



Cash Reserve Policy

Adopted by the Board of Directors

on March 20, 2013

INTRODUCTION

The complex nature of Western Municipal Water District's operations and its various legal, legislative, and contractual requirements dictate a multifaceted and sophisticated financial structure. The District has implemented operating programs in order to secure water and wastewater service resources at the lowest possible cost to its customers without compromising service reliability or quality. These operating programs and strategies include a major investment in local water distribution facilities, recycled water facilities, wastewater treatment and disposal facilities, and contractual obligations and commitments.

I. POLICY STATEMENT

A key element of prudent financial planning is to ensure that sufficient funding is available for current operating, capital, and debt service needs. Additionally, fiscal responsibility requires anticipating the likelihood of, and preparing for, unforeseen events. Western Municipal Water District ("District" or "WMWD") will at all times strive to have sufficient funding available to meet its operating, capital, and debt service obligations. This funding will be accumulated and maintained in order to pay for operating expenses and capital expenditures in a manner consistent with its Operating Budget and Capital Spending Plan, respectively, and avoid significant customer rate fluctuations due to changes in cash flow requirements.

The Board of Directors of WMWD ("Board") may designate specific reserves and maintain minimum balances consistent with statutory obligations that it has determined to be in the best interest of the District. The policy directives outlined in this document are intended to ensure WMWD has sufficient funds to meet current and future needs. Reserve balances will be reviewed by District staff and the Board during the preparation and approval of the annual Capital Spending Plan.

As an issuer of revenue bonds, the District understands and is committed to its contractual obligation to pay debt service and other financial obligations that are imposed by bond indentures. Therefore, should it be necessary, the Board will modify reserve levels in order to meet indenture requirements.

In order to protect the District's investment in its various assets and to satisfy its commitments under its financial, regulatory, and contractual obligations, the District has developed and segregated a number of reserves. The efficient and discrete management of these reserves, when combined with their appropriate fortification, add additional assurance that the current levels of service reliability and quality will continue into the future.

II. DEFINITIONS

The District's reserves can be classified into three categories that include Restricted Cash and Investments, Capital Reserve Funds, and Operating Reserve Funds. A "fund" is a segregation within the District's accounting system to keep sources and uses for a particular purpose easily identifiable and reportable.

Restricted Cash and Investments: Restrictions on the use of these monies are imposed by an outside source such as creditors, grantors, contributors, laws or regulations governing use.

Capital Reserve Funds: These funds are established by action of the Board and are designated for the construction or acquisition of capital assets, including the replacement of existing assets. Similar to Restricted Cash and Investments above, there may be restrictions associated with the use of reserves in some Funds imposed by an outside source, such as Added Facility Funds where funding comes from capacity charges.

Operating Reserve Funds: These funds are established by action of the Board to safeguard the financial flexibility, liquidity, and stability of the District, and to maintain stable customer charges and rates from year to year. Operating Reserve Funds may be funded from accumulated net revenues and, when appropriate, available short-term liquidity arrangements.

III. GENERAL PROVISIONS

The District maintains its capital and operating reserves in separate funds within its accounting system in a manner that ensures accurate tracking of transactions and provides transparency to its ratepayers. The reserve balances are considered the minimum necessary to maintain the District's creditworthiness and adequately provide for:

- Compliance with applicable statutory requirements
- Financing of future capital facilities and replacement of existing assets
- Cash flow requirements
- Economic uncertainties, local disasters, and other financial hardships or downturns in the local or national economy
- Contingencies for unforeseen operating or capital needs

In the context of funding future capital facilities and replacing existing assets, the District will analyze the most cost effective and efficient method to finance a project, be it through debt financing, pay-as-you go financing, use of reserves, use of grant proceeds or State loans, or through some combination of those various sources.

The District has established the following categories that comprise its reserves, with each accounted for individually.

- Restricted Cash and Investments – comprised of unspent bond proceeds, bond reserve funds, customer deposits, construction advances, and other customer-paid balances that have a corresponding liability.

- Capital Reserve Funds consist of two major categories:
 - Restricted – comprised of capacity charges, such as Water Added Facility Funds, Wastewater Added Facility Funds, and Distribution System Funds.
 - Unrestricted – comprised of System Improvement Funds, Asset Replacement Funds, and Water Reliability Funds.
- Operating Funds – comprised of 1) operating reserves for the Headquarters Fund, SARI Fund, Wholesale Water Fund, Arlington Desalter Fund, as well as for Retail Water and Wastewater funds; and 2) major maintenance reserves.

A principal tenet of this Reserve Policy shall be crediting of interest income to specific reserve funds until the respective fund’s maximum, if any, is achieved. Once the maximum balance is reached within a specific reserve fund, the surplus interest earnings will be reallocated to other reserve funds whose funding level is below the minimum or maximum requirement recommended by this policy, as long as there is no legal prohibition in doing so.

Reserve balances will be reviewed on an annual basis at, or near, the end of the fiscal year during the preparation and approval of the Capital Spending Plan to ensure compliance with this Policy. In the event an Operating Fund balance exceeds the established aggregate maximum, excess monies will be transferred annually into its associated Asset Replacement Fund.

The minimum established for each fund represents the baseline financial condition that is acceptable to the District from risk and long-range financial planning perspectives. Maintaining reserves at appropriate levels is a prudent, ongoing business process that consists of an iterative, dynamic assessment and application of various revenue generating alternatives. These alternatives (either alone or in combination with each other) include, but are not limited to: fees and charges, water service, wastewater service, capital financing, investment of funds and levels of capital expenditures.

In general, reserve balances approximate the District’s cash and investments.

To preserve its strong credit ratings, in every fiscal year the District shall endeavor to maintain 90 to 270 days of operating cash without regard to any liquidity facility.

The board shall approve any reallocation of funds or any transfers among funds.

IV. FUND TARGET LEVELS AND MANAGEMENT

A. Restricted Cash and Investments

Unspent Bond Proceeds: these funds are considered restricted for the use designated in the bond’s Official Statement.

Bond Reserve Fund:

- Definition and Purpose – Established as a condition of each bond issue. The funds are legally protected by bond covenants and can only be used in the event of default by the District or to pay down principal at maturity.
- Target Level – The bond reserve requirement is established at the time of the bond issue. The amount could be recalculated as the bonds are paid down depending on the bond covenant.
- Events or Conditions Prompting the Use of the Reserves – May be used by the Trustee if the amounts in the Principal Fund, Mandatory Redemption Fund or Interest Fund are insufficient or for the retirement of all bonds then outstanding.

Customer Deposits and Construction Advances:

- Definition and Purpose – Monies held on behalf of the District’s customers as required to pay for expenses associated with customer-funded development projects, as well as deposits held on behalf of retail water and wastewater customer accounts (“retail customers”).
- Target Level – Customer deposits related to development are collected based on policies and procedures outlined in the District’s *Developer Handbook and Standard Drawings [for] Water, Recycled Water, and Sewer Facilities*. Customer deposits related to retail customers are collected based on Board adopted policy. The balance will fluctuate depending on the size and complexity of the project(s), the overall number of development projects in process, and the number of retail customers. Therefore, no minimum or maximum levels will be established in aggregate.

B. Capital Reserve Funds

Capital Reserve Funds are used to fund capital projects including water and wastewater system infrastructure, vehicle and major equipment acquisition, and information technology. They are classified as either “restricted” if there is a use restriction placed on the funds by an outside source, or “unrestricted.”

Restricted Capital Reserve Funds

Water Added Facility Fund:

- Definition and Purpose – Established with monies from developer capacity charges. The collection and use are restricted under state law. These monies are used to construct Water Master Plan facilities in areas impacted by growth.
- Conformity to Plans – The District maintains separate master plans for future water facilities that will be constructed in various areas within its jurisdiction for retail water service. Expenditures from this reserve must comply with the District’s Water Master Plans.

- Target Level – The ultimate funding level for a Water Added Facility Fund inherently fluctuates depending on the degree of development activity and the cost of new infrastructure yet is to align with projected expenditures in the District’s Water Master Plan documents. These documents are reviewed annually and are generally updated every five years.
- Events or Conditions Prompting the Use of the Fund – When staff identifies facilities that are necessary to accommodate growth, construction projects may be recommended to the Board of Directors. Amounts for projects or improvements greater than \$100,000 must be requested by District staff and approved by the Board of Directors. Projects or improvements amounting to less than \$100,000 may be authorized by the appropriate staff.
- Funding Source – Capacity charges (Added Facilities Charges, or “AFC”).

Wastewater Added Facility Fund:

- Definition and Purpose – Established with monies provided by developers per contracts negotiated for the provision of sewer service by the District. These monies are used to construct Wastewater Master Plan facilities in areas impacted by growth.
- Conformity to Plans – All projects funded from a Wastewater Added Facility Fund will be included in the District’s five year capital improvement plan and the District Wastewater Master Plans currently in process.
- Target Level – Targets are established on a contract by contract basis and are estimated by the District’s consulting engineers until target levels are established when the Master Plans are adopted by the Board of Directors. Once adopted by the Board, the funding level for a Wastewater Added Facility Fund will inherently fluctuate depending on the degree of development activity and the cost of new infrastructure yet is to align with projected expenditures in the District’s Wastewater Master Plan documents. These documents are reviewed annually and are generally updated every five years.
- Events or Conditions Prompting the Use of the Fund – When staff identifies facilities that are necessary to accommodate growth, construction projects may be recommended to the Board of Directors. Amounts for projects or improvements greater than \$100,000 must be requested by District staff and approved by the Board of Directors. Projects or improvements amounting to less than \$100,000 may be authorized by the appropriate staff.
- Funding Source – Capacity charges (Added Facilities Charges, or “AFC”).

Distribution System Fund:

- Definition and Purpose – Established to upgrade and improve the distribution system within the District’s retail service area. This reserve primarily funds smaller projects and improvements not covered by the Water Added Facility Funds.
- Target Level – The funding levels for this reserve inherently fluctuates depending on the degree of development activity and the cost of new infrastructure.

- Events or Conditions Prompting the Use of the Fund – Amounts for projects or improvements greater than \$100,000 must be requested by District staff and approved by the Board of Directors. Projects or improvements amounting to less than \$100,000 may be authorized by the appropriate staff.
- Funding Source – Distribution System Fees charged on new development as established by the Board of Directors.

Unrestricted Capital Reserve Funds

System Improvement Fund:

- Definition and Purpose – Established to make improvements to existing water or wastewater systems.
- Target Level – This reserve has no specific target level and will be funded on an as needed basis. Any amounts not utilized and no longer needed will be returned to the operating reserve that funded the project.
- Events or Conditions Prompting the Use of the Fund – Improvement projects will be identified by District staff and recommended to the Board during the preparation of the annual capital budget. Approved projects will be funded from the appropriate operating reserve.
- Funding Source – Retail water / wastewater user rates.

Asset Replacement Fund:

- Definition and Purpose – Established to accumulate amounts for the replacement or major refurbishment of aging capital assets.
- Target Level – Minimum funding shall be targeted at the estimated current replacement cost¹ of assets associated with the Fund that are expected to be replaced within the next five years (i.e. will be fully depreciated) excluding certain assets².
Maximum funding shall be targeted at the sum of a) the minimum target level calculated above plus b) 25% of the estimated current replacement cost for capital assets associated with the Fund that have a replacement cost of more than \$7,000,000.
- Events or Conditions Prompting the Use of the Fund – Replacement projects are deemed needed when an existing asset is no longer adequately functioning and the cost to repair the asset or to retrofit to meet current regulations and standards exceeds its replacement cost. Replacement projects will be identified by District staff and recommended to the

¹ The current replacement cost is the original asset cost escalated annually by the Engineering News-Record Construction Cost Index (“ENR CCI”).

² Certain assets excluded from the calculation are those that: (a) are not subject to replacement based on an Operations and Engineering analysis, (b) are non-depreciable assets, (c) have an adjusted useful life of less than or equal to five years (“short-life assets”), (d) have a replacement cost of less than or equal to \$50,000 (“low-cost assets”), or (e) have a replacement cost of more than \$7,000,000 (“high-cost assets”).

Board during the preparation of the annual Capital Spending Plan or throughout the year as needed.

- Funding Source – User rates; property taxes in the case of the Headquarters Fund.
- Annual Funding – The annual funding level is equal to a maximum of the annual depreciation expense based on generally accepted accounting principles. Any under-funding due to insufficient revenue may be recouped in subsequent years that have sufficient revenue (taking into consideration the impact on rates).

Water Reliability Fund:

- Definition and Purpose – Established to accumulate amounts received from retail customers through 1) the Water Reliability Charge for the purpose of increasing water system reliability and capacity, improving the long-term sustainability of the water supply, and/or enhancing and improving water supply management, and 2) the Water Supply Penalty component of the water rate for the purpose of acquiring additional water.
- Target Level – Funding for this reserve inherently fluctuates based on revenue received from retail customers and expenditures for approved uses.
- Events or Conditions Prompting the Use of the Fund – Water Reliability Charge revenues are to be used to fund capital projects. Such projects must be in compliance with one or more of the purposes identified above and demonstrate a nexus between the project's benefit and the water service area that generated the revenue. Water Supply Penalty revenues are to be used to secure additional water for the water service area that generated the revenue.
- Funding Source – User rates.

C. Operating Reserve Funds

Operating Reserve:

- Definition and Purpose – Established to cover temporary cash flow deficiencies caused by timing differences between revenues and expenditures. Also to phase in the impact of unforeseen cost increases such as significant increases in imported water costs, wastewater treatment costs, changes in energy costs, emergency repairs, and other significant expense fluctuations, as well as funding capital projects in System Improvement Funds.
- Target Level – Funding shall be targeted at a minimum of three months and a maximum of six months of average operating expenses based on the annual operating budget.
- Events or Conditions Prompting the Use of the Fund – This reserve may be routinely utilized by staff to cover temporary cash flow deficiencies caused by timing differences between revenue and expenses, unexpected decreases in revenues and increases in expenses, and to fund System Improvement capital projects.
- Funding Source – User rates, property tax revenue and investment earnings.

Major Maintenance Reserve:

- Definition and Purpose – Established to distribute the impact of periodic major maintenance expenditures over multiple years resulting in greater stabilization of user rates.
- Target Level – Funding shall be targeted at a minimum of one year and a maximum of three years of the District’s projected expenditures for major maintenance based on asset maintenance schedules.
- Events or Conditions Prompting the Use of the Fund – This reserve may be routinely utilized by staff when annual maintenance expenditures exceed the current year’s budget.
- Funding Source – User rates.