgeted reserve requirement.

The cadence of the budget adjustments for both years discussed above illustrate the confusing nature of a "budget to budget" comparison on this item. Review of this matter has identified an opportunity to refine final FY 2021 budget amounts regarding the operating reserve and revisit how such amounts are computed in future budgets.

We note that contributions to the operating reserve and to the I&E Fund are somewhat "fungible" as both provide liquidity to the utilities, and impact calculations of debt service coverage, days cash on hand, and related metrics. From a flow of funds perspective amounts that are not maintained in the Operating Funds would be directed to the I&E Funds.

We are prepared to discuss this matter at your convenience.

Review of Budgeted Investment Income

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Water				Sewer			
	<u>FY 2020</u>	<u>FY 2021</u>	<u>Variance</u>	<u>% Variance</u>	<u>FY 2020</u>	<u>FY 2021</u>	<u>Variance</u>	<u>% Variance</u>
1 Balance for Investment Earnings (Line 26)	363,331,100	319,121,000	(44,210,100)	-12.2%	347,354,400	352,932,700	5,578,300	1.6%
2 Estimated Investment Earnings Rate	2.50%	1.50%	-1.00%	-40.0%	2.50%	1.50%	-1.00%	-40.0%
3 Estimated Investment Earnings	9,084,200	4,786,800	(4,297,400)	-47.3%	8,730,800	5,294,000	(3,436,800)	-39.4%
<u>Operating Fund</u>								
4 Beginning Balance	42,803,500	46,779,500			67,301,100	67,301,100		
5 Deposit from Operations	3,976,000	876,600			0	0		
6 Ending Balance	46,779,500	47,656,100	876,600	1.9%	67,301,100	67,301,100	0	0.0%
<u>Budget Stabilization Fund</u>								
7 Beginning Balance	2,000,000	2,000,000			5,000,000	5,000,000		
8 Deposits / (Withdrawals)	0	0			0	0		
9 Ending Balance	2,000,000	2,000,000	0	0.0%	5,000,000	5,000,000	0	0.0%
<u>ER&R Fund</u>								
10 Beginning Balance	27,520,400	27,520,400			44,000,000	44,000,000		
11 Transfers from Revenues	0	0			0	0		
12 Ending Balance	27,520,400	27,520,400	0	0.0%	44,000,000	44,000,000	0	0.0%
<u>I&E Fund</u>								
13 Beginning Balance	232,865,300	226,729,200			77,209,700	94,541,800		
14 Transfers from Revenues	30,098,600	25,343,000			26,706,400	47,936,100		
15 Other Deposits						19,288,300		
16 Budgeted Capital Outlay	(10,125,300)	(17,892,000)			(20,122,200)	(20,481,100)		
17 CIP Expenditures	(45,000,000)	(75,000,000)			0	(50,000,000)		
18 Ending Balance	207,838,600	159,180,200	(48,658,400)	-23.4%	83,793,900	91,285,100	7,491,200	8.9%
<u>Total Revenue Generated Funds</u>								
19 Beginning Balance	305,189,200	303,029,100			193,510,800	210,842,900		
20 Net Sources and Uses	(21,050,700)	(66,672,400)			6,584,200	(3,256,700)		
21 Ending Balance	284,138,500	236,356,700	(47,781,800)	-16.8%	200,095,000	207,586,200	7,491,200	3.7%
<u>Other Funds</u>								
22 Bond Reserve	20,969,800	20,969,800	0	0.0%	64,796,500	64,796,500	0	0.0%
23 Bond Redemption (Avg)	58,222,800	61,794,500	3,571,700	6.1%	82,462,900	80,550,000	(1,912,900)	-2.3%
24 Construction Fund	35,307,100	50,037,700	14,730,600	41.7%	49,433,200	54,191,100	4,757,900	9.6%
25 Total Funds	398,638,200	369,158,700	(29,479,500)	-7.4%	396,787,600	407,123,800	10,336,200	2.6%
26 Subtotal w/o Construction Funds	363,331,100	319,121,000	(44,210,100)	-12.2%	347,354,400	352,932,700	5,578,300	1.6%

Review of Budgeted Operating Reserve Requirement

	(1)	(2)	(3)	(4)	
	<u>FY 2020 Budget</u>		<u>FY 2021 Budget</u>		
	Original	Potentially Revised	Original	Potentially Revised	
	<u>Plan</u>	<u>Plan</u>	<u>Plan</u>	<u>Plan</u>	
WATER					
<u>O&M Expense Budget</u>					
1	Prior Year	121,562,600	121,562,600	131,490,500	131,490,500
2	Current Year	133,490,500	131,490,500	134,120,300	137,127,300
3	Increase	11,927,900	9,927,900	2,629,800	5,636,800
4	% Increase	9.8%	8.2%	2.0%	4.3%
5	Reserve Requirement - Days	120	120	120	120
6	Reserve Requirement - %	33.3%	33.3%	33.3%	33.3%
<u>Reserve Requirement</u>					
7	Prior Year	40,520,900	40,520,900	43,830,200	43,830,200
8	Current Year	44,496,800	43,830,200	44,706,800	45,709,100
9	Increase	3,975,900	3,309,300	876,600	1,878,900
10	% Increase	9.8%	8.2%	2.0%	4.3%
SEWER					
<u>O&M Expense Budget</u>					
11	Prior Year	191,079,400	191,079,400	191,079,400	187,057,200
12	Current Year	187,968,700	187,057,200	190,798,300	184,946,100
13	Increase	(3,110,700)	(4,022,200)	(281,100)	(2,111,100)
14	% Increase	-1.6%	-2.1%	-0.1%	-1.1%
15	Reserve Requirement - Days	120	120	120	120
16	Reserve Requirement - %	33.3%	33.3%	33.3%	33.3%
<u>Reserve Requirement</u>					
17	Prior Year	63,693,100	63,693,100	63,693,100	62,352,400
18	Current Year	62,656,200	62,352,400	63,599,400	61,648,700
19	Increase	0	0	0	0
20	% Increase	0.0%	0.0%	0.0%	0.0%