

## Valley Water Reserve Policy

Valley Water Reserve Policy is reviewed annually with the Board of Directors pursuant to Executive Limitation 4.6 - Financial Planning and Budgeting - "At least annually present the Board with information about Valley Water financial reserves and schedule an opportunity for the public to comment thereon."

The Governmental Accounting Standards Board (GASB) 54 statement, issued in March 2009, required that governmental agencies adopt new standards of reporting fund balance no later than the first fiscal year beginning after June 15, 2010. While the GASB 54 requirement was specifically issued for governmental type funds, Valley Water, under its conservative and prudent fiscal policy, extended the requirement to include the enterprise and internal service funds (Water Utility Enterprise, State Water Project, Fleet, Information Technology and Risk).

Key objectives of prudent financial planning are to ensure sufficient resources for current services and obligations, and to prepare for future anticipated funding requirements and unforeseen events. To meet these objectives, Valley Water strives to have sufficient funding available to meet its operating, capital, and debt service cost obligations. Reserve funds are accumulated and managed in a manner which allows Valley Water to fund costs consistent with the Capital Improvement Program, Integrated Water Resources Plan, and long range financial plans while avoiding significant water charge fluctuations due to changes in cash flow requirements. Valley Water also maintains a cash reserve position that may be utilized to fund unexpected fluctuations in revenues and operating/capital expenditures.

The level of reserves maintained and policies behind them are reviewed annually with the Board of Directors during budget deliberations.

## Definitions

According to a GASB 54 statement issued in March 2009, there are four categories for reporting of fund balances depicting the relative strength of the spending constraints placed on the purposes for which resources can be used:

- A. Restricted fund balance - these are externally imposed legal restrictions or amounts constrained to specific purposes by their providers (such as grantors, bondholders, and higher levels of government), through constitutional provisions, or by enabling legislation.
- B. Committed fund balance - these are self-imposed limitations or amounts constrained to specific purposes by a government itself, using its highest level of decision-making authority; to be reported as committed, amounts cannot be used for any other purpose unless the government takes the same highest-level action to remove or change the constraint.
- C. Assigned fund balance - these are amounts that a government intends to use for a specific purpose; intent can be expressed by the governing body or by an official or body to which the governing body delegates the authority.
- D. Non-spendable fund balance - amounts that are not in a spendable form (such as inventory) or are required to be maintained intact (such as the corpus of an endowment fund). NOTE: For the purpose of this reserve policy, only the spendable fund balances are considered.

Valley Water reserves are comprised of Restricted Fund Balance reserves, Committed Fund Balance reserves and Assigned Fund Balance reserves. Within these categories are budgeted reserves and special purpose reserves which are defined as follows:

1. Budgeted Reserves - Budgeted reserves may vary from those of the Comprehensive Annual Financial Report (CAFR) where it is appropriate to recognize actual cash transactions that are recorded in the CAFR as liabilities. Such adjustments include recognizing inter-fund loans, debt financing, and certain accruals as funding sources available for appropriation or as funding uses that reduce funds available for other purposes. These adjustments must be annually reconciled to the audited CAFR.
2. Special Purpose Reserves, Water Utility Enterprise Fund – These reserves are per the Parity Master Resolution which allows establishment of special purpose reserves by Valley Water Board resolution. Amounts in the Special Purpose Reserves may be used to offset extraordinary expenses and to supplement Valley Water revenues to meet debt service coverage requirements. Special purpose reserves are restricted per debt financing agreements which are in accordance with bond covenants.

## A. Restricted Reserves

### 1. Debt Service Reserve

This reserve was established for various bond issuances. The funds are not available for general needs of Valley Water and must be maintained as dictated in the bond covenants of the various issuances. Not all bond issuances may have all of the following reserves, but the primary debt reserves are: Debt Service Reserve Fund (to fund payments should Valley Water not be able to make debt service payments due to cash shortfalls), Arbitrage Rebate (to accumulate funds to offset the potential liability from excess earnings) and Debt Service Payment Fund (a pass-through reserve for initiating debt service payments).

### 2. Debt Proceeds Reserve

Bond covenants prescribe the use of debt financing proceeds. Debt proceeds typically fund capital projects as described in various bond issues. Debt proceeds, however, are not claimed until project expenses are incurred. Unclaimed debt proceeds are held in trust and identified in Debt Proceeds Reserves.

### 3. Rate Stabilization Reserve for Bond Covenant - Water Utility Enterprise Fund

The Parity Master Resolution for the Water Utility Enterprise requires the provision of a Rate Stabilization Reserve to offset expenses and revenue shortfalls, and to supplement Valley Water revenues to meet debt service coverage requirements. The minimum funding level is 10% of annual debt service due on all senior and parity obligations plus one month of adopted budget operations outlays. The specific level is to be financially prudent and based on reasonably anticipated needs.

### 4. Guiding Principal #5 (GP5) Reserve – Water Utility Enterprise Fund

In May 2018, the Valley Water Board approved a resolution to establish GP5 – Equity and costs are important, to allow certain communities and agencies to receive Valley Water contributions in the form of additional, incremental, dedicated and segregated funds exclusively for water conservation programs, recycled water, purified water, wastewater treatment plant environment updates, Automatic Meter Infrastructure (AMI) updates, or dedicated environmental focused grants from FY 2019 through

FY 2024, subject to 20% matching funds from the communities receiving Valley Water contributions. This funding source is limited to communities and agencies that currently pay State Water Project tax but receive an average of 85% of their water supply from non-Valley Water managed sources, and the Valley Water's contributions shall not exceed the State Water Project taxes paid by these communities and agencies. Any unspent funds shall be returned to Valley Water by FY 2026. The GP5 reserve would be established in FY 2019-20 as a sub-category of the Rate Stabilization Reserve to set aside the unspent/unencumbered balances approved by the Board in FY 2018-19. Per the Water Utility Parity System Master Resolution No. 16-10 adopted by the Board on February 23, 2016, the GP5 reserve must be accounted as a sub-category of the Rate Stabilization Reserve to allow this one-time source of funds, which may be utilized in future years, to be included in the debt service coverage calculation in the future year(s) when the funds are expended. Without this accounting mechanism, Valley Water's future debt service coverage ratio, as reported in future debt issuance Official Statements as well as the Annual Continuing Disclosure reports, will be lower to the extent that a non-current source of funds (GP5 reserve) is used to pay for a current expenditure. The minimum funding level for this reserve is \$0.

## **5. San Felipe Emergency Reserve - Water Utility Enterprise Fund**

This special purpose reserve is required by Valley Water contractual obligations with the U.S. Bureau of Reclamation for the operation and maintenance of the San Felipe Division of the Central Valley Project. The purpose of the reserve is to provide resources for unusual operation and maintenance costs incurred during periods of special stress caused by damaging droughts, storms, earthquakes, floods, or emergencies threatening or causing interruption of water service. Use of this reserve requires authorization by the U.S. Department of the Interior. Per contract, the funding level is accumulated in annual deposits of \$200,000 until the reserve totals \$1.75 million after which interest earned on the reserve is deposited annually.

## **6. Silicon Valley Advanced Water Purification Center Reserve - Water Utility Enterprise Fund**

This special purpose reserve serves as a fund for replacement of micro-filtration modules, reverse osmosis elements, and ultraviolet lamps at the Silicon Valley Advanced Water Purification Center (SVAWPC). Per the Recycled Water Facilities and Programs Integration Agreement between the City of San Jose and the Santa Clara Valley Water dated March, 2010, the annual contribution to the reserve may be up to \$810,000 starting in FY 2009-10 and adjusted annually by 3% for inflation, thereafter, until such time that the reserve reaches the reserve cap. The reserve cap was set in FY 2013-14 at \$2.6 million and to be adjusted by 3% for inflation annually thereafter. The reserve cap is based on a five-year replacement schedule for the micro-filtration modules and reverse osmosis elements. The specific level of this reserve is to be set based on reasonably anticipated needs and uses.

## **7. Supplemental Water Supply Reserve - Water Utility Enterprise Fund**

This special purpose reserve funds water banking activities, transfers, and exchanges necessary to augment supplies during water shortages and to sell or bank unused supplies when water resources are available. The minimum funding level is set at 20% - 50% of the annual imported water purchases budget based on prudent projections of hydrology, Delta conditions, and the water market.

## **8. Drought Reserve - Water Utility Enterprise Fund**

This special purpose reserve funds drought response costs necessary to protect the residents, industry and riparian ecosystems of Santa Clara County, and to minimize water charge impacts during a drought emergency (as determined by the Board). To minimize water rate impacts, this reserve may be funded by Board direction to allocate actual surplus revenue that may have occurred during the prior year. Surplus revenue is defined as the positive difference between actual Water Utility operating revenue and budgeted Water Utility operating revenue. This reserve may also be funded by planned appropriations, which would be paid for by water rates and approved by the Board during the annual water rate adoption process. Drought response costs may include but not be limited to water purchases and exchanges; special studies or system improvements related to delivery of water purchases; incremental conservation activities; and accelerated or opportunistic operations and maintenance activities spurred by the drought. The maximum funding level is set at 10% of adopted budget operating outlays.

## **9. Public-Private Partnership (P3) Reserve – Water Utility Enterprise Fund**

This special purpose reserve provides a funding source for costs associated with the Valley Water's Public-Private Partnership (P3) to design, build, finance, operate and maintain the Expedited Purified Water Program. The minimum funding level for this reserve is \$4 million, and the maximum is \$20 million. The specific level is to be financially prudent and based on reasonably anticipated needs.

## **10. State Water Project Tax Reserve - Water Utility Enterprise Fund**

The purpose of the State Water Project Tax Reserve is to accumulate unspent funds for voter-approved State Water Project contract obligations. Funds accumulated in this reserve will be available to fund State Water Project contract obligations in subsequent years.

## **11. Currently Authorized Projects Reserve - Voter Approved Safe, Clean Water Fund**

This reserve is designated to fund those capital projects that are included in the annually adopted 5-Year Capital Improvement Program (CIP) and which have had funding appropriated by the Board in prior years. The amount of this reserve for each fund at the end of a given fiscal year shall be based on the accumulated unexpended and unencumbered balances of Board-approved capital project appropriations remaining at the end of each fiscal year.

A portion of this reserve is automatically re-budgeted at the beginning of the following fiscal year consistent with those projects that have been identified in the 5-Year CIP for funding in that year. All remaining amounts shall stay in these reserves during the fiscal year unless a budget adjustment requiring the use of these reserves is approved by the Board. At the end of each fiscal year, these reserves shall also be adjusted for any capital projects that are closed out consistent with the 5-Year CIP.

## **12. Encumbrance Reserves - Voter Approved Safe, Clean Water Fund and State Water Project Fund**

This reserve represents the balance of outstanding encumbrances (contractual commitments) at year-end, for which the goods or services have not been received. The reserved fund balance is available for subsequent year expenditures based on the encumbered appropriation authority carried over to the next fiscal year. The funding level of this reserve will be adjusted annually, at year-end, based on the remaining balance of encumbrances still outstanding as of the end of the fiscal year.

### **13. Operating and Capital Reserve - Voter Approved Safe, Clean Water Fund**

The purposes of this reserve are to ensure adequate working capital for cash flow needs and to provide a funding source for operating and capital needs that arise during the year. The funding level is a minimum of 50% of adopted budget operations outlays. The minimum level includes remaining available resources after the needs of all other reserves have been met. The specific level of this reserve is to be set based on reasonably anticipated needs.

## **B. Committed Reserves**

### **1. Liability/Workers' Compensation Self- Insurance Reserve - Risk Fund**

The purpose of the Liability/Workers' Compensation Self-Insurance Reserve is to ensure that Valley Water's self- insurance programs have adequate resources for general liability and workers' compensation ultimate payouts for both known and incurred but not reported claims. Additionally, because of Valley Water's high self-insured retention, and low claims volume, it also provides for reserve funds to cover one large liability loss which would otherwise virtually deplete existing reserves. The reserve is based on independent actuarial evaluations conducted bi-annually for general liability and workers compensation. The reserve level is set each year based on the actuarially determined confidence level for total claims liabilities discounted to present value. The reserve is intended to be used for claim payouts that are greater than those budgeted.

The Board of Directors approved funding of the Workers' Compensation Reserve at the 90 percent actuarial confidence level, and funding of the General Liability Reserve at the 90 percent confidence level at the April 28, 2009 board meeting.

### **2. Property Self-Insurance/Catastrophic Reserve - Risk Fund**

The purpose of the Property Self-Insurance/Catastrophic Reserve is to provide for uninsured property losses to Valley Water facilities such as pipelines and levees and to provide sufficient funds to initiate repair and recovery of damage to Valley Water facilities in advance of Federal Emergency Management Agency (FEMA) activation and reimbursement. The reserve may be used to pay for uninsured/uninsurable property losses which would adversely affect operations and/or to cover all or a portion of Valley Water-paid expenses necessary to initiate immediate service restoration efforts. It is anticipated that in most cases, the reserves would be replenished from later reimbursement by FEMA for costs initially paid from this reserve. The reserve funding level is a minimum of 5 million adjusted for outstanding reimbursements.

When this reserve is used, the corresponding reimbursements received are deposited in the Risk Management Fund to replenish the reserve directly or through subsequent adjustments to intra-District Risk Fund charges.

### **3. Floating Rate Debt Payment Stabilization Reserve - Water Utility Enterprise Fund**

This reserve is intended to stabilize the debt service payments on floating rate debt which by its nature fluctuates constantly. This reserve will be for long-term floating rate debt and not short-term floating rate debt (i.e., commercial paper). The maximum amount is no more than 20% of total floating rate debt service interest payments for a fiscal year. Excess funds over 20% will be used to pay down floating rate debt when advisable (i.e. based on market conditions, future issuance plans, etc.). There is no minimum reserve amount. Should payments for floating rate

interest in a given fiscal year exceed budgeted amounts, this reserve will be drawn down to provide stabilization of debt service interest payments.

#### **4. Operating & Capital Reserve - except for Safe, Clean Water Fund**

This reserve serves several purposes: to ensure adequate working capital for cash flow needs; to provide a funding source for operating and capital needs that arise during the year and, in the case of the water utility, to protect against revenue shortage caused by unusually wet years. The funding level for the Water Utility is a minimum of 15% of adopted budget operations outlays and a minimum of 50% for the Watershed Funds. For the General Fund and Internal Service Funds, the funding level is a minimum of 5% of total adopted budget operations outlays. The minimum level for each fund includes remaining available resources after the needs of all other reserves within those funds have been met. The specific level of this reserve is to be set based on reasonably anticipated needs.

#### **5. Currently Authorized Projects Reserve - except for Safe, Clean Water Fund**

This reserve is designated to fund those capital projects that are included in the annually adopted 5-Year Capital Improvement Program (CIP) and which have had funding appropriated by the Board in prior years. The amount of these reserves for each fund at the end of a given fiscal year shall be based on the accumulated unexpended and unencumbered balances of Board approved capital project appropriations remaining at the end of each fiscal year.

A portion of this reserve is automatically re-budgeted at the beginning of the following fiscal year consistent with those projects that have been identified in the 5-Year CIP for funding in that year. All remaining amounts shall stay in these reserves during the fiscal year unless a budget adjustment requiring the use of these reserves is approved by the Board. At the end of each fiscal year, these reserves shall also be adjusted for any capital projects that are closed out consistent with the 5-Year CIP.

### **C. Assigned Reserves**

#### **1. Encumbrance Reserves - except for Safe, Clean Water Fund and State Water Project Fund**

This reserve represents the balance of outstanding encumbrances (contractual commitments) at year-end, for which the goods or services have not been received. The reserved fund balance is available for subsequent year expenditures based on the encumbered appropriation authority carried over to the next fiscal year. The funding level of these reserves will be adjusted annually, at year-end, based on the remaining balance of encumbrances still outstanding as of the end of the fiscal year.

#### **2. Market Valuation Reserves**

The reserves for market valuation represent the increase/gain (only) in the market value of Valley Water's pooled investments as of the end of the fiscal year as a result of its compliance with the provisions of Government Accounting Standard Board Statement No. 31 (GASB 31), Accounting and Financial Reporting for Certain Investments and for External Investment Pools. GASB 31 requires Valley Water to report investments at fair market value in the Statement of Net Assets, the amount at which an investment could be exchanged in a current transaction

between willing parties, other than in a forced or liquidation sale. Because of this requirement, investment income must be adjusted to reflect the fair value change from one fiscal year to the next fiscal year. However, Valley Water's investment policy dictates a buy-and-hold strategy in which, with very few exceptions, Valley Water holds all securities to their maturity, thereby not incurring loss or gain that could affect the size and yield of the investment portfolio. These reserves do not represent cash available for appropriation and were established to ensure that the increase in the investment value does no result in an overstatement of funding available for expenditure.

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