M E M O

TO: Budget & Finance Committee

FROM: Director of Finance & Business Services

SUBJECT: Reserve Fund

DATE: June 1st, 2018

BACKGROUND:

As part of the budget process, the Reserve Fund Policy is reviewed. It is recommended the committee review the policy and make recommendations as needed

RECOMMENDATION:

Every year the District reviews the Reserve Fund Policy as part of the budget process. This is presented by the District Manager, to the Board of Directors, as part of the budget process.

The policy resides in the San Lorenzo Valley Water District's Policies and Procedures, Finances section.

In the recent past years, the District has had some restricted funds for debt servicing and assessment districts. The remainder is then committed to the operational reserve fund. With the recent rate increases, the fund will eventually be built back up to sufficiently cover the operational and capital reserve funds.

In reviewing the policy, section 6.02 (f) (ii & iii), denotes specific dollar amounts. These amounts can become outdated quickly. It is recommended that some sort of formula is assigned to help signify appropriate levels.

For example, operational reserves should be 3-6 months of the budgeted operational expenditures. This would leave a range that can be calculated off of the budget.

Similar for the capital reserve, it could be a percentage of depreciation. Such as 150% of the prior years audited depreciation amount.

It is recommended the committee possibly propose a revision to the Board.

Article VI. Finances

Section 6.01 Investments

(b) Introduction

The purpose of this Article is to establish formal policies for the prudent investment of the District's unexpended cash. The main objectives of this Article are:

1. Establish guidelines for the investment of all funds belonging to or in the custody of the District in a manner conforming to all state and local statutes governing the investment of public funds, and

2. Provide an optimal combination of safety, liquidity and yield for District Investments.

(c) Basic Policies

(i) PRUDENCE: District funds shall be invested under the "prudent investor standard" (California Government Code Section 53600.3) which essentially states that all investments shall be made with care, under circumstances then prevailing, that a prudent person acting in like capacity would use with funds of like character to safeguard capital and maintain liquidity.

(ii) DELEGATION OF AUTHORITY: Authority to manage the District investment program is delegated to the District Manager. The District Manager is encouraged to consult with the Budget and Finance Committee in between monthly reports to the Board as required by this Article.

No person may engage in an investment transaction except as provided under this Article.

(iii) OBJECTIVES: The objectives of the District's investment activities in priority order are as follows:

1st SAFETY – Safety of principal is the foremost objective of the investment program. The District's investment portfolio shall be designed and undertaken in a manner that seeks to ensure the preservation of the principal invested.

2nd LIQUIDITY – The District's investment portfolio shall be designed to remain sufficiently liquid to enable the District to meet all operating requirements which might be reasonably anticipated. The liquid needs of the District shall be commensurate with the constraints of anticipated cash flow requirements.

3rd RETURN ON INVESTMENTS – The District's investment portfolio shall be designed with the objective of attaining the maximum possible rate of return commensurate with the District's investment risk constraints and the cash flow characteristics of the portfolio.

4th PERFORMANCE STANDARDS: Investments shall only be made as allowable by law with specific reference to California Government Code Section 53600, et seq., and any other applicable provisions of law.

(iv) AUTHORIZED AND ACCEPTABLE INVESTMENTS: District funds shall be invested only in the following investment instruments and within any limits indicated:

1st LAIF – The Local Agency Investment Fund (LAIF) is an investment pool established and controlled by the State of California to afford smaller agencies the benefits of a large investment portfolio, including higher interest rates and greater diversification.

2nd COUNTY OF SANTA CRUZ INVESTMENT POOL – This is an investment pool established and controlled by the County of Santa Cruz to afford smaller agencies the benefits of a larger investment portfolio, including higher interest rates and greater diversification. Authority for the County of Santa Cruz Investment Pool is delegated to the County of Santa Cruz Treasurer.

3rd CERTIFICATES OF DEPOSIT – These are receipts for funds deposited in a bank, or savings and loan, or broker deposits for a specific term and rate of interest. The principal and accrued interest shall be insured by the Federal Deposit Insurance Corporation (FDIC). The principal and accrued interest in any one insured depository institution shall not exceed the limit amount insured by FDIC.

4th PASSBOOK SAVINGS ACCOUNTS – This is a regular liquid savings account. The principal and accrued interest shall be insured by the Federal Deposit Insurance Corporation (FDIC). The principal and accrued interest in any one insured depository institution shall not exceed the limit amount insured by FDIC.

5th U.S. TREASURY OBLIGATIONS – These are negotiable debt obligations of the U.S. Government which guarantee that all interest and principal payments will be paid on time. Among these are Treasury Bills, Notes and Bonds.

6th With Board approval, repurchase bonds issued by the District or accelerate payback of loans incurred by the District, including bonds payable solely from a revenue producing property owned, controlled or operated by the District.

7th Registered warrants, treasury notes or bonds of the State of California, including bonds payable solely from a revenue producing property owned, controlled or operated by the State of California, or by a department, board, agency or authority of same.

(v) DIVERSIFICATION: The purpose of diversification is to reduce overall portfolio risks while attaining market yields. The District will diversify its investments by security type and institution, especially when there is no decrease in yield. Pursuant to California Government Code Section 53601(i) certificates of deposit invested outside of an authorized pool shall not exceed thirty percent (30%) of the District's total investment portfolio.

(vi) MATURITY OF INVESTMENTS: In order to minimize the impact of market risk, generally it is intended, that all investments will be held until maturity. Projected cash flow requirements are the primary factor to be used in determining investment maturity terms. After cash flow needs have been met, yield considerations will be the next factor in determining maturity terms, with the expectations that longer maturity periods will generally yield greater returns on investments. Investments may be sold before maturity if required for cash flow or appreciation purposes.

The maximum maturity term of any investment shall not exceed five years.

(vii) REPORTING: The District Manager shall provide to the Board of Directors monthly investment reports that provide a clear picture of the status of the current investment portfolio, as required by California Government Code Section 53607 and in compliance with the recommendations provided in California Government Code 53646.

(viii) ETHICS AND CONFLICTS OF INTEREST: Officers and employees involved in the District's investment process shall not conduct personal business activity that could conflict with proper execution of the investment program or which could impair their ability to make impartial investment decisions.

(ix) INVESTMENTS POLICIES ADOPTION: In accordance with California Government Code Section 53607 the District's investments policies shall be adopted annually by resolution of the Board of Directors at a public meeting.

Section 6.02 Reserves

(d) Purpose of Reserve Policy

Adequate designations of reserve funds set aside for various legitimate purposes are critical to the successful and stable, short and long-term operation of the San Lorenzo Valley Water District (the "District").

Adequate reserves for the District operations ensure that customers experience both stable rates for service and the security that the District can respond to emergencies, especially regarding water and wastewater quality issues. Adequate reserves ensure that the District will at all times have sufficient funding available to meet its operating, capital and debt service cost obligations, together with future debt or capital obligations, as well as any unfunded mandates, including costly regulatory requirements.

The District manages its working capital in a manner that allows the District to fund costs consistent with its annually updated capital improvement program and budgeted financial plan, and that avoids significant rate fluctuations due to changes in cash flow requirements. The ability of the District to maintain reserve funds is a critical factor in providing reliable service, mitigating rate increases, and ensuring overall financial strength.

Annually, during the budget adoption process, the District Board should review and approve the appropriate levels and uses for reserve funds based upon the needs of the District.

This Reserve Fund Policy (the "Policy") was developed to clearly identify specific designated reserves and reserve funds. It is the intent of this Policy to clearly identify both reserve fund categories and purposes, and set target levels for reserves that are consistent with the District's mission statement, the uniqueness of the District, and the philosophy of the District's Board.

(e) Fund Balance Classifications

The Governmental Accounting Standards Board (GASB) issued GASB Statement Number 54 (Statement 54), Fund Balance Reporting and Governmental Fund Type Definitions in February 2009. Statement 54 abandons the reserved and unreserved classifications of fund balance and replaces them with five new classifications: nonspendable, restricted, committed, assigned and unassigned.

(i) Nonspendable – consists of assets that are inherently nonspendable in the current period either because of their form or because they must be maintained intact, including prepaid items, inventories, long-term portions of loans receivable, financial assets held for resale, and principal of endowments.

(ii) Restricted: Amounts that are subject to externally enforceable legal purpose restrictions imposed by creditors, grantors, contributors, or laws and regulations of other governments; or through constitutional provisions or enabling legislation.

(iii) Committed: Amounts that are subject to a purpose constraint imposed by a formal action of the government's highest level of decision-making authority before the end of the fiscal year, and that require the same level of formal action to remove the constraint.

(iv) Assigned: Amounts that are subject to a purpose constraint that represents an intended use established by the government's highest level of decision-making authority, or by their designated body or official. The purpose of the assignment must be narrower than the purpose of the general fund, and in funds other than the general fund, assigned fund balance represents the residual amount of fund balance.

(v) Unassigned: Residual classification for the government's general fund, and could report a surplus or deficit. In funds other than the general fund, the unassigned classification should be used only to report a deficit balance resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned.

(f) Designated Reserve Funds

(i) Restricted - Debt Service Reserve Fund

The District requires that this fund be maintained at a level sufficient to fund any current debt covenant requirements. Whether funds are held by the debt trustee during the term of the debts or if it is held internally. These are to be used in the event that the District is unable to meet its required semi-annual debt service obligation. Debt covenant requirements will be updated on an as needed basis for any new or retired obligations.

(ii) Committed - Capital Reserve Fund

This fund pays for the replacement of existing facilities and equipment as it reaches the end of its useful life or for major repairs that extend the useful life of facilities. This fund will also cover any emergency repairs to insure a timely response by the District to natural disasters and/or other emergencies. This insures timely acquisition, replacement and upgrade of the District's water system infrastructure and capital assets.

Expenditures from this reserve fund which are subsequently recovered, either partially or fully, from FEMA, OES, insurance and/or any other sources, said revenue shall be utilized solely for the purpose of refunding the Capital Reserve Fund.

The fund level for the Capital Reserve Fund is a target level equal to $2,000,000, unless otherwise directed by the Board at a public meeting. If current funds are below the target level of $2,000,000, the Board can designate a plan to replenish the fund.

(iii) Committed - Operational Reserve Fund

This fund is established to cover unexpected cash flow shortages, expense or losses. These might be caused by delayed payments, unexpected building repairs, or economic conditions. Reserves should not be used to make up for income shortfalls, unless the District has a plan to replace the income or reduce expenses in the near-term future, which would require Board designation. In short, reserves should be used to solve timing problems, not deficit problems.

A commonly used reserve goal is 3-6 months' expenses. The fund level for the Operational Reserve Fund is a target level equal to $1,500,000, unless otherwise directed by the Board at a public meeting. If current funds are below the target level of $1,500,000, the Board can designate a plan to replenish the fund.

- Assigned – none at this time
- Nonspendable – none at this time
- Unassigned – none at this time

(g) Annual Review

The District Manager shall perform a review and analysis of each designated reserve funds for presentation to the Board at a public meeting upon the occurrence of the following:

- Upon consideration by the Board of the annual budget.
- Upon any significant change to and/or expenditure(s) from a designated reserve fund.
- Upon determination that a fund balance is less than the established target level, without a near term replenishment plan.
- As part of the annual review, a summary of the funds and fund level(s) shall be listed out, as well as the anticipated levels for that fiscal year.