ORANGE WATER AND SEWER AUTHORITY

A public, non-profit agency providing water, sewer and reclaimed water services to the Carrboro-Chapel Hill community.

MEETING SUMMARY
Finance Committee Meeting
October 8, 2018, 4:00 – 5:00 PM, in the
OWASA Boardroom

Committee Members:	Ray DuBose (Chair), Robert Morgan, John Young, Yinka Ayankoya (ex-officio)
Other Board Members:	Bruce Boehm (by phone), Jody Eimers
Staff:	Mary Darr, Ed Kerwin, Kelly Satterfield, Todd Taylor, Mary Tiger, Stephen Winters
Public:	None

The Finance Committee met on Monday, October 10, 2018 to review to discuss longer-term approaches and strategies for managing operating expenses.

The six Board members in attendance discussed ways to identify and benchmark expenses that may be able to be reduced through different operating approaches. John Young provided background information (see attached memo from John, "Preliminary Ideas for How to Conduct a Strategic Cost Review").

The Committee agreed that staff will conduct an initial analysis to help the Committee identify areas of OWASA's operations that may be able to be accomplished more efficiently and less costly. The Committee also agreed to meet in the first half of December 2018 to discuss staff's analysis as well as planning assumptions for the Fiscal Year 2020 Budget.

Stephen Winters, CPA
Director of Finance & Customer Service

Attachment: Preliminary Ideas for How to Conduct a Strategic Cost Review (Memo from John Young)

Preliminary Ideas for How to Conduct a Strategic Cost Review

John Young, October 6, 2018

Goals

Earlier this year, when the Board approved the FY2019 budget and the first rate increases in 7 (?) years, some Board members expressed interest in looking at the organization's medium- to long-term cost structure.

Board and staff members share the goal of delivering high-quality services to customers at the lowest possible cost to them. Routine budgeting approaches tend to focus on continuous improvement and short-term costs. (See Appendix, *Why Routine Budget Approaches Won't Address Long-Term Expenses*, for further explanation.) Therefore, we should deploy new tools and focused problem solving to identify operational *innovations* that achieve and sustain long-term affordability for our customers.

The outcomes of a strategic cost review might include special initiatives designed to improve the recurring operating expenses (the cost structure), or new budgeting practices, or both.

For example, major recurring operating expenses include the labor and vehicle costs that are tied to meter readings, activations, and deactivations. The AMI initiative is a strategy that will reduce these recurring expenses (and provide other customer benefits). Are there other strategic business *innovations* we could implement?

Ideas on How to Conduct a Strategic Cost Review

A strategic cost review is appropriate on a periodic basis, but not annually.

A strategic review considers the possibility of business model innovation. It is different than continuous improvement efforts, which generally is a more incremental approach.

We could consider a 3-phase approach:
1. **Perspective**: build a shared understanding that will serve as our platform for generating and evaluating ideas
2. **Possibilities and proposals**: identify potential innovations; select the most promising innovations
3. **Performance**: develop programs to implement the innovations; track progress and improve

Here are some tools we might deploy in each of these phases. This is a menu for discussion; I do not recommend adopting all of the tools:

Tools for **Perspective:**
- A goal- or scenario-based 5-year budget exercise (For example, how would we allocate operating expenses if we held total expenses flat for the next 5 years?)
- "Cost driver" analysis. This means building a tree structure of total costs, then potentially performing a sensitivity analysis of individual tree leaves to find interesting areas for discussion
- A 5-year forecast of major expense line items + a 5-year history (even better to use cost driver tree leaves)
- Benchmarking other organizations (on-site interviews!, phone interviews, surveys, AWWA), especially in key categories identified by the cost driver analysis

Tools and steps for **Possibilities and Proposals:**

- Brainstorming; design thinking
- Prioritizing ideas (many tools)
- Outlining top proposals (many tools)
- Customer value and impact analysis (many tools)
- ROI and/or NPV analysis

Note: currently, we are evaluating retirement savings and health benefits

Tools for **Performance:**

- Program plans (many tools)
- Program-level KPIs, including explicit long-term expenses savings
- Program-level tracking, including long-term budget savings KPI

We are currently tracking, at a program level, the operating savings from the AMI program. Are we doing this for GIS? For Energy Management?

Operating expenses, capital investments, or both?

The review could examine both long-term operating expenses and capital investments. My own focus is primarily directed toward the operating expense cost structure, rather than capital investments, because:

- Capital investments are generally one-time decisions; operating expenses often become routine and built into the baseline of future annual budgets
- OWASA already has a rigorous, effective annual process to screen and prioritize individual capital investment projects. Presumably, the investments selected by the staff and board are required to maintain service levels or they have an attractive ROI (for example, AMI)
- In prior years, we looked at benchmark data for routine capital investments in distribution and collection; our capital investment policies and portfolio of projects are guided by this information
- Deferring a capital investment just postpones the costs; it doesn't actually eliminate them. In addition, some deferrals might increase operating expenses and/or reduce service levels during the deferral period
- Capital investments (hopefully) create assets with long-term value, similar to savings account investments. Operating expenses (hopefully) provide near-term value but generally not long-term value, similar to flying a commercial airplane, with or without passengers in the seats; the funds can't be recovered

Note that some of our innovations to reduce long-term operating costs might require new (more) capital investments. AMI is a great example of increasing capital investment to reduce operating expenses and improve service.

Appendix: Why Routine Budget Approaches Won't Address Long-Term Operating Expenses

Through the annual budget review process, board members probe and review operating expense and capital investment (CIP) budget lines in the coming FY to identify and remove any low-value expenses.

The capital investment discussions are a critical part of the annual budget process. The staff and board ensure one-time capital investments are required to maintain service levels or they have an attractive ROI (for example, AMI). As explained in the last section, *Operating expenses, capital investments, or both?*, the annual CIP probably works pretty well to address the key question: *Are there capital investment items that can/should be deferred or eliminated?*

But what about operating expenses? This portion of the annual review tends to address questions about near-term spending only, such as:

- *Are there extravagant or careless FY operational expenses to reign in?*
- *Are there individual discretionary items in the FY operational expense budget that are unnecessary?*

In OWASA's case, board members generally identify few cuts because the staff manages run-rate expenses effectively and because it is difficult for board members to have the perspective and time to tackle details of the line items.

In these discussions, we don't directly address long-term and recurring operating expenses (the operating "cost structure"). And the information and tools are not focused on the long-term operating expenses outlook.

Furthermore, any FY budget cuts that board and staff members identify generally don't make a material long-term difference. They simply don't add up fast enough and often they can't be sustained for multiple years without affecting service quality.

The annual budget process can be characterized as a continuous improvement approach, which has its merits. However, it does not provide the tools, information, time, and mind space for considering operational *innovations* that would lead to fundamental cost structure changes.