

DEPRECIATION



Operators, take note – depreciation defines your job. As facilities wear out, you fix them. When you cannot fix them anymore, facilities should get replaced. So, tell your management to handle depreciation right.

“Depreciation” is just a term. But funding depreciation – turning a figure into money in the bank – makes it useful. That money may pay all repair and replacement (R&R) costs as they come due. There might even be cash left over to partially fund capital improvement program (CIP) costs, too. Some states recognize the usefulness of funded depreciation and require applicants to do it to get their grants and loans.

Funding depreciation is a great idea. If a system does nothing else to prepare for R&R and CIP, calculating and saving annual depreciation is a good, simple method of amassing some cash. Fully funded depreciation will only be a down payment on future CIP costs, but one must start somewhere.

Funded depreciation has its weaknesses for municipal-owned utilities:

- ❖ Depreciation looks backwards – facilities bought in past dollars. CIP happens in the future, in inflated dollars.
- ❖ Current ratepayers, using simple logic, think they

Depreciation, as it is commonly handled, is a paper transaction based on a straight line. “Paper transaction” meaning no money is deposited anywhere. It’s just a number on “paper.” “Straight line” meaning the total invested is divided by the number of years the asset is assumed to be useful to arrive at the annual amount of depreciation. Think: \$10,000,000 divided by 40 years = \$250,000 annual depreciation.

should only pay the current costs of providing service to them. If a utility is funding depreciation, which means it is charging for it, many current customers could pay in for decades, die and never see the fruits of their payments.

- ❖ Many municipal utilities were and still are paid for at least partly with federal and state grants and subsidized loans. Will that continue in the future? And at what level? No one knows. Somehow you must coordinate funding of depreciation with getting grants and subsidized loans. All other things being equal, and they are not, it is better to save too much than to save too little.

Consider some situations:

- ❖ A system is built with debt, and it funds depreciation, too. Through their rates, current customers pay current costs (debt payments), plus they “pay it forward” into a CIP reserve for future customers. Do those ratepayers think that is fair? Do they feel all supportive and warm about being “double-charged?” Will they say, “Double-charging is not logical,” or maybe something more colorful?
- ❖ A system funds depreciation. When CIP time comes the system gets a big grant and an interest-subsidized loan (effectively a partial grant). Thus, current customers paid into a future CIP fund, but those costs get (at least partially) paid by a grant and interest subsidy. Now what is to happen to any leftover CIP fund money? More troublesome...
- ❖ A system funds depreciation. When CIP time comes the system applies for a grant and interest-subsidized loan. But the grant/loan agency says, “Sorry, you have lots of cash, no grant, no interest subsidized loan for you.” Make that situation even worse. The system that saves ahead serves poor people and gets turned down for funding. But another system serves better off people, it does not save, and it gets the grant and loan.

On the municipal-owned utility rates front, rates should be set to pay actual costs – operating, debt, payments to reserves, whatever. Those costs need to be real, or at least a best estimate of what the current portion of a likely but difficult-to-tie-down cost would be.

Management of each system needs to decide what is right for their system, but they should consider these things to start:

- ❖ Build some savings into the rates to prepare for paying at least the upfront costs of doing a replacement or expansion. (Call it “depreciation” if you like.) All systems should amass the dollars they will need to pay engineers to design a fix, pay bond and legal advisors to determine how to fund the fix, and maybe pay a few other upfront expenses. They should amass additional savings for operating reserves, R&R reserves, and debt coverage reserves, so they can show the grant and loan agencies they are good planners, making them good credit risks and grant candidates.
- ❖ Management should set rates that are fairly structured. That is hard. To do it, either be a rate analyst, or hire a rate analyst.
- ❖ When replacement/expansion time is approaching, if the utility is a good candidate for grants and subsidized loans and time is not short, apply. Otherwise, arrange for best-fit market-rate municipal bonds or leases. Don’t

Rate Analysis and Training for Environmental Systems

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waste time waiting for a grant that will not happen. Grants have a shelf-life. Wait for a 15 percent grant for three years when infrastructure construction inflation is five percent per year and the grant value has “expired”.

- ❖ As soon as management can see what the likely funding mix will be, build the annual cost of that funding into new rates, structured fairly, of course. Most systems can have a good idea of what the funding mix will be two, maybe three years out. Then, set rates. Getting a two- or three-year jump with new (higher) rates is not too onerous to ratepayers and it really helps to reduce rate shock.

Nearly all capital improvements are paid for by borrowing all, or at least part of CIP costs. Debt works well to distribute CIP costs over time to current customers. Add funded depreciation and other savings to the mix, collected fairly, and you are on your way to sustainability.

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