The "Clean Water Team"

MEMORANDUM

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To: Wastewater Citizens Advisory Committee Members

From: Julie Chadburn

Date: September 12, 2018

Subject: RESERVE POLICY AND ENERGY CONTRACTS

CCWRD Reserve Policy Discussion

Attached for reference is the slide from the August 16, 2018 meeting of the Citizen's Advisory Committee that summarized the prior and current Reserve Policy components. During the course of discussion relating to this slide, some questions were posed regarding elements of the CCWRD Reserve Policy. The purpose of this briefing document is to clarify the Reserve Policy and the reasons underlying each of the component parts of that policy.

Bond Reserve:
The recommended level of CCWRD debt reserves is a one-year equivalent of "maximum annual debt service". The reasons underlying this recommendation have roots in levels of reserves recommended by the Government Finance Officers Association (GFOA) and other bodies as well as the demands and expectations of the credit markets. Assurance that the issuer will have the financial wherewithal to meet their obligations as they come due, in any economic environment, is crucial to achieving and maintaining high investment grade credit ratings and accessing the lowest cost of capital. For both credit considerations and in furtherance of prudent financial practices, the CCWRD should strive to achieve this level of reserves to ensure access to low cost capital in future years, help mitigate the impact of disruptions in the credit markets on the CCWRD operations, and provide assurances to investors that CCWRD has the financial resources needed to make its ongoing debt service payments. One year of maximum annual debt service is a standard debt reserve target for public agencies.

Operating Reserve:

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The recommended level of Operating Reserve for the CCWRD is a 120-day (four month) equivalent of annual operating costs. The GFOA recommends when determining a customized target amount of working capital, the enterprise should start with a baseline of the equivalent of 90 days of annual operating expense and then adjust the target based on the unique characteristics of the particular enterprise. Among the factors identified by GFOA that determine the uniqueness of an enterprise are asset age and condition, volatility of expenses, control over expenses and ease of process to increase service rates. Given that the assets are aging and will require repair and replacement, that certain risks exist that can impact expenses, that there is a reliance upon both sales tax and connection charge revenue (both of which can vary during adverse economic times), and that the ability to increase rates can be a lengthy process, an operating reserve target above the baseline 90-day recommendation is warranted. The recommended level noted above is 30 days more than the baseline to accommodate the characteristics of the CCWRD. This reserve amount was previously set at 120 days prior to the adjustment made in year 2013 to accelerate the Capital Improvement Program activities and reduce the amount of borrowed cash on the books. By way of comparison, other public utilities in southern Nevada have elected to target a 180-day operating reserve.

Capital Expansion Reserve:

The recommended level of Capital Expansion Reserve for the CCWRD is a one-year average of the next ten years of identified capital replacement needs. This level of capital reserve will enable the CCWRD to better react to capital needs as they arise and to better deal with the timing of infrastructure improvements relative to system needs. The level of the capital reserves, once established, can be managed as reserves are used to meet pressing needs and as the average annual CIP costs change over time. Another view of capital reserves is that they provide a means for addressing critical capital needs (that cannot be delayed) during times of turmoil or uncertainty in the capital markets and during other times when access to funding may be impeded. This method of setting the target reserves is similar to that used by other public utilities in southern Nevada.

Budget Stabilization & Natural Disaster Reserve:
The recommended level of Budget Stabilization & Natural Disaster Reserve for the CCWRD is an amount equal to ten percent of the operating expenses in the prior fiscal year established by Nevada Revised Statute (NRS) 354.6115. This reserve is similar to the Operating Reserve in that it is intended to provide stability to the CCWRD operations during times of economic turmoil or in the wake of unforeseen and uncontrollable events. In essence, this reserve can be linked to the Operating Reserve and viewed as just over an additional month of overall operating reserves. Viewed this way, the combined reserve coverage is still less than that which is standard for other public utilities. This reserve is intended to provide some insulation against changes in budgetary performance that might otherwise impact rates or operations.

Capital Replacement Reserve:
The recommended level of the Capital Replacement Reserve is two percent of the total asset value based upon original cost, or $50 million, whichever is greater. This reserve is similar in intent to the Capital Expansion Reserve, in that it is intended to provide a means for making timely repairs to system assets that may be required during uncertain economic times or in the wake of other disruptions. The difference between the two reserves is that this reserve is for replacement and rehabilitation of existing assets, while the Capital Expansion Reserve is intended to provide a means to accommodate new capital requirements. The method of determining the level of this reserve is similar in theory to the practice of funding depreciation, in that it is based upon asset replacement cost.

OPEB Reserves:
Other Post-employment Benefits ("OPEB") are benefits other than those covered by a pension plan that units of government provide to their retired employees. These benefits are largely made up of health care costs, but may include other insurance or disability-related costs or services. In both 2012 and 2015, the Governmental Accounting Standards Board (GASB) issues Statements that prescribe the way that OPEB is accounted for and shown on financial statements. Compliance with the most recent GASB Statement (74) became effective in 2015 and is now a part of the way that these benefits are being

reported and managed. The amount of funds needed in the reserve is actuarially set, based upon the projection of benefits actually owed to retired employees. It is prudent to appropriately fund the OPEB obligations as not to be in a future position of shortage, which could lead to shortages in other areas of the budget. The recommendation with regard to OPEB is to fund the amount that has been determined to be actuarially needed to pay future claims as they come due.

Summary

Each of the foregoing reserves is designed to cover specific contingencies, yet they may also be viewed as a system of reserves that compliment and supplement one another. As was noted during our discussion at the August 16 meeting, one of the primary reasons underlying a comprehensive reserve policy is that it helps to ensure that the credit markets continue to take a favorable view of the CCWRD as a credit. Since it is expected that the CCWRD will be in the credit markets in the coming years, maintaining the current "AAA" rating is of heightened importance. This is the highest credit rating achievable, and serves to help the CCWRD achieve the lowest cost of capital attainable.

With specific reference to the operating and capital reserves, it is also imperative that the CCWRD systems be able to function at needed levels, even during times of economic calamity. The treatment of wastewater is a critical and essential public service and, similar to the delivery of water and power, is required for basic quality of life. Further, the CCWRD operates in an environment of some uncertainty relative to future demands that may accompany changes in environmental regulation as well as growth in the market. For these and other reasons cited in this summary, there needs to be a reasonable level of assurance that the CCWRD can meet its service mandate without interruption or without fail.

It is also worth emphasizing that the reserve targets discussed herein are functions of other variables and, thus, will vary or change over time. By way of example, the debt reserves will change as the total amount of debt outstanding changes. The Capital Replacement Reserve will change as the combined asset value changes. In this regard, the identified reserve levels serve as financial planning targets for CCWRD administration to use as guiding principles over time.

Energy Question:

There was a brief discussion about energy costs for the District, and the potential impact of the passage of Question 3 on the November 6 ballot. As you will recall, the Flamingo Water Resource Center's electrical energy is purchased under contract from the Colorado River Commission (CRC). This agreement allows the District to secure the needed energy that site at a set rate for a 5-year period. This contract will run through 2029 with the potential for extension. We also have additional power purchase agreements for energy generated at Hoover Dam. These contracts have varying lengths, expiring in 2032 and 2067 and are also administered through the CRC.

Energy for the lift stations and other treatment sites is purchased from NV Energy. Staff will continue to gather information from energy and economic sources, but believes at the current time it is too soon to accurately project the potential impacts to us. If we believe we have good analysis to report back to the committee, we will do so at a future meeting.

RESTRICTED RESERVES:	Current	New Reference	Over / (under) Target
Bond Reserve	$35.1M	$32.5M	$2.6M
RESTRICTED RESERVES SUBTOTAL	$35.1M	$32.5M	$2.6M
UNRESTRICTED RESERVES:			
O&M Reserve	$17.5M	$26.0M	($8.5M)
Capital R&R Reserve	$50.0M	$50.0M	0
Capital Expansion Reserve	$22.1M	$25.0M	($2.9M)
Budget Stabilization & Natural Disaster	$3.5M	$7.75M	($4.25M)
Other Post Employment Benefits (OPEB)	$11.3M	$21.5M	($10.2M)
Worker's Comp	$634,000	$634,000	0
UNRESTRICTED RESERVES SUBTOTAL	$105.03M	$130.88M	($25.85M)
TOTALS	$140.13M	$163.38M	($23.25M)