



City of Detroit  
Water & Sewerage Department  
Financial Services Group

Date: January 7, 2015

To: James Fausone, Chairman

From: Nicolette Bateson, Chief Financial Officer

Re: Update of FY 2015 Budget and Long-term Financial Plan

The financial performance report presented in the December 2014 Finance Committee binder highlighted the second year of a negative water system revenue variance through the first quarter FY 2015 of approximately \$17 million. Conversely, operations and maintenance (O&M) expense categories indicate a positive variance of \$9.7 million for that same quarter. Given that there is a low probability that the negative revenue variance will improve for the remainder of the fiscal year, and that this is not an anomaly, it is important to understand the budget implications and actions to address declining revenues for the present and future years.

**Short-term Response – Cost Containment:** The near term task is ensuring that the FY 2015 budget is amended to offset the declining revenue. Given that DWSD is in a state of optimization, cost containment is a daily focus of the DWSD team. As we are currently performing a detailed analysis in preparing the FY 2016 budget (which inherently includes FY 2015), there are several categories where the DWSD has decreased its budgeted expenses. As the following are ongoing efforts, they explain the positive budget variance through September 30, 2014, but will continue forward to further bring expenses into alignment with revenues for the remainder of the fiscal year.

1. As of November 30, 2014, there is a positive attrition variance of 32 positions.
2. Timing of a number of one-time projects, in particular in the information technology area, have been delayed due to competing organizational priorities. While this is likely a shift from this year to next year, this does provide cash flow relief.
3. There have been a number of procurement activities that are reducing the O&M expense. These include property insurance, inventory management, supplies, savings from increased vendor competition, reduce “as needed” contract procurements, and modernized materials management practices.

It should also be noted that cash as of June 30, 2014 has been designated for one material FY 2015 expense item (estimated bankruptcy fees of \$20 million). The presentation of this item in the December 2014 Finance Committee binder was awkward and will be revised in subsequent financial performance reports.

The process to transform the budget process, within the constraints of the existing systems, began in November 2014. These changes will enable the management team to accurately quantify and report the related dollar amount of these cost containments within the next few weeks. The lack of strong systems does not preclude the analysis, but it does take longer because of the manual work-arounds.

### **Wholesale Revenues**

Wholesale revenue projections have historically been based on volumes within customer contracts. While the merits of that approach were to demonstrate the Department's commitment to the analytics of that process, the long-term unintended consequences of a mismatch between contract volumes for budgeting purposes and realities of declining sales have become evident. In November 2013, the Department and its wholesale sewer system customers reached a leading edge sewer system rate methodology that provides for long-term sustainability of the system and rational predictability of revenues. As that process evolved, the roadmap for a similar dialog with water system customers became evident. That dialog began last spring and is continuing into this rate season.

### **Retail Revenues**

The FY 2015 retail revenue forecast provided more conservative estimates on both volume and offsetting bad debt expense than prior years. The focus on the retail side is assessing the effectiveness of customer engagement to reduce bad debt expense and increase cash flows. As many of these new programs began in the first quarter of FY 2015, preliminary data does not provide sufficient information to highlight specific successes or failures. That being said, the cash flow has improved from customer collections efforts.

### **Long-term Forecasting**

The Department presented its first high-level ten year forecast in April 2013. Internal efforts to continue that were set aside as the priority shifted to the ten-year forecast present by Conway MacKenzie as support to the City of Detroit's Plan of Adjustment. This management team is an advocate of the ten year forecasting model. Stand-up of the Great Lakes Water Authority, including bifurcation of the wholesale and retail systems provide a long list of unknown assumptions. The five year forecast that will be presented in the next few weeks as part of the budget presentation will be based on the "baseline" forecast of DWSD as it is today. That baseline will serve as an important yardstick to measure the cost-effectiveness of new operating scenarios.

### **Cash Flow Forecasting**

The Department has initiated cash flow forecasting which is presently done on a monthly basis and is alignment with the bond trust indenture flow of funds. At the beginning of FY 2015 qualified individuals were engaged to provide detailed, best practice cash flow analysis for the Department. Unfortunately, uncertainty over the Department's future structure undermined the ability to retain those qualified individuals. With the resolution of the City of Detroit's Chapter 9 in December 2014, the uncertainty is reduced. I will present the new Financial Services Group (FSG) organization structure to the Finance

Committee next Monday and will begin an active recruitment to build the missing staff capacity in the FSG.

### **Overall Financial Condition**

The Water and Sewer Systems' Statement of Fund Net Position (a/k/a "balance sheet") has a life-to-date negative fund position. This is a by-product largely of capital asset write-offs, swap terminations, unfunded retiree healthcare, and prior year operating losses; all of which occurred over a number of decades. Reversing this negative net position, on a high level, is based on the following.

1. Building sustainability into the rate structure as achieved by the wholesale sewer rate simplification in late 2013, the existing dialog with wholesale water customers, and establishing retail revenue requirements that are cognizant of collection policies and volume projections.
2. Recognizing that declining volumes are a national trend as outlined in the many presentations from Jan Beecher, PhD, Michigan State University Institute of Public Utilities, which were distributed to the Board of Water Commissioners and others.
3. Effective project management, including engineering, procurement, and finance, to control costly project decisions.
4. Effective debt management to maximize refund opportunities and to shift from heavy reliance on debt to an optimized use of debt and revenue financed capital.
5. Acknowledge that the impacts of the City's financial restructuring will not be recorded until FY 2015 which will eliminate the unfunded retiree healthcare liability and pension certificates of participation liability.
6. Continuing the organizational optimization, energy management, and other related initiatives that were slowed during the City of Detroit's Chapter 9 proceedings.

While the present challenges from financial metrics, system sustainability, and ineffective financial systems are not new, they are certainly fixable and achievable. As the forecast presented in the 2014 water and sewer system official statements demonstrate, the opportunity for significantly improved long-term financial sustainability exists. The Board's ongoing support of the initiatives highlighted in this memo are critical to our success.