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# THE IMPACT OF FINANCIAL OPERATIONS OF UTILITY COMPANIES ON THE FINANCIAL POSITION OF THE CITY

## ABSTRACT

In this paper, the main topic will be the financing of utility companies and the financial impact on the budget of the local business units. A special emphasis will be placed on the financing of utility companies in Slavonski Brod. The paper defines each area of utility services and presents the utilities as services of public interest as well their privatization in general. The paper reports on the financing of these services and on the European Union regulations and directives concerning them.

In addition, the paper includes an overview of the sources of funding of utility companies and loan opportunities. Guarantees and subsidies are included as financing measures of the activities of communal companies.

The practical part presents an interview with key individuals of the city of Slavonski Brod with regard to the impact of the budget on the financing of utility services of the utility company in this city – “Komunalac Ltd.”.

**Keywords:** Utility companies, financing, Slavonski Brod city, “Komunalac Ltd.”, budget, public interest

## 1. Introduction

Utility companies are not geared to maximize profits, but rather to meeting the needs of users of public services. Actual revenue should be sufficient to cover the marginal operating costs. Utility companies give priority to fulfilling public duties in relation to profits. Therefore, as the owners of utility companies, local governments should control the performance, to encourage rationalization and increase the efficiency of their operations. The utilities sector in Croatia includes the provision of public utility services of interest to individuals and legal entities, and the construction and maintenance of facilities and equipment of communal infrastructure as a comprehensive system in the area of local government units. The utility services sector through the provision of energy supply, water treatment and disposal of wastewater and solid waste provides key prerequisites for improving the quality of life and work of the population and economic entities.

The main aim of the study is to determine the impact of the financial operations of utility companies on the financial position of the City. For the implementation of the main goal of this paper, it presents and analyses the financial performance of utility companies, and especially the funding sources. In order to cover the given topic, primary and secondary publications related to the financial operations of utility companies are used as well as the methodological framework for the analysis and assessment of the financial position of local government units.

The work is divided into three parts. In the first part, the descriptive approach depicts the main features of the utility services and public utilities. The second part exhibits sources of financing of utility companies through the aspect of public prices and fees. Furthermore, there will be mention of subsidizing utility services by the local governments and discussion of the financial performance of utility companies through the impact on the budget of the local unit. The third part presents the impact of the financial performance of utility companies on the budget of local government units through the example of Slavonski Brod.

## 1.1 Methodology

The main features of the utility services shall be explained by methods of description and statistical analysis, in order to calculate selected indicators of financial operations that are based on the budgets of local government units and the financial statements of utility companies. Secondly, the paper will use the methods of interviews that will be conducted with officials of the local public administration, and the executives of selected utility companies.

## 1.2 Review of previous research

The authors were guided by several previous researches. Many of those are cited throughout this paper. The theoretical background is drawn from mr. sc. T. Antić and his book *Komunalno upravno pravo (Public Utilities Legal System)*. Several other domestic authors were consulted: dr. sc. A. Bajo and dr. sc. M. Primorac on their researches about local utility companies and local government funding. The authors have derived several definitions and theoretical framework from the book *Public-private partnerships: Principles of Policy and Finance*, Oxford (Yescombe, 2014). However, the second part of the paper, in which the authors discuss a case study, consists mainly of internal company data, for which the authors did not find other previous researches.

## 2. The concept and fundamental features of utility services

The utilities sector implies municipal activities, in particular the provision of municipal services of interest to individuals and legal entities, the finance of construction and the maintenance of facilities and equipment of the communal infrastructure as a comprehensive system in the area of local government units (also in the counties as provided by law (Antić, 2007). It includes part of the economy that relates to the provision of utility services, which because of their specificity require special rulings and relations within this area (HGK, 2010).

## 2.1 Communal activities as activities of public interest

Communal activities are those connected to the public infrastructure. The public infrastructure can be defined as facilities that are necessary for the functioning of the economy and society. These are thus not an end in themselves, but a means of supporting a nation's economic and social activity (Yescombe, 2014). This public infrastructure is usually maintained by companies from the public sector. The specificity of the public sector is reflected in the type of services they cover, and it is about the services that are the foundation of urban living. The utility system is integrated and determined by the Utility Services Act. Special features in this sector are related to:

- defining the respective service as a utility service,
- determining the way in which municipal services are performed,
- pricing of utilities and price controls,
- financing of the utilities from special sources (Zakon o komunalom gospodarstvu / Law on Utility Services, 2003).

Public utility services delivered to users are services of public interest. Communal activities are carried out as a public service. Because municipal services are of public interest, it has become evident that nowadays, life in the cities and municipalities would be unthinkable without them.

Utility services are activities that serve the public interest and ensure the key living and working conditions of citizens as well as the work of economic and other entities. They constitute an indispensable condition of life and work, and in accordance with the above-mentioned municipal economies are based on the following basic principles:

- communal activities are performed as a public service,
- they should ensure continuous and ongoing operations of the utilities,
- they should ensure the maintenance of utility facilities in working order,
- they should ensure the performance of the utilities according to the principles of sustainable development (Kemeter, 2009).

## 2.2 The privatization of municipal services

The question of ownership of structures and facilities of the communal infrastructure is important to the previous question for investment in the construction of structures and facilities of communal infrastructure, which have been intensified in recent years in the Republic of Croatia. Investments in the construction of the municipal infrastructure to protect the environment and to ensure the level of European standards of utility services to the citizens is a precondition for the development of JLSs and the overall Croatian economy, which the state encourages through important projects of building facilities and equipment of the communal infrastructure.

Nevertheless, the issue of transformation of utility companies is of decisive importance for establishing the owner of utility facilities and municipal infrastructure, which are used for public utility services of potable water, sewage and wastewater, transportation of passengers in public transport, sanitation, waste disposal and retail markets. This is a special process for the Republic of Croatia in which the best solutions are being sought for the determination of the owners of legal entities registered for the performance of public utilities (Sarvan, 2007).

Yescombe questions why there has been such a worldwide growth in interest in utility companies. For him the reason is limitation of public budget funding (Yescombe, 2014). Modern tendencies are increasingly focused in the area of privatization of municipal services with the aim of maximizing the efficiency of their realization. In the future, public services will also develop with a focus on quality and cost-effectiveness, but with great caution, because a public service must serve the public interest. It is there for the people, so the public interest should not be neglected nor should the users be cheated or exploited. In the case of privatization, there must be strong supervision (Pusić, 2006).

In order to achieve effectively managed utilities, privatization is inevitable. Utilities that will be provided according to market principles, with the best bidders entering into performance contracts for utility services with local governments, are currently probably the most appropriate way of performing the utility activities. The local government will have to be an expert in all segments, in order to have a strong supervisory role.

### 2.3 *The impact of the financial operations of utility companies on the local governments' budget*

Thanks to the accelerated process of urbanization, investment in capital infrastructure has become a significant factor in improving the quality of life of the population of local units and a key prerequisite for economic growth. Along with the increase in the standard of living of the population, rises the need for increasing the quality and diversity of supply from public services in local communities.

Local units in Croatia often entrust the providing of a certain segment of the public utility services to specific legal entities (utility companies) that are controlled mainly through its ownership stake. The analysis of the financial performance of utility companies in Croatia raises the question of the impact on the financial performance of utility companies in the local governments' financial health.

The conditions for local governments borrowing from 1996 to 2010 are shown in Table 1.

Local units may borrow by means of credit, loans and issuing securities. Through the aforementioned legislative framework, individual and cumulative (aggregate) limitations of local government borrowing were identified. The scope of possible borrowing of the local units includes consent for:

- borrowings of legal persons with direct or indirect ownership of local units that are in the annual accounts for the year preceding the year in which the borrowing suffered a loss;

- borrowings of legal persons with direct or indirect ownership of local units to borrow for a period of two years from the date of entry of the establishment in the court register;
- borrowing institution founded by the local unit (Zakon o proračunu, The Budget Act, 2008).

Since local governments have limited support for the borrowing, they are borrowing through the utility companies bypassing budgetary constraints. The negative consequences of overloading utility companies debt does not refer exclusively to the likelihood of converting latent liabilities of local government units into direct. Even the much smaller effects are large enough to start approaching with caution the borrowings of utility companies. The mere insolvency of utility companies may result in increased prices of local government borrowing on the market due to the connection of their financial operations, and indirectly by creditworthiness.

Although the bodies of the local unit are not authorized in making financial plans of utility companies, because of the interconnectedness of local government and utility companies, it is necessary to observe a consolidated (consolidated) view of the financial health of local government units and companies owned by them. This fact is gaining in importance in the current economic conditions that threaten with an increase in the utility sector insolvency and politically unpopular measures to increase the prices of public services (Bajo, Primorac, 2010).

The current financial crisis has affected the business of local government units and companies owned by them. Aggregate revenues of local government units will be reduced from 25 billion 2008 to 23.3 billion HRK 2009.

**Table 1** *The conditions for local governments borrowing from 1996 to 2010*

Year	Permitted purpose of borrowing	Annual debt service limit	Additional limitation (% income on the business of all local government units)
1996-1997	Reconstruction and Development (financing of capital projects)	30% of budget expenditures	Does not exist
1998-2002			
2003-2004		20% of income in the year preceding the year in which it is borrowed	3%
2005-2006			2%
2007-2010			2.3%
2011			2.5%

Source: *Zakon o proračunu (The Budget Act), Narodne novine (The Official Gazette) 92/94, 96/03, 87/08*

**Table 2 Financial operations of local units and utility companies**

The numerator	The denominator	Local units	Utility companies	Other
<b>2008</b>				
Current revenue	Total revenue	0.74	0.95	0.94
Total expenditure	Total revenue	1.01	1.00	1.01
Operating expenditures	Total expenditure	0.74	0.95	0.80
Operating expenditures	Current revenue	0.80	1.00	0.85
Total expenditure	Population	5.704	2.144	7.848
Business expenditures	Population	4.235	2.043	6.278
<b>2009</b>				
Current revenue	Total revenue	0.96	0.96	0.96
Total expenditure	Total revenue	1.08	1.01	1.06
Operating expenditures	Total expenditure	0.77	0.94	0.82
Operating expenditures	Current revenue	0.86	0.99	0.90
Total expenditure	Population	5.693	2.182	7.876
Business expenditures	Population	4.374	2.060	6.434

Source: City of Slavonski Brod (2010). *Annual Financial report for the City of Slavonski Brod for year 2009*, Available at: <http://www.slavonski-brod.hr/> (Accessed on: August 28, 2011)

In the same period, expenditures remain unchanged (25.3 billion HRK) resulting in an increase in the total deficit from 257 to almost 2 billion HRK and with the addition deficits by utility companies, the deficit of the consolidated local sector in 2009 was 2.1 billion HRK (Bajo, Primorac, 2010).

The liquidity of the consolidated local sector in the observed period (2008 and 2009) was mainly threatened due to the poor liquidity of utility companies. However, it should be noted that the aggregate liquidity of local units was so good that even after consolidation it is still quite high. The ratio of cash and short-term liabilities as well as cash and current expenditure reflects the extent to which an entity is capable of financing short-term liabilities and current expenditure with the most liquid assets. The ratio of cash and short-term liabilities of local government units decreased from 1.12 to 0.67 or from 0.52 to 0.36 for the consolidated local sector. This means that the subjects of the consolidated local sector in 2009 on average could almost instantly meet about 36% of the current liabilities.

Analogously, the local unit in 2009 could pay with the most liquid assets about 13% of the current expenditures, and utility companies, only about 5%, which is why the ratio of cash and current expenditures for the consolidated local sector in 2009 is 0.1. Liquidity of local units and utility companies is shown in Table 3.

The existing stock of net financial assets of utility companies threatens the financial position of local government units that support the operations of utility companies by various mechanisms. Exposure of local units to poor financial performance of utility companies also affects the credit risk of local government units and may ultimately have a negative impact on their borrowing costs, and in case of financial instability on a wider scale, will have an impact on the fiscal sustainability of the entire local government sector.

Global financial instability has prompted the recent growing interest in studying the borrowing and debt of public sector entities, as well as privately owned enterprises and the population on the whole. Although, due to its apparently small share in the total state debt, the local government debt is often overlooked, particularly local government borrowing represents an indispensable segment of public sector borrowing.

**Table 3 Liquidity of local units and utility companies**

The numerator	The denominator	Local units	Utility companies	Other
<b>2008</b>				
Current assets	Current liabilities	8.41	1.48	4.28
Total surplus	Current revenue	- 0.02	0.00	-0.01
Money	Current liabilities	1.12	0.11	0.52
Money	Current expenditure	0.18	0.05	0.14
<b>2009</b>				
Current assets	Current liabilities	6.87	1.16	3.76
Total surplus	Current revenue	-0.08	-0.01	- 0.06
Money	Current liabilities	0.67	0.10	0.36
Money	Current expenditure	0.13	0.05	0.10

Source: City of Slavonski Brod (2010). *Annual Financial report for the City of Slavonski Brod for year 2009*, Available at: <http://www.slavonski-brod.hr/> (Accessed on: August 28, 2011)

In the context of the management of local public debt, it is necessary to address indirect (potential) obligations not only because of the (un)certainity of their conversion into direct debt, but also because of the seriousness of the potential effects that such conversion may have (Primorac, 2010).

With the explicit conditional and unconditional obligations of local units, which with the issued loans and securities include arrears and guarantees issued, the local sector is often faced with the implicit obligations arising from borrowing of utility companies. Even though local government units and utility companies are formally separate, local units often support the financial operations of utility companies with subsidies and capital grants, but also indirectly by providing guarantees. In addition, by borrowing through public utility companies, local units bypass budgetary constraints on borrowing prescribed by the budget and the annual Law on State Budget Execution of the Republic of Croatia (Bajo, Primorac, 2010b).

It is therefore necessary to observe together the financial operation of local units and utility companies in order to create a complete picture of the financial "health" of the local public sector. Croatian legislation does not provide for the consolidation of local government units and companies owned by them, but a stronghold for such action can be found in the International Public Sector of Accounting Standards.

All this points to the necessity of formal consolidation of the financial statements of local units and utility companies. In addition, the role of the local units in the financial planning of utility companies should increase, whereby every major borrowing by utility companies should be preceded by a thorough analysis of the impact of the planned borrowing on the financial operations of the utility company and on the local unit in which the company operates. Due to the expanded scope of the obligations included in the scope of possible borrowing of local government units, it is necessary to introduce a system of credit risk assessment of local units and utility companies with the goal of optimal allocation of consent for borrowing. Credit risk assessment should be a mainstay for giving guarantees to local government units and their utility societies (Bajo, Primorac, 2010b).

### 3. Influence of the financial performance of utility companies on the local governments' budget

As we mentioned in the introduction, the purpose of utility companies is not to make profits. Therefore, the funding impact of the utility companies on the local government budget can only be negative, or may lead to the condition where the utility companies need too much funding from the budget for their functioning. Utility companies should operate sustainably, in a way that as few resources as possible are allocated from the budget, while, at the same time, the services offered to citizens are as low cost as possible.

#### 3.1 Sources of financing of utility companies (public prices and fees)

Providing of utility services is financed from municipal services charges, utility charges, local budgets and other sources under special regulations (Sarvan, 2009). The issue of pricing of municipal services in the Republic of Croatia necessarily includes the issue of controlling the amount of utility charges. The municipal services provide funds for operations of the utilities: water supply, drainage and wastewater treatment, storm water drainage in addition, public passenger transport, maintenance of cleanliness in the part relating to the collection and disposal of municipal waste, municipal waste disposal, retail markets, transport of the deceased, chimney sweeping.

The price, method of calculation and method of payment for utility services is determined by the supplier of services, who is paid for the utility services. The payer of the price is the owner of the property (which is connected to the system of communal infrastructure), or the user when the owner of the obligation transferred the contractual commitment to the user. The price of the utilities can contain an amount for the maintenance and financing of the construction of facilities and equipment of the communal infrastructure in the area or for the needs of the LGUs in which the service is delivered, in accordance with the Programme of facilities construction and communal infrastructure equipment.

From 1 January 2000, the process of determining the price of utilities has been amended and now, the provider of utility services is obliged before every change of the price, that is, tariffs of the services, to obtain prior approval from the executive and the LGU in the area where the service is provided. That body shall respond within 15 days from the date of application for obtaining the previously mentioned consent. If the executive body of the LGU in the mentioned period does not respond, it is considered that the consent has been given. However, when the same approval is withheld for the new rates and prices, the tariffs and services are applied when they are accepted by the LGU that own the largest ownership stakes as providers of utility services (Sarvan, 2010).

The price list report must contain the elements according to which it is possible to assess whether the price changes of utilities are justified. This includes the type of utility services and the method of calculation and payment of services, the structure of the existing price of utilities, the proposed new price of the service and its structure, the percentage of price change compared to the existing price, the reasons for the change in the price with detailed explanation and calculation, and the date of application of the new prices. The LGU on whose territory the service is delivered shall, within 15 days from the date of application of the new charge for utilities, notify the ministry responsible for the price and the county office responsible for the economic activities.

#### 3.2 Borrowing of utility companies

The growing trend of local government borrowing through the utility companies is worrying. Institutions and corporate entities whose founder and majority owner is the local unit may contract debt only with the prior consent of the representative body of the local unit. Utility companies owned by local units may borrow short and long term. In the short term, borrowing is due to the uneven dynamics flow of funds in their budget, usually in a commercial bank in which they have their accounts for regular operations (Bajo, 2007). Although the law has not been determined, the local unit should not give consent to institutional and utility companies to finance current expenditure, but only consent for capital investment. For the financing of capital pro-



jects of local institutions and companies in the long run, they take loans from banks and, increasingly, by issuing corporate bonds.

Local units cannot borrow in the name of and on the account of establishments and utility companies, but they can give, without any Government consent, the guarantee for the fulfilment of their obligations. The detailed procedure for issuing guarantees is determined by the statutes of the local unit, and approval, conditions and procedure of borrowing is determined by the representative body of the local government unit. The total amount of debt and granted guarantees are prescribed in the yearly decision on the execution of the local unit budget. The local government unit shall notify the Ministry of Finance on the number of guarantees issued. However, there are no additional requirements of the Government and the Ministry of Finance in terms of reporting (Bajo, 2007). In the Republic of Croatia, borrowing by local government units is prescribed in the Budget Law and the Law on Annual State Budget Execution of the Republic of Croatia. Local units may borrow by raising means of credit, loans, and issuing securities. According to the Budget Law, a legal person in direct or indirect ownership of the local unit and institutions founded by the local unit may use long-term borrowing only for investment with the consent of the majority owner or founder. The scope of possible borrowing of the local units includes consent for:

- borrowings by legal entities with direct or indirect ownership of local units that are in the annual accounts for the year preceding the year in which the borrowing suffered a loss;
- borrowings of legal entities with direct or indirect ownership of local units to borrow for a period of two years from the date of entry of the establishment in the court register;

- borrowing institution founded by the local unit.

The above legal provisions clearly indicate the possibility of undisturbed unlimited borrowing by utility companies if in the year, preceding the year in which they borrow did not suffer a loss, and that it has been more than two years from the date of their establishment in the court register. In the segment on granting guarantees, the legal provisions prevent imprudent behaviour, so that the local unit may issue a guarantee to fulfil the obligations of the legal entities and institutions, to the legal entity holding the majority of direct or indirect ownership and the institution of which it is the founder. However, the given guarantee is included in the scope of possible borrowing of the local unit.

### 3.3 Subsidizing of utility services from the budget of local units

According to the Budget Law, the budget users are government bodies, institutions, boards of minority self-governments, budgetary funds and local self-government whose expenses for employees and / or material expenses are funded from the budget. Users of local units' budgets are those who are funded by local units, whose source of income comes from the budget of the local unit in the amount of 50% or more and who are listed in the register of budget users (Zakon o proračunu, The Budget Act, 2008).

This can include for e.g. employees in museums, kindergartens, social service agencies, health care institutions whose founders and majority owners of the unit (Bajo, 2009). The Utility Services Act stipulates that the zone coefficient determines the representative body of local self-government in some zones, and the highest ratio in the first zone LGU is 1.00.

**Table 4 Subsidies and capital grants to local government units (in m/HRK)**

	Towns		Municipalities		Counties		TOTAL	
	2008	2009	2008	2009	2008	2009	2008	2009
Subsidies	1,010	1,102	37	38	10	10	1,057	1,150
Capital grants	58	32	23	18	179	133	260	182
<b>TOTAL</b>	<b>1,069</b>	<b>1,134</b>	<b>60</b>	<b>56</b>	<b>188</b>	<b>143</b>	<b>1,317</b>	<b>1,333</b>

Source: City of Slavonski Brod (2010). *Annual Financial report for the City of Slavonski Brod for year 2009*, Available at: <http://www.slavonski-brod.hr/> (Accessed on: August 28, 2011)

**Table 5 Shares and equities in local units**

		Shares and equity (total)	Banks and other financial institutions in the public sector	Trade associations in public sector	Domestic banks and other financial institutions outside public sector	Domestic trade associations outside public sector
2008	Towns	11,430	1	9,927	46	1,466
	Municipalities	1,724	5	1,434	31	250
	Counties	617	0	290	0	345
	<b>Total</b>	<b>13,771</b>	<b>6</b>	<b>11,651</b>	<b>77</b>	<b>2,061</b>
2009	Towns	11,720	1	10,022	47	1,661
	Municipalities	1,935	2	1,632	37	260
	Counties	585	0	302	0	336
	<b>Total</b>	<b>14,240</b>	<b>2</b>	<b>11,957</b>	<b>84</b>	<b>2,257</b>

Source: City of Slavonski Brod (2010). *Annual Financial report for the City of Slavonski Brod for year 2009*, Available at: <http://www.slavonski-brod.hr/> (Accessed on: August 28, 2011)

The representative body, depending on the location of facilities and communal equipment of a certain area determines the areas on their own terms and criteria.

Subsidies in the public sector amounted to about 79% of total subsidies of local government units in 2008, and in 2009, this share increased to almost 82%. The total amount of subsidy has increased in the observed period from 1.06 to 1.15 billion HRK, where most of the subsidies are received by cities (over 95%). The amount of capital assistance in the same period decreased and the total amount of aids to the local units' utility companies remained at around 1.3 billion HRK per year.

### 3.4 The finances of the utility companies and the impact on the budget of the local unit

Thanks to the accelerated process of urbanization, investment in capital infrastructure has become a significant factor in improving the life quality of the local units' population and a key prerequisite for economic growth. The increase in the living standard of the population has raised the need for in-

creasing the quality and diversity of public services supply in local communities. Local units in Croatia often grant a certain segment of public services (municipal services) to specific legal entities (utility companies) that are controlled mainly through its ownership stake.

According to the latest figures in Croatia, 167 companies operate in major ownership within the local units. They provide services in the field of water supply, retail markets, transport, waste collection and waste management, funeral services and preserving the environment. They are mostly organized as companies and are liable to income tax. Only the City of Zagreb joined all companies in a holding company. In the majority-owned companies, there may be several local units (mostly in cities). Financial operations of local public companies are often beyond the reach of public policy because they do not undergo the same system of supervision and control such as the budgets of local units that are regularly under debate in the local representative bodies. It is the same with the pricing of public services that through the years has to undergo formal discussion at meetings of shareholders, rather than be analysed in the local representative bodies. Insight into the structure of the equity portfolio for local units can be obtained by observing the structure of stocks and shares and equities.

The total value of shares and equities in the local government units has increased from 13.8 billion HRK in 2008 to 14.2 billion HRK in 2009, whereby the structure (with 84% share) is dominated by

stocks and shares in the equity of companies in the public sector. The ownership structure of utility companies implies potential interdependence of financial operations of local units and utility companies.

#### **4. Impact of the financial performance of utility companies on local governments' budget – the example of Slavonski Brod**

As already mentioned in the paper, "Komunalac Ltd." will be taken as an example of a utility company. "Komunalac Ltd." from Slavonski Brod is a utility company established in 1946 under the name City Maintenance. Over time, the company has changed its name and structures including RO, KRO, and OOUR and in 1996 it came to its present organization structure. It was registered in the Commercial Court in Slavonski Brod under the Public Utilities Act as a company "Komunalac Ltd." from Slavonski Brod, fully owned by the City.

The company deals with the following activities: removal and disposal of municipal waste, maintenance of cemeteries and funeral activities, maintenance of public roads and green areas, vegetable - nursery production, services, retail markets, retail and funeral equipment. Until mid-2002 the company employed 290 workers. Due to accumulated financial obligations, organizational collapse of human relations, and political conflicts, bankruptcy proceedings were initiated which ended in October 2003 by the adoption of the Bankruptcy Plan by the creditors. The company, once again, found itself, at the beginning; the formation of the Assembly, the Supervisory Board and the Management Board, and the total number of employees decreased to 170 employees. The main body of the company is the Assembly appointed by the City Council and has only one member. The company is largely financed from its own resources. Below, we analyse the financial performance of this company.

#### **4.1 The financing of the municipal association "Komunalac Ltd."**

The revenues of the company "Komunalac Ltd." for performing utilities are provided by the prices of municipal services and the city budget. The budget allocation that funds activities to maintain public transport and green spaces have been the same for eight years and the volume of business has increased significantly. The Income Statement for the company "Komunalac Ltd." for 2011 and 2010 is shown in Table 6.

**Table 6 Income Statement of the company "Komunalac Ltd." for 2011 and 2010 (in 000 HRK)**

	2010	2011
Sales revenue	25,483	26,833
Other operating income	1,665	2,178
Total operating revenues	27,148	29,011
Changes in inventories of finished goods and work in progress	99	44
Material costs	5,260	5,016
Staff costs	12,692	12,136
Amortization	2,608	2,127
Other operating expenses	5,997	7,890
<b>Total operating expenses</b>	<b>26,513</b>	<b>27,268</b>
Profit from operations	635	1,743
Net financial expenses	238	174
Profit before tax	397	1,569
Income tax	134	319
Net profit	263	1,250

Source: "Komunalac Ltd.," income statements from 2010, 2011, internal company documentation

Operating income includes income arising from deliveries of finished products and services rendered based on original invoice amount. Revenues are also recognized in accordance with the financial reporting standards and for the delivery of products and services. Income from the sale of "Komunalac Ltd." is shown in Table 7.

**Table 7 Sales revenue (in 000 HRK)**

	2011	2010
Revenue from utilities	20,609	19,610
Income from cemetery services	2,867	2,520
Income from rent	2,276	2,236
Other	1,081	1,117
<b>Total</b>	<b>26,833</b>	<b>25,483</b>

Source: "Komunalac Ltd.," income statements from 2010, 2011, internal company documentation

The largest share of sales revenue is the revenue from municipal services and they make up almost 90% of total revenues. Other operating income of "Komunalac Ltd." in 2011 amounted to 2,178m HRK, and in 2010 to 1,665m HRK. These revenues include revenues from the collection of previously written-off receivables, income from reversal of deferred costs and the liabilities write-off.

#### 4.2 Debt amount and structure

Payables and receivables of the company "Komunalac Ltd." are shown in the following tables.

**Table 8 Trade receivables (in 000 HRK)**

	2010	2011
Domestic customers	14,838	13,363
Impairment of trade receivables	6,533	-10,135
	8,305	3,228

Source: "Komunalac Ltd.," income statements from 2010, 2011, internal company documentation

The Company conducts value adjustment for receivables that are overdue for a period of 120 days from the due date. In the course of these financial statements, the Company does not consider these receivables uncertain, because it is a matter of regular customers with whom the Company realizes significant revenues from operations. These actions were undertaken to collect a certain portion of the receivables and were billed in 2011.

**Table 9 Other receivables (in 000 HRK)**

	2010	2011
Receivables from government and other institutions	285	81
The service of "tow car"	135	181
Employees	214	214
Other	642	292

Source: "Komunalac Ltd.," income statements from 2010, 2011, internal company documentation

**Table 10 Liabilities to banks and leasing companies (in 000 HRK)**

Commitments	2010	2011
Loan	4,253	2,081
Finance lease	912	456
<b>Total</b>	<b>5,165</b>	<b>2,537</b>

Source: "Komunalac Ltd.," income statements from 2010, 2011, internal company documentation

Borrowings related to bank loans refer to the bank loan approved in 2003 for reprogramming the bankruptcy plan. The loan for HRK was approved with an interest rate in the sum of the one-month Euribor + 1.9 percentage points, and due on 1 November 2012. Other long-term liabilities are shown Table 11.

**Table 11 Other non-current liabilities (in 000 HRK)**

Commitments	2010	2011
According to the state for sold apartments	443	448
Provision for retirement benefits and jubilee awards	847	704
Provision for litigation	209	209
<b>Total</b>	<b>1,499</b>	<b>1,361</b>

Source: "Komunalac Ltd.," income statements from 2010, 2011, internal company documentation

These include long-term liabilities to the state of sold apartments, provisions for bonuses and retirement benefits and provisions for litigation.

#### *4.3. The impact of the financial operations of utility companies on the financial position of the City of Slavonski Brod*

The fundamental problems that arise when looking at the financial operations of utility companies in relation to the financial picture is low liquidity and high liability associations, which affect the price increase for public services. From the utility revenues in 2011, the City realized HRK 1,029,000.00. These revenues consist of municipal contributions, utility charges and connection fee.

Municipal contributions are the largest and amount to HRK 9,000,000.00. The billing of the municipal contribution is governed by the Act. Municipal contributions are intended to finance the construction of facilities and equipment of the communal infrastructure: public areas, unclassified roads, public lighting. Communal tax was planned for HRK 10 million and, based on the Act on the Utilities Sector (Official Gazette no. 26/03-cleared text 82/04, 110/04-Regulation 178/04) Decision on communal compensation (Sl. Vjesnik, The County no. 14/01, 08/09).

Funds of utility fees in full are allocated for implementation of the program of work on maintaining the municipal infrastructure. Fees for connection to municipal infrastructure amounted to HRK 1,000,000.00, based on the Act on connecting to the utility infrastructure, and in agreement with the Programme for construction of facilities and equipment of communal infrastructure.

"Komunalac Ltd." considers that the budget allocation assigned by the city for their services is rather low for a company that operates in four working units (1. Work Unit "Hygiene", 2. Work Unit "Green and Clean", 3. Work Unit "City Cemetery" and 4. Work unit, "City Market"). It is difficult to allocate resources and select priorities. However, the company is aware of the situation in which is the city of Slavonski Brod finds itself and hopes that the situation will improve in the future.

Total revenues of the company are mostly fully anticipated so that it cannot count on any extra income. The company is working to reduce costs and with the eventual implementation of cost reduction, it could count on some increment. "Komunalac Ltd.", regardless of being a utility company and owned by the city, must adapt to changes in the environment, technological changes, political and legal, as well as market and demographic changes.

Legal entities in direct or indirect ownership of the town of Slavonski Brod and institutions founded by the City of Slavonski Brod can make long-term borrowing for investment only with the consent of the majority owner or founder.

The representative body decides on the total value of activities and projects that are planned and approved in the budget. The programs of these activities are listed in the relevant governing bodies and adopted in the budget of the City by the City Council if they exceed 0.5% of receipts and revenues, i.e. if their value exceeds one million HRK. The decisions regarding the acquisition and alienation of movable and immovable property also have to be taken by the representative body. The City Council authorizes the Mayor to carry out the procurement procedures of goods, works and services and concluding contracts for the all of the activities and projects whose value exceeds the amount of Article 48 of the Act in accordance with legal regulations.

Asked whether the budget allocation is sufficient to fund activities that are financed from the City budget, the city responded that: the City budget financed only "Komunalac Ltd." for the work of cleaning the sidewalks and streets, street washing, mowing and maintenance of greenery. For the past several years, 5 million HRK have been foreseen in the budget for the cleaning and maintenance of public spaces. "Komunalac Ltd." argues that these funds are not sufficient. The actual i.e. real or market price could be obtained when the City would call for tenders and anyone in the market could make bids.

## **5. Conclusion**

The utilities sector includes the part of the economy that relates to the provision of utility services, which due to their specificity require special legal provisions and management of relations within this

area. It consists of nine main activities, which include a specific segment of the business operations and each of these units are managed separately. Trade associations, public institutions, services – own work units, as well as any person or entity may provide utility services. The funds for municipal activities are provided from the utilities prices, utility charges, the budgets of local governments and other sources pursuant to special regulations.

There are utility companies engaged in public water supply, sewage and water treatment, waste management, maintenance of public areas, city markets, maintenance of cemeteries and crematoria, public lighting, public transport passenger transport, maintenance of unclassified roads and sweeping chimneys. As public interest activities, utility services are activities that serve the public interest, and ensure the satisfaction of vital living and working conditions of citizens, as well as economic and other entities. Local government units can entrust individuals or legal entities to provide communal utility services that are financed from their own budget and based on a written contract. Modern tendencies are increasingly focused on the privatization of municipal services with the aim of maximizing the efficiency of their realization. In the future, public services with a focus on quality and cost will develop, but with a great caution since public services must serve the public interest.

The financing of municipal activities is done according to dual instruments. First, instruments of business financing are incomes based on price of utility services. The second are instruments of public funding, such as income-based utility charges, budget funds, funds from contributions and funds from other sources under special regulations. The funds for municipal services are provided through the price of utilities, the utility charges, and the local government budget and from other sources according to special regulations.

As an example, in the case of the company "Komunalac Ltd.", revenue for performing utilities is provided from municipal services and the city budget. The budget allocation, which funds activities to maintain public transport and green spaces, has remained the same for eight years and the volume of business has increased significantly. The same operating income includes income arising from deliveries of finished products and rendered services based on the original invoice amount. Revenues are also recognized in accordance with the financial record-

ing standards, and by the delivery of products and services. The largest share of sales revenue is the revenue from municipal services and they provide almost 90% of total revenues.

As far as the city of Slavonski Brod is concerned, in relation to the financial operations of the company "Komunalac Ltd.", which is owned or majority-owned by the city, HRK 5,000,000.00 is allocated to the company and this allocation has been constant over the years. From the interviews, we have learned how much is appropriated for which activity, how profitable they are, and how income flows from unit to unit and such. From all that was mentioned, we can conclude that the city has an impact on the company's operations to the extent that it provides funding for the construction of municipal infrastructure and the like while the company generates revenues that are solely related to their activity.

Looking at the hypothesis of this study it can be concluded that the financial operations of utility companies affect the financial position of local government units because the city also sets aside their own funds from the budget for their activities. Although the amount is fixed and in principle does not change in emergencies, revisions may occur and in such situations, the impact is felt the most.

The debt of utility companies is not the main cause of instability because along with the utility companies' debt, there are debts from other companies that participate in the city budget and distort the financial picture of the city. Budgetary support certainly helps utility companies but it is still insufficient for all the activities that the utility companies should and want to provide.

In the end, authors propose guidelines for further research. Undoubtedly, as it was shown, utility companies affect the local government budget. Tax reforms that occurred in Croatia in the last year resulted with less income for local governments. Therefore, the question remains whether the budgets of utility companies should be furthermore consolidated from local government budgets. Another proposal questions whether a price increase of utility services brings more benefits for the local population. The last, and maybe most important research proposal is the question should the local government allow private utility companies to perform tasks that are still reserved for public companies.

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## **UTJECAJ FINACIJSKOGA POSLOVANJA KOMUNALNIH DRUŠTAVA NA FINACIJSKU POZICIJU GRADA**

### **SAŽETAK**

Radom se istražilo financiranje komunalnih društava, odnosno utjecaj financijskoga poslovanja na proračun lokalnih jedinica. Poseban naglasak stavljen je na financiranje komunalnih društava Slavnskoga Broda te njihov utjecaj na proračun. U radu je definirano svako od područja komunalne djelatnosti te je prikazana komunalna djelatnost kao djelatnost javnoga interesa, kao i privatizacija te djelatnosti općenito. Rad govori o praksi financiranja djelatnosti te o direktivama u smjernicama Europske unije.

Rad sadrži i pregled izvora financiranja komunalnih društava i mogućnosti kreditiranja. Obuhvaća također jamstva i subvencije kao mjere financiranja aktivnosti komunalnih društava.

U praktičnome dijelu bit će prikazan intervju s čelnim ljudima grada Slavnskoga Broda vezano za utjecaj proračuna na financiranje komunalnih djelatnosti komunalnoga društva Komunalac d.o.o.

**Ključne riječi:** komunalna društva, financiranje, Slavonski Brod, Komunalac d.o.o., proračun, javni interes