

RANCHO CALIFORNIA WATER DISTRICT  
42135 WINCHESTER ROAD/BOX 9017  
TEMECULA, CA 92589-9017

# CASH RESERVE POLICY

---

ADOPTED BY THE  
BOARD OF DIRECTORS  
ON  
DECEMBER 8, 2016



## TABLE OF CONTENTS

<b>I. BACKGROUND AND INTRODUCTION.....</b>	<b>1</b>
<b>A. Operating Reserves.....</b>	<b>1</b>
<b>B. Debt Reserves.....</b>	<b>1</b>
<b>C. Capital Facility Reserves.....</b>	<b>2</b>
<b>D. Replacement Reserves.....</b>	<b>2</b>
<b>II. FUND DEFINITION AND USE.....</b>	<b>3</b>
<b>A. 1.2.5 Classes of Bank Accounts.....</b>	<b>4</b>
<b>i. 1.2.5.1 General Accounts.....</b>	<b>4</b>
<b>ii. 1.2.5.2 Special Funds.....</b>	<b>4</b>
<b>III. FUND BALANCE PARAMETERS.....</b>	<b>7</b>
<b>IV. GENERAL FUND RESERVE COMPONENT TARGETS AND FUNDING PRIORITY.....</b>	<b>8</b>
<b>A. Working Capital Reserve.....</b>	<b>9</b>
<b>B. Drought Reserve.....</b>	<b>9</b>
<b>C. Rate Stabilization Reserve.....</b>	<b>10</b>
<b>D. Water Replenishment Reserve.....</b>	<b>10</b>
<b>E. Risk Management Reserve.....</b>	<b>11</b>
<b>V. FUNDING TIMELINE GOALS OF GENERAL FUND RESERVES.....</b>	<b>12</b>
<b>VI. CALCULATION OF NON-DISCRETIONARY FUND RESERVE REQUIREMENTS.....</b>	<b>13</b>

## **CASH RESERVE POLICY**

### **I. BACKGROUND AND INTRODUCTION**

The complex nature of Rancho California Water District (RCWD/District) operations and its various legal, legislative, contractual, and divisional boundary requirements dictate a multifaceted and sophisticated financial structure. The District has implemented numerous operating programs in order to secure water and wastewater service resources at the lowest possible cost to its valued customers without compromising service reliability or quality of service. These operating programs and strategies include a major investment in local water production facilities, recharge water facilities, reclaimed water facilities, wastewater treatment and disposal facilities, and contractual obligations and commitments.

In order to protect RCWD's investment in its various assets and satisfy its commitments under its numerous financial, regulatory, and contractual obligations; the District has developed and segregated a number of funds and 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.

These reserves can be broken out into four types that include **operating reserves, debt reserves, capital facility reserves, and replacement reserves.**

- A. Operating reserves** would predominately be funded from water and sewer user rates and be accumulated in the District's General Fund.
- B. Debt reserves** are those funds that relate to the management of the District's \$333,980,000 in outstanding bonded indebtedness. The proceeds from these bonds have been used to fund the construction cost of the District's backbone utility plant. These funds are accumulated in a debt-service-related fund from which annual

principal and interest costs are paid and where contractually required reserve trust funds are held for the benefit of bond insurers and bondholders.

- C. Capital facility reserves** are funded from developer-impact fees and proceeds from bonds. Their collection and use are restricted under state law. These funds are used to finance the construction of required water-and wastewater-related facilities.
- D. Replacement reserves** are funded from charges reflected on water and wastewater bills and are restricted for the replacement of an aging utility plant. Current estimates demonstrate that future facility replacements will need to be funded with a combination of replacement reserves generated from user fees and future bond proceeds.

The debt service, capital facility, and replacement reserve fund balances are evaluated on an annual basis during the adoption of the District's non-operating budget. The non-operating budget is a 50-year financial plan which projects debt costs and facility requirements and balances those needs with revenue and fund balance projections. The General Fund requirements are evaluated on an annual basis during the adoption and creation of the operating budget.

RCWD's operations and financial structure are also impacted by a number of external factors. Perhaps the most critical factor impacting RCWD's operations is weather conditions. Weather conditions impact the District's ability to benefit from its local water production and significantly impact water demand levels due to the majority of District water use dedicated to outdoor uses such as landscape and agricultural irrigation. Under prolonged drought conditions, RCWD's native water supply in groundwater and Vail Lake are increasingly negatively impacted such that, pumping levels are reduced to manage appropriate aquifer levels, and draws from Vail Lake are reduced or eliminated, depending on availability. In such cases, the District must make up the lost native water production

by purchasing additional imported water, which significantly increases District water supply costs, as the cost of import water is five times the cost of local water. Historically, local water production saves the District approximately \$15,000,000 to \$25,000,000 annually depending on native quantities available in any given year which represents 20 to 40% of the District's annually operating budget. Over the course of a five-year drought, the District has experienced an 11,000 acre-feet or 40% native production decline which represents an additional \$11,000,000 in operating costs. Such material increases in cost would require dramatic rate increases if passed through in their entirety in the specific years impacted. Accordingly, prudent reserves play a critical role to help mitigate such rate increases and provide for a smoother rate transition for short-term drought impacts.

Based upon prudent financial management practices and required by legal, legislative and contractual obligations, the appropriate level and separation of reserves is critical to the financial health of RCWD. When reserve levels fall below acceptable levels, additional costs are incurred, resulting in the delay or discontinuance of critical programs. Likewise, when reserve types and their uses are poorly defined, then the setting aside and/or segregation of these funds becomes more difficult, and the integrity of their use may deteriorate. This policy defines required fund types for segregation purposes, their funding levels, their funding priority, and funding timeline.

## **II. FUND DEFINITION AND USE**

The District currently maintains the following funds:

- General Account Fund
- Connection Fee Fund-Code Section 66001
- Debt Service Fund
- Bond Reserve Fund
- Replacement Fund
- Construction Fund

A description of these funds is found in the District’s Administrative Code, Part II – Fiscal Policies. Following is an excerpt from t Chapter 1 – Finance Administration, detailing the various fund types for the Board’s information.

**1.2.5 CLASSES OF BANK ACCOUNTS**

The following classes of accounts shall be established and maintained for the District.

**1.2.5.1 General Accounts**

All District funds shall be placed in one or more of the types of accounts or investments listed under Section 1.2.3 of this Chapter, and shall be further segregated based upon the source of the money and the planned use of the money. Money received by the District which is not legally restricted for the payment of bonded indebtedness or otherwise restricted by internally-established policies and which shall be used to meet the ordinary operation and maintenance expenses of the District shall be deposited to the general funds of the District. The Board of Directors shall establish and maintain separate general funds for the Rancho Division, the Santa Rosa Division, and the Wastewater Division, and money shall be deposited to the appropriate divisional general fund, based upon the source and use of the funds.

**1.2.5.2 Special Funds**

Special funds may be any one of the types of accounts listed in Section 1.2.4 of this Chapter. The Board of Directors may establish and maintain any number of special funds as may be required for sound financial administration and by administrative regulation or law, and may designate money from a specific source, or sources, to be deposited in special funds.

The allocation of money to special funds of the District shall be accounted for and recorded within the general ledger system; all money allocable to a special time deposit or investment fund shall be pooled for investment purposes in accordance with the District’s pooling policy.

**1.2.5.2.1 Special Funds Pursuant to Government Code Section 66001**

Pursuant to Government Code Section 66006, the District shall establish and maintain special connection fee funds for the deposit of money received by the District for the connection of a service to a public water or sewer system. Money received for the connection of a service located within the boundaries of the Rancho Division to the public water system shall be deposited in the special account hereby designated, the “Rancho Division Connection Fee

Fund,” and money received for the connection of a service located within the boundaries of the Santa Rosa Division to the public water system shall be deposited in the special account hereby designated, the “Santa Rosa Division Connection Fee Fund.” Money received for the connection of a building to the public sewer system shall be deposited in the special account hereby designated, the “Wastewater Division Connection Fee Fund.”

#### **1.2.5.2.2 Bond Improvement Funds**

The Board of Directors may establish and maintain any number of bond improvement funds to account for the proceeds of bonds of the District, which are restricted for capital construction purposes.

#### **1.2.5.2.3 Debt Service Funds**

The Board of Directors shall establish and maintain debt service funds to account for money received by the District from the collection of assessments and standby charges or from the sale of property for delinquent assessments, and from the payment of the monthly debt service surcharge attached to water rates. Money placed in the debt service funds shall be restricted for the payment of bonds and of the interest thereon, other related bond costs, and when economically advantageous, cash funding of capital projects. Until such time that the total bonded indebtedness of the District is discharged, these funds shall not be used for any other purpose. When all of the principal of and interest on the bonds has been paid, the balance of the money remaining in the debt service funds may be transferred to the appropriate general fund or other designated fund, such as the replacement reserve fund.

Money received by the District which is restricted for payment of the bonded indebtedness of the Rancho Division shall be deposited in the special account hereby designated, the “Rancho Division Debt Service Fund,” and money received by the District which is restricted for payment of the bonded indebtedness of the Santa Rosa Division shall be deposited in the special account hereby designated, the “Santa Rosa Division Debt Service Fund.”

#### **1.2.5.2.4 Replacement Funds**

The Board of Directors shall establish and maintain special replacement funds to account for money received by the District from the payment of the monthly depreciation surcharge attached to water rates and the monthly sewer service charge. Money placed in the replacement funds shall be restricted for the acquisition and construction of capital replacement facilities and may not be used for any other purpose without the express authorization of the Board of Directors.

Money which is restricted for the replacement of water facilities in the Rancho Division shall be deposited in the special account hereby designated, the “Rancho Division Replacement Fund,” money received which is restricted for the replacement of water facilities in the Santa Rosa Division shall be deposited in the special account hereby designated, the “Santa Rosa Division Replacement Fund,” and money received by the District which is restricted for the replacement of wastewater facilities shall be deposited in the special account hereby designated, the “Santa Rosa Water Reclamation Facility Replacement Fund.”

#### **1.2.5.2.5 Other**

The Board of Directors may establish and maintain such other special funds as may be necessary to account for money received by the District from special charges that it may, from time to time, impose for any lawful District purposes.

These funds can be broken down into two categories defined as “discretionary” and “non-discretionary.” *Discretionary* funds would include only the General funds of the District and are distinguished from *non-discretionary* funds by the elasticity at which they can be funded and their flexibility of use. Unlike the non-discretionary funds, the General funds use and funding level are impacted to a greater degree by external economic factors such as energy rates, imported water rates, and drought conditions—all of which have a material impact on the District’s cost of operations.

Non-discretionary fund types and their funding levels are driven by long-term capital needs and legal or legislative restrictions. In addition, the non-discretionary funds are utilized to fund long-term programs and, thus, are greatly impacted by the time value of money. Due to these factors, their segregation and funding levels become more restrictive. In contrast, the general funds have funding mechanisms that are more elastic because they are funded with water and sewer rates which can be adjusted on a less restrictive and periodic basis and, due to the short-term nature of their use, are not as sensitive to the impact of the time value of money.

The use of the term “discretionary” funds is not meant to imply that the General funds of the District are completely unrestricted. The operating nature of the District creates certain needs for

fund balances to offset the risk of operations and provide certain protections for adequate funds in case of unforeseen events. A summary of these risks and ascribed reserve requirements are as follows:

### **III. FUND BALANCE PARAMETERS**

Due to the difference in the volatility and nature of *discretionary* versus the *non-discretionary* fund types, it is recommended that their funding parameters be based upon differing assumptions.

Parameters for non-discretionary funds are driven by a combination of legal and legislative requirements, as well as a long-term cash flow plan. For example, the debt service fund balance requirements are projected over a 50-year period, and the impact of numerous parameters has an influence upon its required balance. These parameters include the level of capital projects required to meet new demands, interest rates, the level of variable rate debt, replacement funding debt requirements, inflation, assessed values of property, and other variables. In other words, the cash flow plan drives and affirms the level of the non-discretionary fund types.

Since the District is required to hold certain reserve balances, it has entered into a variable rate debt program that maximizes the benefits of holding long-term reserves. The District's variable rate debt program creates a need for stable and segregated reserve requirements, as they provide a hedge against rising interest rates. This program has provided millions of dollars in interest rate savings since its inception, due to the lower rate of variable rate debt when compared to fixed rate debt. Along with a lower interest cost, variable rate debt brings a higher risk of volatility caused by a potential rise in interest rates. Maintaining a proper level of reserve balances that will earn higher interest rates to offset a rise in interest costs minimizes this volatility risk. Maintaining a disciplined reserve balance policy, when implemented properly, not only minimizes the interest rate risk of variable rate debt, but also adds to rate stability in times of rising interest rates.

A conservative hedge ratio of variable rate debt to reserve balances has been determined at 150%. This ratio was determined based upon the historic spread between the 30-day LIBOR index (London Inter-Bank Offered Rate) and the TBMA index (The Bond Market Association Municipal Swap Index) that has averaged 270% in recent years. In simple terms, the District can offset the risk of one hundred and fifty dollars of variable rate debt with one hundred dollars of reserves.

Based upon the information provided above, fund balance parameters for the various funds of the District will be determined as follows:

**General fund** – See calculation of five components below.

**Connection fee fund** - Determined by a long-term cash flow plan that will be updated and reviewed on an annual basis.

**Debt service fund** - Determined by a long-term cash flow plan that will be updated and reviewed on an annual basis and bond covenants.

**Bond reserve fund** - Amount determined by bond covenants.

**Replacement fund** - Determined by a long-term cash flow plan that will be updated and reviewed on an annual basis.

**Construction fund** - Determined by a long-term cash flow plan that will be updated and reviewed on an annual basis.

**Variable rate debt considerations** - Before fund balances are reduced, the impact upon the District's variable rate hedge position will be calculated and the impact of interest rate costs will be considered before balances are reduced. If it is determined that holding a higher reserve balance will provide a material reduction in interest rate costs, then the higher reserve balance will be maintained over the matching-debt period.

#### **IV. GENERAL FUND RESERVE COMPONENT TARGETS AND FUNDING PRIORITY**

The General Fund is comprised of five components with individual target levels and relative funding priority levels based on the major classifications of risk to the District's operations. Each component of the General Fund reserve receives available revenues in order of its priority until its target level is met. Special revenues applicable to a particular component, such as with drought

penalties to the Drought Reserve, are applied directly to the applicable reserve component to assist in funding the target level more quickly than would otherwise be available from general revenues. Each component reserve with their target levels and priority is described below.

- A. Working Capital Reserve** – This reserve acts as the “base” reserve and is intended to provide sufficient liquidity from a cash-flow perspective to facilitate the normal dynamic of first having to pay expenses before receiving funds from customers. Having this cash flow liquidity is essential, especially in context to being able to pay for imported water which is over 50% of normal operating budgets and fluctuates significantly from month-to-month. This reserve target is set at a minimum of four months of the total annual operating budget.
- B. Drought Reserve** – This reserve helps mitigate the risk of short-term low- to moderate-drought impacts by funding unanticipated purchases of imported water needed, due to declines in native supply or spikes in demand from the weather. It acts as a type of water supply stabilization fund and is typically utilized to some extent every year and in very heavily, more pronounced drought years. These imported water purchases are financially significant to the District and are expenses beyond the District’s control. Although drought penalties are dedicated to this fund through the Water Shortage Contingency Plan during implementation of severe stages, this funding stream is rare compared to the frequent nature the reserve is needed and so it is placed at a high priority compared to the other components of the General Fund Reserve. Experience with severe drought conditions has shown that local water yield can be reduced by up to 5,000 acre-feet per year. The Drought Reserve target is set at one year’s impact of estimated drought costs, which is estimated by multiplying the

potential 5,000-acre-foot production reduction by the current cost differential between local and treated import water.

- C. Rate Stabilization Reserve** – The District’s Rate Stabilization Reserve provides broad protection against unexpected costs or loss of revenues and acts as the primary discretionary reserve, when considering mitigating rate increases. It covers funding for unanticipated major expenses during a year such as unbudgeted major leak repairs, as well as acts to mitigate rate increases from known cost increases for future years, such as with imported water or energy rates. This reserve is ranked after the Drought Reserve due to its broad nature and the District having more discretion either over the types of expenses it would cover or the ability to respond with other mitigating actions. The Rate Stabilization Reserve target is set at three months of budgeted operating costs.
- D. Water Replenishment Reserve** – The District has a significant resource in storage capacity through both the groundwater aquifer and Vail Lake. The Water Replenishment Reserve provides funds on hand to purchase water to replenish or store within these two resources when water is available. The reserve target is based on a total of 13,500 acre-feet, which represents an average year’s amount of recharge and recovery water, multiplied by the current cost of untreated imported water. It is ranked lower than the others, as it addresses multi-year water supply needs and is strictly discretionary in nature. This reserve is also not as reliant on being funded from typical

operating revenues as the other General Fund reserve components since it can be specially funded by inefficient or wasteful water rate tiers.

- E. Risk Management** – The Risk Management Reserve is comprised of two main components to mitigate against the risk of costs on claims that would be self-insured and against costs to repair or replace assets that are uninsured. It is designated as the lowest priority to receive General Fund revenues due to the nature of its infrequent use and ability to be funded by other reserves or non-operating funds.

*Self-Insured Component-* The District currently maintains self-insurance levels of \$100,000 for liability and \$25,000 for property coverage on a per-occurrence basis. Maintaining these self-insurance limits has materially reduced the District's annual insurance premiums. In the case of a major event, the District would be liable for its self-insurance limits on a per-occurrence basis. Historical experience demonstrates that it is prudent for the District to maintain reserves at five times the self-insurance amount. This would equate to a \$500,000 reserve for liability and \$125,000 for property for a total of \$625,000. The water divisions collectively and the Wastewater Division would each have a \$625,000 target to reflect the more independent nature of the risks for water and wastewater operations. This self-insurance portion of the Risk Management Reserve target would reflect any changes to the District's self-insurance levels.

*Uninsured Component-* It is not economically justifiable or in some cases possible to obtain insurance for a substantial amount of the District's assets and as such an uninsured portion of the Risk Management Reserve is necessary to cover replacement costs in the event of a major natural disaster, such as an earthquake. Examples of

uninsured types of facilities include tanks, dams, and water and wastewater mainlines. Replacement costs are estimated at 2% of total utility plant assets based upon current FEMA guidelines. However, the District sets its uninsured portion of the Risk Management Reserve at 50% of its total exposure, which equates to 1% of the historical cost of utility plant assets. This takes into consideration that, although the replacement cost of the utility plant could be double that of the current historical book value of the total utility, the risk is mitigated by the varied demographics of the District which scatter the utility plant assets over a large service area, thus reducing the probabilities of damage to the total utility plant.

#### **V. FUNDING TIMELINE GOALS OF GENERAL FUND RESERVES**

The five reserve components within the General Fund Reserve are further classified into one of three prioritized groups of reserve level targets to establish goals for when they should be fully funded. The three groups are “Critical,” “Minimum,” and “Target” reserves. Annually, staff is to present a Reserve Funding Plan for the Board of Directors’ consideration, based on these funding timeline goals.

The Critical group is considered essential to the basic functioning of the District. Components within the Critical group have a 5-year goal to be fully funded. The Working Capital Reserve falls within the Critical group.

The Minimum group is considered necessary to the short-term financial integrity of the District to protect from certain and frequent risks. Components within the Minimum group have a 10-year goal to be fully funded. The Drought Reserve and the Rate Stabilization Reserve fall within the Minimum group.

The Target group represents the remaining components of the General Fund and are important to the long-term financial integrity of the District to protect from known, but less frequent risks. Components within the Minimum group have a 15-year goal to be fully funded. The Water Replenishment Reserve and the Risk Management Reserve fall within the Target group.

<b>GENERAL FUND RESERVE FUNDING PRIORITY AND TIMELINE</b>			
<b>Reserve Group</b>	<b>Reserve Type</b>	<b>Funding Priority</b>	<b>Funding Timeline</b>
<b>Critical</b>	Working Capital	1	Within 5 Years
<b>Minimum</b>	Drought Reserve	2	Within 10 Years
	Rate Stabilization	3	Within 10 Years
<b>Target</b>	Water Replenishment	4	Within 15 Years
	Risk Management	5	Within 15 Years

**VI. CALCULATION OF NON-DISCRETIONARY FUND RESERVE REQUIREMENTS**

As was detailed above, the non-discretionary funds consisting of the connection fee, debt service, bond reserve, replacement, and construction funds will be determined on an annual basis when the non-operating and long-range financial plans of the District are updated and adopted. These plans project the cash balance needs of the various funds over a long-term planning horizon based upon the many and varied parameters that impact their requisite levels. An extensive public review of these plans is facilitated during the annual budget process by the District’s Board of Directors and management.