NOTICE OF SPECIAL MEETING OF BOARD OF DIRECTORS

ALAMEDA COUNTY FLOOD CONTROL AND WATER CONSERVATION DISTRICT, ZONE 7

100 NORTH CANYONS PARKWAY • LIVERMORE, CA 94551 • PHONE (925) 454-5000 • FAX (925) 454-5727

TIME:	**6:00 p.m.**
DATE:	**Wednesday, October 5, 2011**
LOCATION:	**Zone 7 Administration Building**
	100 North Canyons Parkway, Livermore, California

Any member of the audience desiring to address the Board on an item under discussion may do so upon receiving recognition from the President. After receiving recognition, please step to the podium and state your name and address.

In compliance with the Americans with Disabilities Act, the meeting room is wheelchair accessible and disabled parking is available at the Zone 7 Administrative Building lot. If you are a person with a disability and you need disability-related modifications or accommodations to participate in this meeting, please contact the Zone 7 Board Secretary, Judy Rector, at (925) 454-5053 or fax (925) 454-5724. Notification 48 hours prior to the meeting will enable Zone 7 to make reasonable arrangements to ensure accessibility to this meeting. {28 CFR 35.102-35, 104 ADA Title II}

A G E N D A

1. Call Meeting to Order
2. Pledge of Allegiance
3. Citizens Forum

   This is an opportunity for members of the audience to speak on an item not listed on the agenda. The Board cannot deliberate or take action on a non-agenda item unless it is an emergency as defined under Government Code Section 54954.2.

4. Status of Zone 7's Water Enterprise Reserve Funds

   Recommended action: Discussion only.

5. Verbal Reports
6. Adjournment
7. Upcoming Board Schedule:
   (All meeting locations are in the Board Room at 100 North Canyons Parkway, Livermore, California, unless otherwise noted)

   a. Regular Board Meeting: October 19, 2011, 7:00 p.m.

Materials related to an item on this agenda that have been provided to the Board less than 72 hours prior to the meeting are available for public inspection at the Zone 7 office at the time of, and prior to, the meeting and at www.zone7water.com. All other material otherwise provided to the Board will be available at the public meeting.

ALAMEDA COUNTY FLOOD CONTROL AND WATER CONSERVATION DISTRICT, ZONE 7
100 NORTH CANYONS PARKWAY • LIVERMORE, CA 94551 • PHONE (925) 454-5000 • FAX (925) 454-5727

ORIGINATING DIVISION: Finance and Business Services
CONTACT PERSON: Tamara Baptista/John Yue

AGENDA DATE: October 5, 2011 ITEM NO. 4

SUBJECT: **Status of Reserve Funds**

SUMMARY:

- On August 29, 2011, and September 13, 2011, the Finance Committee met for staff presentations of the preliminary treated water rates for calendar year 2012.
- The Finance Committee discussed the alternatives presented, and directed staff to forward for the Board's discussion a recommendation of a 5% increase to the treated water rate for 2012.
- After discussion at the Board meeting September 21, 2011, the Board requested a special Board meeting to discuss the status of reserve funds prior to finalizing the treated water rate.

FUNDING:

Reserves, commonly referred to as working capital, come from the accumulated balances (surpluses) of the respective Funds over time. The Water Enterprise (Fund 52), Renewal/Replacement & System-Wide Improvements (Fund 72), Expansion (Fund 73) and State Water Facilities (Fund 51) have distinct reserves in the respective Funds.

RECOMMENDED ACTION:

Receive the presentation and discuss the reserve funds status.

x:/sec2/bl/prelim water rate 2012.doc

M E M O R A N D U M

DATE: October 5, 2011
TO: Jill Duerig, General Manager
FROM: Tamara Baptista and John Yue
SUBJECT: **Reserve Funds**

SUMMARY:

Key elements of prudent financial planning include ensuring sufficient funding is available for current operating, capital and debt service costs; anticipating and preparing for future funding needs; and allowing for unforeseen disasters and other unforeseen events.

BACKGROUND:

In governmental accounting, there are generally three categories of reserves.

1. Restricted Reserves: Restrictions are imposed by an outside source. For example, it may be required by bond covenants in the case of debt issuance. Zone 7 currently has no restricted reserves.

2. Designated Reserves: Set aside for a specific purpose determined by the Board of Directors. The Board of Directors has the authority to redirect the use of these funds as needs of the Agency change.

3. Unrestricted Reserves: Have no imposed restrictions as to their use.

In considering such general definitions and other best management practices, the Zone 7 Board of Directors adopted a Financial Management Policy in March 1999 that documented the principals to be followed in conducting the financial activities of Zone 7. A copy of the adopted Financial Management Policy and minute order are enclosed (Attachment A). In summary, these principals fell into the general categories of financial management goals, budgeting (to ensure a balanced budget, reserves for emergencies and cash sufficient to pay bills on a timely basis), revenue policies (to ensure that funds are available so that the Agency can accomplish its mission), expenditure policies (to ensure the Agency adheres to its spending plans and effectively manages its services) and policies related to capital improvement and expansion funding (to ensure that assets are properly maintained, replaced and expanded over time to meet the level of service expectations of the community). The expansion policy itself is consistent with the Mitigation Fee Act (Government Code §66000, *et seq.*) which requires that any fees collected from developers be kept in a separate fund and that these fees shall not be commingled. Annual reports must be prepared and published within 120 days of the end of each Fiscal Year. Typically, these reports are presented to the Board at the regular December meeting. Generally Accepted Accounting Principles for Government also calls for separate accounting and reporting of government functions (Flood Control – Funds 50 and 76) and proprietary functions (Water – Funds 51, 52, 72 and 73).

In March 2005, the Board expanded the Financial Management Policy by adopting a Reserve Fund Policy. The policy and minute order are attached (Attachment B). The Reserve Fund Policy established several Designated Reserve funds for various specific purposes related to the water enterprise and, thus, water rates. The purpose of each is described in the policy.

- Emergency/Operating Reserves: Designated by the Board of Directors to provide for emergencies and cash flow requirements. The amount of these reserves is determined by the fund to which they apply. This reserve is maintained at 20% of operating expenses; Flood Control estimated at flood repair cash flow needs; and the State Water Project at 50% of revenue.

- Rate Stabilization: Designated by the Board of Directors to provide funds in the case of an unforeseen event such as a natural disaster, water shortage or other catastrophic event. Use of these funds is approved by the Board of Directors.

- Designated Reserve: Designated by the Board of Directors to provide for increases in operating expenses in excess of the target established by the Board. The Board authorizes use of these funds. [Note that there are no funds in this reserve at present.]

- Capital Projects and Contingencies Reserve: These reserves are earmarked by the Board of Directors for capital improvements to meet regulatory requirements, system reliability and future demand. These capital improvements are included in the 10-Year Capital Improvement Program and the Asset Management Program both of which are reviewed by the Board of Directors each fiscal year. These reserves are also used to fund unanticipated capital projects. Use of these funds is approved by the Board of Directors.

The Water Enterprise Fund (52) generates revenue from water sales to fund the operating expenses and transfer capital contribution, in accordance with the funding levels determined by the Asset Management Plan (AMP), to fund Renewal/Replacement & System-Wide Improvements (R/R&SWI) projects (Fund 72). As the AMP projects are fully integrated with the 10-Year Capital Improvement Program (CIP), the reserves in the R/R&SWI Fund are wholly designated for capital projects identified in the CIP.

The Expansion Fund (73) and State Water Facilities Fund (51) are funded by water connection fee revenue, and property taxes, respectively. These two Funds have no impact on the funding requirements of Water Enterprise or R/R&SWI Funds, and therefore have no effect on water rates. The discussion below will focus mainly on the Water Enterprise reserves, and review the use of capital in R/R&SWI Funds.

The following summarizes the unaudited balance as of June 30, 2011, in each of the three general categories of Restricted, Designated and Unrestricted reserves in the Water Enterprise and R/R&SWI Funds.

1. Restricted Reserves – None in either funds
2. Designated Reserves
    a. Emergency/Operating Reserves – Applicable to Fund 52 only, $7,333,506

b. Rate Stabilization - Applicable to Fund 52 only, $5,000,000

c. Designated – Applicable to Fund 52 only, none

d. Capital Projects & Contingencies – Applicable to Fund 72 only, $16,543,984

e. Sinking Funds - Applicable to Fund 72 only, $2,313,878 (building)

3. Unrestricted Reserves - Applicable to Fund 72 only, $7,577,506

DISCUSSION:

The Government Finance Officers Association (GFOA) cites the following major reasons for adopting a reserve (fund balance) policy:

1) Plan for contingencies
2) Maintain good standing with rating agencies
3) Avoid interest expenses for operating budget needs and capital projects
4) Invest fund balance
5) Ensure cash availability when revenue is unavailable

The GFOA also notes that, “A government’s unreserved fund balance should be inversely proportional to its total budget size.”

There are a variety of factors to consider when determining the unrestricted reserve fund balance, including:

a) The predictability of revenues and volatility of its expenditures
b) The availability of resources in other funds as the potential drain on the General Fund
c) Liquidity
d) Designations[1]

For additional reference, California Special District Association’s Special District Reserve Guidelines is attached.

A review of other water agencies’ reserves policies reveal a diverse range of reserve types and levels. This reflects the differing considerations contemplated by each agency’s unique financial management and other policies, and make-up of revenue and expense components. Additionally, target or minimum-maximum amounts for identified reserves are not readily described in policy statements. For example, the proportion of volumetric revenue; use of debt or pay-as-you-go; and size of the agency. These varying considerations make for an imperfect benchmarking comparison. In an attempt to determine the range of reserves budgeted in other water agencies, a basic measure looking at the amount of reserves as a percentage of annual operating budget was used. The results ranged from 13% (Sonoma County Water Agency) to 80% (Contra Costa Water Agency). Based on a 5% water rate increase scenario for 2012, the Water Enterprise Fund reserves is projected at 52% of the annual operating budget.

Water Enterprise Reserves

[1] Appropriate Level of Unreserved Fund Balance in the General Fund (2002) GFOA Recommended Practice

As previously outlined, the Water Enterprise Fund (52) has the following Designated and Unrestricted Reserves for FY10/11 (unaudited actuals), and FY11/12 (projected assuming a 5% water rate increase for 2012):

Water Enterprise Fund (52)	Unaudited Actuals Ending Balance FY10/11	Projected Reserves Ending Balance FY11/12
Designated Reserves		
Rate Stabilization Reserve	$5.0 Million	$5.0 Million
Operating/Emergency Reserve	$7.3 Million	$6.7 Million
Designated Reserve	$0	$0
Unrestricted Reserve	$7.6 Million	$5.6 Million
Total	$19.9 Million	$17.3 Million

Approximately $2.0 million of the FY10/11 and FY11/12 Total Reserve balances is set aside for anticipated future Bay-Delta related expenses based on estimated costs received from DWR and other Delta-related expenses.

Under the Reserve Fund Policy, the Operating/Emergency Reserve is currently targeted at 20% of the annual operating budget. Given the current budget, 20% is a target level of $6.7 million. A recent Water Research Foundation survey of water agencies' Internal Financial Policies performed in the first quarter of 2011 recommends a working capital reserve of greater than or equal to 3 months (or 33%) of annual operating and maintenance expenses. The Unrestricted and Designated (not Rate Stabilization or Operating/Emergency) Reserves are typically used for planned budget smoothing. A prescribed target amount for the Designated Reserve at, say, 10% of the annual operating budget, can facilitate absorption of budget bumps in the future. Another way of looking at this is that while 20% may be low for an Operating/Emergency Reserve, taken together with the Unrestricted Reserve, the total reserve might be considered $12.3 million, or 37% of the operating budget.

The Water Research Foundation survey also suggests that a contingency/rate stabilization-type reserve should be targeted at 20% of the annual water volume revenues. If applied to Zone 7, the Rate Stabilization Reserve could be targeted at $6.4 million (20% of projected FY10/11 water volume revenue). Applying this guideline, the current level of $5,000,000 might be considered low. A higher target level makes some sense given that over the last dozen years, actual deliveries have varied from 80% to 106% of the requested deliveries. Given the unpredictability of revenue plus the significant swings in water costs (budgets are based on normal operations but there are major variations in hydrology and allocations; taken with the desire to store as much as possible both in-basin as well as in Semitropic and Cawelo, when the water is available), a larger Rate Stabilization Reserve could make sense.

Renewal/Replacement & System-Wide Improvements Working Capital

The recent AMP study established an annual transfer amount for capital projects. Establishing an annual amount preserves rate stability even when actual capital expenditures may vary. The R/R&SWI Fund (72) has the following Designated and Unrestricted Reserves for FY10/11 (unaudited actuals), and FY11/12 (projected assuming a 5% water rate increase for 2012):

Renewal/Replacement & System-Wide Improvements Fund (72)	Unaudited Actuals Ending Balance FY10/11	Projected Reserves Ending Balance FY11/12
Designated Reserves		
Capital Projects and Contingencies Reserve	$16.5 Million	$14.6 Million
Building Sinking Fund	$2.3 Million	$2.7 Million
Unrestricted Reserve	$0	$0
Total	$18.8 Million	$17.3 Million

The working capital amount is based on the funding needs of capital projects as described in the 10-Year CIP for R/R&SWI. The CIP is updated, reviewed, and adopted by the Board every two years. The 40-year AMP (most recently adopted by the Board in June 2011) to maintain, renew, replace and improve existing assets is periodically updated to reflect necessary and changing project needs and related funding. As the AMP projects are systematically incorporated into the 10-Year CIP for R/R&SWI, the Designated Reserve levels in this Fund is maintained at a level necessary to carry out the planned projects without any excess or Unrestricted Reserve.

The use of these various reserve funds over the last several years is shown in a series of graphs, along with a table showing existing Water Enterprise reserves and different options which are attached.

RECOMMENDED ACTION:

Receive the presentation and discuss the reserve funds status.

Attachments:
A – Financial Management Policy
B – Reserve Fund Policy
Historical Use of Reserves and Balances – Funds 52 and 72
Existing Reserves and Various Options
CSDA Special District Reserve Guidelines

Director Layton then moved for the adoption of Resolution No. 99-2016 approving an agreement with the Department of Water Resources for Phase II of the South Bay Aqueduct Enlargement Study in an amount not-to-exceed $265,000. Additionally, he directed staff to get progress reports and budget deliverables from DWR. The motion was seconded by Director Kalthoff and passed by a vote of 6-0.

Item 9--Proposed Financial Management Policy

Mr. Orellana stated that local government has always had the responsibility to carefully mange its fiscal affairs to provide for public services and programs. As limited funding makes it necessary for public agencies to deal with more complicated financing methods and financial pressures it is particularly important to develop guidelines for financial management. It is also important to assure that our customers and constituency that public resources are responsibly managed.

Mr. Orellana then called attention to three-page listing of proposed Financial Management Policies which articulate principles to be followed in conducting Zone 7's financial activities. In addition to stating the Board's financial management principles and guidelines, it confirms the Board's intent to ensure that the Agency is run in a financially responsible manner and provides staff and the public with the Agency's financial goals and states the Board's policies to achieve those goals.

The proposed policy includes the following areas: financial management goals; operating position policies; revenue policies; expenditures policies; and capital improvement and expansion policies.

Mr. Orellana noted that though in practice Zone 7 has historically managed its finances in conformance with the proposed policies, the adoption of the proposed Financial Management Policy formalizes these practices and publicly states the Board's intent for managing the Agency's financial affairs. Staff recommends adoption of a minute order approving the Financial Management Policy.

Mr. Orellana added that the Board's Finance Committee reviewed the policies at their meeting on March 4. Suggestions made at that time were incorporated into the document before the Board this evening.

Director Marchand had a number of additions/revisions. He believed that the opening paragraph should be rewritten to emphasize that the Zone's primary responsibility is to protect the health and safety of the community it serves. He also suggested: 1) wording which would spell out the Zone's intent to use connection fees to pay for the expansion of services; and 2) wording which states that Zone 7 will maintain a replacement allowance from the water rate for the timely replacement of capital assets at the end of their useful life.

Director Layton made the following suggestions for additions to the policy: 1) determine how much reserves are needed; and 2) develop a strategy for communicating revenues and expenditures. A communication goal would help the public and Board to understand the budget and compare it to those of other districts.

Director Kalthoff moved for adoption of the Financial Management Policy with additions as noted. The motion was seconded by Director Marchand and passed by a voice vote.

Zone 7 Water Agency
Financial Management Policy

Zone 7 of the Alameda County Flood Control and Water Conservation District has as its primary responsibility the protection of the health and safety of the community it serves. To achieve that end, Zone 7 resolves to prudently manage its funds and to maintain public records for the disposition of its funds using generally accepted accounting principals. It is responsible also to adequately plan for the funding requirements of current operating and capital resource needs necessary to achieve the Agency's mission. The governing board of the Agency appropriately prioritizes these needs within the context of protecting the health and safety of the community it serves. It is the intent of the Board to ensure that it is able to accomplish its mission by providing for the financial stability and health of the Agency. The purpose of these guidelines is to support this intent.

Financial Management Goals

- To provide quality services and products in an efficient and cost-effective manner.
- To ensure a sustainable funding base to provide for the needs of the residents of the Agency's service area.
- To be able to respond to changes in the economic environment and service demands with minimal impact on the customers while maintaining the financial integrity of the Agency.
- To maintain a program of prudent financial management to ensure the most advantageous cost of capital borrowings and to assure the public that the Agency is well managed and financially sound.
- To communicate financial information in a manner that is understandable to the Board and the general public.

Operating Position Policies

Operating position refers to the ability to balance the budget on a current basis, maintain reserves for emergencies and maintain sufficient cash to pay bills on a timely basis.

- Zone 7 will pay current operating expenditures with current operating revenues.
- Zone 7 will strive to maintain adequate managed reserves to provide for unforeseen expenditures of an emergency nature; provide for orderly budget adjustments when revenues are lost through actions not under its control; protect its customers from fluctuations in water rates as a result of unforeseen natural or uncontrollable occurrences; provide for matching funds for grants that may become available outside

the normal budget process; and to meet unexpected nominal increases in operating or current capital costs.

- Zone 7 will attempt to maintain an adequate level of reserves in each fund it is responsible for in order to prudently address the above circumstances.

- Zone 7 will use available resources for one-time capital or emergency expenditures only if it has adequate long-term resources to fund any resulting ongoing costs.

- Zone 7 will ensure that disbursements, collections and investments are managed to provide sufficient cash for daily financial needs.

Revenue Policies

Revenues determine the ability of the Agency to carry out the activities directed at accomplishing its mission.

- Zone 7 will strive to maintain a diversified and stable revenue base to protect itself from short-term fluctuations in any one source.

- Zone 7 will evaluate each revenue source annually and examine historical patterns and future projections to prepare realistic forecasts to develop its annual and long-term spending plans.

- Zone 7 will seek to improve its revenue position by monitoring legislation, participating in legislative advocacy groups and developing and pursuing new innovative sources as necessary.

- Zone 7 will use one-time or special purpose revenue for one-time expenditures, preferably corresponding to the source and not to subsidize ongoing operating costs.

- Zone 7 will set rates and fees to generate sufficient revenue to support operating and capital costs for the enterprise.

- Zone 7's intent is to use connection fees to pay for expansion of services.

Expenditure Policies

Expenditure control determines how well an Agency adheres to its spending plans. Expenditure policies measure how effectively services are managed and outputs produced and how efficiently they are delivered.

- Zone 7 will maintain a balanced annual operating budget in all of its funds.

- Zone 7 will pay for all current operating and maintenance expenses from current revenues and available fund balances.

- Zone 7 will determine the cost of all services provided to outside entities and seek reimbursement for the cost of such services, subject to consideration of the benefit received by the community served.

- Zone 7 will maintain a budgetary control system that enables it to adhere to the adopted budget.

- The delivery of services through cooperative agreements with other public and/or private agencies will be encouraged whenever greater efficiency and effectiveness is expected and/or if sharing of costs provides clear benefit to the service community.

- Technology and productivity advancements designed to reduce or avoid increasing operational costs will be implemented whenever possible.

Capital Improvement and Expansion Policies

A significant amount of Zone 7's assets are in land, buildings and equipment. These assets must be properly maintained, replaced and expanded over time in order to meet the level of service required by the Agency's customers.

- Zone 7 will maintain a comprehensive capital maintenance and improvement program that is updated on a regular basis.

- Zone 7 will base capital improvement programs on its long-term needs in order to minimize future maintenance and replacement costs.

- Zone 7 will coordinate the prioritization and phasing of capital improvements with anticipated availability of funding.

- Zone 7 will estimate and consider future maintenance and replacement needs for all new equipment and capital facilities prior to making a decision to proceed with the project.

- Zone 7 will maintain a replacement allowance from water rates for the timely replacement of capital assets.

- Zone 7 will identify the funding source for each capital improvement and/or expansion project prior to making a decision to proceed.

- New development will be required to provide funding for any new capital needs resulting from the additional service requirements.

Item 8—Proposed Reserve Fund Policy

The Board heard a report from Mr. Orellana on a proposed Reserve Fund Policy.

- A presentation on this topic was made to the Finance Committee in January.
    - Draft policy containing: purpose; approved use; and schedule of review for each of Zone 7's reserve funds.
- Objectives: ensure sufficient funding is available for current operating, capital and debt service cost needs; preparation for future funding requirements and unforeseen events.
- California State Auditor released a report on special districts which included a recommendation that a policy statement be developed to document the purpose of reserve funds and their intended use.
- Survey of six Bay Area water agencies and their policies on reserves.
- Zone 7 designated reserve funds:
    - General Fund/Flood Control: for flood emergencies pending any state or federal reimbursement
    - State Water Facilities: emergency cash flow while waiting for property taxes to come in
    - Water Enterprise: Rate Stabilization Reserve Fund
    - Special Drainage Area: Building Sinking Fund
    - Renewal & Replacement/Improvements: Building Sinking Fund
    - Expansion: Building Sinking Fund

Director Kohnen expressed the following concerns with the rate stabilization fund:

- Current rate payers were paying for something that might occur in the future.
- During a drought, water conservation could be encouraged by attaching a surcharge to water rates.

Director Marchand defended the rate stabilization fund by saying that it was established to prevent a recurrence of what happened in 1991 when because of drought conditions, we had to raise rates 33%. He stated that he supported the current reserve funds and the policy as presented. Having prudent levels of reserves are an indication that we are planning for the future

Director Marchand moved for the adoption of the Reserve Fund Policy as presented by Mr. Orellana. The motion was seconded by Director Concannon and passed unanimously.

Item 9—Committee Reports

Finance Committee of January 24, 2005—The committee met to hear a presentation of the annual audit report for the year ending June 30, 2004.

Item 10—Items for Future Agendas—Directors--none

Item 11—Verbal Reports—Directors

ALAMEDA COUNTY FLOOD CONTROL AND WATER CONSERVATION DISTRICT
5997 PARKSIDE DRIVE • PLEASANTON, CALIFORNIA 94588-5127 • PHONE (925) 484-2600 FAX (925) 462-3914

ORIGINATING DIVISION: Administrative Services
CONTACT PERSON: Jon Orellana

AGENDA DATE: February 16, 2005 ITEM NO: 8

SUBJECT: **Proposed Reserve Fund Policy**

SUMMARY:

A key element of prudent financial planning is to ensure that sufficient funding is available for current operating, capital and debt service cost needs. An additional critical element of fiscal responsibility is to be prepared for future funding requirements and possible unforeseen events. In order to provide for these factors, Zone 7 Water Agency must set aside a prudent level of reserve funds. Therefore, it is recommended that the Board adopt the attached reserve fund policy to document and give staff direction for managing these funds.

BACKGROUND:

In March of 1999 the Board of Director's adopted a financial management policy that documented the principals to be followed in conducting the financial activities of Zone 7. The policy stated the Board's financial management principles and guidelines which included the following:

<u>Operating Position Policies</u> to ensure a balanced budget, reserves for emergencies and cash sufficient to pay bills on a timely basis.

<u>Revenue Policies</u> to ensure that funds are available so that the Agency can accomplish its mission.

<u>Expenditure Policies</u> to ensure the Agency adheres to its spending plans and effectively manages its services.

<u>Capital Improvement and Expansion Policies</u> to ensure that assets are properly maintained, replaced and expanded over time to meet the level of service required by the Agency's customers.

The first component speaks to reserves in a general fashion; however, it would be prudent to delineate policies specifically that address the purpose, guidelines and review process for these funds.

DISCUSSION:

During the past year, the California State Auditor released her report on independent special districts their reserve accumulation, compensation and reimbursement for directors and conflict of interest. This recommendation addresses reserves and recommends a policy statement to document their purpose and intended use. Although the Board reviews and approves the level of reserves with the approval of the annual budget and the general guidelines are in the Financial Management Policy, we believe that it would be prudent to clearly identify the purpose of the resaves, guidelines for their use and review periods.

Reserve funds generally fall into two categories restricted and unrestricted. Restricted reserves have their use imposed by an outside entity such as debt service reserves which are governed by bond covenants. Unrestricted reserves, although they have no externally-imposed restrictions, can have internally designated purposes. An example is the rate stabilization reserve which is to be used in the case of a prolonged drought or other major catastrophe that impacts the Agency's revenue. Board approval would be required for use of these funds. Unrestricted, undesignated reserves would have no specific use identified.

Zone 7 currently has no restricted reserves as it currently has not bonded debt. It does have the following designated reserves:

Fund 50 - General Fund/Flood Control
Operating/Emergency Reserves – to be used in the case of a flood control emergency pending receipt of any State or federal reimbursement.
Project Reserves – to be used for future projects for which a schedule has yet to be established.
Building Sinking Fund – to accumulate a share of the funds required to purchase a building at the end of the 15-year lease.

Fund 51 – State Water Facilities
Operating/Emergency Reserves – to be used to provide cash flow while awaiting receipt of property taxes, to provide the revision of charges from the State Department of Water Resources and to cover any shortage in development fees.

Fund 52 – Water Enterprise
Rate Stabilization Reserve – to be used when revenues are impacted by a serious natural disaster such as drought or earthquake.
Operating/Emergency Reserves – to be used as operating capital, to allow for adjustments made through the County process and to fund emergency expenses.
Designated Reserves – to be used to offset increases in personnel, water, chemicals and power which exceed the projected targets.

Fund 71 – Special Drainage Area
Building Sinking Fund – to accumulate a share of the funds required to purchase a building at the end of the 15 year lease.

Fund 72 – Renewal&Replacement/Improvements
Building Sinking Fund – to accumulate a share of the funds required to purchase a building at the end of the 15-year lease period.

Fund 73 - Expansion
Building Sinking Fund – to accumulate a share of the funds required to purchase a building at the end of the 15-year lease period.
Future Contractor's Share – to accumulate funds necessary to make payments to the Department of Water Resources for the years after buildout is completed.
South Bay Aqueduct Expansion/Improvements - to accumulate funds necessary to make payments to the Department of Water Resources.for the years after buildout is completed.

The attached policy statement delineates the purpose of these funds, their approved use and the schedule of review. We believe it is important to document these in order that a written record is kept of the Board's direction with respect to these funds. It is also a means of public disclosure to assure that the public is aware of why these funds are needed and what their restrictions are.

RECOMMENDED ACTION:

Adopt by Minute Order the attached Reserve Fund Policy.

Zone 7 Water Agency
Reserve Fund Policy

Policy Statement

Zone 7 of the Alameda County Flood Control and Water Conservation District has adopted a Financial Management Policy which includes planning for current operating and capital resource needs to ensure it can achieve its mission by providing for financial stability and health of the Agency. Among the stated goals is to be able to respond to changes in the economic environment and service demands with minimal impact on its customers while maintaining the financial integrity of the Agency.

Key elements of prudent financial planning include ensuring sufficient funding is available for current operating, capital and debt service costs; anticipating and preparing for future funding needs; and allowing for unforeseen disasters and other unforeseen events.

Zone 7 will maintain reserve funds to ensure it can fund emergency expenses; cash flow requirements; capital improvement plans and future operating requirements while avoiding significant rate fluctuations due to changes funding needs. It will also maintain a cash reserve position that may be utilized to fund unexpected fluctuations in revenue and operating/capital expenditures. Staff will review the amount of reserves recommended each year with the Board of Directors at the presentation of the annual Agency budget.

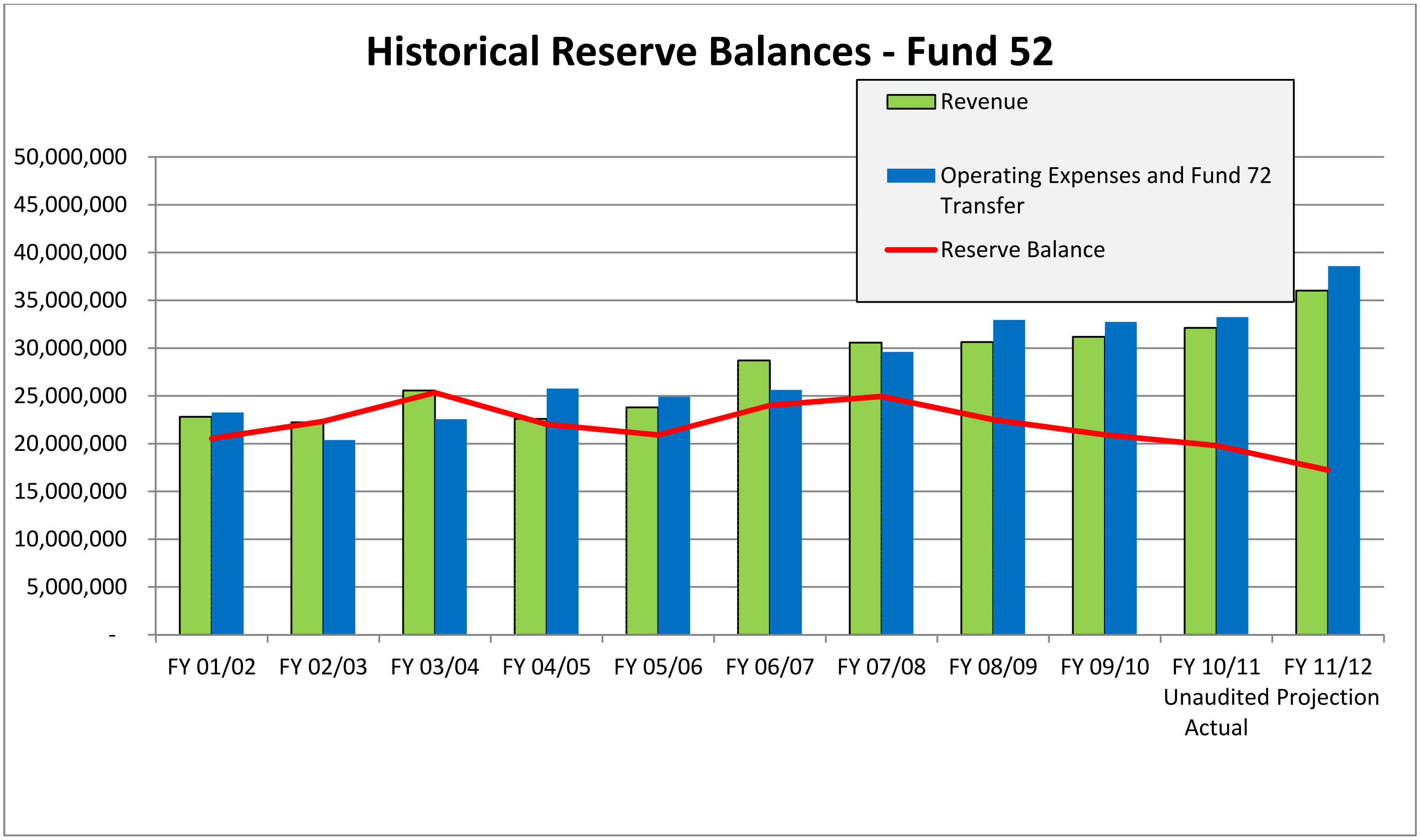
Definitions

- Restricted Reserves: Restrictions imposed by an outside source. May be required by bond covenants in the case of debt issuance.
- Designated Reserves: Set aside for a specific purpose determined by the Board of Directors. The Board of Directors has the authority to redirect the use of these funds as needs of the Agency change.
- Unrestricted Reserves: Have no imposed restrictions as to their use.

Designated Reserve Funds

- Emergency/Operating Reserves: Designated by the Board of Directors to provide for emergencies and cash flow requirements. The amount of these reserves is determined by the fund to which they apply. The water enterprise is maintained at 20% of operating expenses; flood control estimated at flood repair cash flow needs; and the State Water Project at 50% of revenue.
- Rate Stabilization: Designated by the Board of Directors to provide funds in the case of an unforeseen event such as a natural disaster, water shortage or other catastrophic event. Use of these funds is approved by the Board of Directors.
- Designated Reserve: Designated by the Board of Directors to provide for increases in operating expenses in excess of the target established by the Board. The Board authorizes use of these funds.

- Capital Projects and Contingencies Reserve: These reserves are earmarked by the Board of Directors for capital improvements to meet regulatory requirements, system reliability and future demand. These capital improvements are included in the 10 year Capital Improvement Program and the Asset Management Program both of which are reviewed by the Board of Directors each fiscal year. These reserves are also used to fund unanticipated capital projects. Use of these funds is approved by the Board of Directors.


Historical Reserve Balances - Fund 52
Revenue
Operating Expenses and Fund 72 Transfer
Reserve Balance
50,000,000
45,000,000
40,000,000
35,000,000
30,000,000
25,000,000
20,000,000
15,000,000
10,000,000
5,000,000
-
FY 01/02
FY 02/03
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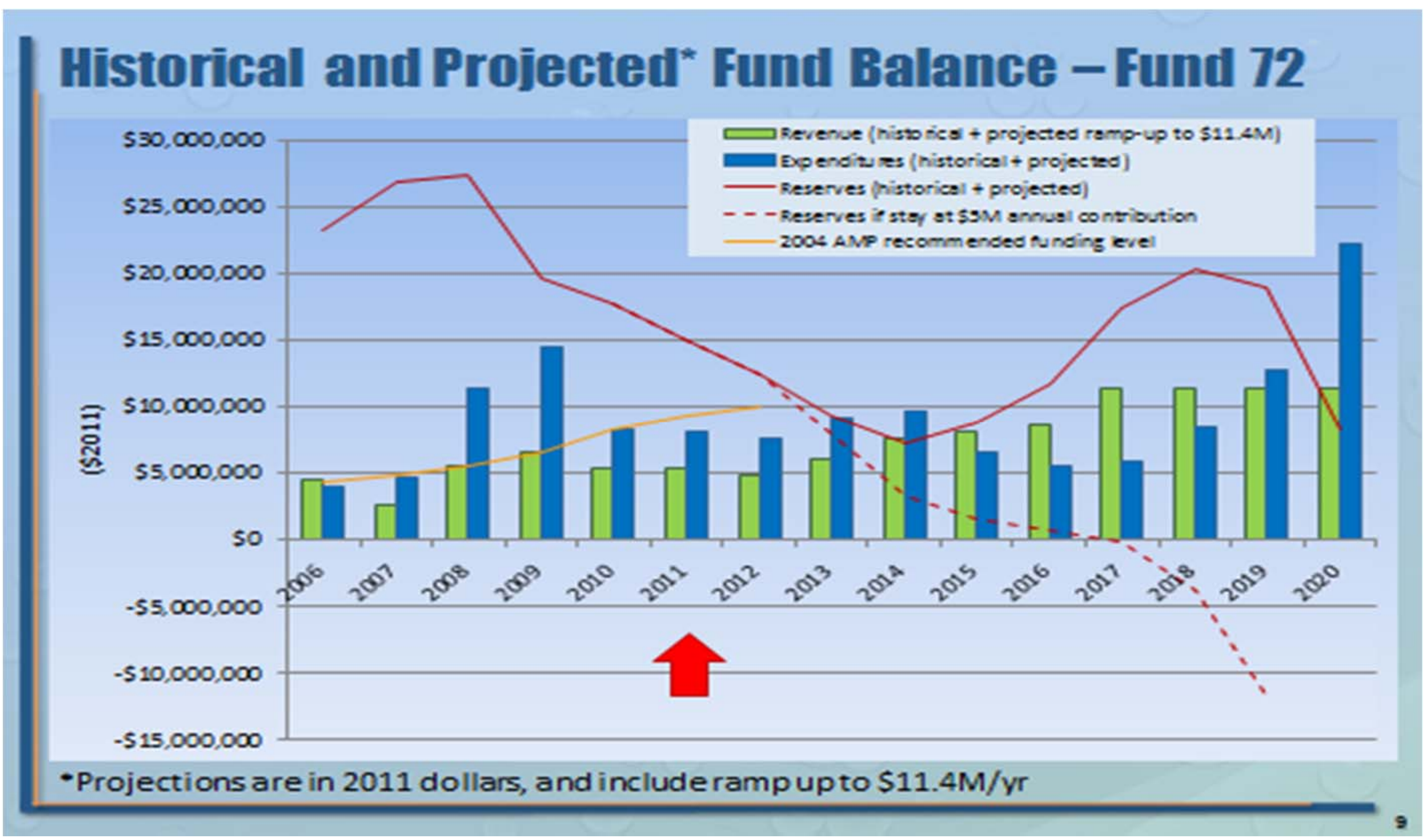
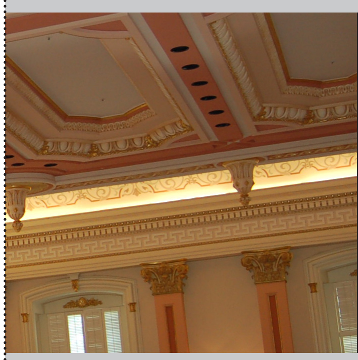
FY 10/11 Unaudited Actual
FY 11/12 Projection


Historical and Projected* Fund Balance – Fund 72
Revenue (historical + projected ramp-up to $11.4M)
Expenditures (historical + projected)
Reserves (historical + projected)
Reserves if stay at $3M annual contribution
2004 AMP recommended funding level
$30,000,000
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
-$5,000,000
-$10,000,000
-$15,000,000
($2011)
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
*Projections are in 2011 dollars, and include ramp up to $11.4M/yr
9

Fund 52 Reserves Targets and Amounts - Current Reserve Fund Policy and Options

$'s based on 5% increase of 2012 water rate	Existing		Option 1		Option 2		Option 3	
	Target	Amount	Target	Amount	Target	Amount	Target	Amount
Board Designated Reserves								
Operating/Emergency Reserve	20%	$ 6,708,414	33%	$ 11,068,883	20%	$ 6,708,414	20%	$ 6,708,414
Rate Stabilization		$ 5,000,000	15%	$ 5,402,012	20%	$ 7,202,683	20%	$ 7,202,683
Designated Reserves		$ -	2.5%	$ 838,551.73	4%	$ 1,341,683	10%	$ 3,427,114
Special Designated reserves					Delta(?)	$ 2,000,000		
Total Designated Reserves		**$ 11,708,414**		**$ 17,309,447**		**$ 17,252,780**		**$ 17,338,211**
Unrestricted Reserve		**$ 5,629,797**		**$ 28,764**		**$ 85,431**		**$ -**
Total Designated and Unrestricted		**$ 17,338,211**		**$ 17,338,211**		**$ 17,338,211**		**$ 17,338,211**

Special District Reserve Guidelines



CSDA
Providing value for
special districts.

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Acknowledgements

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The Formation of
Special District Reserve Guidelines

Answering a Call, Fulfilling a Need

The genesis for CSDA's *Special District Reserve Guidelines* was a 2000 Little Hoover Commission report entitled, "Special Districts: Relics of the Past or Resources for the Future?" The report includes a section on special district reserves with an introductory finding that states: *"Hundreds of independent special districts have banked multi-million dollar reserves that are not well publicized and often not considered in regional or statewide infrastructure planning."*

The section raises a number of issues relating to special district reserves including:

- Lack of guidelines and consistency
- Lack of visibility, and publication of, district financial information
- Lack of understanding among constituents and policymakers of district finances
- Lack of districts incorporating reserve information into infrastructure planning

The Commission's report claimed that, statewide, independent special districts have over $19.4 billion in reserves and many special districts have excess retained earnings (reserves). The report recommends that guidelines for prudent reserves be established, and that investment policies and practices be reviewed to determine if additional oversight is warranted.

The Little Hoover Commission report generated significant media coverage with banner headlines claiming that "obscure" public agencies have "hoarded" billions in reserves. Legislative hearings on special district finances were held and interest was spiked among grand juries, leading them to investigate how special districts within their counties handle reserves. The Sacramento Grand Jury report of 2000-2001 states: *"Few of the enterprise districts have an easily understood, board-approved and documented plan describing the development and use of undesignated retained earnings."*

CSDA Forms Task Force

Although special district advocacy organizations have concerns with some of the report's findings and data interpretation, CSDA believes that the establishment of reserve guidelines will assist special district governing officials and administrators in fulfilling their fiduciary responsibilities. To accomplish this, CSDA formed a task force in 2001 to identify both the essential elements of a reserve policy and the issues to be discussed during policy development.

The *Special District Reserve Guidelines* were developed by the task force as a tool for special district governing officials and administrators to assist them in fulfilling their commitment to provide cost-effective and efficient public services for the communities they serve. The guidelines may be used to evaluate an existing reserve policy, develop a new reserve policy, and/or promote comprehensive and easily understood policies within a special district. CSDA encourages district officials to incorporate guideline elements into their policies that are applicable to their district based on its size and the services it offers.

These guidelines are general in nature and should not be reviewed as legal or financial opinions. Prior to a district's adoption of any policy, the agency should seek review by its legal counsel, accountant and/or auditor to ensure compliance with all applicable rules and regulations.

In developing the guidelines, the task force recognized that many independent special districts already have established reserve policies and most, if not all, special districts officials recognize their fiduciary responsibilities and take them very seriously. What may have generated the concern regarding special district reserves is not lack of policy, but lack of outreach to constituents and others regarding district operations. It is essential that special districts increase the level of understanding outside their boardroom and initiate an outreach program on district financial management to increase the level of understanding among the public, media and legislators.

To assist special districts in their effort to either launch or enhance their community outreach efforts, CSDA introduced a new member benefit – "Public Outreach Assistance Service". CSDA's outreach assistance program is a fee-based copy editing/writing and graphic design service developed to encourage districts to increase their visibility and the level of understanding among constituents, the media and other decision-makers. Additional information on this program can be obtained by calling CSDA at (877) 924-CSDA.

Prudent Accumulation and Management of Reserves

The principles and guidelines that follow reflect the common belief among special districts that there should be clear and well-articulated rationale for the accumulation and management of reserve funds. Individual districts should formulate and adopt a reserve policy, as it is an integral part of the prudent accumulation and management of reserves. The public has a general lack of understanding regarding the purpose of special district reserves and appropriate reserve levels. Districts can make great strides in dispelling misperceptions related to reserve levels--while building stronger bonds with the communities they represent--through the adoption of a well-developed reserve policy and efforts to educate and inform the public of reserve particulars.

While it is essential that districts adopt reserve policies, it is critical to understand that a reserve policy must be developed in a manner consistent with other financial policies, budgetary practices, district programs, and legal requirements. Three foundational elements are essential prerequisites to the development of any reserve policy:

1. A clear, organizational philosophy/mission
2. A well-developed capital improvement plan, as a critical element of regular strategic-planning efforts
3. Use of a standardized method of financial reporting, such as GASB 34

Principles and Guidelines

1. Identify the uniqueness of the district.
    a) Consider district goals, needs, and constraints.
    b) Utilize life-cycle analysis if district is capital intensive. Regularly measure condition of assets.

2. Have a complete understanding of the district's core business.

3. Develop and maintain a strategic plan, including a well-developed capital improvement plan.

4. Make communicating with customers and constituents a priority.
    a) Seek input through customer surveys, community meetings, and other means.
    b) Inform customers and constituents of output and seek their input in evaluating policies.

5. Recognize that a good reserve policy must be consistent with other financial policies, such as balanced operating budget or investment policies.*****

*****An excellent resource on this point is "Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting," available from the Government Finance Officers Association. For more information, log onto www.gfoa.org.

6. Clearly identify reserves, both categories and purposes. Set target level for reserves that are consistent with district's mission, the district's uniqueness, and the philosophy of the district's board and community.

7. A broad reserve policy may include many elements or sub-policies. Some areas that may need sub-policies include:
    a) rate-stabilization funds
    b) fees and charges
    c) debt issuance and management
    d) deferred maintenance
    e) contingency funds

8. Engage in strategic planning.
    a) By developing, regularly evaluating and, when necessary, modifying strategic plans, districts can more efficiently plan and shape their futures. Strategic planning can help district boards anticipate and adapt to changing environmental, regulatory and demographic conditions. This assists districts in establishing appropriate reserve funds and adopting adequate target levels.
    b) Seek community input in the strategic planning process, i.e., ratepayers, business groups, community organizations, etc.
    c) While a district might invite some community members to participate in a formal strategic planning meeting with the board, a more likely scenario is for the district to engage various stakeholders through surveys, focus groups, or a series of neighborhood meetings.

9. Make communicating with customers and constituents an integral part of the district's financial practices. Whether through a quarterly newsletter or a condensed annual report, it is critical for districts to explain their financial position to their customers in layman's terms. If a district needs assistance or new ideas on how to effectively communicate with its constituents or customers, CSDA is available to assist through its Public Outreach Assistance Service or other means.

Specific Considerations for Budgeting and Allocating Fund Balance or Retained Earnings

1. <u>Define organization's objectives:</u>
    - Short-term
    - Long-term
    - Operating
    - Capital

2. Identify where funds are used:
   - Operating revenues
     These are the general-purpose funds through which ongoing activities are funded.
   - Special-purpose revenues
     Most often these are legally restricted for a particular use. For example, a special assessment for infrastructure must be separately accounted for and spent on the designated infrastructure costs.
   - Debt proceeds
     These should be used to fund costs that provide a benefit across fiscal years. The issuance of debt allows the district to allocate these costs by spreading the debt service to these periods. Debt proceeds should never be used for short-term operating costs because this would entail allocating current operating costs to future periods.
   - Other one-time revenues
     One-time revenues should be used for one-time expenses. If a special district gets one-time revenues and uses it to provide additional full-time positions or to fund on-going operating costs, there may be a budget crisis when the one-time funding runs out.

Capital Planning

A Capital Improvement Program (CIP) exists to identify and prioritize a district's need for capital goods. A CIP should prioritize the importance and timing of the various assets to be acquired. In addition, a CIP should contemplate how those goods will be paid for – cash (equity) or debt. A capital plan is a strategic or comprehensive plan for the acquisition and implementation of the district's capital assets as a group, or over time. In that sense, it is different from a finance plan, which focuses on individual acquisitions and how to pay for them.

To fulfill its mission, the district must make capital investments. Debt -- especially tax-exempt debt -- is recognized as an important and continuing source of a district's capital to fund improvements necessary to achieve its mission and strategic objectives. A CIP provides the framework by which decisions will be made regarding the use of cash and debt to finance capital projects. Debt is defined to include all short- and long-term obligations, guarantees and instruments that have the effect of committing the district to future payments. The assumption of debt, both direct and indirect, will be subject to the district's approval. Any debt issued by subsidiary entities is subject to these policies. In satisfying their fiduciary responsibilities, it is critical that the district's board and management know the extent of debt obligations.

CIP Objectives

1. To provide guidelines to management on the use of reserves and debt to support the district's capital needs while achieving the lowest overall cost of capital.
2. To provide selected financial measures, with specific targets, to ensure that the district continues to operate within appropriate financial parameters while allowing the agency to maintain financial stability and the highest acceptable credit rating that permits it to issue debt at favorable rates.
3. To bridge the cash flow gap between the district's available funds and its capital needs when the assumption of debt is deemed prudent.

Debt Allocation

Given that a district has limited debt capacity, management must prioritize debt resources among all uses, including capital projects, equipment financing, real estate investment, financial opportunities, and other projects. In allocating debt, the following guidelines may be used:

- **Core mission:** Only projects which relate to the core mission of the district will be considered for tax-exempt debt financing.
- **New revenue stream or budgetary savings:** A project that has a related revenue stream or can create budgetary savings will receive priority consideration. However, this is not meant to exclude other projects that are key to the district's mission. For these projects, the use of debt must be supported by an achievable financial plan that includes servicing the debt and meeting any new or increased operating costs. These costs could include the funding of a replacement and renovation reserve. For projects that can create budgetary savings, the budget may be reduced to fund the debt service and any additional savings may be invested into other critical capital projects.
- **Length of useful life:** The useful life of a project needs to be taken into account when considering long-term debt for capital investment.
- **Capacity to attract outside funds:** Project-generating revenues, federal and state grants, expendable reserves, and other sources are expected to finance a portion of the cost of a project. Debt is to be used conservatively and strategically.
- **Other considerations:** The above factors are not intended to be all-inclusive. Management's judgment ultimately will determine the use and amount of debt.

Debt Portfolio

No undue restriction should be imposed on the nature of a debt instrument as long as it can be appropriate and advantageous for the purpose of limiting interest-rate exposure and reducing debt-service costs. Fixed-rate debt provides more long-term interest rate stability than variable-rate debt, however, variable-rate debt can be a desirable component of the debt portfolio because it is typically issued at lower interest rates. Because the use of variable debt exposes the debt portfolio to interest rate fluctuations, the district should limit the use of variable-rate debt, and use it only when it is clearly advantageous.

Credit-rating Maintenance

Maintaining the highest acceptable credit rating is a primary objective of a CIP. This permits the district to continue to issue debt and to finance capital projects at favorable interest rates, while meeting its strategic objectives. The district should limit its overall debt to a level that maintains an acceptable credit rating with the bond-rating agencies.

Creating a Capital Plan

Creating a capital plan takes six basic steps:

1. Establish goals
2. Assess needs
3. Develop strategic cash vs. borrow approach
4. Identify methods available for funding
5. Design the loan or secure financing
6. Organize approach

Establish Goals

The key elements in setting clear capital plan goals include:

1. Understanding the role of the planning horizon.
2. Integrating the use (or lack thereof) of reserves.
3. Understanding the repetitive nature of implementing the CIP.

Planning horizons are important considerations in well-developed capital plans. For example, it makes little sense to try to plan for a 10- or 20-year horizon if innovation, technology, demographics or legislative threats to the plan occur often or on short notice. Conversely, agencies that are in low-technology businesses and stable demographic circumstances can afford to (and probably should) plan for long periods.

The extent to which a particular district has accumulated reserves will dramatically impact the capital plan. The development of, and adherence to, strong reserve policies can greatly simplify funding choices for the capital plan. But, blind adherence to arbitrary reserve levels can be just as inhibiting as no reserves at all. The key is to make the reserve accumulation, or depletion, work in harmony with the capital plan, the operating budget and the risk management of the district.

The last point is worth emphasizing. The capital plan is by its nature repetitive. For that reason, many districts choose to review and update it annually, usually as an adjunct to deliberation of the operating budget. This keeps the capital plan current and tempered by current information on the financial and political priorities of the district.

Assess Needs

Every capital plan starts with a needs assessment. The assessment should rely on a comprehensive inventory of capital assets already owned, an estimate of their remaining useful lives, and a good understanding of future requirements. While a detailed review of the steps necessary for an effective needs assessment are beyond the scope of the *Special District Reserve Guidelines*, the needs assessment is the foundation for virtually all of the decisions that will arise in the capital planning process. As a result, it pays big dividends to emphasize this element of the plan.

Useful tools in the operation of the needs assessment may include: community focus groups or commissions, local and regional planning agency studies, staff input, and reviews by engineering, accounting and legal experts.

A Strategic Decision – Pay-as-you-go or Borrow?

Once major acquisition needs are identified and service goals established, the district faces the decision of whether to pay cash or borrow to acquire capital assets. There are two theories as to which is the best approach to take. Those who believe that paying cash is the most desirable way of funding capital assets point to the inherent fiscal conservatism of such an approach. This approach is often referred to as "pay-as-you-go" or "pay-as-you-acquire." Use of this approach produces cash equity in capital assets and is often promoted because a dollar not borrowed is a dollar on which interest need not be paid.

On the other side of the spectrum are the "pay-as-you-use" proponents, who usually argue that accumulation or creation of major amounts of equity in capital assets is economically inefficient, particularly for those districts that are capital intense and whose capital goods are "used up" over long periods of time. The rationale behind this approach is that the district's stakeholders should "pay" for the assets required to deliver the goods or services of the agency over a time period that more closely mirrors the useful life of those assets.

Most districts use a blended approach. Often, a district's approach is dictated as much by affordability as by philosophy, as few public bodies can afford (either in a political sense or economic one) to pay cash for all capital assets. Similarly, financing of smaller capital goods, or those with short or uncertain useful lives, is also inefficient.

Identify Methods Available for Financing

Once the goals have been set, the needs assessed and the decision whether to pay cash or finance the asset has been made, some thought must be given to the method of financing. For example, even if an asset is to be procured for cash, and the cash is on hand in a reserve set aside for that purpose, a decision still must be made on whether to replenish or restore that reserve, and over what time period and from what source it will be replenished.

Choosing to issue debt means that the following choices must be made: form of debt, mode (fixed or variable rate), repayment terms, and method of sale. These are the tactical decisions that often blur the understanding of the strategic elements of the capital plan.

Designing the Loan – The Tactical Plan

If a decision is made to borrow, there is a dizzying array of choices to be made. Some districts choose to borrow from banks or private lenders; others choose public offerings of debt. Lease financing may be considered as an alternate to bond financing. Some districts pool their needs with other similarly situated districts in order to reduce costs through efficiencies of scale.

Regardless of the choice of lenders or approach, important considerations of this element include matching the useful life of the financed asset to the borrowing term. Common sense tells us that we should hesitate to finance automobiles with 30-year bonds. By the same token, a water treatment plant with a design life of 50 years can be safely and prudently financed over long periods of time.

This element of the capital plan should also carefully consider other needs within the strategic plan when pledging assets or revenues to lenders. A generous package to a lender on today's asset may make tomorrow's asset financing problematic or impossible. The key is to ensure that each tactical financing plan within the capital plan works harmoniously with other elements of the plan and is flexible enough to allow for the inherently changing nature of the capital plan.

Organizing the Approach

The successful capital planning process looks a great deal like the successful budgeting process. The end-result articulates the goals and objectives of the organization to all stakeholders and relies on accurate and unbiased assessment of needs. It provides for an evaluation of the desired assets to distinguish between "wants" and "needs." It is written and shared with the district's stakeholders.

The capital plan is revisited often and provisions for changing or amending it are straightforward. Finally, it incorporates periodic analysis of results and achievements for management and governing bodies.

Summary

A capital plan need not be elaborate or weighty to be effective. Many effective capital plans consist of a single spreadsheet and several paragraphs of supporting text. The development of the plan is vital to the efficient use of capital. It is a key ingredient in a lender's assessment of management's effectiveness and control. It is among the most important tools an elected official possesses to discharge the duties of office.

Readers who are interested in additional information about the development of capital plans should consider a variety of books, and other information sources, on the topic. Some suggested examples are shown in the attached resource listing at the back of this document.

Fund Equity and Retained Earnings

In a public entity, the board and management have to decide how much money is enough for the district's needs and how much is too much. Public entities such as utility districts collect fees from users to provide day-to-day services, as well as to maintain the corporate facilities. A water district has operating expenses such as water purchase and delivery costs, maintenance and operations and infrastructure costs. Fees collected by districts need to provide for day-to-day operations, as well as the anticipated repair and replacement of the infrastructure. The excess of the amount collected in fees and other revenues during the fiscal year over the amount expended during the same period go into the fund equity or retained earnings. Fund equity and retained earnings is the net excess of assets over liabilities.

Governmental-fund types use the terminology "fund balance" to describe the net excess of assets over liabilities. Enterprise-fund types (governmental organizations that are operated and account like a commercial enterprise) use the term "retained earnings" to describe the net excess of assets over liabilities.

To further understand the fund balance or retained earnings and how much is enough, review the following financial statement (*Exhibit 1)*. Under the enterprise statement, the total assets are $3.5 million dollars and the retained earnings are in excess of $2.5 million dollars. Is this enough?

Exhibit 1

XYZ GOVERNMENT BALANCE SHEET

	General	Enterprise
Assets:		
Total Assets	423,450	3,502,459
Liabilities and Fund Equity:		
Total Liabilites	136,000	935,000
Total fund balance/retained earnings	287,450	2,567,459
Total liabilites and fund equity	423,450	3,502,459

In Exhibit 2, more detail shows that the assets are primarily invested in buildings and improvements. Analysis of the components of the retained earnings shows that over $2.1 million of the $2.5 million in retained earnings is a result of net investment in fixed (not spendable) assets.

Exhibit 2

XYZ GOVERNMENT BALANCE SHEET

	General	Enterprise
Assets:		
Cash	65,000	113,559
Cash with fiscal agent	25,000	-
Investments	258,000	1,178,400
Receivables	48,000	29,000
Inventory	7,200	24,000
Prepaid expenses	250	1,500
Restricted investments	20,000	-
Building and improvements		3,580,125
Accumulated depreciation		(1,424,125)
Total Assets	423,450	3,502,459
Liabilities and Fund Equity:		
Accounts payable	118,000	135,000
Deferred revenue	18,000	-
Bonds Payable		800,000
Total Liabilites	136,000	935,000
Fund Equity:		
Investment in fixed assets	-	2,156,000
Retained earnings:		
unreserved		7,459
Reserved for:		
inventory	7,200	24,000
Designated for:		
debt service	-	200,000
capital improvements	-	150,000
contigencies	100,000	30,000
Undesignated	180,250	
Total fund balance/retained earnings	287,450	2,567,459
Total liabilites and fund equity	423,450	3,502,459

Is this organization in good financial shape? That depends on the condition of the current assets and the short- and long-term needs of the organization as they relate to its resources. If there exists $2 million dollars in current infrastructure needs, then financing may be required. Is enough set aside for contingencies? If water costs increase by 10 percent, how will that affect total retained earnings? If the federal government mandates high water-quality standards, then what will be the equipment costs related to meeting this new standard?

Governmental entities collect, hold and expend resources in public trust. If not enough is collected, they risk not being able to meet mandated needs. If too much is collected, then the government overburdens the public and ties up resources that taxpayers could use in the economy. Governments have not always done a good job budgeting and making long-term plans for capital needs and for contingencies. Historically, governments spend most of their resources each year. Governmental entities need to examine their operations and make long-term plans and budgets to ensure that expenses are anticipated and resources set aside.

Some governments, either through good fortune or good planning, have set aside retained earnings for future plans and needs. What most governments have failed to do, as emphasized in the Little Hoover Commission's report, is to effectively communicate their plans for the retained earnings and explain why the balance is appropriate.

Each district needs to:

1. Examine its financial position.
2. Examine its current and long-term needs.
3. Determine the need for a long-term capital plan.
4. Establish target fund balance or retained earnings.
5. Communicate its goals and needs through policy, budgets and enhanced financial statements note disclosures.
6. Anticipate public scrutiny of financial statements and disclose how finances are being used.

Summary

CSDA facilitated the Reserve Guidelines Task Force in response to the concerns outlined in the Little Hoover Commission's report "Special Districts: Relics of the Past or Resources for the Future?" Our goal was to prepare a document that could be used by all independent special districts as a map in the preparation or review of the district's reserve policy. We encourage you to have your financial and legal professionals review the final policy prior to adoption to ensure you are in compliance with all current laws and regulations. Districts should schedule a regular review of their reserve policy as the financial environment within which it operates may be dynamic as well as there may be applicable legislative or regulatory changes.

The report concluded that there is a disconnect between special districts and their constituents and other local government entities. Districts should consider preparation of a public outreach program to communicate financial and program information on a regular basis to affected or interested populations. How involved each respective public outreach program is for a district is typically determined by the size and complexity of the district. It may be as simple as adding the information to an agency's website or the development of an annual report. In response to the demand for help in effectively communicating this information, CSDA launched its Public Outreach Assistance Service. This program is a member service of CSDA and can be tailored to meet the various communication needs of both small and large districts. It is important that each agency not only develop a reserve policy, but ensure that your constituents and fellow local governments understand your financial position and decision-making tools.

We hope you find these guidelines helpful and if you have any comments or suggestions on how we can improve this document, please contact us at (877) 924-CSDA.

Glossary

Net assets: The amount of assets in excess of liabilities
For governmental-fund types, this excess is referred to as “fund balance.”
For enterprise-fund types, this excess is referred to as “retained earnings.”

The GASB has made a distinction between reserved equity and designated equity in accordance with NCGA-1 (Governmental Accounting and Financial Reporting Principles).

<u>Designations v. Reservations</u>
While cash set asides are popularly referred to as “reserves,” it is important and more accurate to identify them as designations or reservations. The two are distinctly different.

Designations: Net funds that are set aside based on board policy or tentative plans. Discretionary.

Examples:

- Designated for cash-flow (to help cover operating expenses during shortfalls)
- Designated for capital improvements
- Designated for contingency
- Designated for rate stabilization

Fund-balance designations may be established to indicate tentative plans for financial resource utilization in a future period, such as for general contingencies or for equipment replacement. Such designations reflect tentative managerial plans, or intent, and should be clearly distinguished from reserves. Such plans, or intent, are subject to change and may never be legally authorized or result in expenditures. Designated portions of fund balance represent financial resources available to finance expenditures other than those tentatively planned. Designations should be reported as part of the unreserved fund balance, i.e., “Designated for ...” or disclosed parenthetically or in the notes to the financial statements.
(National Council on Governmental Accounting Statement: NCGAS-1, paragraph 120)

Reservations: Net funds that are not appropriable. Assets that cannot be spent or are limited by legal or contractual requirements.

The following are examples of reservations that may be made because the funds are not appropriable:

- Reserved for inventory
- Reserved for restricted cash or investments
- Reserved for investment in net fixed assets

Often debt covenants require that certain reserve balances be maintained to secure payment of the debt service. **Debt-service reserves** is an example of a contractual requirement to set-aside funds.

Many governments and their accountants have referred to the excess of assets over liabilities as "reserves," however, preparers and users need to be careful with the terminology used in conjunction with financial information.

Reserves should be reported in the "Fund Balance" section of governmental fund balance sheets, not as liabilities or between liabilities and fund balance. The "Fund Balance" section may be subdivided between or among its reserved and unreserved components, or separate "Reserved Fund Balance" and "Unreserved Fund Balance" sections may be used. (NCGAS-1, paragraph 121)

Use of the term "reserve" in proprietary fund accounting should parallel commercial accounting and reporting. Thus, it should be limited to indicating "Reserved Retained Earnings." (NCGAS-1, paragraphs 121)

Restricted Funds: Equivalent to reserved funds.

Some governments often need special funds for building projects or special funding. Resources restricted for expenditure for specific purposes may be accounted in the general fund, provided that any applicable legal requirements can be met and the use of a separate fund is not legally mandated. If this type of funding is accounted along with other general funding, any excess balances should be recorded as restricted funds in the "Fund Balance" section of the financial statements.

Fund Balance Reserves (Reservations) and Designations

In governmental-fund accounting and reporting, use of the term "reserve" should be limited to indicating that a portion of the fund balance is not appropriable for expenditure or is legally segregated for a specific future use.

An example of a portion of a fund balance that is not appropriable for expenditure is the Reserve for Inventories, which indicates that the portion of fund balance represented by inventories is not available for appropriation and expenditure at a balance sheet date.

An example of a reserve indicating that a portion of the fund balance is legally segregated is the Reserve for Encumbrances, which indicates that a portion of the fund balance has been segregated for expenditure on vendor performance.

In instances where part of the fund balance is reserved, the remainder should be reported as Unreserved Fund Balance. (NCGAS-1, paragraph 118)

GASB 34 Note:
Under GASB 34, the formal presentation of the report should not include use of the terms reservations, reserves, or designations. Funds are broadly classified as either restricted funds (equivalent to reserved funds) or unrestricted funds (designated or undesignated surpluses). In the footnotes to the financial report, however, these additional terms can be effectively employed to provide greater detail and full disclosure of plans for the district's fund balance/retained earnings, the importance of which cannot be overstated.

Resources

The Government Finance Officers Association (GFOA) is a great source for more information regarding various government financial matters, including fund balance and financial reporting. GFOA has an extensive publications department. View a list of their full offerings by logging onto their website at www.gfoa.org. The following publications may be useful:

- "Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting"
- "An Elected Official's Guide to Fund Balance"
- "An Elected Official's Guide to Financial Reporting"
- "Governmental Accounting, Auditing, and Financial Reporting"