



Item No. 5
Revised

DISCUSSION ITEM
March 9, 2022

TO: Board of Directors

FROM: Administration & Finance Committee
(Directors Seckel, Dick, Thomas)

Robert Hunter **Staff Contact: Hilary Chumpitazi**
General Manager

SUBJECT: Reserve & Fund Policy Review

STAFF RECOMMENDATION

Staff recommends the Administration & Finance Committee, MWDOC Board of Directors, Member Agencies, and the public review, discuss and provide input and comments on the Reserve Policy Alternatives and Considerations Report (Thomas Report). These discussions should continue through the April meeting cycle in order to allow all parties sufficient time to review the report and discuss possible actions. The committee should direct the General Manager to:

- Include in the third draft budget any reserve actions that can be decided at this time with regards to the rates and projected draw on reserves (e.g., Tier 2 Reserves);
- Disaggregate the General Fund into an active carry-over project/program component, a non-active project/program component with use conditions, and a non-active project/program component without use conditions;

COMMITTEE RECOMMENDATION

Committee recommends (To be determined at Committee Meeting)

DETAILED REPORT

MWDOC's reserve policy and amounts have been actively discussed since the early 2000's, were a key component of the 2011 Settlement Agreement and last updated in 2017.

| | | | |
|---|------------------|---------|-----------|
| Budgeted (Y/N): NA | Budgeted amount: | Core __ | Choice __ |
| Action item amount: | Line item: | | |
| Fiscal Impact (explain if unbudgeted): | | | |

Those considerations have focused on the “Designated Reserves” including General Operations, Grant & Project Cash Flow, Election Expense, Building Repair, and OPEB. And while reported on the balance sheet in the monthly Financial Report for decades, the Other Funds have been consistently not part of the discussion. The current discussion is intended to focus on both the Designated Reserves and the Other Funds for a more comprehensive review. The Thomas report states that “there is not a single answer to the question of the “right amount of reserves” and that “each agency has its own risks and considerations”. It observes that MWDOC’s level of Designated Reserves “is consistent with highly rated and well managed agencies”. A primary focus therefore becomes the other funds and categories on the balance sheet. These are briefly described below.

Restricted Fund Balances - Water Fund – T2C (Tier 2 Fund)

If MWDOC purchases more water from Metropolitan Water District of Southern California (MET) during the ten-year period of the purchase order agreement then designated for Tier 1 pricing then the higher Tier 2 pricing comes into effect. In 2013 this fund was reviewed and a determination was made that \$3.7 million of the \$4.7 million fund balance could be refunded to the Member Agencies with acceptable risk exposure. Subsequent to that review, a new purchase order has been executed with a higher Tier 1 limit and water demand has decreased. There is essentially no risk that MWDOC will incur Tier 2 costs during the remainder of the current purchase agreement. The current balance in the Tier 2 Fund is \$1,035,035. If applied to the budget and rates proposed in the second draft budget it would balance the budget, reduce the proposed meter charge by approximately \$0.80 and reduce the proposed groundwater customer charge by approximately \$21,000.

Excess Revenue over Expenditure – Operating Fund & Other Fund

All operating funds are posted to these two funds when received. Most of MWDOC’s operating revenues (e.g., not water sales revenue) is received early in the fiscal year and expended throughout the year. These funds therefore decrease as the fiscal year progresses and are updated monthly on the balance sheet. At the end of the fiscal year the Operating Fund balance (either positive or negative) is transferred to the Designated Reserves excepting any pre-paid amounts for next fiscal year.

WEROC Capital & WEROC (Operating) Funds

These two funds are operating and capital reserve funds specific to WEROC. They can change each month but are updated at the end of each fiscal year.

General Fund and General Fund Capital Funds

These two funds are used for carryover amounts for multiple-year projects and programs. For example, the carryover construction funds from the recently completed seismic retrofit and building remodel project and the funding for multiple-year engineering projects. These funds are updated at the end of the fiscal year but accumulate residual funds over time if all the carryover funding isn’t expended. The two funds need to be disaggregated into three separate components: active carry-over project/program component, a non-active project/program component with use conditions, and a non-active project/program component without use conditions. The active project component should remain in the General Fund until completed, the non-active project funds with use conditions should be segregated for the required utilization. There are several alternatives for the ultimate utilization of the non-active component without use conditions as described in the Thomas Report.

Municipal Water District of Orange County

Reserve Policy Alternatives and Considerations

March 2022

The Municipal Water District of Orange County (“MWDOC” or the “District”) reviews its Reserve Policy periodically to ensure that it has sufficient reserves to address its cash flow needs and support the financial strength of the District. This report summarizes MWDOC’s existing policy, issues and considerations driving the need for liquidity to meet MWDOC’s financial requirements over time and provides some alternatives for managing reserve levels. In particular, the level of reserves required as MWDOC continues its existing operations – serving as a wholesale provider of Metropolitan Water District (“Metropolitan”) supplies, a service provider through the “Choice” programs, and representing the MWDOC member agencies at Metropolitan - will be different than the needed liquidity should MWDOC take on project development or be directed to acquire supplies beyond those provided by Metropolitan.

Background

MWDOC last updated its Reserve Policy in 2017. At that time the policy was consistent with recommendations from the Government Finance Officers Association (GFOA). GFOA recommends that agencies fund working capital and other reserves to mitigate current and future risks and to ensure stable services and fees, as well as establish reserve targets and ranges. Strong and transparent financial policies, including maintaining prudent reserves for emergencies, rate stability, and working capital are consistent with best practices in the utility industry^{1,2} and are important to MWDOC as they help to:

- Maintain the short-term and long-term financial strength
- Maintain stable rates for member agencies and help ensure manageable rate increases.
- Fund unanticipated cost contingencies.
- Ensure cash exists for the timely payment of bills.
- Provide funding for anticipated projects and programs.

The Reserve Policy sets targets based on “days cash on hand” or “days cash”, a common measure of liquidity. This measures the amount of reserves (typically, unrestricted cash and investments in the reserve fund or funds) available to fund operating expenses. Days cash on hand is equal to the amount of available reserves divided by one day’s worth of operating and maintenance expenses. Some agencies include depreciation in expenses, but this depends on the specific circumstances surrounding the agency’s financial environment. In MWDOC’s case, the days cash measure is based on operating and maintenance expenses exclusive of purchased water expenses. This is done since the purchased water expense is a “pass through” and is only incurred when water is purchased by a member agency – and that member agency is responsible for the cost of the water

used by that member agency. As discussed below – there is risk the member agency may not be able to fund the purchased water on a timely basis, and the operating reserves are designed to cover such a shortfall.

¹ Government Finance Officers Association, Best Practice –Working Capital Targets for Enterprise Funds

² Water Research Foundation, Defining a Resilient Business Model for Water Utilities, 2014

Since operating expenses vary over time as an agency adjusts activities, programs and initiatives, the absolute amount of reserves needed to meet a target based on days cash on hand will also be adjusted to reflect such changes. For example, if a target of 180 days cash is established, as operating and maintenance expenses increase over time due to inflation, the amount of money needed to be retained in reserve would also increase in order to maintain 180 days cash. Similarly, if the agency’s activities decrease over time and operating and maintenance expenses decline, needed reserves would also decline.

Existing Reserve Policy

MWDOC’s reserve policy identifies three categories of reserves:

Unrestricted Designated Reserves:

- a. General Operations. Amounts held in the General Operations reserve cover typical fluctuations and differences between revenues and expenses during the year. These reserves are available to meet unexpected expenses both in timing and amounts.
- b. Grant & Project Cash Flow. This reserve is available to cover cash flow needs while MWDOC submits requests for reimbursement of expenditures under various grant agreements.
- c. Election Expenses. This reserve enables MWDOC to collect money over time to fund the cost of elections. Elections were estimated to cost \$1.2 million (for seven elections).
- d. Building Repair. The Building Repair reserve is targeted at 15 days cash and is reserved for unplanned or emergency repairs or other non-budgeted expenditures to repair, replace or refurbish the building resulting from accidents or unexpected events such as damage from a severe windstorm or fire.
- e. OPEB. This reserve is set to cover 5-15% of MWDOC’s outstanding retiree health obligations. MWDOC intends to maintain a fully funded obligation. The amount in the OPEB reserve is determined every two years, based on the actuarial valuation of the liability.

Restricted Reserve:

- a. Tier 2 Contingency. MWDOC established the Tier 2 contingency reserve to cover the difference cost of any Tier 2 purchases of water from the Metropolitan Water District. The amount in the Tier 2 Reserve at June 30, 2021 was \$1.035 million. Using the proposed 2023 Supply Tier 2 Rate (\$532/af) would be enough to cover over 4,000 acre-feet of Tier 2 water at Metropolitan’s proposed rates for Tier 2.

WEROC Reserves:

WEROC reserves are included in a separate account and are determined each year by the MWDOC board and WEROC contributors. These reserves are used to meet unforeseen expenses and needed capital improvements and emergency response infrastructure.

Each of the designated reserve funds and the WEROC reserves are reviewed during the annual budget review process and, to the extent that reserve levels deviate from their respective targets, the General Manager will make recommendations to the Board regarding the level of reserves.

The unrestricted designated reserves and OPEB reserves of \$6.4 million shown in Table 1.

| MWDOC Reserves as of June 30, 2021 | | |
|---|------------------------|----------------------------|
| Reserve Category | Proposed Amount | Adjustment Protocol |
| Operating Reserve | \$3,738,505 | Based on Days Cash |
| Grant & Project Cash Flow | \$1,500,000 | Operational Needs |
| Election Expense | \$461,678 | Previous Election Costs |
| Building Repair/Replacement | \$436,542 | Estimated Cost Schedule |
| OPEB Reserve | \$297,147 | Board Action to Fund |
| Total | \$6,433,872 | |

Table 1. Designated Reserves

The Unrestricted Designated reserves represent about 176 days cash.

Other Available Fund Balances

As of June 30, 2021, MWDOC had approximately \$12.4 million in available unrestricted cash and investments, including prepayments for water by member agencies. Given budgeted operating and maintenance expenses (not including the pass through costs associated with purchase of water from Metropolitan Water District and depreciation) of \$13.3 million, total days cash at June 30, 2021, was equal to 341 days. As noted above, the total Designated Reserves at the end of the fiscal year were \$6.4 million. The remaining balances consist of the WEROC reserves (both capital and operating) of about \$406,000 and the Operating General Fund and Capital General Fund. The Operating General Fund includes all amounts not designated for a reserve and any amounts associated with carryover projects (e.g., projects that span more than one year). The remaining undesignated fund balances could be used for a number of purposes as discussed later in this report.

Reserve Level Guidance – What is the Right Level of Reserves?

There is not a single answer to the question of the “right amount of reserves”. Each agency has its own risks and considerations. The credit rating agencies provide some guidance on the amount of reserves highly rated municipal water utilities should maintain. The credit rating agencies view liquidity in the form of available reserves as a critical component of their evaluation of the financial strength of a public agency. Even though MWDOC has no debt and has no plans to issue debt in the near-term, the credit rating parameters are helpful guidelines as to healthy financial condition of a public agency. Table 2 shows the amount of liquidity each of the national credit rating agencies assign to different credit levels. As seen in Table 2, days cash ranging from 150 days to 360 days cash would be found in AA to AAA rated water agencies.

| Rating Agency Cash & Liquidity Metrics | | | |
|---|----------|-----------|----------|
| S&P¹ | | | |
| Rating | AAA | AA | A |
| Days' Cash Level | > 150 | 90-150 | 60-90 |
| Actual Available Cash Reserves | > \$75mm | \$20-75mm | \$5-20mm |
| Moody's Criteria | | | |
| Rating | Aaa | Aa | A |
| Days' Cash Level | > 250 | 150-250 | 35-150 |
| Fitch | | | |
| Rating Category | Stronger | Midrange | Weaker |
| Days' Cash Level | > 360 | ~ 180 | < 90 |

¹ S&P's cash and liquidity assessment evaluates both days' cash and actual available cash reserves.

Table 2. Rating Agency Metrics

While MWDOC has no outstanding debt and does not have plans to issue debt in the near-term, the credit guidelines are indicators of strong financial health. Should MWDOC identify the need to issue debt in the future, prudent reserves will support strong credit ratings and lower cost of borrowing, regardless of the lender.

GFOA recommends that enterprise funds set a working capital reserve target starting with a baseline of 45 days operating expenses in working capital, plus additional funds as necessary to meet specific circumstances. Depending on the specific circumstances, many water agencies have significantly larger reserve balances to account for things like

disasters and emergencies, fluctuation in water sales, and unpredictable but foreseeable expenses (e.g., spikes in energy costs).

MWDOC's Risk Profile

MWDOC has previously identified a number of risks that could impact cash flow and cash needs during the year. These risks include unanticipated expenses, the need to purchase Tier 2 supplies, delays in payments from member agencies, emergency capital expenditures (primarily for unanticipated building repairs and WEROC), lower interest earnings, business recovery expenses resulting after a natural disaster (e.g., an earthquake, pandemic, etc.), and delays in the receipt and reimbursement from grant programs. The past few years have demonstrated the need for financial resiliency to address unexpected circumstances, including COVID19 and the associated measures to deal with the pandemic, conflict in Europe, potential cyber threats MWDOC and its member agencies, and weather related events. Unlike many water agencies, MWDOC's revenue stream is relatively stable since its primary source of funding comes from member agency payments that are based on the number of retail connections, not water sales. Further, member agencies make payments at the beginning of the year – eliminating potential collection risk over the course of a year.

MWDOC's primary risks to cash flow are the potential for unanticipated costs due to emergencies, delays in payments from its member agencies for water purchases, delays in reimbursement from grants, and the potential for Tier 2 water purchases from Metropolitan.

Emergencies. Unanticipated expenses due to emergencies such as fires, earthquakes, and health crises are always a threat. Reserve levels to cover such events are needed to avoid fiscal stress or the need for supplemental calls on member agencies for additional funds during particularly difficult times.

| 3 | FY | CustNbrName | Sum of NOV | Sum of DEC |
|---|----------------------|--|-------------------|-------------------|
| 4 | = FY21-22 | 120 City of Brea | 11,553 | 13,456 |
| 5 | | 130 City of Buena Park | 317,171 | 272,079 |
| 6 | | 140 Santa Margarita Water District (ID9) | 545,267 | 491,723 |
| 7 | | 150 East Orange County Water District | 718,158 | 695,445 |
| 8 | | 160 El Toro Water District | 485,075 | 525,485 |
| 9 | | 170 City of Fountain Valley | 7,073 | 9,885 |
| 0 | | 190 City of Garden Grove | 286,223 | 186,595 |
| 1 | | 200 City of Huntington Beach | 554,665 | 247,595 |
| 2 | | 210 Irvine Ranch Water District | 1,673,805 | 1,215,673 |
| 3 | | 220 City of La Habra | 72,740 | 18,740 |
| 4 | | 230 City of La Palma | 3,989 | 2,105 |
| 5 | | 233 Laguna Beach County Water District | 309,255 | 306,870 |
| 6 | | 250 Mesa Water District | -33,206 | -14,240 |
| 7 | | 270 Moulton Niguel Water District | 2,122,648 | 2,047,636 |
| 8 | | 283 City of Newport Beach | 295,596 | 708,286 |
| 9 | | 290 Orange County Water District | 7,517,850 | 7,519,153 |
| 0 | | 300 City of Orange | 1,311,775 | 1,335,357 |
| 1 | | 310 City of San Clemente | 649,799 | 627,875 |
| 2 | | 350 Santa Margarita Water District | 1,989,667 | 2,017,398 |
| 3 | | 380 City of Seal Beach | 8,008 | 9,000 |
| 4 | | 400 Golden State Water Company | 598,930 | 555,750 |
| 5 | | 402 South Coast Water District | 450,210 | 444,491 |
| 6 | | 404 South Coast Water District - JRWSS | 0 | 0 |
| 7 | | 406 Trabuco Canyon Water District | 190,268 | 174,826 |
| 8 | | 430 City of Westminster | 12,786 | 15,668 |
| 9 | | 440 Yorba Linda Water District | 1,859,895 | 1,740,721 |
| 0 | | 450 Serrano Water District | 5,891 | 7,554 |
| 1 | FY21-22 Total | | 21,965,091 | 21,175,126 |

Table 3. Sales by Member Agency – November, December 2021

Water Payment Delays. Delays of one month or more for payment of water purchases from member agencies are covered from reserves. As shown in Table 3, monthly sales in

November and December of 2021 totaled \$21-22 million. Individual member agencies had bills as high as \$7.5 million, with a number of entities in the \$1.5-2 million range. While the likelihood of a ransomware or other event preventing a member agency from making a timely payment for water purchases is low, such an event would have significant impact on cash flow.

Delays in Grant Reimbursements. As MWDOC accesses more grant monies for water use efficiency activities and other projects, the need for cash reserves increases as most grants are provided on a reimbursement basis. This means MWDOC must meet expenditures out of its available funds and wait to receive funds from the granting authority for eligible costs.

Tier 2 Purchases. While demands for imported water are well below MWDOC's Tier 1 amounts, if groundwater production were to be curtailed or demands increase dramatically due to weather impacts, some MWDOC member agencies may push MWDOC purchases from MWD into the Tier 2 level. Further, during MWD allocations, it is possible that MWDOC would need to purchase supplies above its allocation at rates that are higher than Tier 1.

MWDOC's Current Financial Position and Potential Reserve Actions

MWDOC is in a strong financial position, with over \$12 million of unrestricted reserves at June 30, 2021. As such it can meet its obligations, while in a solid position to endure the risks highlighted above. MWDOC's reserve policy identifies unrestricted reserves that result in about 170 days cash. This level of reserves is consistent with highly rated and well managed water agencies. But, MWDOC's reserve policy does not address two important factors. First, the policy does not address how quickly reserves would be replenished if used. Second, the reserve policy does not address how to deal with available unrestricted funds above reserve targets. In addition, it would be helpful to describe the purpose of each of the funds – in addition to specifying the target and how the amount is calculated.

Replenishing Reserves. Generally, reserve policies define how reserves are used and replenished. The circumstances under which reserves are used are tied to the purposes of the reserve fund. For instance, general operating reserves would be used for emergency expenditures that have not been budgeted. If used, reserves would need to be replenished as quickly as possible without placing undue burdens on the member agencies. As such, a target to replenish reserves over a period of two to five years is often used. Sources of such funding include revenues in excess of expenditures in a given year. Such a "surplus" could occur if expenses in a given year were less than budget/anticipated. If such funds are not available, then member fees could be increased to replenish funds at an affordable rate.

Available Unrestricted Funds. At June 30, 2021, MWDOC had about \$6.9 million in available funds above the amount identified as need in the reserve policy. The primary source of these funds are the accumulation of revenues in excess of expenditures over time. Some of these funds are "carryover" funds for projects that will be expended, but the majority of funds are unrestricted. This provides opportunities for MWDOC and its member agencies to use these funds in any of the following ways:

(1) Create a “Water/Project Fund” in which such available funds would be deposited to be used for future water purchases, research, development or water supply efforts as identified by the MWDOC board.

(2) Create a Rate Stabilization Fund in which the uncommitted (exclusive of the carryover amounts) would be transferred. These Rate Stabilization Funds could be used to (a) replenish designated reserves, (b) pay for one-time expenditures, and (c) used over a period of time such as the next two to five years to mitigate increases in member agency fees

(3) Use the available funds for credits on member agency’s future payments to MWDOC.

(4) Use the remaining available funds to pay down MWDOC’s unfunded pension liability through additional discretionary payments or through MWDOC’s Section 115 Trust.

(5) Refund some or all of the undesignated funds above the carryover amounts to the member agencies during the next budget cycle. Of course, the board could determine that funds could be used to accomplish one or more of these options.

MWDOC should also determine how it will utilize future year’s excess of revenues over expenditures by identifying those portions that are carryover, and transferring any remaining funds to the fund or funds created as described above, reducing future member agency payments or replenishing designated reserves.