



Long Beach Water

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To: Christopher J. Garner, General Manager

From: B. Anatole Falagan, Assistant General Manager

For: Board of Water Commissioners

Date: May 26, 2020

Subject: Analysis and responses to questions resulting from Board Budget Workshop, May 21, 2020.

The Board Budget Workshop, held on May 21, 2020, has generated several questions from Commissioners regarding the material and topics covered in the presentations. Staff has prepared analyses and responses to those questions. Both questions and answers are addressed below by category.

Board Policy 2016-36 Financial Reserve Policy and Reserve Targets

The following comments and questions have been received in this category:

1. Provide a summary of the Board's Financial Reserve Policy, the basis for the targets, and an assessment if reserve targets can be lowered.
2. Provide a list of reserve amounts for the last six (6) budget years
3. At one time, the Auditor opined that we were maintaining excessive reserves. I believe the issue was resolved. Could staff please discuss.

Question 1 – Board Policy 2016-36 Financial Reserve Policy

Board Policy 2016-36 was developed with Board input, and by staff in conjunction with the Cost of Service Study undertaken by Raftelis Financial Consultants, a nationally recognized firm in rate and financial analyses. A copy of the policy, adopted in 2016, is attached. The policy identifies its purpose by restating relevant sections of the City Charter granting the Board of Water Commissioners exclusive power and control to use



Water Department funds. The policy establishes, by Board adoption, financial reserve targets for the Water and Sewer Funds.

Section 1, Reserve Parameters, establishes for each fund, separately, two (2) targets and the basis for those targets.: a minimum target of 90 days of operational expenses (excluding capital expenses); and a maximum target equivalent to the sum of the minimum target plus a Rate Stabilization Reserve, and plus an Emergency Capital Reserve. These terms, and their calculations are all explained in the policy.

1.A. Use of the Targets and the Reserve Funds

The policy establishes the principal use of the funds below the Target Minimum to mitigate an unplanned temporary loss of revenue, or an increase in costs.

Above the Target Minimum and below the Target Maximum, the funds are intended to maintain stable and predictable rates and to mitigate an unplanned emergency capital expenditure.

Above the Target Maximum, the policy establishes the principal use of funds to mitigate increases in rates and charges.

1.B. Practices in Financial Reserve Targets and Management

Based on industry reporting by multiple credit rating agencies, a 90-day minimum financial reserve target is a widely-used industry practice, and a metric used by the credit rating agencies in their assessment of credit ratings for agencies. Having funds significantly above the 90-day minimum reserve are often agency specific. For instance, an agency may have undertaken a series of rate increases to create a cash reserve to fund capital projects, to avoid debt financing. In that case, an agency's financials would show in some cases a 365-day financial reserve.

It is an accepted practice and offered guidance to have a target minimum and target maximum financial reserve, offering a governing board a measure of discretion above the target minimum, and establishing the target maximum as the basis for which to focus exclusively on mitigation of rate increases and charges.

The financial reserve targets, as a practice, are established as guidance. An agency's finances can cause it to have reserves that fall below its target minimum. In providing an agency's credit rating, credit rating agencies may often evaluate an agency's reserves and a combination of other factors, such as:

- projections of rate increases and fund balance recovery over time
- debt ratios of senior and subordinate indebtedness
- debt coverage ratios and trends



1.C. Future discussion of Financial Reserve Policy

Modifications to financial reserve targets below a 90 days operating cash level would be: 1) viewed unfavorably by credit rating agencies; and 2) while the lowering of the target might not impact the just executed Line of Credit, it would negatively impact the ability to obtain lower interest rates at a later time when seeking issuance of bonds to retire the amounts incurred under the Line of Credit.

In addition, changes to the reserve policy will not change the near-term budget and rate decisions. If desired, it is possible to provide another review of the financial reserve policy as part of a mid-year budget review, when more data will be available to inform the performance of the Fiscal Year 20-21 budget, and in preparation for the Fiscal Year 21-22 budget.

Question 2 – Reserve levels for the previous six (6) budget years

Graphs for both the Water Fund and Sewer Fund are attached, reflecting the following aspects of the financial reserves, for both Water and Sewer funds, for the previous six (6) budget years. Where applicable, the reserve levels are shown along with the established Minimum Reserve Targets. The Board adopted the current Financial Reserve Policy during Fiscal Year 15-16. Prior to the adoption of the policy, there was only staff guidance on the appropriate reserve levels for both funds.

Question 3 – The 2012 Audit of Water Department Budget, Rates, and Reserves

The Audit, conducted in 2012, focused on the Department's budgets and rates, and the resulting effects on financial reserves. At the time, the historical practice had been a target of \$6 million for the Water Fund financial reserves, established sometime prior to 2005. The Sewer Fund lacked a financial reserve target. The outcome of the Audit requested the following specific actions from the Water Department, summarized as:

- Establish a Financial Reserve Policy that delineates targets that assess the levels of the reserves and aid in budget and rate planning.
- Establish more comprehensive Capital Budget and Projects planning, to address the realities of major capital project expenditures and construction progress/delays.
- Provide more continuous budget projections throughout the fiscal year, to better inform the budget and rate planning/setting process.

Since the publication of the Audit in 2012, the Board of Water Commissioners and Water Department staff have made the following changes to address each of the findings:



- The Board adopted Policy 2016-36, establishing both minimum and maximum financial reserve targets, their calculation methodology, and guidance on the use of funds at various levels in relation to those targets.
- Since 2012, staff has comprehensively revamped the methodology for establishing CIP budgets, including more detailed assessment of project expenditures and schedules, as well as factoring adjustments to Capital Budgets reflect potential risks in project delays.
- Since 2012, staff has endeavored to provide, at a minimum, a mid-year fiscal year review and End-of-Year projection/assessment to inform the Board in budget and rate planning for the next fiscal year. Additionally, since 2015, staff has been actively engaged with the Board in providing Quarterly Financial summaries to keep the Board informed of budget progress.

Alternate Rate and Fund Balance Projection: 4% - 6% - 8% Sequence

A question was asked about the effects of a sequence of rate increases different from the scenarios presented at the May 21, 2020 workshop.

Attached is the graph, similar in format to the graphs presented in the May 21, 2020 workshop, noting the rate increases and the projected Water Fund balances for Fiscal years 21 through 24. Specifically, the graph highlights the effects of a 4% increase for FY 21, a 6% increase for FY 22, and an 8% increase in FY 23.

Attachments



BOARD OF WATER COMMISSIONERS

Policy Statement 2016-36

RE: FINANCIAL RESERVE TARGETS FOR WATER AND SEWER FUNDS

PURPOSE:

Per Section 1403 (13) of the Long Beach City Charter, the Board of Water Commissioners has the complete and exclusive power and duty to expend all money received in connection with the operation of the Water Department or management of properties under the control of the Commission.

Per Section 1407 (1) – (3), the Board of Water Commissioners has the ability to use funds:

- (1) For the necessary expense of operating and maintaining the water works and the sewer system, and for such preliminary surveys, reconnaissances, options, estimates, engineering data, experimentation and investigation, as in the discretion of the Commission shall be necessary, or as shall be incidental to the extension or betterment of the physical properties, or the business of the department and/or the acquisition of additional lands, water, water rights and/or other property.
- (2) For the payment of the principal and interest, or either, due or coming due upon outstanding notes, certificates or other evidences of indebtedness issued against revenues from said water works and sewer system in accordance with this Charter, or bonds or other evidences of indebtedness heretofore or hereafter issued for the purpose of such water works and sewer system, or parts thereof.
- (3) For the necessary expense of constructing, extending and improving such water works and sewer system, including purchases of lands, water, water rights, and other property; also the necessary expenses of conducting and extending the business of the Water Department.

Consistent with this authority established under the Long Beach City Charter, the Board of Water Commissioners has adopted this policy establishing financial reserve targets for the Water and Sewer Funds.

For the Water Fund and Sewer Fund, each separately:

Section I. Reserve Parameters

- (1) Sufficient cash and securities should be kept on hand to:
 - a. At a minimum, fund ninety (90) days of operational expenses (excluding capital expenses);



- b. Above the minimum, and up to a maximum, maintain stable and predictable rates and charges, and mitigate unplanned capital expenditures;
- c. Above the maximum, mitigate increases in rates.

Section II. Reserve Calculations

(1) Target Minimum

- a. The Target Minimum reserve should be the fund balance as of September 30 of each year, equal to twenty-five percent (25%) of the fund's operational expenses for that year closing on September 30, excluding capital expenditures.

(2) Target Maximum

- a. The Target Maximum reserve shall comprise the sum of the Target Minimum and the following additional amounts, based on the budget closing on September 30.
 - i. A Rate Stabilization Reserve of an amount equal to five-percent (5%) of projected volumetric revenues;
 - ii. An Emergency Capital Reserve of an amount equal to an index of capital project costs, based on a rolling three (3) year average of those indexed costs from the immediately prior three (3) fiscal years.

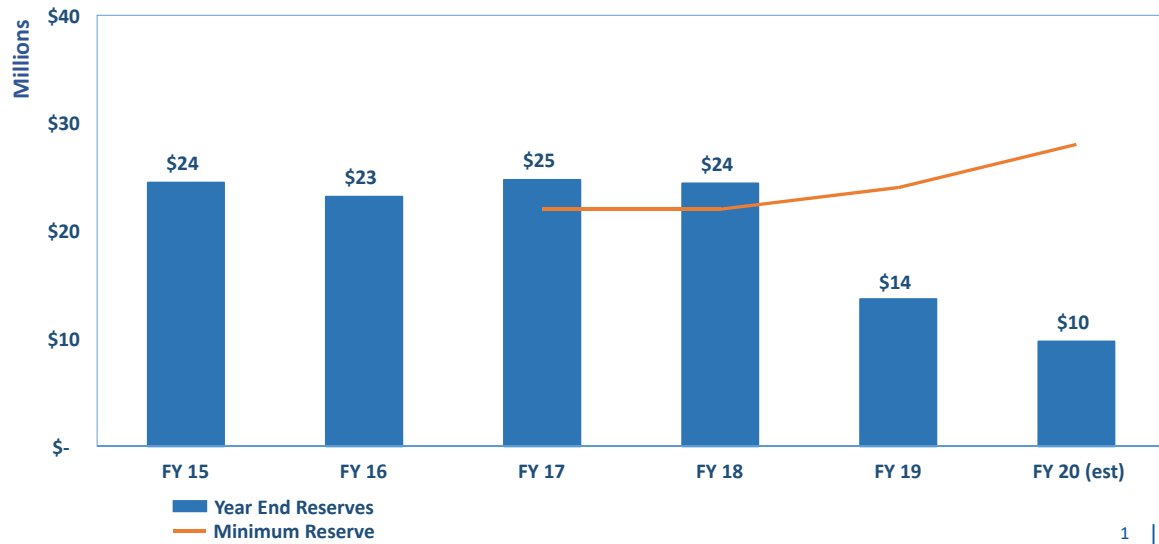
Section III. Principal Purposes of Reserve Funds

- (1) Below the Target Minimum, the principal use of these reserve funds should be to mitigate against an unplanned temporary loss of revenue, or an increase in costs.
- (2) Above the Target Minimum and below the Target Maximum, the principal use of these reserve funds is to:
 - a. Maintain stable and predictable rates and charges through the use of reserve amounts equal to the Rate Stabilization Reserve;
 - b. Mitigate unplanned emergency capital expenditures through the use of reserve amounts equal to the Emergency Capital Reserve
- (3) Above the Target Maximum, the principal use of these reserve funds is to mitigate increases in rates and charges.

Notwithstanding the fund parameters, targets and principal purposes listed above, the Board of Water Commissioners may direct the use of funds for any lawful purpose, consistent with its powers and duties established under the Long Beach City Charter.

ADOPTED: August 18, 2016

Water Fund Year End Reserve History



Sewer Fund Year End Reserve History



5-Yr Water Fund Projected Ending Reserves

