

# Understanding CAP's Strategic Reserves, Extraordinary Cost Reserve and Working Capital

## **What are the Strategic Reserves?**

The Strategic Reserves are not a single fund, but rather a collection of individual reserves 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.

## **What is the Extraordinary Cost Reserve?**

The Extraordinary Cost Reserve is a committed reserve established through Board action that is a revolving fund intended to pay for large expenses, opportunities, or large projects that may not be appropriate for the water rate or may cause unplanned temporary increases in the water rate. Additionally, it can also be utilized for activities that directly or indirectly support CAWCD's mission to deliver Colorado water reliability, such as mitigation, conservation, water acquisition and other water-related activities.

## **What Working Capital?**

Working Capital is used to smooth out timing differences when cash is received and when it is paid out during the year. These funds are utilized for daily cash needs.

Working Capital includes accounts at the State Treasurer and accounts at our bank for daily operating purposes. Working Capital is essentially CAP's checkbook—it is used to receive incoming monies and pay bills.

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

UNASSIGNED / UNRESTRICTED	ASSIGNED	RESTRICTED	COMMITTED
Working Capital	Operating Reserve		Extraordinary Cost Reserve
	Contingency Reserve		
	Capital Reserve		
		Repayment Reserve	Water Storage Reserves
		Emergency O&M Reserve	Recovery Reserve
		Supplemental Water Reserve	Navajo Decommissioning Reserve
		Bond Reserves	CAGR Reserves
		Captive Insurance Reserves	
		CAGR Replenishment Reserves	
		CAGR I&WR Reserves	
		9(d) Debt Reserve	

■ : 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 the strategic reserves.

## Why are there different reserve types?

Accounting standards require reserves to be categorized into the following classifications:

- 1. Unassigned/Unrestricted Reserves** do not have restrictions placed on them by contract or statute. Working Capital falls into this category.
- 2. Assigned Reserves** are reserves the Board of Directors have established with specific criteria. Strategic Reserves fall into this category as they were established by the organization based on its own risk considerations.

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** are those that have a legal or statutory constraint on their use, or the Board has established by resolution for a specific purpose. Extraordinary Cost Reserve is a Committed Reserve.

## How often are the targets reviewed and updated?

Strategic Reserves, Extraordinary Cost Reserve and Working Capital strategies and targets are reviewed, at a minimum, every two years as part of CAP's financial planning cycle. After review and based on the purpose and analysis, the Board establishes target amounts. In April 2024, the Board set the Strategic Reserves target at \$166 million, the Extraordinary Cost Reserve target at \$444 million, and the Working Capital target at \$91 million. The measurement date for the Strategic Reserves, Extraordinary Cost Reserve and Working Capital accounts are December 31, which is generally the highest point during the year.

## How is the strategic reserves target determined?

The **Operating Reserve target** of \$85 million is based on one year of a 10-year average 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 total operating expenditures, well within the GFOA Best Practice.

The **Capital Reserve target** of \$73 million is based on two times the 10-year average of annual capital expenditures. The annual expenditure variable is a reliable "yardstick" on which to base the calculation. Each year's capital expenditure currently represents about 1% of the cost of replacing the entire replaceable portion of the CAP system.

The "two times" factor arises for two reasons:

- The first reason is a theoretical risk management concept. Assuming the probability of a single unplanned event is "X" percent, there is a lower probability of a second unplanned event, and an even lower 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 causes a business interruption, there needs to be money available to make repairs and to fund ongoing planned capital needs. The funds that are used must be replaced, so additional money needs to be available to continue operations until replacement funding is secured.

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

In 2024, with updated analysis, the Board approved a \$5 million increase in the Strategic Reserves target. The \$5 million increase is attributed inflationary factors in the Operating Reserve. The Capital Reserve maintained a target of \$73 million. The Contingency Reserve remained at \$8 million. The overall increase in the Strategic Reserves target was from \$161 million to \$166 million.

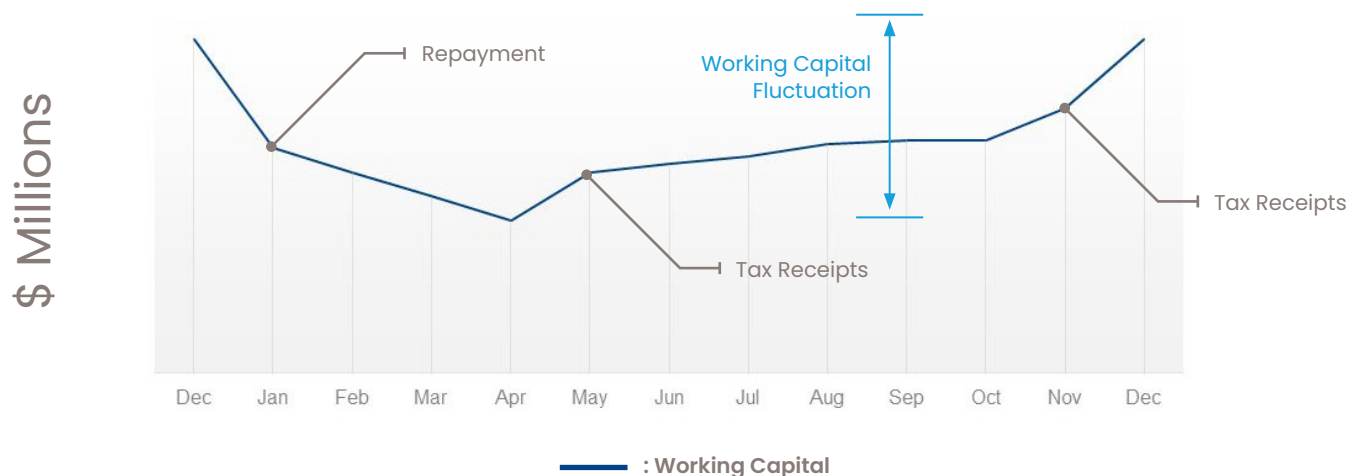
Dollars in Millions

Strategic Reserves Target	2024 Update	2022 Target
Operating Reserve	\$85	\$80
Capital Reserve (combined)	73	73
Contingency Reserve	8	8
<b>Total Strategic Reserves Target</b>	<b>\$166</b>	<b>\$161</b>

## How is the working capital 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 expenses at the low point.

## Working Capital in a typical year



In 2024, the Board approved a \$2 million increase to the Working Capital target. The overall increase in the Working Capital was from \$89 million to \$91 million.

Dollars in Millions

	2024 Update	2022 Target
Working Capital Target	\$91	\$89

## How is the Extraordinary Cost Reserve target determined?

The Extraordinary Cost Reserve provides funding for capital and non-capital projects over an 8-year timeline. Extraordinary Cost Reserve funded projects have been identified as meeting specific criteria, for example major non-routine projects, those with a long lead-time for replacement parts, or those that adapt the system to environmental impacts and changes. Other criteria include new system construction and decommissioning projects. In 2024, the Board increased the target from \$281 million to \$444 million, a \$163 million increase, to plan for large future projects.

## What are the Reserve Management Guidelines?

The Board established Reserve Management Guidelines in May 2022 to identify a flow of funds. The general rule is to fill Strategic Reserves to target, then Working Capital to target, and then Extraordinary Cost Reserve to target. The Extraordinary Cost Reserve is currently below the newly established target and will take several years to get to the target. Once the target is met, any excess funds will flow to Working Capital.



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