

Understanding CAP's Strategic, Extraordinary Cost 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?

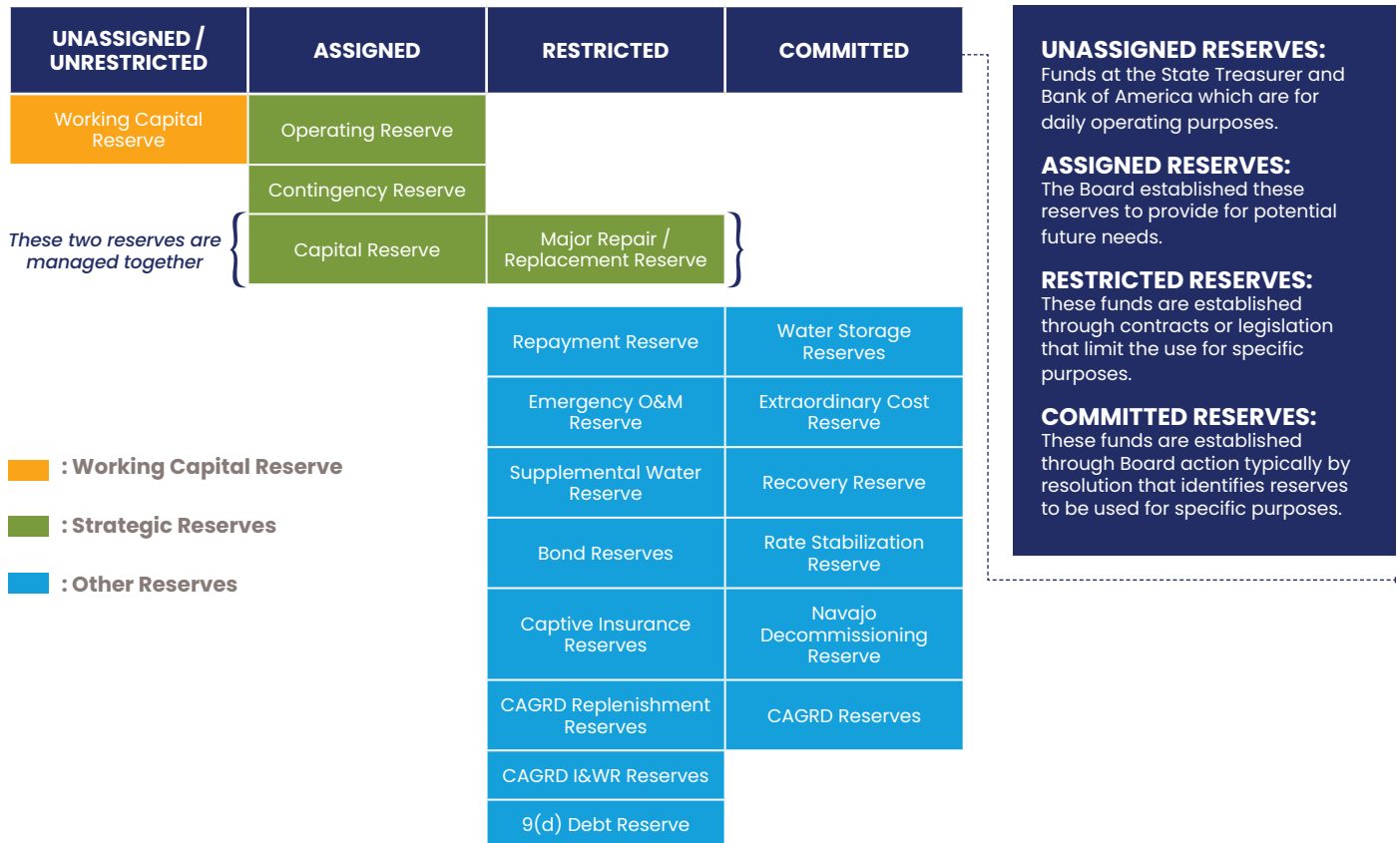
The Working Capital Reserve has historically been under the Strategic Reserves umbrella but based upon customer feedback and Board discussions in early 2020, the Working Capital Reserve has now been separated from Strategic Reserves. The Working Capital Reserve is used to smooth out timing differences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

The Working Capital Reserve includes an account 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.

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.

The following is a visual of CAP's various 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.

Major Repair / Replacement Reserve is included in this reserve as its purpose is to cover the costs associated with major repair or replacement of CAP infrastructure.

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, Extraordinary Cost and Working Capital Reserves strategy and targets are reviewed, at a minimum, every two years as part of CAP's financial planning cycle. Based on that review, the Board establishes an overall target amount for the Strategic, Extraordinary Cost and Working Capital Reserves, based on the purpose and analysis of each account. In May 2022, the Board set the Strategic Reserves target at \$161 million, the Extraordinary Cost Reserve target at \$281 million, and the Working Capital Reserve target at \$89 million. The measurement date for the Strategic, Extraordinary Cost 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 \$80 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 \$73 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 2022, with updated analysis, the Board approved an \$8 million increase in the Strategic Reserves target. The new target increased the Capital Reserve target from \$70 million to \$73 million. The overall increase in the Strategic Reserves target was then from \$153 million to \$161 million. The Contingency Reserve remained at \$8 million.

Dollars in Millions

Individual Strategic Reserve Accounts	2022 Update	2020 Target
Operating Reserve	\$80	\$75
Capital Reserve (combined)	73	70
Contingency Reserve	8	8
Total Strategic Reserves Target	\$161	\$153

The “two times” factor arises for two reasons:

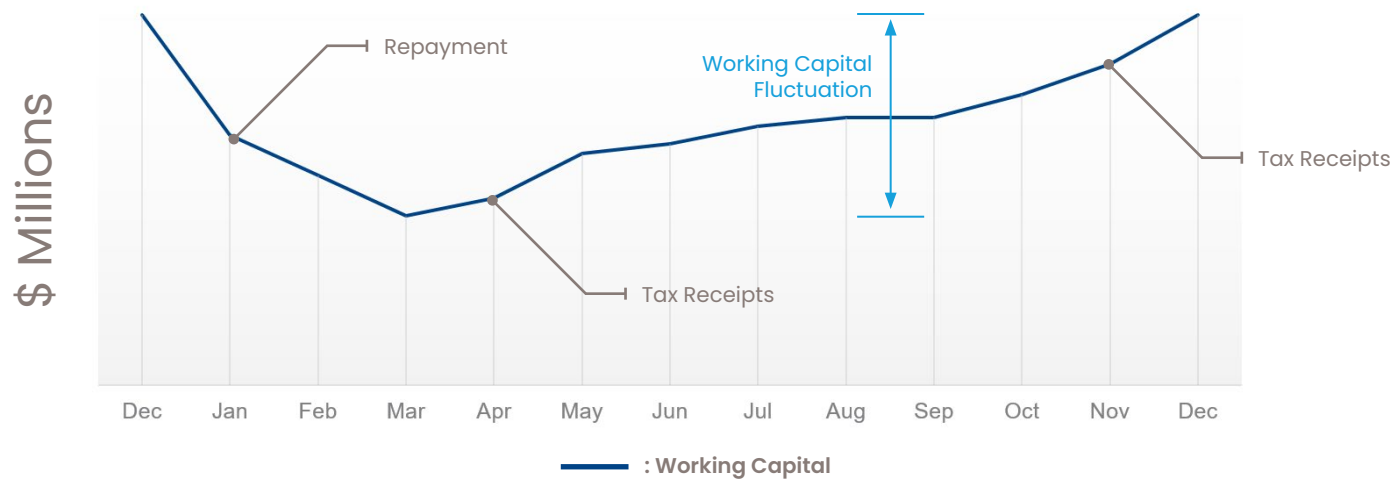
- The first reason is a theoretical risk management concept. The probability of a single unplanned event is “X” percent. There is also a lesser probability of a second unplanned event, and an even lesser probability for a third, etc. The “two times” factor is to approximate the combined probability of 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 \$38 million increase to the Working Capital Reserve target. The overall increase in the Working Capital Reserve was then from \$51 million to \$89 million.

Dollars in Millions	2022 Update	2020 Target
Working Capital Reserve Target	\$89	\$51

How is the Extraordinary Cost Reserve target determined?

The Extraordinary Cost Reserve is based on capital and non-capital projects for a 7-year horizon. Generic projects have been identified that meet specific criteria or components, like being a major non-routine project cost, having long-lead time of replacement parts, or adapting to potential environmental impacts. Other criteria would also include being a new system construction or a decommissioning project. The prior target was not previously defined; however the Board approved the \$281 Million target in May 2022.

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. Extraordinary cost reserves are 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.



Central Arizona Project

P.O. Box 43020

Phoenix, Arizona 85080

623 869-2333

www.CentralArizonaProject.com