



FINANCIAL POLICIES

The District's budget is closely aligned with the financial policies established. These policies serve to strengthen the current and long-term financial health of the District and are visited, at a minimum, on an annual basis to ensure they represent the most current and realistic framework for decision making.

POLICY 1: Restricted Cash

The District will maintain cash, to be used solely for its intended purpose, in an amount equal to funds restricted by legal requirements, contractual agreements and trustee requirements.

The District is limited in the means in which it may use certain cash ("restricted cash") due to legal and contractual requirements.

Other reserves/funds are unrestricted; they are established by Board direction to address potential needs as defined in the policies that follow. Unrestricted reserves may be adjusted in amount and directed for needs other than those initially contemplated, but funds described in Policy 7 for replacement/major maintenance must be used only for needs of the enterprise from which the funds were generated.

AB 1600 requires that development impact fees ("capacity fees") and interest generated from such can only be used for capital projects related to expansion, not replacement or enhancement. These funds are maintained separately in the appropriate enterprise **Construction Fund**.

Vested sick leave results from contractual obligations with employees. Cash is maintained in an amount equal to the vested sick leave obligation. Upon voluntary termination, retirement or death of an employee, the vested sick leave accrual is paid to the employee or their beneficiary.

Trust funds hold cash that has been deposited with the District for future obligations that may or may not occur. These obligations include developer/customer deposits and pre-funding by Triunfo Water and Sanitation District for their portion of JPA capital projects and 3 months operating expense.

A **Debt covenant** is a legally binding condition or requirement included in a debt agreement — such as a bond indenture, loan agreement, or other financing arrangement — that the borrower (the District) must adhere to for the life of the debt obligation. Debt covenants are designed to protect lenders and investors by establishing specific financial, operational, or reporting requirements. Common examples include maintaining minimum debt service coverage ratios, timely transfer of debt service payments to a trustee or paying agent, compliance with insurance requirements, and adherence to rate covenants that ensure sufficient revenues are generated to service outstanding debt. The District shall comply fully with all terms, conditions, and requirements of debt covenants for the duration of the applicable debt obligation. Compliance with debt covenants will be monitored and verified on an ongoing basis by the Deputy Treasurer, Director of Finance and Technology, and Finance Manager, consistent with the District's Debt Management Policy.

POLICY 2: Balanced Budget/Annual Board Review

The District will maintain a balanced operating budget for each enterprise fund with annual revenues equal to or greater than annual expenditures. However, the Board may determine that reserves be used to augment operating revenues under certain circumstances. The Board will review annually the working capital, cash, projected income and debt coverage levels to determine the adequacy of each.

If in any given fiscal year operating expenditures will exceed the operating revenue projected in the same year, causing a budget imbalance, cost cutting measures or revenue enhancements may be addressed before spending *reserves* to support ongoing operations. Cost cutting measures may include reductions in capital improvement projects, reductions in staff or reductions in expenditures for materials, services, or supplies. Such expenditure or staff reductions may result in reduced service levels. Alternatively, the Board may determine that circumstances warrant taking money from reserves to offset expenses larger than operating income.

At year-end, net revenue after expenses ("income") will be transferred to funds as directed by the Board, subject to any legal limitations on the Board's discretion. Funds balances are addressed annually as part of the budgeting process.

Available cash in the various funds reflects the District's ability to pay current bills and commitments, as well as underwriting the risk level the District is willing to accept.

**POLICY 3: Rate Stabilization Fund**

The District will maintain a Rate Stabilization Fund in an amount of \$8 million to maintain rate stability for customers in times when short or mid-term cash needs are volatile.

The District's potable water operating revenue *can vary greatly* based on climatic conditions. During periods of heavy rain, potable water revenue can decrease significantly. During significantly hot, dry periods, a reverse trend is seen wherein significant revenue is generated by higher sales than average. During periods of extended water shortage the impact on potable water revenue can be similar to the effect of heavy rain. Rather than raising water rates on a temporary basis to cover expenses during these times, the Rate Stabilization Fund (RSF) allows the Board to balance operating revenue to operating expenses through use of the reserve.

POLICY 4: Financing Alternatives

As part of the biennial Infrastructure Investment Plan (IIP) compilation process, the District will examine options available to pay for the proposed projects, including the option of financing.

Biennially the Board reviews needs for capital improvements and major maintenance over the upcoming ten years. Expenditures are projected on an annual basis, but the available fund balance for replacement or major maintenance is not always adequate to cover the need when it arises. The Board favors a pay-as-you-go program for the IIP program, but the District may not have funds available to pay for projects in any given year, or projects anticipated in future years may be of a type that would be difficult to finance. Such considerations may dictate financing as the preferred alternative. If a project requires substantial expenditures over several years and interest rates are low, the District may consider issuing financing in the near-term and reserve the available funds for investment when interest rates are yielding a higher return.

The Board has determined as a policy principle that rates should be set to meet a minimum debt-service coverage ratio of 1.50. A debt service coverage ratio of 1.50 offers the District a higher probability of earning a more favorable rating from credit agencies in alignment with the District's Strategic Plan Objective No. 5: "Achieve a high credit rating for LVMWD's three enterprises". A higher credit rating can result in reduced debt service payments over time and a corresponding benefit to ratepayers through lower costs.

POLICY 5: Fiscal Impact Analysis

Staff shall prepare a fiscal impact analysis for each budget appropriation request not included as part of the Annual Budget. Available fund balances are intended to be appropriated only for "one-time" nonrecurring expenditures not covered by the current annual budget.

When non-budgeted items are brought before the Board for consideration, the resulting fiscal impact will be analyzed. The Board requires all requests for new or supplemental budget appropriations to be accompanied by a fiscal impact statement including:

- Amount of funds requested
- Source of funds requested
 - New revenue
 - Reallocation of existing appropriations
 - Grants
- Impact of Request
 - New rates or fees
 - Decrease in one activity to support another activity
 - Effect on fund balance

POLICY 6: Operating Funds Cash Requirement

The District will maintain cash (net of restricted cash) in the Operations Fund of each enterprise equivalent to 25% of the operating budget.

An available cash reserve to cover operating shortfalls is a prudent management practice to be used for both short term cash flow and contingency planning for unforeseen situations. Examples include:



- Unexpected increases in costs or declines in revenues
- Legislative or judicial mandate to provide a new or expanded service or program
- Natural disaster emergencies which exceed the Emergency/Insurance Fund
- One-time Board approved non-capital expenditures or capital need if the IIP fund is inadequate
- Interruptions in billing process to customers

If such unforeseen circumstances occur, staff will present the Board with options for curing the deficiency, including use of this fund.

POLICY 7: Replacement and Major Maintenance Fund by Enterprise (potable water, sanitation, recycled water)

Each of the District's three enterprises will maintain a Replacement Fund for major maintenance, replacement and improvement of facilities and infrastructure not related to growth. The source of funds will be current user fees. Each Replacement Fund will maintain cash levels equal to the most current three- years of actual depreciation expense. If a replacement fund's cash target is exceeded, the Board will consider using the excess for prepayment of outstanding debt, if appropriate.

Prudent stewardship of assets requires that maintenance be performed to postpone or decelerate the aging process. As a general rule, maintenance costs for an item become more expensive as the asset ages. Also, changes in technology could result in replacing an asset with one which provides lower operating expenses or greater revenues or replacement of assets may be required due to changes in regulatory standards.

Major maintenance and replacement are on-going operating costs that should be paid for by user fees. Appropriate cash levels within a Replacement Fund enables the District to pay for planned or unplanned projects in any given year.

The water stand-by charge is levied against developed and undeveloped land and is dedicated to maintenance and replacement of potable water infrastructure and facilities. Recognizing that undeveloped land has added value because of the availability of potable water service, these owners have a vested interest in seeing the system maintained.

POLICY 8: New Construction Fund by Enterprise

The District will pay for expansion or new facilities necessitated by growth from capacity fees collected from new development and maintained in the appropriate enterprise's Construction Fund.

Current ratepayers should not be burdened with costs associated with growth due to new development. The fair share of cost of expansion will be borne by the developers through capacity fees.

The District has a master plan that identifies projected infrastructure and facility needs through build-out and is used as the basis for determining capacity fees. Capacity fees may be pledged for debt service payments, if the need for the expansion occurs before adequate capacity fees can be collected.

Prepaid capacity fees not used are subject to refund with interest, provided the developer has not started his project and the District has not begun construction on the system.

POLICY 9: Internal Service Replacement Fund for Buildings, Vehicles and Equipment

The Internal Service Fund will have revenues (i.e. user charges, interest income and all other income) sufficient to meet operating expenses, maintenance costs, depreciation expense, and inflation factor for other needs not exclusive to one of the three enterprises.

The District uses the internal service fund as an internal accounting and budget mechanism to equitably distribute general operating costs such as for buildings, vehicle and equipment replacement and maintenance costs among District user programs and to assure that adequate funding is on hand to replace or maintain these assets.

POLICY 10: Emergency/Insurance Fund

The District will maintain an Emergency/Insurance Fund to cover claims not covered by insurance, fines and penalties imposed by regulatory agencies and disaster repairs and expenses. The target for this Fund is two percent (2%) of the total value of capital assets, including LVMWD's share of the Joint Power's Authority capital assets. The Board must approve any expenditure from this Fund. Self-insurance retentions will be paid out of operating budgets.

To protect the investment in assets and to ensure continuation of District operations, the District purchases insurance for general liability, property and worker's compensation. The District has the responsibility to pay for deductibles or self-insurance retentions. Also, the District has some risks that may not be economically or actually insured, such as certain types of pollution (odor), flood, and mold. Also, the insurance on District's sewer lines or water lines is limited to the cost of emergency clean-up and does not include the cost of repairing the failure. Because of this potential exposure, the District has established the Emergency/Insurance Fund at two- percent of the value of capital assets less the value of land, which amount will be determined annually after the audit. The Fund can only be used when approved by the Board.

This policy is in line with our experience in having to pay damages that are not covered by insurance and cover expenses that are not reimbursed on a timely basis by the Federal Emergency Management Agency (FEMA). Like the Rate Stabilization Fund, not having the Emergency/Insurance Fund available in the event of a disaster could significantly impact the District's cash flow and possibly impact future utility rates during troublesome times.

POLICY 11: Designation of Net Position in Excess of Reserve Targets

When operating reserves for an enterprise fund exceed the amounts required by these Financial Policies, the Board may internally designate unrestricted net position in excess of the established reserve balance targets for specific purposes, including the Pure Water Project Las Virgenes-Triunfo.

The Board has a policy favoring pay-as-you-go for capital projects. The District considers cash on hand in excess of the reserve levels established by Policy 6 as available for capital or any one-time project. When operating reserves exceed the targets established by these Financial Policies, the Board may internally designate unrestricted net position for specific purposes, including the Pure Water Project Las Virgenes-Triunfo or pay-as-you-go capital projects. Such designations are internal management decisions, do not constitute a formal governmental accounting standards board (GASB) net position classification, and may be modified or rescinded by Board action at any time.