by John J. Haas, President, Ranson Financial Consultants, L.L.C.

The DOW at 12,000 – does it really matter?

The Dow Jones Industrial Average (DJIA) ended above 12,000 for the first time on Thursday, October 19, 2006 – a day after breaking the 12,000 barrier for the first time. By the time this article reaches readers, it may be higher yet, or somewhat lower. The Dow Jones Industrial Average is one of many measurements of how the stock market is performing. The DJIA is the average price of the stock of 30 of the most capitalized and recognizable companies in the United States. Some of these companies include General Electric, Intel, Microsoft and Wal-Mart. I recommend that you check out Bloomberg.com on the Internet to learn more the DJIA, specifically and the stock market, generally.

John Haas, President Ranson Financial Consultants, LLC

The stock market and local units of government

So what does this mean for cities and rural water districts? Well, the stock market affects local units of government due to the competition of capital (money). Generally speaking, capital will flow in and out the bond market and stock market in an inverse relationship. This means that when money is flowing into the bond market it is going out of the stock market and vice versa. As capital flows into the stock market due to expected higher total returns relative to the bond market, then the bond market will have to increase interest rates to attract money back into it. As the DJIA has reached 12,000, there may be an expectation for it to continue to go even higher. Therefore, local units of government have to pay higher interest rates to attract capital to finance necessary improvements. On the other hand, if the stock market would "tank," then there would be a flight to safety. This means there would be a greater demand for safe investments, and interest rates would go down. No matter what happens in the stock and bond markets there are always winners and losers. It just depends if you are an investor or a borrower at any given change in the markets.

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Paying off debt

The Kansas Rural Water Finance Authority (KRWFA) and Ranson Financial Consultants have been receiving questions lately regarding the advisability of local units of government paying off their debt. The answer to the question is "it depends." If your water utility system is not generating sufficient revenue to meet its bond covenants, and there are sufficient funds to pay off debt, then I would recommend paying that debt down or off. However, if there are sufficient revenues to meet bond covenants and the system has sufficient funds to pay off the debt, then the answer is still "it depends." If the interest rate on the city's or RWD's debt averages around 4.00% and you can invest your funds at an interest rate of 5.00%, then we would recommend not paying off debt. If the interest rate differential between the city or RWD's borrowing rate and investment rate is 1.00% and the city or RWD has $1,000,000 of investments, then the city or RWD will earn $10,000 a year taking advantage of the differential. If the entity has debt with an average interest rate in excess of 5.00% then I would recommend refinancing the existing debt and still keep the cash. Later on in this article, I will discuss the differential between investment and borrowing rates. I encourage you to call me at 316/264-3400 if you need assistance with this analysis.

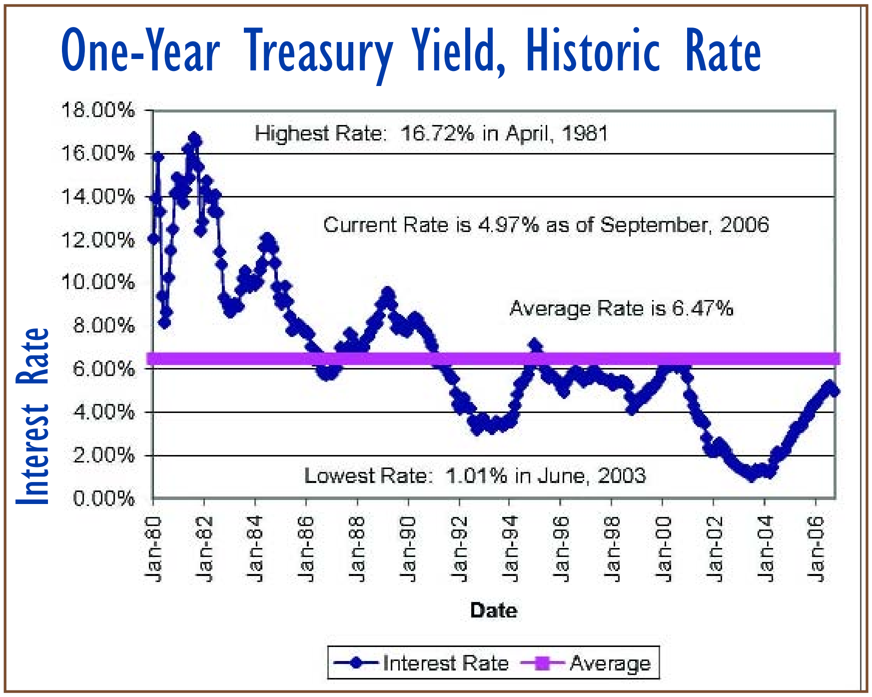
Financial Integrity Assurance Contract (FIAC) and annual audits

The Kansas Rural Water Finance Authority is under contract with the Kansas Department of Health and Environment (KDHE) to service the Financial Integrity Assurance Contract (FIAC). Local Units of

Government that cannot secure borrowing via the Kansas Public Water Supply Loan Fund (KPWSLF or the Loan Program) with its tax base (e.g. rural water districts) or are small systems that in need of assistance are required to participate in FIAC. FIAC was designed to allow small borrowers to obtain loans at the same low interest rates as larger borrowers. Through FIAC, the KRWFA reviews quarterly financial reports and annual audits to make sure these borrowers maintain compliance with covenants of the Loan Program. Ranson Financial Consultants, LLC (Ranson) is under contract with KRWFA to review and comment on the annual audits.

During the annual review of the audits it was noticed that a number of cities and RWDs did not meet state statutes regarding the investment of public funds. Kansas statutes require any investments in excess of Federal Depository Insurance Corporation (FDIC) limits ($100,000) to have securities pledged for the excess amount (K.S.A. 9-1402). Within several audits, it was stated that these entities had amounts in excess of FDIC insurance at some time during the year. This exposes these investments to the bank's ability to pay back "excess" deposits instead of the federal government – a huge credit differential. This leads us to another significant point: one rural water district, after reading our report that it had been in non-compliance, called to advise that they had been in compliance. Evidently, once the audit was completed the auditor did not take the time to review it with the governing body. Otherwise, the governing body would have caught the "mistake." Or was there even a discussion? Or did anyone look at the audit report? My suggestion is to always have the auditor review the annual audit report with management and the governing body. This is a good time to discuss what has been done correctly and what needs to be improved regarding the finances of the system.

The timing of when the audit is completed and presented to the governing body is another very important issue. If you do not have last year's audit report in time to help prepare the next



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year's budget, then management and the governing body are pretty well just shooting in the dark. It is very important to use independently verified numbers (the audit report) as the basis for next year's budget. It is money well spent to encourage the auditor to have the audit report completed prior to the date the budget is completed. Many local units of government delay the delivery of the audit because they are encouraged to do so by the auditor charging lower fees.

The audit should also demonstrate compliance with all bond and loan covenants. Our recent review of 30 plus FIAC-systems indicated that almost 20 percent of the audits were silent about these covenants. Of the 80 percent that noted compliance, almost a fourth of those did not demonstrate how the water utility system was in compliance. This job then falls to KRWFA to determine if the RWD, public wholesale district or small city is in compliance or not. Because of this we have to make certain assumptions that the auditor should know as facts. If we make the wrong assumptions then we may mistakenly demonstrate the system's non-compliance with its covenants. In addition, commercial and investment banks may also make the same mistakes when evaluating your system's credit when borrowing from the bond market; thereby costing your customers' money due to borrowing costs in the form of higher fees and interest rates. It is very important that the audit reflects your RWD's or city's compliance with its covenants.

When a city's general obligation debt gets to be over 50% of direct debt, or 60% of direct and indirect debt (which includes school districts, counties and other legal public entities with overlapping boundaries), many of the commercial banks will no longer bid on its new issue of general obligation bonds. The interest rate the city pays will be higher if commercial banks will no longer bid on its debt.

Affordability

There are two issues regarding affordability: the amount of debt that the local unit of government (water utility system) can afford versus the population of the local unit of government (customers of the water utility system). Affordability comes fto a basic analysis: debt service coverage ratio and debt to assessed valuation. Rural water districts are usually required to have a debt service coverage ratio of 125%. This means for every $1.00 of debt service the system needs to generate a $1.25 of revenue available for debt service. Revenue available for debt service is defined as gross revenues, less operating expenditures (which does not include depreciation or interest expense). In simplest terms, the debt service coverage ratio is the ratio of the annual net operating income compared to the annual debt service (principal and interest). Cities usually have a debt service coverage ratio of 100% if it borrows from the Kansas Public Water Supply Loan Fund or issues

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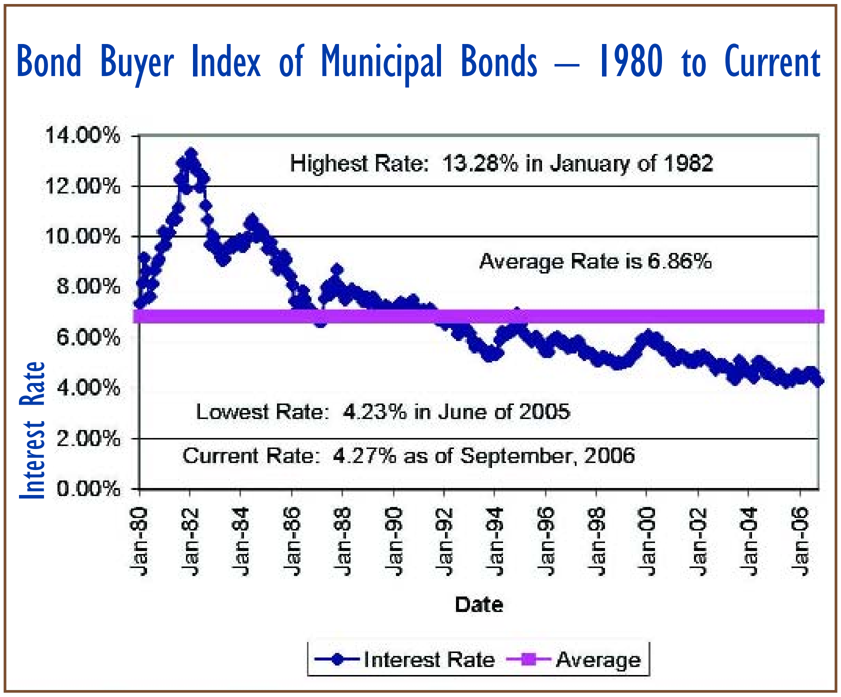
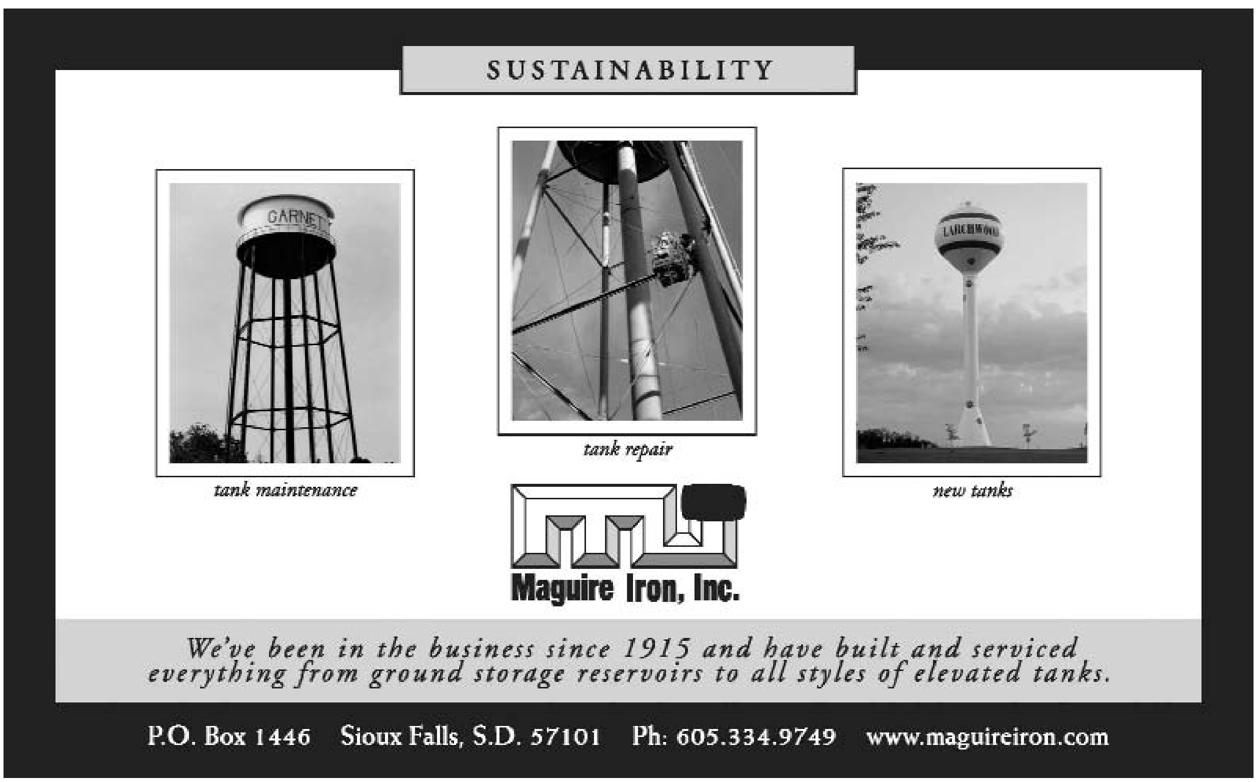
general obligation bonds. I recommend, however, a debt service coverage ratio for cites of at least 110% to make sure that in any one year the system generates sufficient revenue to pay all of its expenses. If a city issues revenue bonds it is also subject to a debt service coverage ratio between 120 and 125%.

Cities that issue general obligation bonds for utility improvements also have to be concerned about the debt to assessed valuation. The statutory limit of general obligation debt is thirty percent of equalized assessed valuation. If the city's equalized assessed valuation is $5,000,000 – then its debt limit is $1,500,000. Generally speaking, however, a city's general obligation bonds issued for improvements to a utility are not subject to the debt limit, but these bonds are subject to a city's overall credit analysis. For example, if a city's equalized assessed valuation is $5,000,000 and has $1,000,000 of general obligation bonds outstanding for street improvements and $2,000,000 of outstanding general obligation bonds for water improvements, then it is within its statutory debt limit. Its ratio of debt to equalized valuation, however, is 60%. When a city's general obligation debt gets to be over 50% of direct debt, or 60% of direct and indirect debt (which





includes school districts, counties and other legal public entities with overlapping boundaries), many of the commercial banks will no longer bid on its new issue of general obligation bonds. The interest rate the city pays will be higher if commercial banks will no longer bid on its debt.

This issue of *The Kansas Lifeline* also contains an article by KRWA President Dennis Schwartz who writes about the affordability (rates charged) for water. This year we have noticed a substantial increase in contacts with rural water districts and cities requesting water rate reviews. The cost of water continues to accelerate at a rapid rate. This increase in cost, unfortunately, needs to be passed along to customers. As a wise person once told me "Even if you are a non-profit entity – if you do not show a profit you will not be one for very long." Don't be surprised if the average cost of 5,000 gallons doesn't exceed $35 a month if you live in a city and $50 a month if you are served by rural water within the very near future. Like gasoline the water customer will pay for it, basically at any price. But once it hits these amounts your system can definitely expect conservation measures to be implemented by the consumer.

Another ratio that is looked at is debt per capita. Many cities are what I refer to as "in-betweeners." In-betweeners are those cities that need to issue debt to grow, but place a high potential burden on the existing population. If direct debt per capita exceeds $1,500 or indirect and direct debt per capita exceeds $3,500, then you can expect the city's credit risk to increase, which reduces the chance that a commercial bank will bid on debt. Again, this causes the cost of borrowing to increase.

Kansas Public Water Supply Loan Fund Historical Interest Rates

Kansas Public Water Supply Loan Fund
Historical Interest Rates

Month	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
January		4.25	3.98	4.73	4.37	4.08	3.91	3.80	3.60	3.60
February		4.15	4.00	4.77	4.25	4.11	3.92	3.73	3.58	3.57
March		4.09	4.00	4.80	4.13	4.14	3.89	3.68	3.53	3.53
April		4.09	4.04	4.77	4.11	4.15	3.86	3.62	3.56	3.53
May		4.15	4.05	4.69	4.15	4.16	3.81	3.69	3.58	3.58
June		4.17	4.09	4.69	4.18	4.18	3.69	3.82	3.56	3.62
July		4.15	4.16	4.68	4.21	4.13	3.59	3.97	3.46	3.67
August		4.12	4.25	4.65	4.19	4.08	3.60	3.99	3.42	3.68
September		4.10	4.35	4.52	4.11	4.01	3.78	3.90	3.43	3.63
October		4.07	4.44	4.45	4.08	3.92	3.92	3.78	3.44	3.54
November	4.31	4.00	4.58	4.44	4.04	3.89	3.97	3.66	3.49	

Kansas is leading the nation with the ability to leverage the EPA grant by a 4-to-1 ratio. For every one dollar of EPA grant the Kansas program can provide four dollars of loans. As of September 30, 2006 small systems have received 104 of the 150 loans (69%) for a total of $124,184,008.07 of the total $334,759,998.06 (37%) committed in loans. Systems serving a population of 5,000 or fewer are classified as small systems under the Kansas Public Water Supply Loan Fund.

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The bond market

Since my article on interest rates in the March 2006 issue of *The Kansas Lifeline*, we have seen some important changes in the bond market, which are favorable to local units of government. Short-term rates continue to climb (investment dollars) and long-term rates continue to go down (borrowing dollars). It is my opinion that the bond market cannot get any better than this! Local units of government can actually borrow money at an interest rate that is less than it can invest money.

Investing your money

Since March 2006 the yield (the implied interest rate) on the One-Year T-Bill has risen from 4.77% to 4.97%. In some months it went over 5.00%. This is an increase of 20 basis points. This means a local unit of government should be receiving higher returns on its investments as compared to six months ago. The average yield on the One-Year T-Bill since 1980, however, declined from 6.51% to 6.47% (a quirk of statistics). As you can see in the One-Year Treasury Bill Chart on page 27: "One-Year Treasury Yield – Historic and Average Rates," the yield on the One-Year T-Bill continues to climb to its historic average. This increase in the rate on the One-Year T-Bill can be directly correlated with the Federal Reserve's continued increase in the discount rate. Six months ago the discount rate was 4.75%; it is currently 5.25%. Many prognosticators anticipate one more Fed rate hike this year with a decline starting next year. Therefore, it is important that you lock in a portion of your idle funds for as long as possible. Six months ago I had predicted a 5.00% T-Bill interest rate for some time next year – I guess it came a little early.

Borrowing money

The interest rate as reflected in the Bond Buyer Index of Municipal Bonds has also increased since my article in March – but just barely. Previously, this interest rate was 4.26%. Currently, the interest rate is 4.27% – only a one basis point increase. The chart on page 29, the "Bond Buyer Index of Municipal Bonds – 1980 to Current," demonstrates that borrowing costs are still significantly less than the 26-year average (6.86%). Therefore, if required, it is still a good time to borrow money. And, with short-term investment rates exceeding borrowing rates (4.97% vs. 4.27%) I would recommend staying as liquid as possible. The best scenario would be to borrow for as long as possible with a short redemption feature. This would allow your city or RWD to call debt if either investment rates or borrowing rates go down.

The Kansas Public Water Supply Loan Fund (KPWSLF)

While other rates have increased, the interest rate on the KPWSLF has actually gone down since March. As of October 2006 the interest rate was 3.54% – down from 3.60% in March. With minimal closing costs and a below market interest rate (3.60% vs. 4.27%) the KPWSLF is the best option to finance your water system's next improvements. The sidebar on the previous page, "Public Water Supply Loan Fund – Historical Interest Rates," demonstrates that since its low of 3.42% in September 2005 the interest rate of the KPWSLF has remained fairly consistent. KRWA's Web site does an excellent job of tracking historical interest rates on the KPWSLF since 1997.

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Final thoughts

I never dreamed I would be happy paying $2.00 a gallon for gasoline, but a reduction from $3.00 per gallon has received a joyous response from all over the United States. In March we had $70 barrel oil. Today, that same barrel of oil is about $60. If energy costs continue to go down, or at least stay even, then the economy will continue to grow and the stock market will go up. Borrowing rates should remain fairly static for the next six months. We will see.

In closing, I also want to encourage you to attend the 2007 Annual KRWA Conference at Wichita, March 27 – 29. The conference offers excellent opportunities for your board/council and staff to attend training sessions on finance and the various funding options for water and wastewater improvements or expansion. Meanwhile, if you have specific questions, I encourage you to contact the KRWA or Finance Authority or me directly.