

Understanding CAP's Strategic and Working Capital Reserves

What are the Strategic Reserves?

The Strategic Reserves are not a single fund, but rather a collection of individual accounts that have been established for a variety of specific purposes. They are cash reserves for unusual or unplanned events, such as equipment failures, business interruption or unplanned costs. These reserves may be drawn upon if unusual or unplanned events occur, or they may never be used at all. Strategic Reserves can be categorized as either Assigned Reserves or Restricted Reserves.

What is the Working Capital Reserve?

The Working Capital Reserve has historically been under the Strategic Reserves umbrella, but based upon customer feedback and Board discussions in early 2020, the Working Capital Reserve has now been separated from Strategic Reserves. The Working Capital Reserve is used to smooth out timing differences in revenues and spending within each year. This is considered an Unassigned/Unrestricted Reserve and utilized for daily needs.

The Working Capital Reserve includes accounts at the State Treasurer and an operating account at a bank for daily operating purposes. The Working Capital Reserve is essentially CAP's checkbook—it is used to receive incoming revenues and pay ongoing expenses.

The following is a visual of CAP's various reserves:

UNASSIGNED / UNRESTRICTED	ASSIGNED RESERVES	RESTRICTED RESERVES	COMMITTED RESERVES
Working Capital Reserve	Operating Reserve		
	Contingency Reserve		
	Capital Reserve	Major Repair / Replacement Reserve	
		Repayment Reserve	Water Storage Reserves
		Emergency O&M Reserve	Extraordinary Cost Reserve
		Supplemental Water Reserve	Recovery Reserve
		Bond Reserves	Rate Stabilization / S02 Reserves
		Captive Insurance Reserves	Navajo Decommissioning Reserve
		CAGR D Replenishment Reserves	CAGR D Reserves
		CAGR D I&WR Reserves	

 : Working Capital Reserve

 : Strategic Reserves

 : Other Reserves

UNASSIGNED RESERVES:

Funds at the State Treasurer and Bank of America which are for daily operating purposes.

ASSIGNED RESERVES:

The Board established these reserves to provide for potential future needs.

RESTRICTED RESERVES:

These funds are established through contracts or legislation that limit the use for specific purposes.

COMMITTED RESERVES:

These funds are established through Board action, typically by resolution that identifies reserves to be used for specific purposes.

None of these reserves are part of strategic reserves.

Why are there different reserve types?

UNASSIGNED/UNRESTRICTED RESERVES

Unassigned/Unrestricted Reserves do not have restrictions placed on them by contract or statute.

ASSIGNED RESERVES

Assigned Reserves are reserves the Board of Directors have established with specific criteria.

The Assigned Reserves are comprised of:

- 1. Operating Reserve** - Provides funds for continued operations in the event of a catastrophic event for employees, contractors, materials and supplies, etc., while cash may be delayed if deliveries are reduced or stopped.
- 2. Contingency Reserve** - Prepares for potential property and liability damages, to respond to any claims, judgments, and related costs against CAWCD, its officers, directors and employees. Also provides coverage for extraordinary medical claims and legal claims.

- 3. Capital Reserve** – Arranges coverage for capital expenditures, both for costs relating to repair or replacement in an extraordinary event occurrence, as well as to keep other projects progressing while repairs are made.

RESTRICTED RESERVES AND COMMITTED RESERVES

Restricted Reserves and **Committed Reserves** are those that have a legal or statutory constraint on their use or the Board has established by resolution for a specific purpose. The exclusion of Restricted Reserves and Committed Reserves from the Strategic Reserves target is prudent, as these reserves are contractually required so CAWCD has no alternative but to maintain those resources. The Strategic Reserves are established by the organization based on its own risk considerations. Ideally, Strategic Reserves accounts would never have to be used.

How often are the targets reviewed and updated?

The Strategic and Working Capital Reserves strategy and targets are reviewed, at a minimum, every two years as part of CAP's financial planning cycle. The Board establishes an overall target amount for the Strategic and Working Capital Reserves, based on the purpose and analysis of each account. In May 2020, the Board set the Strategic Reserves target at \$153 million and the Working Capital Reserve target at \$51 million. The measurement date for the Strategic and Working Capital Reserve accounts is December 31, which is generally the highest point during the year for the Reserves.

How is the strategic reserves target determined?

The **Operating Reserve target** of \$75 million is based on one year of "net expenditures"—the annual fixed operating budget expenses, less non-cash items (amortization and depreciation) and variable cost (power), less the amount of revenues from the ad valorem property tax not dedicated to a specific purpose.

The Government Finance Officers Association (GFOA) Best Practice for operating reserves recommends maintaining a balance of not less than two months of either operating revenues or operating expenditures. The Best Practice goes on to say that "the government should also consider a variety of factors, including predictability and volatility of expenditures, exposure to significant one-time costs, whether the government is a general government or an enterprise fund, etc., and that the appropriate level may be significantly in excess of the two-month minimum." CAP's target for Operating Reserves of one year of "net expenditures" is approximately equal to 3.5 months of operating expenditures, well within the GFOA Best Practice.

The **Capital Reserve target** of \$70 million is based on two times the average of annual capital expenditures. The annual expenditure variable is a reliable "yardstick" on which to base the calculation. The Capital Reserve's purpose is to have a source of funds to make unplanned repairs to infrastructure. Each year's capital expenditure currently represents about 1% of the cost of replacing the entire replaceable portion of the CAP system.

In 2020, with updated analysis, the Board approved a \$9 million increase in the Strategic Reserves target. The new target increased the Capital Reserve target from \$61 million to \$70 million. The overall increase in the Strategic Reserves target was then from \$144 million to \$153 million. The Contingency Reserve remained at \$8 million.

Dollars in Millions

Individual Reserve Accounts	2020 Update	2018 Target
Operating Reserve	\$75	\$75
Capital Reserve (combined)	70	61
Contingency Reserve	8	8
Total Strategic Reserves Target	\$153	\$144

The “two times” factor arises for two reasons:

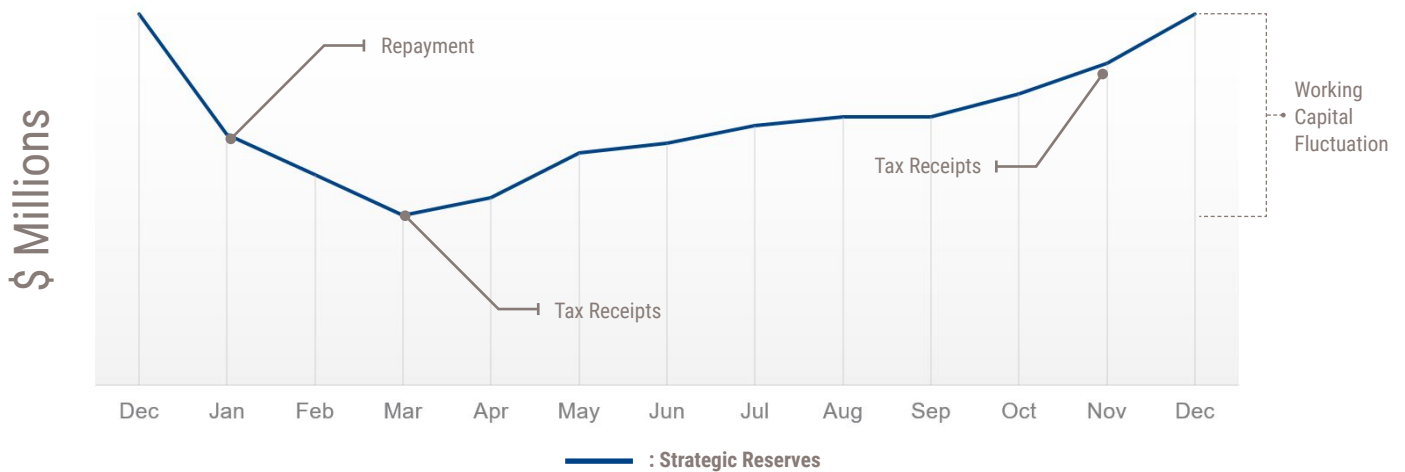
- The first reason is a theoretical risk management concept. The probability of a single unplanned event is “X” percent. There is also a lesser probability of a second unplanned event, and an even lesser probability for a third, etc. The “two times” factor is to approximate the combined probability of multiple unplanned events.
- The second reason for the “two times” factor is more pragmatic. If an unplanned event occurs, there needs to be money to make repairs and to fund ongoing planned capital needs if there is a business interruption. The funds that are used must be replaced, so additional funds need to be available to continue operations until replacement money (e.g., borrowing or revenue) is in place.

The **Contingency Reserve Target** is based on industry best practices and CAP’s historical experience. The target consists of \$5 million in Property/Casualty, \$2 million for Legal and \$1 million for Medical coverage.

How is the working capital reserve target determined?

The historical annual fluctuation of Working Capital provides the basis for the working capital target. The high and low point for each year and then averaged over two years are evaluated with the exclusion of unique circumstances. Enough must be available for operating reserves at the low point.

Reserves in a typical year



The Board approved a \$16 million increase to the Working Capital Reserve target. The overall increase in the Working Capital Reserve was increased from \$35 million to \$51 million.

<i>Dollars in Millions</i>	2020 Update	2018 Target
Working Capital Reserve Target	\$51	\$35

Why were the Strategic and Working Capital Reserves significantly below their targets in previous years?

Previously, Strategic Reserves were significantly below target. At the end of 2017, the cumulative balance of the Strategic Reserves accounts was \$118 million—\$61 million below the target at that time.

Just as the Lower Colorado River operates under a structural deficit—using more water each year than it receives—CAP was also under its own financial structural deficits. More was being spent than was being received.

Most CAP revenues accrue to the Working Capital Reserve, which is then used to cover ongoing costs including fixed OM&R and CAP’s annual repayment to the United States. When revenues to the Working Capital Reserve exceed ongoing expenses, the surplus can be used to replenish or build other Strategic Reserves accounts. But when revenues are insufficient to cover costs—as had been the case for the previous few years—then CAP must draw from its other Strategic Reserves accounts. The CAWCD Board made several critical decisions over the last few years to drive the strategic reserves back to the recommended target levels.



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