

# Vandenberg Village Community Services District

## Reserves Study



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## Overview

### Vandenberg Village Community Services District

Vandenberg Village Community Services District was established in 1983 as a local government agency under California Government Code Section 61000, et seq., to provide water and wastewater services to the community of Vandenberg Village, an unincorporated area of Santa Barbara County north of Lompoc. It is governed by a Board of five locally elected directors. Vandenberg Village Community Services District currently provides water and wastewater service to approximately 2,600 connections in Vandenberg Village.

In 1960, Vandenberg Utilities Company and Vandenberg Disposal Company were formed to provide water and sewer services to the Vandenberg Village area. In 1973, these two companies were authorized by the Public Utilities Commission to merge into Park Water Company to obtain the needed financial influence to join the City of Lompoc in the construction of a regional wastewater system. In June of 1974, Park Water Company entered into an agreement with the City of Lompoc and participated in the construction of the Lompoc Valley Regional Wastewater Management System. Not long afterward, sewer rates increased by 150 percent even though the construction was primarily financed by a grant from the Environmental Protection Agency.

Frustrated with the quality of local water and after being faced with some of the highest water and sewer rates in the State, Vandenberg Village property owners formed the Vandenberg Village Association Water and Sewer Committee. This Committee engaged consultants who determined it would be feasible to form a community services district to purchase Park Water Company, to capitalize on the tax-exempt status offered to publicly-owned utilities and gain local control over its management. In 1983, residents petitioned the Local Agency Formation Commission (LAFCO) and held an election in which voters approved the formation of a community services district with 1673 in favor and 253 against. Thereafter, the first five-member Board of Directors was elected to serve the District. Those directors were Jack Gabus, Howard Grantz, Charles McKenna III, Jock Sutherland, and Glenn Welch.

The first attempt to purchase Park Water Company failed. Residents passed a \$4 million bond measure in 1985 when 1,979 out of 2,180 ballots cast favored the measure. However, on July 29, 1987, the PUC appraised the utility at a higher rate than the VVCSD had anticipated, and a new bond election was then necessary. On June 28, 1988, despite opposition, the District's voters authorized an additional \$1.4 million bond issue for the acquisition of Park Water Company. At midnight on December 1, 1988, Park Water Company and VVCSD finally entered into an agreement for the purchase of water and sewer systems at the sale price of \$3,985,755.

The District currently operates 32 miles of water distribution system, three groundwater wells, one 500,000-gallon tank reservoir, one 300,000-gallon tank reservoir, two 1,000,000-gallon tank reservoirs, three booster stations, two pressure-reducing stations, and a pressure filter treatment system. The District utilizes standby diesel generators to maintain normal operations during power outages.

The District also operates 29 miles of wastewater collection system, with four pumping lift stations and 574 manholes. Until 1978, wastewater treatment was also provided locally. Since then, the Village's wastewater system has been connected to the Lompoc Regional Wastewater Reclamation Plant (LRWRP) for treatment and disposal. The District has a contractual entitlement to 0.89 million gallons per day (MGD), 16.18 percent, of Lompoc's 5.5 MGD plant capacity.

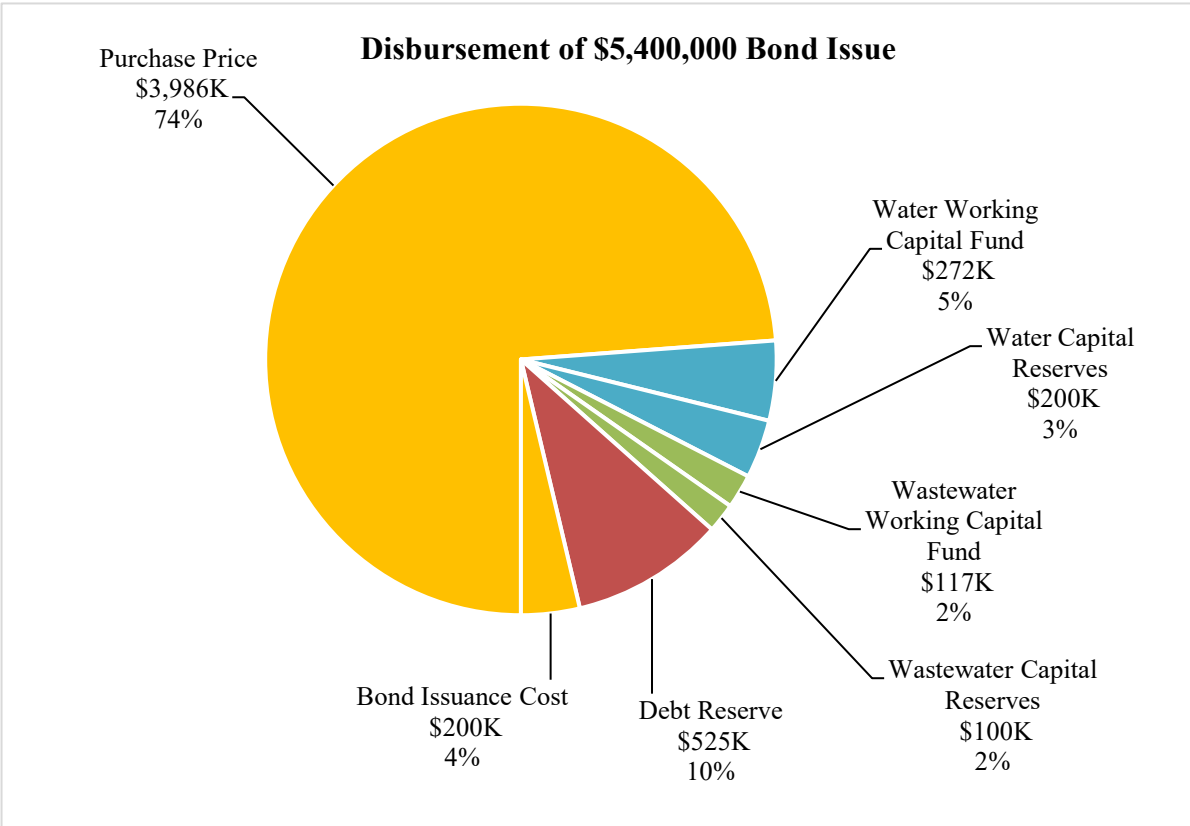
# VVCSD Reserve Policy

The American Water Works Association recognizes that there is no single capital financing strategy that works for every water utility. The AWWA M29 Water Utility Capital Financing Manual states each utility “must select a strategy specifically tailored to meet its own unique financial, operational, regulatory, and political challenges (Fedder, Hofeld, & Mastracchio, 2014).”

Since taking over the operations from Park Water Company, the VVCSD Board of Directors has set aside funds for water and wastewater operating and capital reserves. Historically, VVCSD capital improvements have been funded through those cash reserves. Apart from the revenue bonds used to purchase the assets from Park Water Company (PWC), the Board of Directors has not endorsed the use of financing for water capital expenditures. However, VVCSD is obligated to fund its portion of capital projects required to maintain the Lompoc Regional Wastewater Reclamation Plant (LRWRP). VVCSD may fund its share of the projects through its WCRF account held by the city, through wastewater reserves held by VVCSD, through debt proceeds and repayment obligation at its capacity share in the LRWRP, through issuing debt of their own, or any combination of those options (Lompoc, City of & Vandenberg Village Community Services District, Lompoc Regional Wastewater Reclamation Plant Agreement, 2010). Currently, VVCSD is responsible for 16.18 percent of the City of Lompoc Wastewater State Revolving Fund Loan (Agreement Number 06811-550-0) for a total of \$15 million including imputed interest. The final payment of \$741K is due in 2029.

## Formation

The VVCSD Board of Directors set aside a portion of the \$5.4 million bond issuance as reserves (Rodenhi, 1988). \$389K was earmarked for a working capital (operating reserve) fund: \$272K for water and \$117K for wastewater. Additionally, \$300K was set aside for capital reserves: \$200K for water and \$100K for wastewater. The remainder of \$525K was restricted as Debt Reserves. **Figure 1** illustrates the bond disbursement.



**FIGURE 1 BOND DISBURSEMENT**

## *Capital Reserves*

At the District's formation, in addition to the amount set aside from the bond disbursement, the amount reserved for capital improvements consisted of the amount of depreciation expense for the current fiscal year less the capital purchases for that year. At Fiscal Year End 1990, the calculation resulted in a negative reserve amount rather than the positive amount anticipated. As a result, the method for calculating capital reserves was changed to use the annual capital budgeted amount instead of depreciation (Ballard, Robinson, & Walker, 1990).

### **Resolution 99-94**

In 1994, the Vandenberg Village Community Services District Board of Directors adopted Resolution 99-94 to formalize its first reserve policy and to direct staff to set aside funds for those reserved accounts (Vandenberg Village Community Services District, February 3, 1994).

## *Depreciation*

Resolution 99-94 directs staff to include depreciation expense on the annual expense budget and that the rates established for each year will include sufficient cash to fully fund that depreciation expense. This amount was to be transferred to the Replacement Reserves account at least quarterly.

## *Replacement Reserves*

Resolution 99-94 established a Replacement Reserves account and directed staff to transfer the amount of accumulated depreciation to date into that reserved account. The purpose of the funds was to replace the District's capital equipment and facilities at the end of their useful lives.

## *Emergency Reserves*

Resolution 99-94 directed staff to transfer \$500,000 from unreserved retained earnings into an Emergency Reserves account. The purpose of the funds was to provide protection against a catastrophic loss and provide a cushion for inaccuracy in the long-range replacement program.

### **Resolution 176-06**

In 2006, the Vandenberg Village Community Services District Board of Directors rescinded Resolution 99-94 and adopted Resolution 176-06 to revise the reserve policy in response to the repayment of the \$5.4 million in revenue bonds and the subsequent discontinuance of the 20 percent bond covenant. The board established a reserve contribution factor and directed staff to incorporate that factor into the rate structure to help meet the reserve targets in the resolution.

The reserves targets outlined in Resolution 176-06 are two-pronged. First, the resolution sets the monetary targets for capital, emergency, and operating reserves. Second, the resolution directs staff on how to set aside funds to meet those targets. However, as capital projects are completed, asset values and depreciation expenses increase. Accordingly, the reserve targets also increase. As a result of this annual change, achieving the targets each year may not be possible without large rate increases during periods of costly capital expenditures.

## *Depreciation*

"Depreciation expense allows for the systematic amortization and recovery of the original cost of the investment" (Woodcock, Giardina, & Cristiano, 2017, p. 43). Resolution 176-06 directs staff to include the annual depreciation expense on the operating budget and that the rates established for each year will include sufficient

cash to fully fund that depreciation expense. The Fiscal Year 2023-2024 operating budget forecasts a water depreciation expense of \$250,000.

### *Reserve Contribution Factor*

Resolution 176-06 established a reserve contribution factor to be incorporated into the rate structure. This factor, expressed as a percentage of the annual operating expense budget, is designed to generate revenues specifically for reserves. District staff is directed to consider the amount of money available in reserves relative to the target, investment performance, the timing of planned and foreseeable capital projects, the strategic plan, and other pertinent considerations and present a factor to help achieve that target. The Finance Director at the time expressed a desire for the target to be equal to the 20 percent previously established by the bond covenant but no specific reserve contribution factor was formally adopted by the board. However, staff has continued to use the 20 percent guidance as a budgeting guideline.

### *Emergency Reserves*

Resolution 176-06 established a method for calculating the *Emergency Reserves* target. Another term for this reserve is a *contingency fund*. The 99-94 target was a fixed \$500,000 to cover both water and wastewater emergencies. The 176-06 target is 10 percent of the value of the capital assets (\$1,051,783 for water and \$2,588,598 for wastewater *audited* as of June 30, 2023). The target amount is \$3,640,381.

This amount is intended as protection against catastrophic loss and to provide a cushion for miscalculations in long-range planning. “One method for determining the balance to maintain in such a reserve is to determine the cost of replacing the most expensive facility of the utility system and reserving an amount equal to that cost” (Bradley, Giardina, & Matthews, 2017, p. 28). Note that the current *Emergency Reserves* target for the water fund is likely insufficient to replace the most expensive facility in the District’s water system which would be approximately \$2.5 million for one water well.

### *Operating Reserves*

Resolution 176-06 reestablished an *Operating Reserves* and established a method for calculating the reserve target. Another term for this reserve is a *working capital reserve*. At the District’s formation, the board of directors established a water operating reserve of \$272,000 (approximately eight months of water expenses) and a wastewater operating reserve of \$117,000 (approximately five months of wastewater expenses) from the bond proceeds. The current target is 25 percent (three months) of the current operating expense budget (\$529,942 for water and \$710,840 for wastewater for Fiscal Year 2023-2024). This is equal to 90 days of expenses. The target amount is \$1,240,782.

This amount is intended as a cushion to fund three months of operating expenses. Because water sales are dependent on weather conditions, water sales can be significantly lower when the weather is wet, it is industry practice to stabilize income by utilizing Operating Reserves (American Water Works Association, 2018). “A 45- to 90-day...O&M reserve is a frequently used industry norm” (Bradley, Giardina, & Matthews, 2017, p. 27).

### *Capital Reserves*

Resolution 176-06 changed *Replacement Reserves* to *Capital Reserves* and established a method for calculating the *Capital Reserves* target. The 99-94 target was to transfer the accumulated depreciation each quarter into the reserve account. The 176-06 target is to maintain reserves equal to the accumulated depreciation (\$3,658,664 for water and \$7,549,207 for wastewater *audited* as of June 30, 2023) plus 25 percent of the current operating expense budget (\$529,942 for water and \$710,840 for wastewater for Fiscal Year 2023-2024). The target amount is \$12,448,653.

This amount is intended to replace assets and fund capital projects. “A minimum balance for this reserve is often defined based on a percentage...of the cost of system assets or a rolling-average of planned capital expenditures” (Bradley, Giardina, & Matthews, 2017, p. 28). In addition to the projects noted in the VVCSD Capital Improvement Plan<sup>1</sup>, the City of Lompoc’s 2024-2030 Capital Improvement Plan has allocated wastewater expenditures of \$9 million (Lompoc, City of, 2023). VVCSD’s share of those upgrades is approximately \$1.5 million for FYE 2024, FYE 2025, and FYE 2026.

## **Lompoc Regional Wastewater Reclamation Plant (LRWRP)**

The agreements with the City of Lompoc for the Lompoc Regional Wastewater Reclamation Plant allows the city to obligate the district to debt issued to finance additions, improvements, or other capital expenditures for the benefit of the LRWRP at the ratio of VVCSD’s capacity share (Lompoc, City of & Vandenberg Village Community Services District, Lompoc Regional Wastewater Reclamation Plant Agreement, 2010; Lompoc, City of & Park Water Company, Lompoc Valley Regional Wastewater Management System Agreement, 1974). In 2006, the city applied for and received a State Revolving Fund loan from the State Water Resources Control Board (California State Water Resources Control Board, 2006). The total imputed amount is \$92 million and VVCSD’s share is \$15 million. Annual payments of \$742K are due each July with the final payment scheduled for 2029.

### *Wastewater Capital Reserve Fund (WCRF)*

In 1977, the City of Lompoc and Park Water Company (PWC) established a Wastewater Capital Reserve Fund (WCRF) per guidelines published by the State Water Resources Control Board (SWRCB) (California State Water Resources Control Board, 1974; Lompoc, City of; Park Water Company, 1977). The 1974 SWRCB Guidelines set a minimum balance of 10 percent of the cost of the Lompoc Regional Wastewater Reclamation Plant allocated to PWC. During construction, the amount was set at \$89K per year. On June 30, 1988, the WCRF account balance was \$564K. In January 1989, the month after taking over water and wastewater operations from PWC, the VVCSD Board of Directors requested information regarding the WCRF calculations. A letter from the City of Lompoc Water Resources Manager stated that the WCRF reserve requirement was \$3,353,650 (Keefe, 1989). After negotiations, the City of Lompoc and VVCSD signed a Memorandum of Understanding in July 1990 which set the WCRF balance at the 10 percent minimum specified in the 1974 SWRCB Guidelines (\$334,721) and detailed what happens when the balance is above or below the established balance. A check for \$192K was disbursed to VVCSD from the WCRF account held by the city.

The term of the original wastewater agreement expired in 2009 (Lompoc, City of & Park Water Company, Lompoc Valley Regional Wastewater Management System Agreement, 1974) and, in 2010, a new agreement between VVCSD and the City of Lompoc was finalized (Lompoc, City of & Vandenberg Village Community Services District, Lompoc Regional Wastewater Reclamation Plant Agreement, 2010). Although the dollar amount increases, the agreement reduced the percentage required by the WCRF balance to five percent of the cost of the LRWRP Upgrade Project allocated to VVCSD which equates to \$742,642. Interest is paid to the account at the H.15 Federal Reserve interest rate and any funds above the required balance on June 30 are returned to the District. When large capital projects reduce the WCRF account below zero, the District is required to pay interest to the City of Lompoc at the H.15 interest rate for the amount borrowed from the city.

## **Policy Review**

The American Water Works Association (AWWA) recommends that reserve targets be reviewed annually during the budgeting process to monitor levels and to evaluate conformance with the policy. “Decisions can then be made to maintain, increase, or spend down reserve balances, as appropriate, with an understanding of the impact of such decisions to the upcoming budget period and long-term financial plan of the utility” (American Water

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<sup>1</sup> See *Anticipated Capital Expenditures* starting on page 12

Works Association, 2018). Reserve balances are reviewed by the VVCSD Board of Directors twice annually, during both the capital budget process and the mid-year budget review.

Additionally, AWWA recommends that the reserve policy be reviewed every three to five years. “This time frame is appropriate given that customer demands, operating cost profiles, debt levels, and capital infrastructure activity can vary during this time, which would affect the appropriate level of reserve balances. This type of review allows for the philosophy of establishing reserve targets to be modified to better reflect existing conditions and current issues” (American Water Works Association, 2018). The VVCSD Finance/Budget Committee reviewed the Reserve Policy in August 2010 (four years after its adoption), June 2012 (two years after the last review), May 2015 (three years), and March 2019 (four years).

## Industry Standards, Requirements, and Recommendations

### American Water Works Association

For over 100 years, AWWA has set the industry standards of minimum requirements, materials, equipment, and practices used by the water industry. Many consultants reference the AWWA M1 *Principles of Water Rates, Fees, and Charges* manual as part of their rate-setting analysis (Bartle Wells Associates, 2018; NBS, 2022; Raftelis, 2020; Tuckfield & Associates, 2022; Tuckfield & Associates, 2020). First published in 1954, the manual is currently in its 7<sup>th</sup> edition and is over 400 pages long (Woodcock, Giardina, & Cristiano, 2017). Additionally, AWWA recognized the limitations of the M1 Manual for smaller systems and the authors developed the M54 *Developing Rates for Small Systems* manual to be used in concert with the M1 Manual by small systems (Bradley, Giardina, & Matthews, 2017).

AWWA M29 *Water Utility Capital Financing*, 4<sup>th</sup> edition presents both traditional and innovative utility financing alternatives to meet both short-and long-term capital requirements (Fedder, Hofeld, & Mastracchio, 2014).

The AWWA Cash Reserve Policy Guidelines recognize that utilities are capital-intensive enterprises with volatile revenue streams that must provide critical service on an uninterrupted basis. “During periods of high rain fall, water usage and corresponding revenue can decline as irrigation use decreases. In contrast, during drought periods, utilities are often faced with mandatory water restrictions that can have the same negative impact on water use and revenue. As such, cash reserve balances are a critical component to a utility’s financial resiliency and sustainability” (American Water Works Association, 2018). Capital expenditures are not incurred on an equal basis each year and, for a small utility, the cost of a capital project may exceed the annual operating budget. While the impact of large projects can be mitigated by debt financing, there are many advantages to cash funding a portion of capital costs.

### California Special Districts Association

The California Special Districts Association (CSDA) *Reserves Guidelines* were developed after the release of the Little Hoover Commission report in May 2000 entitled, “Special Districts: Relics of the Past or Resources for the Future?”. In that report, the commission stated that “Hundreds of independent special districts have banked multi-million dollar reserves that are not well publicized and often not considered in regional or statewide infrastructure planning” (Little Hoover Commission, 2000). Although some of the commission's findings were disputed by special district advocacy groups, CSDA agreed that reserve guidelines were needed and formed a task force to develop the CSDA Reserves Guidelines. Now on its second edition, CSDA has recognized that many special districts have established reserve policies and that most special district officials recognize their fiduciary responsibilities and take them seriously. The task force believes that lack of policy is not the issue but lack of outreach to constituents and others regarding district operations.

According to CSDA, reserves are the foundation of the sustainable delivery of core services. Through prudent reserves, special districts offer taxpayers and ratepayers significant benefits including (California Special District Association, 2022):

1. Savings to balance budgets
2. Emergency preparedness
3. Stable rates
4. Well-maintained infrastructure
5. Investment in the future

“Special districts need adequate reserves to ensure they can respond to their community’s needs in the event of emergencies or disasters, like flooding, earthquakes, wildfires, or even droughts. Prudent reserves are often needed to accumulate the capital to pay for large infrastructure projects, or to secure financing. In addition, reserves provide a safety cushion to stabilize rates and maintain adequate services during economic downturns” (California Special Districts Association, 2020).

## **Governmental Accounting Standards Board**

“The Governmental Accounting Standards Board (GASB), established as an arm of the Financial Accounting Foundation in April 1984, was created to promulgate standards of financial accounting and reporting on activities and transactions of governments and is the source of authoritative governmental GAAP for California local governments” (California State Controller's Office, 2023).

GASB Statement No. 54 requires the classification of fund balances as non-spendable, restricted, committed, assigned, or unassigned.

- *Non-spendable Fund Balance* – amounts that cannot be spent because they are either (a) not in spendable form or (b) legally or contractually required to be maintained intact.
- *Restricted Fund Balance* – amounts restricted externally by creditors, grantors, contributors, or laws and regulations of other governments or restricted by law through constitutional provisions or enabling legislation.
- *Committed Fund Balance* – amounts that can only be used for specific purposes according to constraints imposed by formal action of the Board of Directors.
- *Assigned Fund Balance* – amounts that are constrained by the Board’s intent to be used for specific purposes but are neither restricted nor committed.
- *Unassigned Fund Balance* – amounts that have not been restricted, committed, or assigned to specific purposes.

## **California State Controller’s Office**

Each year, per California Government Code § 53891(b), the State Controller’s Office (SCO) releases an updated Special District Uniform Accounting and Reporting Procedures Manual to assist special districts in staying compliant with governmental accounting and reporting requirements. SCO is the legal authority for prescribing uniform accounting and reporting procedures for local agencies in California. Failing to comply with the minimum disclosure requirements can result in legal action by the State of California under Government Code § 12464 (California State Controller's Office, 2023).

SCO does not recommend reserve targets but does recommend that reserves be established in each fund and that the reserves be classified as either assigned or committed if the amounts have been designated for a specific purpose.

## **California Government Code § 53646(b)(3)**

California Government Code § 53646(b)(3) requires the District to keep on hand sufficient funds to meet the next six months of budgeted expenditures.

## **Government Finance Officers Association**

The Government Finance Officers Association (GFOA) is a non-profit association comprised of state and local government finance professionals and elected officials from the United States and Canada. A key part of its



mission is to promote best practices and good public finance, including reserve policies (Kavanagh, A Risk-Based Analysis of General Fund Reserve Requirements, 2013).

GFOA notes that reserves are the cornerstone of financial flexibility which provides governments with options for responding to unexpected issues and provides a buffer against risks. Reserves are one of the tools used to manage risk, chiefly by “self-insuring” against certain risks (Kavanagh, Reitano, & Jones, Rethinking Budgeting: Should We Rethink Reserves?, 2023; Government Finance Officers Association, 2015). Common risks are revenue volatility, infrastructure failures, and natural disasters. An emerging risk factor is cyberattacks.

In its analysis of the reserve requirements for Colorado Springs, Colorado, GFOA used the “Triple-A” approach<sup>2</sup> to analyze risk factors (Kavanagh, A Risk-Based Analysis of General Fund Reserve Requirements, 2013). **Figure 2** describes the approach used in the study.

### Accounting for Uncertainty – The “Triple-A” Approach

Sizing a reserve requires estimating highly uncertain events, like natural disasters and economic downturns. To develop an adequate response, the GFOA used the “Triple-A” approach:<sup>1</sup>

- **Accept.** First, we must accept that we are subject to uncertainty, including events that we haven’t even imagined.
- **Assess.** Next, we must assess the potential impact of the uncertainty. Historical reference cases are a useful baseline.
- **Augment.** The range of uncertainty we really face will almost always be greater than we assess it to be, so we should augment that range. Historical reference cases provide a baseline, but that baseline may not be adequate to account for all future possibilities.

**FIGURE 2 GFOA “TRIPLE A” APPROACH**

The GFOA also recommends that the reserve amounts be categorized by component, making the purpose of the reserve more transparent, especially for capital-intensive governments. For example, having a reserve for emergencies and a reserve for economic uncertainty would make their purpose more clear than one all-encompassing reserve (Kavanagh, A Risk-Based Analysis of General Fund Reserve Requirements, 2013; Government Finance Officers Association, 2011). A single-number approach has the disadvantage of obscuring the full range of risks that the government faces (Kavanagh, Reitano, & Jones, Rethinking Budgeting: Should We Rethink Reserves?, 2023). **Figure 3** illustrates some benefits of viewing reserves as more than a pool of money.



**FIGURE 3 COMPREHENSIVE PERSPECTIVE ON THE ROLE OF RESERVES**

<sup>2</sup> The Triple-A approach is adapted from: Makridakis, S., Hogarth, R., & Gaba, A. (2009). *Dance with Chance: Making Luck Work for You*. Oneworld Publications.

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## Capital Funding Strategies

The American Water Works Association recognizes that there is no single capital financing strategy that works for every water utility. The AWWA M29 Water Utility Capital Financing Manual states “Each utility must select a strategy specifically tailored to meet its own unique financial, operational, regulatory, and political challenges (Fedder, Hofeld, & Mastracchio, 2014).” Appendix B of the manual outlines the following funding strategies:

### Strategy 1: Rate Revenue Funding – 0% Debt

This pay-as-you-go strategy funds all capital expenditures through revenues.

Pros:

- A steady flow of revenue irrespective of the capital improvement plan.
- Avoidance of debt reduces long-term risk and increases long-term financial flexibility.

Cons:

- Large rate increases are needed during years of costly capital expenditures.
- Current ratepayers are paying 100% of the cost of capital expenditures which will also benefit future ratepayers.
- The accumulation of capital reserves required for a project in advance of the expenditure could be considered excessive by ratepayers.

### Strategy 2: Balanced Debt Financing and Rate Revenue Funding – 40% Debt

This strategy provides a balance between debt financing and rate revenue funding. This approach is used to minimize rate increases.

Pros:

- Reduces the need for large rate increases during years of costly capital expenditures.
- Current ratepayers would not need to pay 100% of the cost of capital expenditures. Future ratepayers would pay a portion through the debt financing payments.

Cons:

- The use of debt financing increases the utility costs with the added interest payments and bond issuance costs.
- The use of debt marginally increases long-term risk and decreases long-term financial flexibility.

### Strategy 3: Heavy Reliance on Debt Financing – 80% Debt

This strategy relies heavily on debt financing to fund capital expenditures. “This heavy reliance on debt financing is not a long-term strategy employed by most water utilities.”

Pros:

- For the short term, mitigates the need for large rate increases.

Cons:

- Heavy use of debt financing results in higher rate increases over the long term due to the debt-service coverage requirements.
- Heavy use of debt financing greatly increases utility costs with the added interest payments and bond issuance costs.
- Heavy use of debt financing greatly increases long-term risk and significantly decreases long-term financial flexibility because a high percentage of revenues are allocated to debt service.

CSDA recommends pay-as-you-go funding when sufficient revenues and reserves are available and long-term borrowing rates are higher than expected cash reserve fund and points out that pay-as-you-use strategies limit the need for building major amounts of equity in capital assets which can be less economically efficient for districts that are capital-intensive (California Special District Association, 2022). Additionally, GFOA states that a highly leveraged organization has less flexibility. Reserves are a critical source of financial flexibility, so high leverage may call for higher reserves (Kavanagh, A Risk-Based Analysis of General Fund Reserve Requirements, 2013). Two commonly used measures of indebtedness are debt per capita, the burden placed on citizens by municipal indebtedness, and debt service (principal and interest payments) as a percent of city expenditures, the pressure placed on the budget by debt payments. It is recommended that the agency make every effort to set aside sufficient revenues to finance ongoing maintenance needs and to provide reserves for periodic replacement and renewal and that no debt should be issued for periods exceeding the useful life or average useful lives of the project being financed.

## Reserve Targets

### Emergency Reserves

Emergency reserves are used to fund the replacement of critical assets damaged by catastrophic events. AWWA recommends consideration of the following factors when determining the target for emergency reserves (American Water Works Association, 2018):

- Risk factors – The types of natural disasters, extreme weather conditions, or other force majeure events that the system may be at risk for and the extent of the damage that could result.
- Critical facilities – Identification of the specific facilities (including condition and replacement costs) that are critical to the operation of the system and may be vulnerable to identified threats.
- Availability of other funds – The ability to quickly access other funds in the event of an emergency, such as a line of credit or a loan from another fund (e.g., a loan from wastewater reserves to water reserves)

### Operating Reserves

Operating reserves are used to manage risks, to manage fluctuations in revenue, and to meet working capital needs. The most common metric for establishing operating reserve targets is a specific number of days of operating expenses. According to AWWA, the range of operating reserves can vary from two to 12 months of expenses. “One of the principal causes of differences observed in operating reserves between utilities is whether a utility has a single reserve policy that is intended to account for liquidity, revenue volatility, rate stabilization, debt, capital, etc. as opposed to having multiple reserve policies for separate and specific purposes” (American Water Works Association, 2018).

### Capital Reserves

Capital reserves are used to provide funds for planned and unplanned infrastructure replacements. Utilities are capital-intensive enterprises and, while a Capital Improvement Plan can assist the utility with timing and estimated costs, expenditures cannot always be budgeted in equal annual increments. Therefore, cash funding for large expenditures is generally accumulated by setting aside a portion of the required reserves in the years before the anticipated expense. AWWA states that “the size of the utility is an important factor in determining the recommended amount of capital reserves” and that small utilities “may need a larger capital reserve fund relative to its annual operating budget or capital replacement program to have sufficient funds for unplanned or emergency capital replacements” (American Water Works Association, 2018).

### Setting Reserve Targets

Before a target is set, the agency should decide on the level of cash funding it wants to provide. Although debt financing can mitigate the impact of large capital expenses on annual budgets and user charges, there are many advantages to cash funding a portion of capital expenditures.

- Full Funding (Rate Revenue Funding) – establishing a target so that cash is available when needed for pay-as-you-go funding.
- Threshold Funding (Balanced Debt Financing and Rate Revenue Funding) – establishing a target that minimizes the risk exposure from debt and sets aside sufficient funds for projects and emergencies.
- Baseline Funding (Heavy Reliance on Debt Financing) – establishes a target of simply having sufficient cash to obtain financing and comply with covenants.

## VVCSD Reserve Target Calculations

**Table 1** below shows the calculations for determining the annual reserve contribution amount needed for replacement and rehabilitation (R&R) over the life of VVCSD's assets based on the current value of those assets and their anticipated service life (American Water Works Association, 2018).

**TABLE 1 REHABILITATION AND REPLACEMENT CALCULATIONS**

	ORIGINAL COST	CURRENT COST *	SERVICE LIFE (years)	ANNUAL R&R (rounded)
<b>WATER</b>				
Source Of Supply Plant - Wells & Springs	393,853	1,042,286	10	104,000
Pump Structures & Improvements	366,362	698,634	40	17,000
Pumping Equipment	619,727	1,049,298	25	42,000
Pumping Equipment-Standby Power	116,533	176,866	20	9,000
Water Treatment Equipment	313,516	621,052	30	21,000
T & D Distribution Reservoirs/Standpipes	2,254,095	5,394,605	40	135,000
T & D Mains	2,742,872	7,830,949	75	104,000
T & D Services	478,809	1,449,119	30	48,000
T & D Hydrants	427,311	798,268	40	20,000
General Plant-Structures & Improvements	984,031	1,895,871	40	47,000
General Plant-Gates	17,994	23,917	10	2,000
General Plant-Office Furniture & Equipment	57,059	78,645	12	7,000
General Plant-Computer Equipment	125,277	189,392	5	38,000
General Plant-Transportation Equipment	95,658	126,884	7	18,000
General Plant- Heavy Equipment	82,516	109,451	12	9,000
General Plant-Tools/Shop & Garage Equipment	155,517	215,592	20	11,000
General Plant-Laboratory Equipment	14,307	19,684	15	1,000
General Plant-Power Operated Equipment	53,228	75,529	15	5,000
General Plant-Communication Equipment	5,988	17,862	15	1,000
<b>TOTAL WATER</b>	<b>9,304,652</b>	<b>21,813,904</b>		<b>639,000</b>
<b>WASTEWATER</b>				
LRWRP Capacity Rights	17,164,115	25,372,615	35	725,000
Pump Structures & Improvements	25,686	35,452	40	1,000
Pumping Equipment	696,648	936,570	15	62,000
Pumping Equipment-Standby Power	59,404	90,680	20	5,000
T & D Mains	2,122,828	5,148,180	75	69,000
General Plant-Structures & Improvements	776,346	1,030,078	40	26,000
General Plant-Gates	3,864	5,125	10	1,000
General Plant-Office Furniture & Equipment	29,153	38,670	12	3,000
General Plant-Computer Equipment	86,862	131,240	5	26,000
General Plant-Transportation Equipment	188,866	250,517	7	36,000
General Plant-Heavy Equipment	42,301	56,109	12	5,000
General Plant-Tools/Shop & Garage Equipment	208,744	282,315	20	14,000
General Plant-Power Operated Equipment	53,228	75,529	15	5,000
General Plant-Communication Equipment	5,988	17,861	15	1,000
<b>TOTAL WASTEWATER</b>	<b>21,464,032</b>	<b>33,470,942</b>		<b>979,000</b>

\* Current cost calculated by multiplying an inflation factor<sup>3</sup> to the original cost based on the year of installation.

<sup>3</sup> Construction Cost Index History - As of September 2023 | Engineering News-Record (enr.com)

AWWA asserts that, over the long run, setting rates to recover the average R&R amount should be sufficient. However, when large expenditures are scheduled, funds should be set aside to build up the reserve before the projected expense to mitigate the impact on rates.

**Table 2** and **Table 3** demonstrate the reserve fund balances for the next five years assuming the calculated R&R contributions are made and capital improvements are completed as scheduled.

**TABLE 2 ESTIMATED WATER RESERVE BALANCE**

	<b>2024</b>	<b>2025</b>	<b>2026</b>	<b>2027</b>	<b>2028</b>
Beginning of Year Balance	2,661,759	3,166,759	3,609,759	3,531,759	3,709,759
Annual R&R	639,000	639,000	639,000	639,000	639,000
Capital Improvements	(134,000)	(196,000)	(717,000)	(461,000)	(3,318,306)
End of Year Balance	3,166,759	3,609,759	3,531,759	3,709,759	1,030,453

**TABLE 3 ESTIMATED WASTEWATER RESERVE BALANCE**

	<b>2024</b>	<b>2025</b>	<b>2026</b>	<b>2027</b>	<b>2028</b>
Beginning of Year Balance	8,451,129	8,647,324	8,866,846	9,263,360	9,975,360
Annual R&R	979,000	979,000	979,000	979,000	979,000
Capital Improvements-VVCSD	(183,000)	(96,000)	(377,000)	(267,000)	(152,500)
Capital Improvements-LRWRP <sup>4</sup>	(599,805)	(663,478)	(205,486)	0	0
End of Year Balance	8,647,324	8,866,846	9,263,360	9,975,360	10,801,860

<sup>4</sup> Does not include Floradale Bridge Interceptor expenses carried over to FY 2023-24

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## Reserve Balances

**Table 4** and **Table 5** summarize audited revenues, expenses, and activity to cash reserves. The operating income reconciliation is to account for the lag between accounting accruals and cash flow. For example, revenues are posted when the customer is billed but cash is not posted until the customer pays their bill. Therefore, the cash for the revenues reported on June 30 may not be received until after July 1.

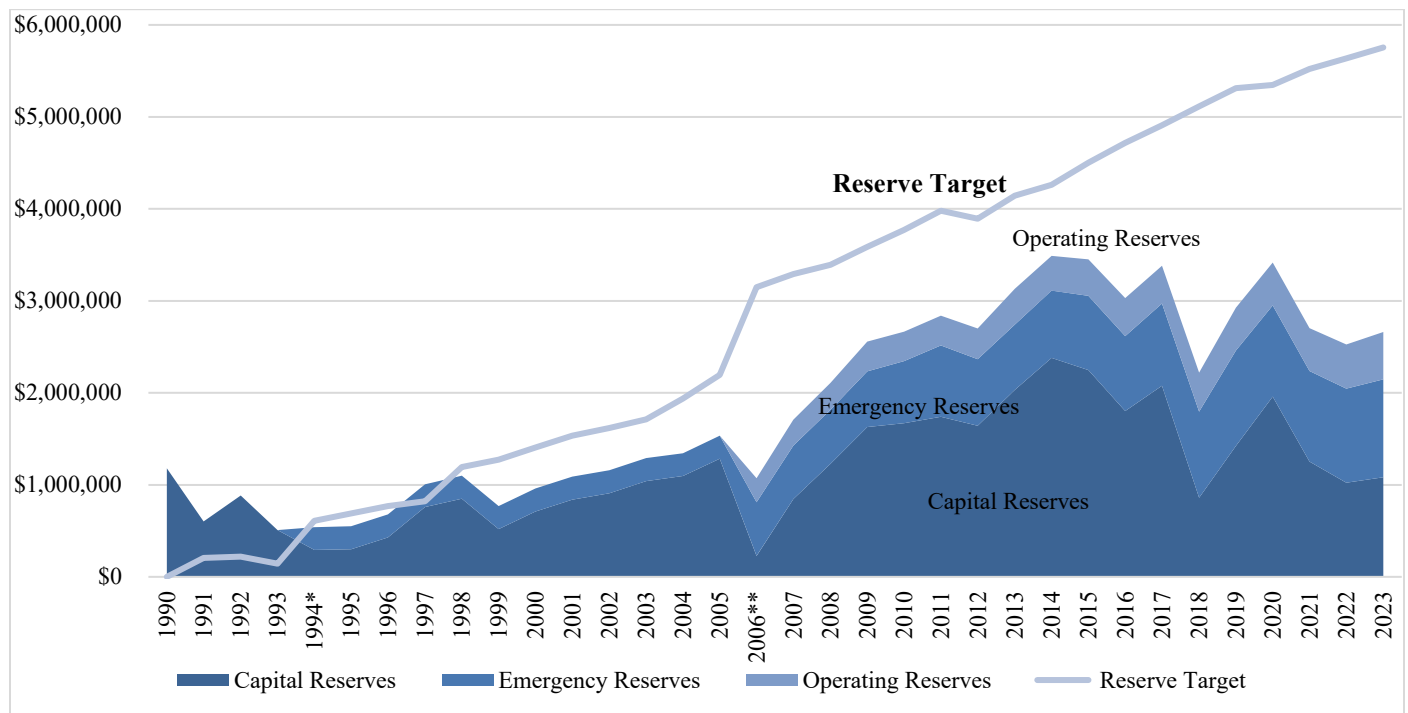
**TABLE 4 WATER RESERVE BALANCES**

Category	FY 2019-2020 Audited	FY 2020-2021 Audited	FY 2021-2022 Audited	FY 2022-2023 Audited
Operating Revenue	1,883,561	1,898,921	1,874,068	1,675,528
Operating Expenses	(1,856,048)	(1,829,523)	(1,732,280)	(1,769,848)
<b>Net operating income (loss)</b>	<b>27,513</b>	<b>69,398</b>	<b>141,788</b>	<b>(94,320)</b>
Less Purchase of Capital Assets	(112,993)	(1,070,280)	(286,068)	(64,475)
Plus (Less) Operating Income Reconciliation	89,589	63,465	(83,652)	94,256
Plus (Less) Interest Income/FMV Adjustments	73,822	21,078	(45,311)	(2,651)
Plus Depreciation	193,814	192,873	201,541	222,768
<b>Addition to/Withdrawal from Cash</b>	<b>244,232</b>	<b>(792,864)</b>	<b>(213,490)</b>	<b>249,898</b>
<b>Beginning Balance</b>	<b>3,355,060</b>	<b>3,626,805</b>	<b>2,903,339</b>	<b>2,831,637</b>
Addition to/Withdrawal from Cash	271,745	(723,466)	(71,702)	155,578
<b>Ending Balance</b>	<b>3,626,805</b>	<b>2,903,339</b>	<b>2,831,637</b>	<b>2,987,215</b>
Less cash on hand	(400)	(400)	(400)	(400)
Less restricted cash	(323,118)	(312,987)	(306,847)	(325,056)
<b>Available cash reserves</b>	<b>3,303,287</b>	<b>2,589,952</b>	<b>2,524,390</b>	<b>2,661,759</b>

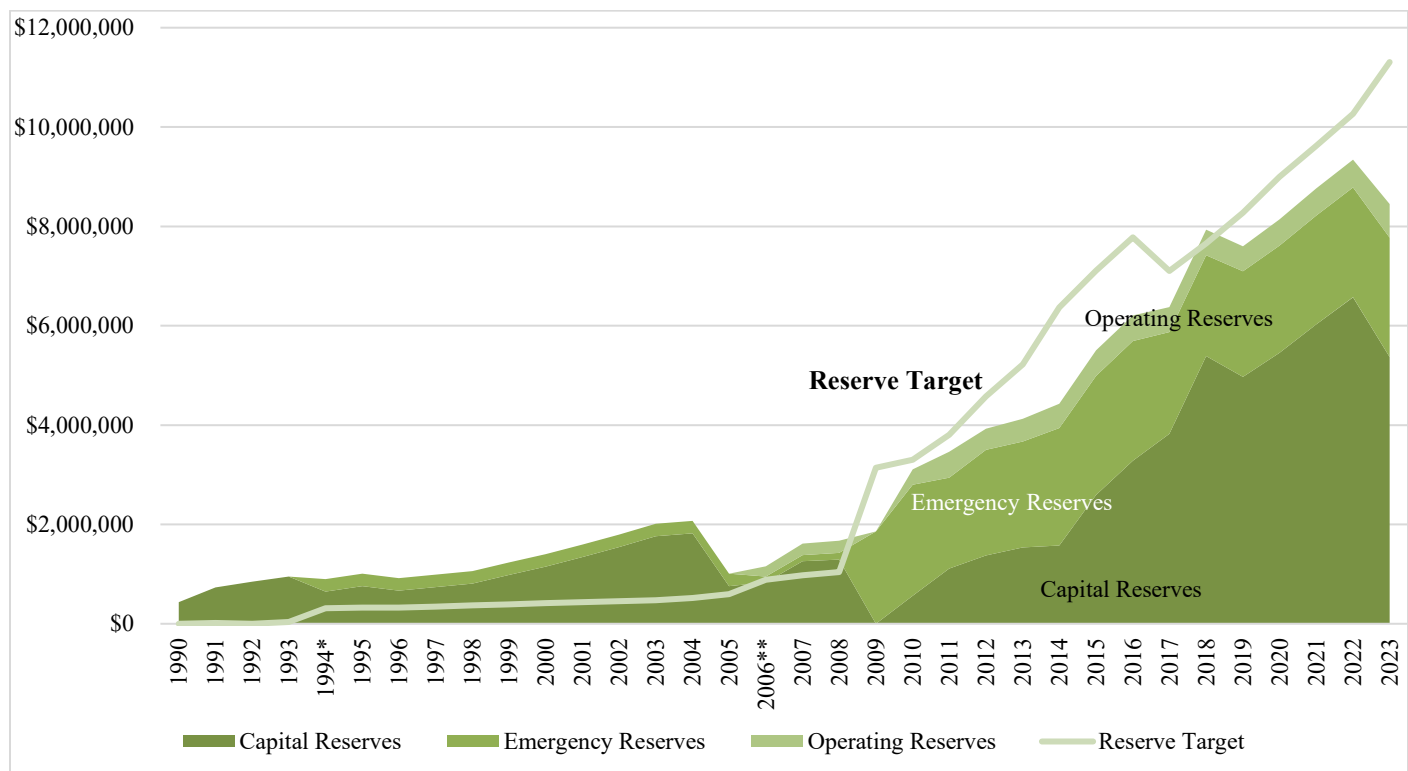
**TABLE 5 WASTEWATER RESERVE BALANCES**

	FY 2019-2020 Audited		FY 2020-2021 Audited		FY 2021-2022 Audited		FY 2022-2023 Audited	
	VVCSD	LRWRP	VVCSD	LRWRP	VVCSD	LRWRP	VVCSD	LRWRP
Operating Revenue	1,669,398	1,105,530	1,666,784	1,077,454	1,657,746	1,099,203	1,659,658	1,077,928
Operating Expenses	(1,434,317)	(490,403)	(1,542,369)	(490,403)	(1,246,513)	(490,403)	(1,293,774)	(490,403)
<b>Net operating income</b>	<b>235,081</b>	<b>615,127</b>	<b>124,415</b>	<b>587,051</b>	<b>411,233</b>	<b>608,800</b>	<b>365,884</b>	<b>587,525</b>
Balances to Audit	850,208		711,466		1,020,033		953,409	
Less Payment on Long-Term Debt	0	(741,091)	0	(741,091)	0	(741,092)	0	(741,090)
Less Purchases and Adjustments to Capital Assets	(345,643)	0	(74,736)	0	(207,529)	0	0	(1,916,537)
Plus (Less) Operating Income Reconciliation	48,499	0	89,008	0	6,912	0	(3,097)	0
Plus (Less) Interest Income/FMV Adjustments	29,751	120,383	2,870	12,161	(29,106)	(110,293)	164,844	0
Plus Depreciation	78,881	490,403	134,051	490,403	148,580	490,403	159,929	490,403
<b>Addition to/Withdrawal from Reserves</b>	<b>46,569</b>	<b>484,822</b>	<b>275,608</b>	<b>348,524</b>	<b>330,090</b>	<b>247,818</b>	<b>687,560</b>	<b>(1,579,699)</b>
<b>Beginning Balance</b>	7,609,837		8,141,228		8,765,360		9,343,268	
Addition to/Withdrawal from Cash	531,391		624,132		577,908		(892,139)	
<b>Available cash reserves</b>	<b>8,141,228</b>		<b>8,765,360</b>		<b>9,343,268</b>		<b>8,451,129</b>	

**Figure 4** and **Figure 5** illustrate the historical reserve balances for water and wastewater compared to the reserve targets.



**FIGURE 4 WATER FUND HISTORICAL RESERVE BALANCE**



**FIGURE 5 WASTEWATER FUND HISTORICAL RESERVE BALANCE**

## **Assigned Fund Balance**

Because the combined target for reserves under Resolution 176-06 has not been reached, and following the purpose for each reserve fund as referenced in the resolution, staff has assigned a hierarchy to the funds held in reserve per guidance provided by GASB 54. “Amounts that are constrained by the government’s *intent* to be used for specific purposes, but are neither restricted nor committed, should be reported as assigned fund balance” (Governmental Accounting Standards Board, 2009, p. 6). Using this guidance, reserve funds are first assigned to Emergency Reserves then Operating Reserves, and, lastly, Capital Reserves.

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## Anticipated Capital Expenditures

The Capital Improvement Plan was approved by the Board of Directors at their December 6, 2022 Regular Meeting and requires \$13,554,806 from water reserves or through financing, \$34,776,000 from wastewater reserves or through financing, \$101,194 from developers, and \$750,000 from rates over the next 20 years (see **Table 6**). While this plan looks ahead 20 years, there is no expectation that all of these expenditures will need to occur as planned.

**TABLE 6 CAPITAL IMPROVEMENT PLAN TIMELINE**

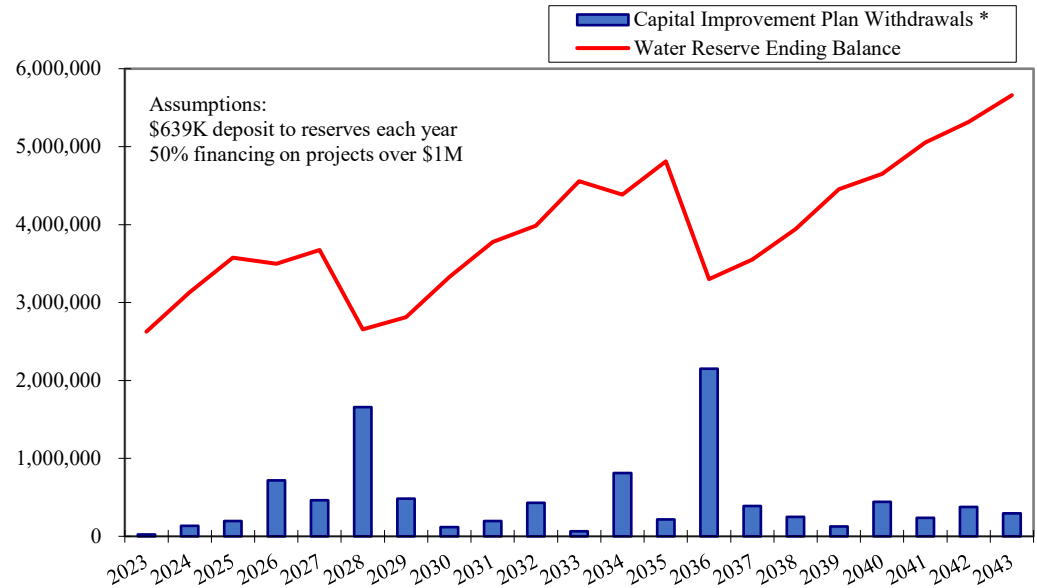
Asset Description	FYE Schedule	Capital Improvement Plan	From Expense Budget	From Water Reserves	From Wastewater Reserves	From Developer
Well 1B	2024	28,000		28,000		
Iron and Manganese Filter Modification	2024	75,000		75,000		
Lab Equipment	2024	25,000		25,000		
B/S #5	2024	6,000		6,000		
LRWRP	2024	183,000			183,000	
			-	134,000	183,000	-
B/S #1 Pump	2025	10,000		10,000		
B/S #2 Pump	2025	10,000		10,000		
B/S #3 Pump	2025	10,000		10,000		
Tank Inspection	2025	16,000		16,000		
Hydrants (201 total)	2025	125,000		125,000		
LRWRP	2025	71,000			71,000	
Pickup Truck F150 #2	2025	50,000		25,000	25,000	
			-	196,000	96,000	-
Well 3B	2026	30,000		30,000		
Iron and Manganese Filter Inspection	2026	6,000		6,000		
Iron and Manganese Filter Pump	2026	10,000		10,000		
Pavement (Site 3)	2026	240,000		240,000		
Valves (518 total)	2026	125,000		125,000		
LRWRP	2026	71,000			71,000	
Sedan	2026	41,000		20,500	20,500	
Copy Machine	2026	11,000		5,500	5,500	
Site 1 & Access Road	2026	560,000		280,000	280,000	
			-	717,000	377,000	-
Iron and Manganese Filter Replace Media	2027	75,000		75,000		
Tank 5A	2027	193,000		193,000		
Tank 5B	2027	193,000		193,000		
LRWRP	2027	17,000			17,000	
Manholes (546 total)	2027	50,000			50,000	
Sewer Mains (31 miles)	2027	200,000			200,000	
			-	461,000	267,000	-
Replacement Wells	2028	3,042,000		2,940,806		101,194
Well 3A	2028	83,000		83,000		
Tank Inspection	2028	18,000		18,000		
Hydrants (201 total)	2028	141,000		141,000		
LRWRP	2028	17,000			17,000	
Pickup Truck F250	2028	55,000		27,500	27,500	
Backhoe	2028	166,000		83,000	83,000	
Clean Energy	2028	50,000		25,000	25,000	
			-	3,318,306	152,500	101,194
B/S #4	2029	7,000		7,000		
Generator	2029	302,000		200,000	102,000	
Pavement (Site 5)	2029	61,000		61,000		

Asset Description	FYE Schedule	Capital Improvement Plan	From Expense Budget	From Water Reserves	From Wastewater Reserves	From Developer
Valves (518 total)	2029	141,000		141,000		
LRWRP	2029	64,000			64,000	
Pickup Truck F150 #3	2029	59,000		29,500	29,500	
Insertter/Folder	2029	21,000		10,500	10,500	
Roof	2029	32,000		16,000	16,000	
District Office Parking Lot	2029	36,000		18,000	18,000	
			-	483,000	240,000	-
Well 1B	2030	89,000		89,000		
LRWRP	2030	66,000			66,000	
Pickup Truck F150 #1	2030	61,000		30,500	30,500	
			-	119,500	96,500	-
B/S #5	2031	8,000		8,000		
Tank Inspection	2031	20,000		20,000		
Hydrants (201 total)	2031	159,000		159,000		
LRWRP	2031	69,000			69,000	
Copy Machine	2031	14,000		7,000	7,000	
			-	194,000	76,000	-
Well 3B	2032	97,000		97,000		
B/S #1 Pump	2032	14,000		14,000		
B/S #2 Pump	2032	14,000		14,000		
B/S #3 Pump	2032	14,000		14,000		
Valves (518 total)	2032	159,000		159,000		
L/S #3	2032	112,000			112,000	
L/S #4	2032	112,000			112,000	
LRWRP	2032	72,000			72,000	
Manholes (546 total)	2032	61,000			61,000	
Sewer Mains (31 miles)	2032	244,000			244,000	
Pickup Truck F150 #2	2032	66,000		33,000	33,000	
Utility Task Vehicle	2032	28,000		14,000	14,000	
SCADA System	2032	168,000		84,000	84,000	
			-	429,000	732,000	-
Iron and Manganese Filter Pump	2033	14,000		14,000		
Water Meters (2,600 total)	2033	750,000	750,000			
LRWRP	2033	75,000			75,000	
Sedan	2033	54,000		27,000	27,000	
Clean Energy	2033	50,000		25,000	25,000	
			750,000	66,000	127,000	-
Well 3A	2034	41,000		41,000		
Tank Inspection	2034	23,000		23,000		
Hydrants (201 total)	2034	178,000		178,000		
Lab Equipment	2034	38,000		38,000		
Valve Truck	2034	455,000		455,000		
L/S #1	2034	139,000			139,000	
LRWRP	2034	77,000			77,000	
Dump Truck F650	2034	153,000		76,500	76,500	
			-	811,500	292,500	-
Valves (518 total)	2035	178,000		178,000		
LRWRP	2035	81,000			81,000	
Sewer Jetter	2035	114,000			114,000	
Pickup Truck F250	2035	73,000		36,500	36,500	
			-	214,500	231,500	-
B/S #4	2036	9,000		9,000		
Replacement Wells	2036	4,163,000		4,163,000		

Asset Description	FYE Schedule	Capital Improvement Plan	From Expense Budget	From Water Reserves	From Wastewater Reserves	From Developer
Well 1B	2036	44,000		44,000		
Iron and Manganese Filter Inspection	2036	11,000		11,000		
Air/Vac Valves (23 total)	2036	25,000		25,000		
LRWRP	2036	84,000			84,000	
Pickup Truck F150 #3	2036	77,000		38,500	38,500	
Copy Machine	2036	17,000		8,500	8,500	
			-	4,299,000	131,000	-
B/S #5	2037	10,000		10,000		
Iron and Manganese Filter Replace Media	2037	112,000		112,000		
Tank Inspection	2037	26,000		26,000		
Hydrants (201 total)	2037	201,000		201,000		
L/S #2	2037	112,000			112,000	
LRWRP	2037	87,000			87,000	
Manholes (546 total)	2037	75,000			75,000	
Sewer Mains (31 miles)	2037	297,000			297,000	
Pickup Truck F150 #1	2037	80,000		40,000	40,000	
			-	389,000	611,000	-
Well 3B	2038	47,000		47,000		
Valves (518 total)	2038	201,000		201,000		
LRWRP	2038	91,000			91,000	
			-	248,000	91,000	-
B/S #1 Pump	2039	18,000		18,000		
B/S #2 Pump	2039	18,000		18,000		
B/S #3 Pump	2039	18,000		18,000		
LRWRP	2039	94,000			94,000	
Pickup Truck F150 #2	2039	87,000		43,500	43,500	
HVAC System	2039	57,000		28,500	28,500	
			-	126,000	166,000	-
Well 3A	2040	132,000		132,000		
Iron and Manganese Filter Pump	2040	18,000		18,000		
Tank Inspection	2040	29,000		29,000		
Hydrants (201 total)	2040	226,000		226,000		
LRWRP	2040	98,000			98,000	
Sedan	2040	71,000		35,500	35,500	
			-	440,500	133,500	-
Valves (518 total)	2041	226,000		226,000		
Camera Van	2041	504,000			504,000	
LRWRP	2041	102,000			102,000	
Copy Machine	2041	20,000		10,000	10,000	
			-	236,000	616,000	-
Well 1B	2042	143,000		143,000		
Valves (518 total)	2042	235,000		235,000		
LRWRP	2042	106,000			106,000	
			-	378,000	106,000	-
Valves (518 total)	2043	244,000		244,000		
LRWRP	2043	30,000,000			30,000,000	
Pickup Truck F150 #3	2043	101,000		50,500	50,500	
			-	294,500	30,050,500	-
Total		49,182,000	750,000	13,554,806	34,776,000	101,194

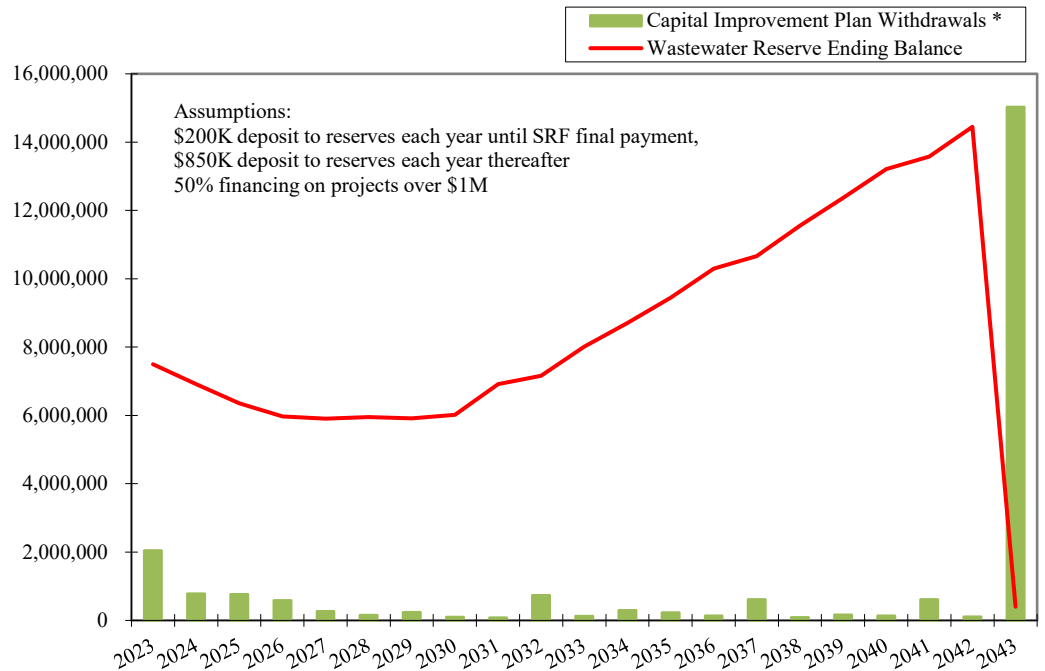
**Figure 6** illustrates the anticipated water reserves deposits and capital improvement plan withdrawals through 2043 assuming a \$639,000 deposit to reserves each year and 50 percent financing on all projects that are anticipated to cost more than \$1 million. The large withdrawals in 2028 and 2036 include expenditures for replacement water wells.

**FIGURE 6 PROJECTED WATER RESERVES**



**Figure 7** illustrates the anticipated wastewater reserves deposits and capital improvement plan withdrawals through 2043 assuming a \$200,000 deposit to reserves until the SRF loan is paid off (at which time the deposit increases to \$850,000 annually) and 50 percent financing on all projects that are anticipated to cost more than \$1 million. The large withdrawal in 2043 is VVCSD’s contribution to the next LRWRP upgrade project.

**FIGURE 7 PROJECTED WASTEWATER RESERVES**





## Comparable Policies

**TABLE 7 COMPARABLE RESERVE POLICIES**

	<b>Vandenberg Village Community Services District</b>	<b>Mission Hills Community Services District</b>	<b>Heritage Ranch Community Services District</b>	<b>Templeton Community Services District</b>	<b>Goleta West Sanitary District</b>	<b>Goleta Water District</b>	<b>Nipomo Community Services District</b>
<b>Year Adopted</b>	2006	2016	2014	2023	2012	2023	2023
<b>Operating Reserve</b>	25% (90 days) Operating Expenses	20% (73 days) Operating Expenses	50% (180 days) Operating Expenses	25% (90 days) Operating Expenses	100% Operating Expenses	\$3,000,000	100% Operating Expenses
<b>Emergency Reserve</b>	10% Capital Assets	5% Capital Assets				\$13,000,000	
<b>Contingency Reserves</b>			\$250,000			\$7,500,000	
<b>Capital Reserves</b>	100% Accumulated Depreciation + 25% Operating Expenses	50% Accumulated Depreciation	100% Accumulated Depreciation + Annual Depreciation Expense	100% Accumulated Depreciation	5% Capital Assets + \$2,000,000		Annual Net Income
<b>Reserve Balance</b>	\$11,112,887	\$3,779,000	\$2,710,675	\$7,650,732	\$10,393,316	\$3,671,165	\$12,344,401
<b>Capital Assets</b>	\$33,245,476	\$13,071,302	\$18,626,823	\$28,956,134	\$56,059,512	\$93,189,503	\$93,698,580
<b>Annual Debt Payments</b>	\$741,092	\$0	\$315,683	\$325,475	\$975,480	\$5,071,113	\$9,825,631
<b>Operating Budget</b>	\$4,172,035	\$2,378,021	\$2,554,567	\$3,956,562	\$4,998,775	\$35,367,551	\$10,946,337
<b>Capital Budget</b>	\$2,666,409	\$1,281,500	\$2,397,973	\$1,402,932	\$7,254,500	\$16,245,000	\$6,235,000

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## Appendix A – Draft VVCSD Reserve Policy

### VANDENBERG VILLAGE COMMUNITY SERVICES DISTRICT

#### RESERVE POLICY

#### EXHIBIT A TO RESOLUTION XXX-24

#### POLICY STATEMENT

Vandenberg Village Community Services District shall maintain reserve funds from existing unrestricted revenues as designated by this policy. This policy establishes the procedure and level of reserve funding to achieve the following goals:

- Provide economic stability during emergencies; and
- Maintain operational sustainability during periods of economic uncertainty; and
- Fund the Capital Improvement Plan.

This Reserve Policy establishes guidelines and procedures for allocating and reporting fund balances following Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*.

The adequacy of the targeted reserve balances and/or annual contributions shall be reviewed annually during the budgeting process and may be revised accordingly.

#### ACCOUNTING GUIDANCE

GASB Statement No. 54 requires the classification of fund balances as non-spendable, restricted, committed, assigned, or unassigned.

- *Non-spendable Fund Balance* – amounts that cannot be spent because they are either (a) not in spendable form or (b) legally or contractually required to be maintained intact.
- *Restricted Fund Balance* – amounts restricted externally by creditors, grantors, contributors, or laws and regulations of other governments or restricted by law through constitutional provisions or enabling legislation.
- *Committed Fund Balance* – amounts that can only be used for specific purposes according to constraints imposed by formal action of the Board of Directors.
- *Assigned Fund Balance* – amounts that are constrained by the Board's intent to be used for specific purposes but are neither restricted nor committed.
- *Unassigned Fund Balance* – amounts that have not been restricted, committed, or assigned to specific purposes.

#### DEPRECIATION EXPENSE

The District shall establish and maintain a Depreciation Schedule of assets. The Useful Life Guidelines, published by the Office of the State Controller, and the Straight-Line method will be used to calculate monthly depreciation expenses. Depreciation will be included in the annual operating expense budget. The District shall establish rates to generate sufficient revenue to fully fund this depreciation expense and place it in reserves.

## **RESERVE CONTRIBUTION FACTOR**

Depreciation alone is insufficient to fund the replacement of equipment, infrastructure, and facilities. Therefore, the District shall incorporate a reserve contribution factor into its rate structure. This factor, expressed as a percentage of the annual water and wastewater operating expense budgets, will generate revenues specifically for reserves. The District shall consider the amount of money available in reserves relative to the goal, investment performance, the timing of planned and foreseeable capital projects, the strategic plan, and other pertinent considerations in approving the reserve contribution factor each year as part of the annual budget approval process.

## **RESTRICTED FUND BALANCE**

Connection fees, development fees, and funds collected from development agreements paid to the District to serve new development with water and wastewater services are designated as restricted reserves. They will be deposited into a separate, interest-bearing account and be used to expand infrastructure and facilities to serve new development as defined in the capacity charge rate calculations. Funds will be administered and maintained per Government Code § 66013.

## **ASSIGNED FUND BALANCE**

The District shall maintain reserve fund balances in the following order of importance:

### Emergency Reserve (Water, Wastewater)

Purpose: This reserve is intended as protection against catastrophic loss and to provide a cushion for inaccuracy in long-range planning.

Target Balance: The minimum balance shall be equal to 10 percent of the audited value of capital assets. The maximum balance shall be equal to the replacement cost for the most expensive facility in the District's system, excluding intangible assets, or 10 percent of the audited value of capital assets, whichever is more.

### Operating Reserve (Water, Wastewater)

Purpose: This reserve is intended as a cushion to fund three months of operating expenses.

Target Balance: The target balance shall be equal to 25 percent of the current annual operating expense budget.

### Capital Reserve (Water, Wastewater)

Purpose: This reserve is intended to replace assets, fund capital projects, and minimize the impact of capital debt financing on future rates. The District recognizes that Capital Reserves may not be sufficient to fully fund capital asset expenditures and financing may be required.

Target Balance: The minimum balance shall be equal to a minimum of 50 percent of the audited accumulated depreciation and a maximum of 100 percent of the audited accumulated depreciation.

## **MINIMUM THRESHOLD**

The minimum balance for the assigned water and wastewater reserve funds shall be equal to 50 percent of budgeted operating expenses per California Government Code § 53646(b)(3).

## **EXCESS RESERVES**

Fund balances over the cumulative maximum fund balance shall be used to pay down long-term liabilities such as capital plan financing or unfunded pension liabilities.

## **INTEREST INCOME**

Reserves will be segregated from operating funds and invested per the District's investment policy. Interest income shall be allocated to the appropriate fund balance following the guidelines outlined in GASB Statement No. 54.

## **ACCEPTABLE USE OF RESERVES**

Reserves should not be used for recurring annual operating costs except when economic conditions require the use of Operating or Emergency Reserves to provide short-term relief.

## Appendix B – Reserve Target Comparisons

**TABLE 8 WATER RESERVES TARGET COMPARISONS**

Accumulated Depreciation	3,658,664	Audit 6/30/23
Capital Assets	10,934,056	Audit 6/30/23
Operating Budget	2,119,767	FYE 2024
Most expensive asset	2,500,000	Replacement Value - Water Well

	Resolution 176-06 Targets	Draft Policy - Maximum Targets	Draft Policy - Minimum Targets
Emergency Reserve	1,093,406	2,500,000	1,093,406
Operating Reserve	529,942	529,942	529,942
Capital Reserve	4,188,606	3,658,664	1,829,332
	<u>5,811,953</u>	<u>6,688,606</u>	<u>3,452,679</u>

**TABLE 9 WASTEWATER RESERVES TARGET COMPARISONS**

Accumulated Depreciation	7,549,207	Audit 6/30/23
Capital Assets	24,123,768	Audit 6/30/23
Operating Budget	2,188,722	FYE 2024 (less debt principal and Floradale Bridge interceptor)
Most expensive asset	500,000	Replacement Value - Lift Station

	Resolution 176-06 Targets	Draft Policy - Maximum Targets	Draft Policy - Minimum Targets
Emergency Reserve	2,412,377	2,412,377	2,412,377
Operating Reserve	547,181	547,181	547,181
Capital Reserve	8,096,388	7,549,207	3,774,604
	<u>11,055,945</u>	<u>10,508,764</u>	<u>6,734,161</u>

### Resolution 176-06 Targets

Emergency Reserve Requirement = 10% capital assets  
 Operating Reserve Requirement = 25% combined operating budget  
 Capital Reserve Requirement = 100% accumulated depreciation + 25% combined operating budget

### Draft Policy - Maximum Targets

Emergency Reserve Requirement = 10% capital assets or most expensive asset  
 Operating Reserve Requirement = 25% combined operating budget  
 Capital Reserve Requirement = 100% accumulated depreciation

### Draft Policy - Minimum Targets

Emergency Reserve Requirement = 10% capital assets  
 Operating Reserve Requirement = 25% combined operating budget  
 Capital Reserve Requirement = 50% accumulated depreciation

## Appendix C – Resolution 176-06

### RESOLUTION 176-06

May 2, 2006

#### BY THE BOARD OF DIRECTORS OF VANDENBERG VILLAGE COMMUNITY SERVICES DISTRICT ESTABLISHING A RESERVE POLICY

WHEREAS, the Board of Directors of Vandenberg Village Community Services District is committed to operating and maintaining the District's water and wastewater systems in a fiscally sound and responsible manner; and

WHEREAS, the Board of Directors desires to provide cost-effective and efficient public services through a stable rate structure and gradual rate increases; and

WHEREAS, during the period 1988 to 2005 when the District was repaying \$5.4 million in revenue bonds, the District was required to satisfy a 20 percent bond covenant in order to demonstrate financial capability to fund operations, capital projects, and debt service; and

WHEREAS, through satisfying the bond covenant and funding depreciation, the District was able to accumulate reserves; and

WHEREAS, although there is no longer a bond covenant requirement, the District plans to continue contributing funds in a regular, disciplined manner to build and sustain reserves at a level sufficient to fund operations, capital projects, and emergencies.

NOW, THEREFORE, BE IT RESOLVED by the Board of Directors of the Vandenberg Village Community Services District that:

1. The District shall establish and maintain a Depreciation Schedule of assets. The Useful Life Guidelines, published by the Office of the State Controller, and the Straight Line method will be used to calculate monthly depreciation expenses. Depreciation will be included in the annual operating expense budget. The District shall establish rates to generate sufficient revenue to fully fund this depreciation expense and place it in reserves.
2. Depreciation alone is insufficient to fund replacement of equipment, infrastructure, and facilities. Therefore, the District shall incorporate a reserve contribution factor into its rate structure. This factor, expressed as a percentage of the annual water and annual wastewater operating expense budgets, will generate revenues specifically for reserves. The District shall take into account the amount of money available in reserves relative to the goal, investment performance, the timing of planned and foreseeable capital projects, the strategic plan, and other pertinent considerations in approving the reserve contribution factor each year as part of the annual budget approval process.
3. The goal of the District is to maintain reserves at a level that equals or exceeds the sum of the following components:
  - a. Operating Reserve Requirement: 25 percent of the current combined annual operating expense budget. This amount is intended as a cushion to fund three months of operating expenses.
  - b. Capital Reserve Requirement: Accumulated depreciation plus 25 percent of the current combined annual water and wastewater expense budget. This amount is intended to replace assets and fund capital projects.

- c. Emergency Reserve Requirement: 10 percent of the value of capital assets. This amount is intended as protection against catastrophic loss and to provide a cushion for inaccuracy in long range planning.
- 4. Reserves will be segregated from operating funds and invested in accordance with the District's investment policy.
- 5. Connection fees, development fees, and funds collected from development agreements paid to the District to serve new development with water and wastewater services are designated as restricted reserves. They will be deposited into a separate, interest-bearing account and be used to expand infrastructure and facilities to serve new development. Funds will be administered and maintained in accordance with Government Code § 66013.
- 6. This resolution rescinds and replaces Resolution 99-94.



## Appendix D – Resolution 99-94

### RESOLUTION NO. 99-94

February 3, 1994

#### **A RESOLUTION OF THE BOARD OF DIRECTORS OF THE VANDENBERG VILLAGE COMMUNITY SERVICES DISTRICT ESTABLISHING POLICIES FOR CONTRIBUTIONS TO RESERVES AND ALLOCATIONS OF INTEREST INCOME**

WHEREAS, it is the intention of the Board of Directors of the Vandenberg Village Community Services District to maintain and operate the District's water and wastewater systems in a fiscally sound manner; and

WHEREAS, sound fiscal management includes the recognition of depreciation expense over the life of the District's capital equipment and facilities and the reserving of that budgeted expense for future replacement; and

WHEREAS, toward the goal of fiscal management and long range planning, the Board of Directors of the Vandenberg Village Community Services District recognizes the need to establish reserve funds; and

WHEREAS, the policies for fiscal management should be formalized for implementation consistent with the desires of the Board of Directors.

NOW THEREFORE, BE IT RESOLVED by the Board of Directors of the Vandenberg Village Community Services District that:

Depreciation: The total cost of capital equipment and facilities, from the commencement of design to and including installation, will be depreciated by the Straight Line method utilizing Useful Life Guidelines as published by the Office of the State Controller. An estimate of this amount will be included in each year's budget for each department of the District. The rates established for each year will include sufficient cash to fully fund this depreciation expense.

Depreciation Schedule: There will be established and maintained a Depreciation Schedule of all District assets which lists each capital item, its total cost, useful life, monthly depreciation expense amount, and other information necessary to determine the total actual monthly depreciation expense to the District.

Replacement Reserves: In order to establish a Replacement Reserve account to cover the depreciation of District capital assets depreciated since the formation of the District in 1988, Staff is directed to transfer the sum of depreciation-to-date into a reserved account, which account will be called Replacement Reserves, and the purpose of which will be to replace the District's capital equipment and facilities at the end of their useful lives.

At least quarterly, the total actual depreciation expense, as well as interest, calculated at the District's current investment rate, will be transferred into the Replacement Reserves account established hereby.

Development Reserves: Connection fees, development fees, and funds collected from development agreements paid to the District to serve new development for water and wastewater systems will be deposited into a separate, reserved, interest bearing account, which account will be called Development Reserves, the purpose of which will be to add to the District's capital system facilities for the expansion of those facilities to serve the new development. Funds will be administered and maintained in accordance with Government Code Section 66000, et. seq.

Emergency Reserves: In accordance with the District's Long Range Financial Plan, there shall be included in each year's budget and funded annually from unreserved retained earnings, an item entitled Emergency Reserves, which amount shall be currently \$500,000. Should said amount fall below the minimum, staff is directed to notify the Board of Directors as soon as practicable but not later than the next scheduled Board of Directors meeting. The purpose of Emergency Reserves will be to provide protection against a catastrophic loss and provide a cushion for inaccuracy in the long range replacement program.

Interest Income: All District funds will be deposited into interest bearing accounts except those funds set aside for rebate to the Internal Revenue Service for arbitrage earnings.

## Appendix E – GFOA Rethinking Reserve Checkpoints



### RETHINKING RESERVE CHECKPOINTS

#### Develop a Risk-Aware Reserves Policy

- ☐ Express your reserves policy as a range of desired reserves, with a floor and a ceiling.
- ☐ Conduct a risk analysis to get a sense of how the risks you face impact the reserves you should hold. We presented three methods of reserve analysis of varying sophistication. Any of them would provide a reasonable basis for a more informed discussion with policymakers about why reserves are necessary and how much should be kept in reserves.
- ☐ Quantification of risk offers important advantages over subjective approaches. We described both “single-number analysis” and “chance-based simulation” methods of quantification. A quantified approach might be particularly useful when there is a strong sense among decision-makers that existing reserves are too high or too low.
- ☐ The single-number analysis will be more accessible to local governments than a chance-based simulation. However, a chance-based simulation is better; it is how insurance companies conduct their analysis. The choice between the two depends on factors such as a government’s ability to pay for outside consulting support, demand from the audience for a more rigorous analysis, and the number of risks and size of reserves in question (more/bigger risks and reserves means more potential to make the best use of funds by optimizing the size of the reserve).



### RETHINKING RESERVE CHECKPOINTS

#### Develop a Comprehensive Reserves Policy

- ☐ A reserves policy is a method to “pre-commit” the organization to wise decisions about reserves.
- ☐ A policy should address the following: 1) why reserves should be accumulated; 2) how much should be accumulated; 3) what strategies should be used for accumulation; and 4) when and for what purpose reserves can be used.
- ☐ The finance officer should strive for transparency in how reserves (a budgetary policy) are reflected in the reporting of fund balances in the annual financial report (an accounting mechanism).



### RETHINKING RESERVE CHECKPOINTS

#### Optimize Investment of Reserve Funds

- ☐ Use a risk analysis to identify tranches of funding, ranging from more likely to be needed to cover unplanned, unavoidable needs to less likely. The less likely tranches may be candidates for less liquid, higher return investments.
- ☐ Convene a discussion with the relevant decision-makers to determine the level of risk the government is willing to take on with respect to investment liquidity versus the potential need to draw upon reserves.



## RETHINKING RESERVE CHECKPOINTS

### Apply Risk Pooling to Reserves

- ☐ If you have separate reserves in the general fund for different risks, combine those reserves.
- ☐ Develop a policy for emergency interfund borrowing.
- ☐ Consider pooling reserves across funds within your government. In some cases, you may already be de facto pooling the general fund with financially weaker funds. Improve your risk portfolio by adding other strong funds to the pool.



## RETHINKING RESERVE CHECKPOINTS

### Understand Bond Ratings and Reserves

- ☐ Fund balances and cash are an important but not an overwhelming determinant of bond ratings.
- ☐ Because fund balances/cash are not costless to accumulate and hold, governments should ask if a higher bond rating is worth the cost of holding. The cost versus benefit of a higher bond rating is a function of the amount and duration of debt the government issues, the likely improvement in interest rates available from a rating increase, the marginal improvement in risk management available from holding more reserves, and the opportunity cost of holding fund balance/cash.

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