EDUCATIONAL SERIES
Release 2, April 14, 2021

RESERVES

FVC's Educational Series serves as educational communications to Vallecitos Water District Board Members and advocates to provide information sufficient to acquire an understanding and comfort level for initiating and supporting Board actions for positive change for the benefit of ratepayers.

Board Members, please see "Caution – Open Meeting Act Compliance" at the end of this release. These communications cannot be a means to reach a consensus of the Board majority or communicate a position on an issue. That must be done at meetings posted and open to the public. These communications are strictly to educate, inform, and mitigate the current lack of transparency at the Vallecitos Water District.

Background

Vallecitos Water District (VWD) is a publicly-owned, sole purpose, special district (political subdivision of the State of California). Its sole purpose is providing water and sewer service to its customers. Being a publicly-owned entity, the public (ratepayers) own the assets of VWD and are burdened with the liabilities VWD incurs on their behalf. VWD's Board of Directors and administration have a legislated fiduciary responsibility to manage and maintain those assets for the benefit of ratepayers and to provide the service for which customers have paid.

Utility companies, whether public or investor owned, are capital-intensive entities, requiring costly maintenance, repair, and replacement of capital assets, like infrastructure and equipment for treatment, transmission, and distribution. Maintaining reserves in cash, cash equivalents, and investments prudently addresses a utility company's short-term needs related to operating, capital asset replacement, and other special needs.

Maintaining too little reserves risks not being able to operate or provide service for periods of time if there is a series of unanticipated expenses. Another risk is not being in compliance with debt covenants that require the utility to maintain specific levels of cash. Maintaining too much in reserves can result from charging too much for the service. The right amount of reserves, while subjective, can be determined by analyzing the specific needs of the utility and applying industry guidance and best practices to policy making and decisions. Reserves are typically broken down into two main categories, restricted and unrestricted, then further categorized by purpose.

Restricted Reserves

The word "restricted," as it applies to reserves, indicates a legal or contractual limitation on the use of funds. Restricted reserves are not addressed in VWD's Reserve Policy.

Debt-related Reserves - Most common restricted reserves relate to debt issuances (loans and bonds) and are necessary to address covenants in debt agreements as well as to comply with arbitrage statutes. Tax-exempt debt proceeds are maintained as restricted reserves and are only available to the utility to reimburse the project(s) costs identified in the loan or bond indenture. The amount of the loan (or bonds) cannot exceed the cost of the financed project(s). Other debt-related restricted reserves like

Debt Service Funds and Replacement Funds are established to comply with specific covenants and statutes.

Capacity Fund Reserves - Another common restriction relates to capital facility fee revenue received. Utility companies assess capital facility fees, or capacity fees (Cap Fees), for the capacity to be used by a new customer. How capacity revenue is reserved depends on what method is used to calculate the Cap Fee. The California Constitution provides that Cap Fee revenue can be used only for the purpose for which the fee is assessed.

The three methods for calculating Cap Fees are the Incremental Cost Method, the Buy-In Method, and a Hybrid Approach.

1. The *Incremental Cost Method* assumes there is not enough available capacity to serve new development so a fee is assessed to pay for future capital projects that accommodate growth (increase capacity in the system). The revenue from a fee determined from this method is restricted to pay only for growth-related capital projects and the debt service for debt-financed growth-related capital. This is the method that VWD uses. These VWD restricted funds, one for water and one for sewer, have a combined deficit balance of $15.5 million, as of June 30, 2020. Accommodations like allowing a particular developer to build without paying fees, delaying much-needed Cap Fee increases, and adopting insufficient Cap Fees have led VWD to "borrow" from other ratepayer-funded reserves. The $15.5 million deficit represents the amount "borrowed" from ratepayers. ***Note: The words "borrow" and "borrowed" are in quotes because VWD has no plan or intention of repayment and, even if VWD incurs the maximum legally allowed tax-exempt debt within the restricted capacity funds, they project the deficit to escalate.***

2. The *Buy-In Method* assumes that there is sufficient capacity to serve new development. Developers pay fees assessed under this method as their fair share of the value of existing assets that have been acquired and maintained with funds paid by existing ratepayers. Revenue from Cap Fees calculated under this method can be placed directly in Unrestricted Capital Replacement Reserves (discussed later) and offset future water and sewer rate increases.

3. The *Hybrid Approach* combines the two methods and is appropriate when there is sufficient capacity for some growth, but future capital projects are needed to accommodate ultimate demand. This is the method that VWD should be using. This method would add a *Buy-In* component to the total Cap Fee. The revenue from the *Incremental Growth* component would be maintained in Restricted Capacity Fund Reserves. The revenue from the *Buy-In* component would be maintained in Unrestricted Capital Replacement Reserves. ***By VWD using the inappropriate Incremental Cost Method, developers have saved millions of dollars, and placed continuous upward pressure on water and sewer rates*** (to be discussed in a future release).

<u>Unrestricted Reserves</u>

The word "unrestricted," as it relates to reserves, means the funds have no contractual or legal limitation other than Article XIII D Section 6(b) of the California Constitution which prohibits the use of proceeds from water and sewer charges for any purpose other than to provide the service for which the charge was assessed. ***Note: VWD has not been in compliance with this provision of the law since 2013 when they started using ratepayer money to subsidize urban development.*** Unrestricted reserves are funded from water and sewer charges in excess of operating and capital replacement costs, i.e., ratepayer money, and investment earnings on the fund balance.

Operating Reserves typically equal from three to six months of budgeted operating expenses and often exclude wholesale water purchases and depreciation. Operating reserves ensure that a utility can continue to operate even if unexpected expenses and financial losses occur. VWD maintains operating reserves at six months of budgeted operating expenses less wholesale water purchases. Depreciation is not included since VWD budgets on a cash basis.

Capital Replacement Reserves ensure the utility has adequate funds to replace infrastructure and other assets when needed to maintain the integrity of the system. Reserve balances equal amounts contributed from water and sewer revenue, property tax and other miscellaneous non-operating revenues, and investment earnings on the balance, less amounts expended for capital asset replacements and debt service on debt-financed capital replacements. ***Note: Cap Fee proceeds and assets related to construction and acquisition of capital assets to accommodate growth should not be included in capital replacement reserves. VWD includes the $15.5 million receivable from developers in their capital replacement reserve balances. This is not prudent or even possible as the $15.5 million is not readily available to pay for capital asset replacement, and likely never will be received.***

Target levels of capital replacement reserves are determined in a variety of ways. Best practices dictate that the method and information used to determine the target balances are easily understood and readily available to the public. Balances in these reserves should be a reasonable estimate of near-term capital replacement needs. VWD determines the capital replacements reserve balances as noted in the following excerpt from their policy:

> The balance for the Water Replacement Reserve shall be greater than the sum of the next three years of projected system replacement costs, but less than the next ten years of system replacement costs. The balance for the Wastewater Replacement Reserve shall be greater than the sum of the next three years of projected system replacement costs, but less than the next eight years of system replacement costs.
>
> Replacement costs shall be projected using the following assumptions:
>
> - Replacement costs equal net additions to infrastructure and system assets increased according to the published Construction Cost Indices from the year of acquisition to the most current monthly index.
> - Water System replacement occurs starting on year forty through year seventy of the life of the additions at an amount equal to 3.226% of the replacement cost for each year.
> - Wastewater System replacement occurs starting on year thirty-five through year fifty of the life of the additions at an amount equal to 6.25% of the replacement cost for each.

Accountants may understand this excerpt, but normal people cannot. Accountants aren't normal.

VWD is using information recorded as much as fifty years ago to estimate replacement costs through the next ten years. Using these formulas, VWD currently estimates that over the next ten years annual capital replacement costs will total $114 million. The recent annual average actual replacement costs (base on available reserve reports dating back to 2014) is $6.8 million.

These unreasonable estimates directly impact the amount of money customers pay for water and sewer service. At the time of the last VWD water rate increase, February of 2020, water capital replacement reserves totaled $31.4 million, which already exceeded the entire 5-year water replacement Capital Improvement Program (CIP) of $16.1 million. Yet VWD adopted rates that included a $6.9 million "transfer to capital reserve" constituting 14.5% of the amount VWD customers currently pay for water. Coincidently***, VWD uses money in capital replacement reserves to subsidize urban development since there is a deficit balance in the developers' restricted capacity funds. VWD water rates could be far less if the reserve policy included more industry standard methods for determining reserve target levels and if VWD would issue bonds instead of "borrowing" from ratepayers.***

A best practice for establishing capital replacement reserve targets is the use the current budget that includes thoughtful estimates of capital replacement needs, often based on thorough condition assessments. For example, the first year of the 5-year replacement CIP is the minimum target level, and the entire 5-year replacement CIP is the maximum target level.

Rate Stabilization Funds are established and maintained to mitigate volatility in water and sewer rates caused by spikes in wholesale rates, water revenue fluctuations from changes in demand, and other unforeseen reasons. The minimum target should be zero affording the Board and management full discretion to use the funds for their intended purpose. Typical maximums relate to percentages of water sales or water purchases. There should be a stated maximum to avoid unnecessary runup in rates to fund rate stabilization. VWD's policy has no limit on rate stabilization funds.

Rate stabilization funds are also used to manage debt service (interest and principal repayment) coverage requirements. Draws from rate stabilization count as revenue for calculating the ratio of revenue to debt service, known as the Debt Service Coverage Ratio (DSCR). Conversely, funding rate stabilization reduces the revenue used in the DSCR. Prudent utilities will fund rate stabilization when the DSCR is high, and draw from rate stabilization when they are in danger of revenue falling below the contractual DSCR which is typically 1.25 times debt service. The target levels of rate stabilization should afford the Board and management discretion to mitigate rate volatility and manage the DSCR.

VWD funds rate stabilization only after the capital replacement reserves exceed their limits. Draws from rate stabilization are, first, to restore capital replacement reserves to their maximum. After capital replacement reserves are restored to their maximum, the rate stabilization funds are automatically funded with the excess amounts and used to stabilize rates. This affords only very limited discretion to the Board and management. In the past, draws from the rate stabilization funds have been disregarded as revenue for the DSCR calculation because of these unconventional provisions.

Special Reserves are established to address specific future liabilities or contingencies that may be unique to an entity. VWD's reserve policy provides for an OPEB Reserve equal to the amount of unfunded liability for Other Post-Employment Benefits (medical insurance premiums for retirees). This reserve should be broadened to include the unfunded pension liability, with full Board and/or management discretion for funding, with maximum target levels equal to the unfunded liabilities. VWD has been pre-funding a 50+ year pension obligation with ratepayer money. If they would instead reserve amounts towards the unfunded liabilities, this unrestricted cash would improve financial ratios and KPIs like days in cash, working capital, current and quick ratios, and enable VWD to maximize debt proceeds. Instead, ***they have limited their capacity to borrow and hindered their ability to restore the developer fund deficit (pay back ratepayers) by reducing their current position and paying down an obligation due in 50+ years. It would have been prudent to issue bonds first, then pay down retirement benefit liabilities to the extent the DSCR remains above the contractual amount***.

Recommendations

VWD's Reserve Policy was written by the author of this release seventeen years ago. The most recent revision was in 2014 with the basic provision from 2004 still in place. Back then it was considered innovative and helped VWD recover from recessions and drought. Now it is considered dated and unconventional. ***Even though revising the Reserve Policy was a priority during a transitional phase of the District when a number of managers and key positions resigned, VWD has maintained the policy, using it as justification for a runup in reserves and successive rate increases.*** The following reserve policy revisions, and accounting and reporting recommendations incorporate best industry practices and support lower water and sewer rates.

1. Incorporate all reserves in the reserve policy, including restricted reserves.

2. For each reserve, the policy needs to include the following: How the reserve is to be funded, allowable uses of the fund, target level minimum and maximum or specific target balance that are derived from simple calculations or budgeted amounts with supportive information readily available to the public. Continue the practice of separate reserves for water and sewer.

Reserve	Funding Source	Allowable Uses	Min Balance	Max Balance
Operating	Net operating income, investment earnings on the balance	Unbudgeted and unexpected operating expenses/losses	Specific balance equal to six months of budgeted operating expenses less the cost of water purchases	
Capital Replacement	Water and sewer revenue, non-operating revenue, reimbursement from debt proceeds related to replacement CIP, investment earnings on the balance	Replacement of District assets, replacement-related debt service, acquisition of assets that do not increase system capacity, restore operating reserve specific balance	First year budgeted replacement CIP	Five-year budgeted replacement CIP
Rate Stabilization	Water, sewer, and miscellaneous operating revenue, investment earnings on the balance	Increased operating costs and unbudgeted and unexpected operating expenses/losses to avoid rate spikes	0	Current year budgeted water sales
Employee Benefit Obligation	Water, sewer, and miscellaneous operating revenue, investment earnings on the balance	Prefund employee benefit obligations, e.g., OPEB and pension	0	Actuarily determined unfunded liability
Capacity (restricted)	Capital facility fee revenue, reimbursement from debt proceeds related to growth CIP, investment earnings on the balance	Acquisition of assets that increase system capacity (growth assets), debt service on financing of growth assets	Actual balance reported pursuant to the Mitigation Fee Act	
Project Fund (restricted)	Debt proceeds, investment earnings on the balance	Reimbursement for project construction costs	Actual balance	
Bona Fide Debt Service Fund (restricted)	Initially with debt proceeds, subsequently with revenues equal to annual debt service	Debt service	Must be depleted to 0 each year	Annual debt service
Replacement Fund (restricted)	Debt proceeds	Debt service in the event VWD is unable to make required payments	0	Lessor of 10% of the issue principal, max annual debt service, or 125% of annual average debt service

3. ***VWD's reserve policy should also note that uses and transfers from any reserve must be in compliance with federal, state, and local law. This provision is only necessary for VWD since VWD is the only water district in San Diego County, and likely all of California, that subsidizes urban development with ratepayer-funded reserves, which is a violation of the California Constitution and a breach of VWD's fiduciary responsibility to water and sewer customers.*** The Policy should also include remedies for inadvertent deficit balances in the capacity fund, like immediate acquisition of debt proceeds.

4. Restricted debt-related reserves (Project Fund, Debt Service Fund, and Replacement Fund) should be established for each separate borrowing and include generic wording to accommodate future debt issuances from either bonds or private placements and include language consistent with safe harbor rules for arbitrage compliance.

5. Total reserves should be reconciled at least annually to cash, cash equivalents, and investment balances.

6. Continue the practice of monthly reserve reporting.

7. ***Do not include the ratepayer "loan" to developers in the capital replacement reserve balances of the monthly reserve activity report. This amount is not readily available to pay for capital replacement and will likely never be collected. Be transparent. Call it what it is. Show the "loan" as an expenditure in the "Replacement" columns entitled "developer subsidy" so that the ending balance is actually cash, cash equivalents, and investments that are readily available to pay for capital replacements***.

Tentative Release Schedule

Educational Series Topic	Anticipated Release Date
Introduction and the Deficit	April 8, 2021
Reserves	April 14, 2021
Debt (overview, resolutions of intent, strategies)	April 30, 2021
Master Plan and Cap Fee Study Overview	May 15, 2021
Cap Fee Study Methodologies (Buy-In component)	May 31, 2021
VWD Current Cap Fee Deficiencies	June 15, 2021
District Legal Counsel (responsibilities and strategies)	June 30, 2021
Ethics and Transparency	July 15, 2021
Water and Sewer Rates (overview, revenue requirement)	July 31, 2021

Additional Information

Please consider obtaining additional background from the following:

VWD's Reserve Policy
https://www.vwd.org/home/showpublisheddocument?id=6010

Olivenhain Municipal Water District's Reserve Policies (Example from a well-respected agency)
https://www.olivenhain.com/wp-content/uploads/Article-16-Non-Restricted-Funds-1.pdf
https://www.olivenhain.com/wp-content/uploads/Article-17-Other-Non-Restricted-Funds-Rate-Stabili.pdf
https://www.olivenhain.com/wp-content/uploads/Article-18-Restricted-and-Other-Designated-Funds.pdf

FVC Educational Series, Release 1, Introduction and the Deficit
https://friendshipvallecitoswater.files.wordpress.com/2021/04/fvc-educational-series-release-1-introduction-and-the-deficit.pdf

Letter to VWD General Manager, February 23, 2021
https://friendshipvallecitoswater.files.wordpress.com/2021/03/feb-23-2021-email-to-vwd-gm.pdf

Letter to VWD General Manager, February 18, 2021
https://friendshipvallecitoswater.files.wordpress.com/2021/03/feb-18-2021-email-to-vwd-gm.pdf

Vallecitos Water District Hidden Subsidies - A case study in the need for transparency and accountability
October 8, 2020
https://friendshipvallecitoswater.files.wordpress.com/2020/10/vallecitos-brief.pdf

San Marcos Water Rates and Politics, a presentation to the San Marcos Democratic Club, June 13, 2020
https://friendshipvallecitoswater.files.wordpress.com/2020/07/san-marcos-dems-presentation-print-version.pdf

Attorney General Consumer Complaint, May 22, 2020
https://friendshipvallecitoswater.files.wordpress.com/2020/07/ag-consumer-complaint-support.pdf

California Water Politics and Pricing, a presentation to the American Institute of Certified Public Accountants Government Performance & Accountability Committee May 5, 2020
https://friendshipvallecitoswater.files.wordpress.com/2020/07/aicpa-california-water-politcis-and-pricing.pdf

San Diego County Taxpayers Association Golden Fleece Nomination, February 12, 2020
https://friendshipvallecitoswater.files.wordpress.com/2020/02/sdcta-vwd-golden-fleece-nomination.pdf

Rate Protest Letter, February 3, 2020
https://friendshipvallecitoswater.files.wordpress.com/2020/03/scaglione-rate-protest-letter.pdf

San Marcos Water Rates and Politics, a presentation to the Republican Women of California, February 3, 2020
https://friendshipvallecitoswater.files.wordpress.com/2020/07/rwc-hand-out.pdf

San Marcos Water and Politics – The Price We Paid, Palomar College Political Economy Days, October 23, 2019
Presentation slides – https://friendshipvallecitoswater.files.wordpress.com/2019/10/san-marcos-water-and-politics-print-version.pdf
Recorded lecture – https://www.youtube.com/watch?v=0AXsalWSWjI
News article – https://thecoastnews.com/140102-2/

Press release regarding developer subsidies
https://friendshipvallecitoswater.files.wordpress.com/2019/09/fvc-article-20191002.pdf

Letter to VWD General Manager regarding Cap Fee deficiencies, May 28, 2019
https://friendshipvallecitoswater.files.wordpress.com/2019/08/vwd-letter-to-glenn.pdf

Caution – Open Meeting Act Compliance

Article IX of the California Constitution requires the business of the public to be conducted in open meetings. The Board can take action, arrive at consensus, and take positions only in open meetings. While two Board Members do not constitute a majority, the potential for stating a position or attempting to gain consensus could happen, either intentionally or inadvertently, with a series of replies or communications. FVC's Educational Series communications cannot be a means to reach a consensus of the Board majority or communicate a position on an issue. That must be done at meetings posted and open to the public. These communications are strictly to mitigate the current lack of transparency at VWD, educate, and inform.

Excerpt for Article IX of the California Constitution:
11122.5.
(a) As used in this article, "meeting" includes any congregation of a majority of the members of a state body at the same time and place to hear, discuss, or deliberate upon any item that is within the subject matter jurisdiction of the state body to which it pertains.
(b) (1) A majority of the members of a state body shall not, outside of a meeting authorized by this chapter, use a series of communications of any kind, directly or through intermediaries, to discuss, deliberate, or take action on any item of business that is within the subject matter of the state body.
https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=GOV&sectionNum=11122.5.