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Robbing Peter to Pay Paul? Enterprise Fund Transfers are Not Recommended

By Sterling L. Carroll, P.E., FRWA Engineer

Belt Tightening, Reduced Tax Revenues and Budget Cuts. The sound of belt tightening is being heard all across Florida beginning at the state capital and progressing to counties and cities. This is the result of Amendment One passing on January 29, 2008. Amendment One, which increases the “Save Our Homes” Homestead Tax exemptions, is drastically reducing tax revenues. The state legislature will be struggling with budget short falls during the current session and soon cities and counties will be wrestling with the same problems. As public officials find themselves in a financial bind they will be looking for other sources of funding.

One ray of hope from Governor Crist’s budget message¹ is his proposal to provide 26.2 million in assistance to fiscally constrained counties *“for revenue loss to be offset beginning with local governments’ fiscal year, which runs from October 2008 to September 2009. The first distribution to these counties will be made in July 2009.”* The legislature would have to include this provision during this session for the counties to see the assistance.

A “fiscally constrained county”² is defined as a county in which a one mill property tax rate will raise no more than \$5 million in revenue annually or within a rural area of critical economic concern as designated by the Governor. About thirty (30) counties currently qualify as “fiscally constrained

counties” under this definition: Baker, Bradford, Calhoun, Columbia, DeSoto, Dixie, Franklin, Gadsden, Gilchrist, Glades, Gulf, Hamilton, Hardee, Hendry, Highlands,³ Holmes, Jackson, Jefferson, Lafayette, Levy, Liberty, Madison, Okeechobee, Putnam, Sumter, Suwannee, Taylor, Union, Wakulla, and Washington.⁴

Don’t expect these funds for counties to find their way to cities (authorities, non-profit associations, or special districts) or to take pressure off of enterprise funds.

What is an Enterprise Fund? An enterprise fund is a separate accounting and financial reporting mechanism for municipal or county services for which a fee is charged in exchange for goods or services, such as a public-owned water and wastewater utility.

Public Trust and Accountability Regarding Water and Sewer Revenues. A primary benefit for public ownership of water and wastewater

utilities is the ability to return the profit ordinarily collected by a private entity to the customer in the form of lower rates. The question for a governing board to address is what constitutes a reasonable return and what does the utility need for its proper long-term operation. As an issue of public trust and accountability, revenues collected from water and wastewater ratepayers should be spent on utility operations.

Simply stated, ratepayers should get what they pay for, services. Enterprise fund monies constitute a public trust. Transfers of those monies from utilities into to general fund pose a problem of accountability for the entities and elected officials. Monies collected for a specific public service and

then redirected for unrelated purposes should naturally become a subject of public scrutiny and debate.

FRWA Recommendation for the Long-Term Health of Water and Wastewater Systems. Florida Rural Water Association (FRWA) believes the public is best served by self-sustained enterprises adequately financed with rates based on sound engineering and economic principles. The analysis should identify the true costs of providing services in the long-term.

Rates and fees collected must be sufficient to maintain level of service, cover expenses, fund capital outlays, retire debt, and support reserves (debt-service, repair and replacement, minor capital projects, infrastructure reinvestment, and emergencies).

We recommend cities and counties resist the urge of balancing the budget on the backs of ratepayers. Citizens and businesspersons, if they knew about it, would be critical of raiding the water and wastewater funds to balance the general fund and may regard this type of practice as a hidden tax in the wake of Amendment One.⁵ The increased scrutiny by taxpayers may be an opportunity for enterprise fund managers to hold the line and protect the public interest, stewardship, and system sustainability. It's happening in other cities like San Diego and Los Angeles.⁶ The Los Angeles Department of Water and Power was denied a summary motion to increase water rates 6% because part of the rate would be used to "provide a property related service" described in a recent California property tax amendment.

One may conclude the message from voters was to reduce taxes and not to shift the burden to other areas to make up for property revenue loss.

Ask the hard questions. Utility managers should be asking themselves several hard questions particularly during the upcoming budget cycle. ⁷ *Do my rates currently provide adequate revenues to adequately cover all the operation and maintenance requirements of the utility? Have we accounted for every cost and future eventuality?*

***Simply stated,
ratepayers should get
what they pay for,
SERVICES.***

- Salaries and Wages
- Employee Fringe Benefits
- Power and Chemicals
- Minor Equipment
- Contract Services

- Engineering
- Laboratory Tests
- Auditors
- Legal Services
- Office Space
- Fittings and Materials
- Supplies
- Other General Overhead
- Debt-Service Reserve
- Repair and Replacement Reserve
- Minor Capital Projects Reserve
- Infrastructure Reinvestment Reserve
- Emergency Reserve

Your evaluation may just uncover the "inconvenient truth" that current water and wastewater rates do not fully cover all the operating costs. Perhaps they fall short of capturing actual capital costs since there is not adequate investment into the infrastructure. This situation is all too common for water and wastewater systems.⁸

Grants are NO Substitute to Proper Utility Operation. Too many public officials and managers anticipate future grants to "bail them out" when the plant and piping becomes run down and needs replacement. With this "entitlement mentality" it is just too easy to neglect existing facilities and run them into the ground instead of being proactive in their repair and replacement. Problems with this approach are: (1) cost

for replacement is several times greater than for repair and maintenance; (2) real cost of utility operation is hidden from the ratepayer and governing board; (3) assets are not properly valued and preserved; (4) improper stewardship of public assets; (5) grants never cover all replacement costs; (6) diversion of public funds from more worthy uses; and (7) today more than ever, counting on grant funding is very precarious.

Self-Sustaining Utility Enterprises.

Enterprise funds are run on a business model, which means they are self-sustaining entities, relying on rates and fees without subsidies given to or received from non-utility operations.⁹ Revenues collected for services support the enterprise fund. Water and wastewater utility accounting is properly separated from the general funds.

Periodically (every 3 to 5 years) the fund and rate structure should be evaluated by the governing body to determine if it is truly self-sustaining and meeting public objectives. This evaluation should ensure that revenues earned, expenses incurred, and net income are adequate for capital maintenance, infrastructure reinvestment, public policy (level of service, health and safety), management, etc.

FRWA staff assists dozens of medium to small systems with rates and fees annually, and experience has shown that most small water and wastewater systems are under funded and do NOT have adequate revenues to cover the true costs of providing services in the long-term. Utility rates are too low and transferring funds from these already under funded operations in order to support the general fund may seem like a good short-term fix, but it is a recipe for disaster. Enterprise fund transfers

are not good public policy and are not in the best interest of the ratepayers.

Enterprise Fund Accounting.

Government accounting practices have not historically included the funding of depreciation, which is essential for the long-term sustainability of enterprise funds. The accounting activity for major asset depreciation is the essential first step in infrastructure reinvestment -- reporting the changing value of infrastructure assets such as water and sewer treatment plants, pipelines, storage tanks, concrete structures, and similar long-lived assets.¹⁰

This movement began as early as the 1970's when a common complaint was levied against federal, state and local governments regarding the lack of infrastructure maintenance.

Enterprise funds should adopt and use the

Governmental Accounting Standards Board (GASB) financial reporting standards.¹¹

These accounting standards are designed for state and local governments, and define the Generally Accepted Accounting Principals (GAAP), which governments must adhere to in order to receive clean audit opinions. The specific standard is GASB Statement No. 34 – Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments, or more commonly known as GASB 34.¹²

GASB 34 "requires that governments report their capital assets in a statement of net assets and requires that the report show the depreciation in value of those assets. Specific asset reporting requirements include: (1) depreciation of assets must begin when the asset, equipment or facilities are acquired or put into service; (2) accumulated depreciation for all assets must be reported; and (3) assets acquired

Experience has shown that most small systems are under funded and do NOT have adequate revenues to cover the true costs of providing services in the long-term.

To this being done?

or built prior to 1980 are not required to be reported.”¹³ Utility professionals should become acquainted with these standard accounting practices and ensure financial personnel are using them.

Expensing City or County Staff and Expenses that Support Enterprise Funds.

A proper accounting activity is the legitimate identification and expensing of support functions in other departments that support enterprise fund activities. Legitimate expenses include items such as computer support, billing, accounting, fleet maintenance, office space, or other activities “provided for water utility operations, and the like. Since inclusion of expenses for such services in the total revenue requirements would be proper if the utility were operating independently, it is also appropriate when the services are furnished by an associated government entity.”¹⁴

A fraction of the city / county commission, manager, assistant manager, attorney, clerk, financial director, financial department, and information services may handle enterprise fund business a portion of each month. This is a form of subsidy to the enterprise fund, and as a consequence the true cost of services provided to residents and businesses could be understated, if not recovered.

It would be appropriate to expense those items to the Enterprise Fund and credit the cost for those line item expenses to the city / county’s General Fund as payment for support services rendered.

The caveat here is these are actual legitimate expenses, not a free-for-all

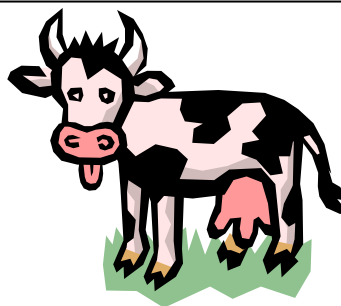
charging against these accounts, but realistic charges for the operation of the utilities. The charges should be reasonable and pass the ‘straight-face test’. The charges should be no higher than those the utility could obtain out in the competitive market if it were a private enterprise. Further the enterprise fund manager should have the ability to refuse charges for services not requested or required for efficient utility operation. These expenses should be carefully accounted for in the budget and handled according to Generally Accepted Accounting Principals.

Enterprise Fund Transfers. One utility director privately remarked at the ever-increasing transfers to the general fund as, “the city has found its cash cow. Now it’s going to milk it dry until the marrow is sucked out the bones.”¹⁵

Unfortunately the transfer of enterprise monies from a government-owned utility to the general fund is common throughout Florida.¹⁶ The largest cities have some of the largest transfers in Florida.¹⁷ One rationale is the city’s inability to obtain ad valorem tax revenues from tax-exempt state or university property, offices and operations.

The question of legality of enterprises fund transfers was explained by a former staff member of the Office of the Chief Inspector General who worked in the Financial Services Auditor group with local Florida governments for over thirty years on matters of accounting systems, financial reporting, and financial emergency conditions. “There is no statute or administrative rule that would restrict

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such inter-fund transfers. There may be restrictions in individual bond covenants but that wouldn't stop most local governing boards.”¹⁸

Equity issues are raised on these types of transfers to the general fund by non-residents that receive water or sewer services. Florida law allows up to a 50% surcharge on water and sewer rates for customers outside of city limits. *When a city transfers a portion of enterprise funds to the general fund these customers outside of city limits provide monetary support to the transfers at a 150% rate compared to the in-city customers* – yet they are not voters and do not have a formal voice in the running of city government.¹⁹ *The question of legality would be stretched to the limit and the city may be opening itself up to a court challenge.*

“One particularly troubling aspect of these statements is the use of transfers among funds. Monies can be moved from one fund to another without affecting the overall assets of a jurisdiction, but if transfers are not carefully noted, they may appear as expenditures in one fund and as new assets or receipts in another fund. These transfers need to be clearly identified not only to avoid confusion but also to provide important operation about a government’s operations. Transfers may indicate that enterprises are subsidizing general government operations, ... to support a city’s general fund. This type of transfer may be welcome relief to local taxpayers but may raise concern among [customers and enterprise fund managers].”²⁰

So the reasons to keep the utility under city control are the same reasons not to tax it as a public service – just as you would not tax the police or fire services.

Payment in Lieu of Taxes. Unfortunately some municipal governments have incorporated a charge that would normally be collected in *ad valorem* taxes if the utility were a private entity. This practice is

questionable and equates to a hidden city tax on city services. The city would be essentially taxing itself. The American Water Works Association manual of practice for rate setting includes this less used form of transfers – that of payment to the general fund in lieu of taxes.

The stated principle is that a city or county would normally collect utility or franchise taxes from a private-utility (just as they do from power, cable, telephone, and gas utilities) and these taxes could be equivalent to the actual tax rate or about five-percent (5%) of total revenues. *“Other cash revenue requirements that may be required to be financed from water system revenues might include payment to the general fund for items such as payment in lieu of taxes, gross-receipts taxes, or a dividend payment. Such additional requirements depend on each local situation and should be considered where applicable.”²¹*

This practice violates the original mission for public ownership of a water and wastewater utility. The

rationale for creating a public entity may have included the following essential objectives: (1) health and safety of citizens; (2) protect most vulnerable residents (aged, young, poor health, economically disadvantaged, etc.); (3) ability to return the profit ordinarily collected by a private entity to the customer in the form of lower rates; (4) provide fire protection; (5) tool to expand the tax base; (6) ability to shape, facilitate or control growth; and (7) promotes home rule and self determination.

The utility provides essential services and is a city asset. The city has the option of privatizing the utility at any given date, but a private owner would have diverging interests from the city. So the reasons to keep the utility under city control are the

same reasons not to tax it as a public service – just as you would not tax the police or fire services. If, however, the argument is compelling for treating it as a private entity -- it might be best to privatize it.

Summary and Recommendations. Florida Rural Water Association recommends cities and counties resist the urge of transferring a portion of enterprise funds to balance the budget. Citizens and businesspersons, if they knew about it, would be critical of the diversion of funds collected specifically for water and wastewater services. This is an issue of public trust and accountability ratepayers should get what they pay for, services.

Florida Rural Water Association believes the public can be served best by self-

sustained enterprises adequately financed with rates based on sound engineering and economic principles. Rates and fees collected must be sufficient to maintain level of service, cover expenses, fund capital outlays, retire debt, and support reserves (debt-service, repair and replacement, minor capital projects, infrastructure reinvestment, and emergencies).

Transfers only exacerbate problems with infrastructure replacement, will in the long run result in exorbitant utility rates and charges, and represent a mismanagement of public stewardship. Cities and counties do have a fiduciary responsibility to run these enterprises as separate self-sustaining service entities.

[This article is the FIRST in a series of five articles on utility operations \(1\) Enterprise Fund Transfers are Not Recommended; \(2\) The Impending Infrastructure Expenditure Gap \(3\) What is an Enterprise Fund & How does it Operate? \(4\) Ratemaking Decisions in Florida's Public Water and Wastewater Utilities; and \(5\) Setting Capacity Charges for Water & Wastewater Systems](#)

ENDNOTES

- 1 The Crist / Kottkamp Administration Fiscal Year 2008-09 Budget Recommendations, www.peoplesbudget.state.fl.us
- 2 **Section 218.67 Florida Statutes – Distribution for Fiscally Constrained Counties.** (1) Each county that is entirely within a rural area of critical economic concern as designated by the Governor pursuant to s. 288.0656 or each county for which the value of a mill will raise no more than \$5 million in revenue, based on the taxable value certified pursuant to s. 1011.62(4)(a)1.a., from the previous July 1, shall be considered a fiscally constrained county.
- 3 *"County Wants Governor To Keep His Promise"*, **Highlands Today**, Jim Konkoly, February 20, 2008 and *"Did Crist Pull A Fast One On Highlands County?"* Highlands Today Editorial, February 21, 2008
- 4 **House of Representatives Staff Analysis**, Bill #: HB 293, Fiscally Constrained Counties, Sponsor(s): Pickens, <http://flhouse.gov/SEctions/Documents/loaddoc.aspx?FileName=h0293.FT.doc&DocumentType=Analysis&BillNumber=0293&Session=2006>
- 5 **Digging into City Hall's money mess - Managing or manipulating?** San Diego lacks consistent checks and balances to monitor its tapping of funds from service fees to pay for day-to-day operations, *San Diego Union-Tribune*, Jennifer Vigil and Lori Weisberg, April 9, 2006
- 6 **Trial looms in transfer of DWP funds**, Beth Barrett, Los Angeles Daily News February 26, 2008, http://www.dailynews.com/ci_8362651?source=rss_emailed, and opinion by CA Political News by Stephen Frank, **L.A. Hack Mayor Antonio Stealing Water Money to Balance Budget**
- 7 **Water Rates**, AWWA Manual M1, Fourth Edition, 1999, American Water Works Association, p. 2
- 8 *"This has been an all too common experience for FRWA's ratemaking professionals."* Gary Williams, Executive Director FRWA
- 9 **Water Rates**, AWWA Manual M1, Fourth Edition, 1999, American Water Works Association, p. 77
- 10 **Governmental Accounting Standards Board (GASB)**, News Release, March 16, 2006, Norwalk, CT, Users of Governmental Financial Reports Require Substantially Different Information than Users of Business Financial Reports - GASB White Paper Identifies Key Differences between Financial Reporting for Governments and For-Profit Business Entities
- 11 **Governmental Accounting Services Board's (GASB) Statement #34: Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments.** <http://www.gasb.org/tech/index.html>
- 12 **GASB White Paper: Why Governmental Accounting and Financial Reporting Is -- And Should Be -- Different**, www.gasb.org/white_paper_mar_2006.html, p. 26-27
- 13 Lee, et. al., **Public Budgeting Systems, 8th Edition**, (Jones & Bartlet Publishers) 2006, Table 2-4, p. 510-513
- 14 **Water Rates**, AWWA Manual M1, Fourth Edition, 1999, American Water Works Association, p. 2
- 15 Verbal statement to author about increasing transfers to the City general fund from the enterprise operation.
- 16 Based on extensive FRWA experience with systems throughout Florida. Also see, Lee, et. al., **Public Budgeting Systems, 8th Edition**, (Jones & Bartlet Publishers) 2006, Table 2-4, p. 431-432, 443
- 17 Verbal comment to author from a retired Assistant General Manager for Water and Wastewater Systems at a large system.
- 18 Statement to author on the subject of the legality of enterprise fund transfers by a former staff member of the Office of the Chief Inspector General. This expert (now retired) worked in the Financial Services Auditor group with local Florida governments for over thirty years on matters of accounting systems, financial reporting, and financial emergency conditions.
- 19 **Florida Statute 180.191 Limitation on Rates Charged Consumer Outside City Limits** -- Allows an automatic surcharge of 25% of rates, fees, and charges to consumers outside the boundaries without a public hearing and up to 50% if the city can justify the charges and holds a public hearing, the burden of proof would then fall upon the customers outside the boundaries if they have *"reasonable grounds to believe that any municipality is about to engage, in any act or practice prohibited by subsection (1), a civil action for preventive relief, including an application for a permanent or temporary injunction, restraining order, or other order, may be instituted by the person or persons aggrieved."*
- 20 Lee, et. al., **Public Budgeting Systems, 8th Edition**, (Jones & Bartlet Publishers) 2006, Table 2-4, p. 443
- 21 **Water Rates**, AWWA Manual M1, Fourth Edition, 1999, American Water Works Association, p. 2-3