



# Memorandum

## MONTEREY REGIONAL WASTE MANAGEMENT DISTRICT

DATE: June 13, 2022  
 TO: General Manager  
 FROM: Director of Engineering and Compliance  
 SUBJECT: Approval of New Reserve Policy

**RECOMMENDATION:** That the Board Approve the New Reserve Policy.

### **BACKGROUND**

Reserves are essential to ensuring fiscal responsibility, a key organizational goal of the District. The Reserves can also provide the savings necessary to balance budgets during periods of fiscal constraint, allow for emergency preparedness, assist in maintaining stable solid waste service rates, provide for a well-maintained infrastructure, and demonstrate a commitment to investing in the future. Maintaining reserves can support the organization's credit rating and periodic debt borrowing capacity. The Government Finance Officers Association recommends that organizations adopt a policy governing the amount of resources to be held in reserve and the conditions under which those reserves can be used. A reserve policy is central to a strategic, long-term approach to financial management for the District.

In November 2002, the Board adopted a Reserve Policy (attached) which stipulated that the District maintain a minimum cash reserve (Operating Reserve) designed to serve as a rainy-day fund in the event that revenue flow or operating expenses are impacted by unexpected occurrences. In February 2009 this policy was amended to establish a minimum balance requirement for the Operating Reserve of 20%. Since the time that this policy was adopted, a reserve balance has been designated each year during the budget process.

Staff supports continuation of the current cash reserve and recommends updating the policy statement as it contains descriptions of conditions that are no longer present at the District and lacks certain elements that could add clarity to the policy's administration. In addition, staff recommends the inclusion of both Capital Equipment and Capital Infrastructure Reserve funds to the new Reserve Policy to address the funding of these major capital replacement cost items. A draft of the new reserve policy was discussed with the Finance Committee at their June 2022 meeting and the committee provided guidance to the staff to finalize the new policy and present it to the Board for their review and consideration for approval.

### **DISCUSSION**

The District has maintained an Annual Operating Reserve for many years as a standard part of the fiscal year budget process. The Board originally approved the Operating Reserve requirement for the fiscal year budget to be 25% of cash operating expenses for the fiscal year. That was subsequently changed in practice to be a 20% requirement; or about 2.5 months of operations spending. The Draft Reserve Policy attached would codify the use of the 20% of cash operating expenses for the fiscal year as the Operating Reserve.

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During strategic planning activities conducted over the past few years, staff and the Board have discussed the value of adopting a capital reserve policy. The purpose of such a policy would be to designate funds on an ongoing basis that are dedicated to funding future capital investment. The main benefits of doing so are: 1) increasing the likelihood funds are available for investment when needed, and 2) spreading the cost of replacing assets over the life of the assets as they are used or depleted. Sequestering funds in this way will help the District pursue a 'pay-as-you-go' investment practice, thereby reducing reliance on debt or the imposition of extreme fee increases during times of high capital investment.

Policy considerations of adding capital reserves include, but are not limited to, the following:

- The existence of the current operating cash reserve has, from time to time, 'forced' the District to adjust the budget to ensure it generates adequate cash to fund the reserve. Adding capital reserves will exert further pressure on cash generation and may result in the need to increase fees at times when otherwise it would not have been necessary for cash flow purposes as evidenced by past practice.
- In past years, some special districts have been criticized for maintaining large reserves because they have not adequately communicated their purpose and the process for utilizing them. The District would need to be mindful of the need to avoid a similar negative public reaction to the accumulation of undesignated cash balances.
- A capital reserve policy will require the Board to determine either a target reserve balance or a funding allocation on an annual basis and contribute toward that balance. Because of the District's diversity of capital projects and the sometimes very high level of spending, establishing a methodology to administer the reserve can be challenging. However, the annual review process by staff and the Board allows for routine review, consideration, and maintenance of the capital reserves.

Based on discussions with the Board, staff has also developed draft guidance for a couple capital expenditure reserves. The District's recycling and disposal operations are very capital-intensive and can result in significant swings from year to year in the funds required for capital investment. The District has historically funded capital spending using cash generated from operations and, from time-to-time, through the issuance of debt. Capital reserves are defined as designated funds set aside by action of the Board of Directors. The reserves can be reviewed and adjusted in response to internal and external changes upon approval of the Board. Nonetheless, staff's recommendation is to set aside reserve funds for qualified future capital repairs, maintenance, replacement and enhancement of the District's infrastructure in alignment with the District's strategic goal of delivering solid waste management services in a financially responsible and sustainable manner in the interests of the community and environment. The attached Reserve Policy presents both a Capital Equipment Reserve and a Capital Infrastructure Reserve in addition to the Operating Reserve. Separate capital reserves are proposed due to differences in asset life, regularity of expenditures or lack thereof, and variability of the expenditure from year-to-year.

## **FINANCIAL IMPACT**

Updating the existing Reserve Policy results in no change to the District's financial position. Establishing new capital reserves would result in a more accurate representation of the true cost of District operations. Successful implementation of these reserves could have the effect of reducing the District's reliance on debt or the use of unusually high fee increases during times of heavy capital spending. Note that the addition of this new reserve policy specifically for capital investments may have an impact on the frequency of the routine rate setting process as it would recover more cost of operations than has historically been done.

## **STRATEGIC PLAN**

The new Reserve Policy is consistent with the District's stewardship responsibilities and all five pillars of sustainability. Updating the existing Reserve Policy and adopting new capital reserves in addition to operating reserve will assist the District in planning and fulfilling its commitment to providing cost-effective and efficient public services to the communities it serves.

## **RECOMMENDATION**

That the Board approve the new Reserve Policy (June 2022).



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Guy R. Petraborg, P.E.

### Attachments:

- Reserve Policy adopted November 2002 (amended February 2009)
- New Reserve Policy – June 2022



# MONTEREY REGIONAL WASTE MANAGEMENT DISTRICT

## **RESERVE POLICY**

*Adopted by Board of Directors on \_\_\_\_\_, 2022*

This Policy replaces the previous Board approved policy of November 2002 as amended in February 2009.

Reserves are essential to ensuring fiscal responsibility, a key organizational goal of the District. They can also provide the savings necessary to balance budgets during periods of fiscal constraint, allow for emergency preparedness, assist in maintaining stable solid waste service rates, provide for a well-maintained infrastructure, and demonstrate a commitment to investing in the future. The Government Finance Officers Association recommends adopting a policy governing the amount of resources to be held in reserve and conditions under which those reserves can be used. A reserve policy is central to a strategic, long-term approach to financial management.

This Reserve Policy defines that the District maintains reserves in three designated categories: an Operating Reserve, a Capital Equipment Reserve, and a Capital Infrastructure Reserve. These reserves are described below and are considered “unrestricted” funds meaning that they are not encumbered by a third party and can be used for the District based on Board approval of use. Note that the general purpose of a reserve policy is to establish reserve funds to help meet known and estimated future obligations or unknown events causing economic or physical disruption. This policy establishes the level of fund balances and the process whereby funds may be spent. The source of all District funds are tip fee revenue, commodity revenue, and service revenue.

This Policy will be reviewed annually during the budget process to ensure conformance with the District’s goals and objectives and compliance with any changes in regulations or standards.

After meeting all normal operating and debt service obligations of the District, the following reserve accounts shall be funded in the order of priority as shown below:

### **1. Operating Reserve**

#### **Purpose**

The purpose of the District’s Operating Reserve is to ensure that the District will at all times have sufficient funding available to meet annual operating costs. The Operating Reserve serves as a rainy-day fund in the event that revenue or operating expenses are impacted by unexpected occurrences. Operating Reserves will be managed in a manner that allows the District to fund expenses consistent with the annually updated Budget. Adequate reserves, along with other sound financial policies, provide financial flexibility in the event of unanticipated expenditures or revenue fluctuations.

#### **Definitions and Goals**

The Operating Reserve is defined as the designated funds set aside by action of the Board of Directors. The Operating Reserve serves a dynamic role and will be reviewed and adjusted in response to internal and external changes.

The District’s goal is to replenish funds used within twelve months to restore the Operating Reserve balance to the target minimum amount. To the extent possible, the District will control operating expenditures and direct budget surpluses to replenish the reserve balance.

### **Target Reserve Balance**

The minimum Operating Reserve balance target is 20% of cash operating expenses, equal to approximately 2.5 months of spending. Cash operating expenses are outlined in the annual budget, identified as all operating expenses less routine non-cash expenses. In a typical year, depreciation & amortization and closure/post closure costs are the largest non-cash operating expenses in the budget.

The target balance will be calculated annually as part of the annual budget process. The Board may choose to set a balance amount above or below the calculated target.

### **Accounting for Reserve**

The Operating Reserve will be recorded in the financial records as a Board designated operating reserve. The Reserve will be funded in cash or cash equivalent funds which will be commingled with the general cash and investment accounts of the District. All investment accounts will be managed in accordance with the District's Investment Policy, which is reviewed and approved annually.

### **Funding of Reserve**

The Operating Reserve will be funded with surplus unrestricted cash generated from operations. The Board of Directors may from time to time direct that a specific source of revenue be set aside for the Operating Reserve.

### **Use of Funds**

The use of Operating Reserve funds will be for unanticipated operating costs or revenue shortfalls and for unplanned repairs, improvements and fixed asset acquisitions. Staff will identify the need to access the reserves and will submit written requests to the Board at a public meeting. Requests for reserve funds will include the amount of funds needed, confirmation that the use is consistent with the purpose of the reserve funds as described in this Policy, and the reason for the shortfall. The funds can only be used with specific Board approval.

A schedule of approved reserve funds requests will be maintained by the District Accounting Manager.

## **2. Capital Equipment Reserve**

### **Purpose**

The District's operations are very capital-intensive and can result in significant swings from year to year in the funds required for capital investment. The District has historically funded capital spending using cash generated from operations and, at times, through the use of debt. The purpose of the District's Capital Equipment Reserve is to ensure that cash is available to fund the repair, maintenance, or replacement of the District's mobile equipment most routinely used and replaced capital assets. At this time, the Capital Equipment Reserve is not designed to set aside funds for all future capital equipment investments. Establishing a Capital Equipment Reserve allows the cost of certain capital mobile equipment expenditures to be spread over time rather than impacting just the budget year in which the assets necessary to operate the District are repaired or replaced.

## **Definitions and Goals**

The Capital Equipment Reserve is defined as designated funds set aside by action of the Board of Directors. The reserve can be reviewed and adjusted in response to internal and external changes upon approval of the Board.

The District's goal is to set aside funds for qualified future capital mobile equipment repairs, maintenance, replacement and enhancement of the District's equipment in alignment with the District's strategic goal of delivering solid waste management services in a financially responsible and sustainable manner.

## **Target Reserve Balance**

The target balance of the Capital Equipment Reserve will be calculated based on the following methodology:

1. Assets subject to Capital Equipment Reserve contribution: This reserve is designed to provide funding for the heavy mobile equipment used extensively in District operations. This includes dozers, compactors large trucks and other rolling stock identified as Mobile Equipment in the annual Capital Equipment Spending Plan that is included in the budget. Reserves will be established for all such equipment costing \$100,000 or more.
2. Initial Capital Equipment Reserve balance calculation: Develop a schedule of qualifying Mobile Equipment, including estimated replacement cost and years remaining to replacement. Initial reserve balance will be calculated as the total replacement cost times the percentage of life consumed. Example: a 5-year old dozer with a 10 year life and \$400,000 replacement cost would result in a calculated initial reserve balance of \$200,000.
3. Annual update of target balance: Each year the reserve balance is increased by the sum of all annual contributions to the reserve and decreased by the use of reserve funds. Annual contributions are calculated by dividing the total replacement cost of an asset by its estimated useful life. Example: a dozer with a 10-year life and \$400,000 replacement cost would result in a \$40,000 annual contribution to the Capital Equipment Reserve. The balance would be reduced by the amounts spent on scheduled mobile equipment replacements in the year.

The target balance will be calculated annually as part of the annual budget process and maintained in a Capital Equipment Reserve balance schedule. The Board may choose to set a balance amount above or below the calculated target.

## **Accounting for Reserves**

The Capital Equipment Reserve will be recorded in the financial records as a Board designated operating and capital improvement reserve. The Capital Equipment Reserve will be funded in cash or cash equivalent funds which will be commingled with the general cash and investment accounts of the District. All investment accounts will be in accordance with the District's Investment Policy, which is reviewed and approved annually.

## **Funding of Reserves**

The Capital Equipment Reserve will be funded with surplus unrestricted cash generated from operations. The Board of Directors may from time to time direct that a specific source of revenue be set aside for the Capital Equipment Reserve.

## **Use of Funds**

The use of the Capital Equipment Reserve will be for the maintenance, repair or replacement of qualified capital mobile equipment assets unless otherwise specifically directed in writing by Board approval. Staff will identify the need to access the reserves and will submit written requests to the Board at a public meeting. The funds can only be used with specific Board approval. Reserve fund requests will include the amount of funds needed, confirmation that the use is consistent with the purpose of the reserve funds as described in this Policy, and a description of the capital asset. Use of Capital Equipment Reserve funds for another specific purpose may also be requested and approved by the Board during the budget process, at the discretion of the Board.

A schedule of approved reserve funds requests will be maintained by the District Accounting Manager.

### **3. Capital Infrastructure Reserve**

#### **Purpose**

The District's disposal and recycling operations are very capital-intensive and can result in significant swings from year to year in the funds required for capital investment. The District has historically funded capital spending using cash generated from operations and, at times, through the use of debt. The purpose of the District's Capital Infrastructure Reserve is to ensure that cash is available to fund new or replacement infrastructure and reduce the magnitude of debt associated with major infrastructure funding. At this time, the Capital Infrastructure Reserve is not designed to set aside funds for all future capital investments. Establishing a Capital Infrastructure Reserve allows the cost of certain capital expenditures to be spread over time rather than impacting just the budget year in which the infrastructure assets necessary to operate the District are constructed or replaced.

#### **Definitions and Goals**

The Capital Infrastructure Reserve is defined as designated funds set aside by action of the Board of Directors for capital infrastructure improvements. The reserve can be reviewed and adjusted in response to internal and external changes upon approval of the Board.

The District's goal is to set aside funds for qualified future capital infrastructure repairs, maintenance, replacement and enhancement of the District's infrastructure in alignment with the District's strategic goal of delivering solid waste management services in a financially responsible and sustainable manner.

#### **Target Reserve Balance**

The target balance of the Capital Infrastructure Reserve will be calculated based on the following methodology:

1. Assets subject to Capital Infrastructure Reserve contribution: This reserve is designed to provide funding for capital infrastructure required in District operations. This includes buildings, roads, landfill base liner systems, environmental control systems, waste processing facilities, fixed equipment, and other major infrastructure identified in the annual Capital Infrastructure Spending Plan that is included in the budget. Reserves will be established for all such infrastructure projects costing \$1,000,000 or more.

2. Initial Capital Infrastructure Reserve balance calculation: Develop a schedule of qualifying capital infrastructure from the fiscal year budget plan. Initial reserve balance will be calculated as the total capital infrastructure budget amount multiplied by ten percent (10%). Example: a fiscal year budgeted capital infrastructure amount of \$4,750,000 would result in a calculated initial reserve balance of \$475,000.
3. Annual update of target balance: Each year the reserve balance is increased by the sum of all annual contributions to the reserve and decreased by the use of any reserve funds. Annual contributions are calculated as the total capital infrastructure budget amount for that fiscal year multiplied by ten percent (10%). Example: a \$5,400,000 capital infrastructure budget cost would result in a \$540,000 annual contribution to the Capital Infrastructure Reserve. The balance would be reduced by any Board approved amounts withdrawn from the reserve account in the year.

The target balance will be calculated annually as part of the annual budget process and maintained in a Capital Infrastructure Reserve balance schedule. The Board may choose to set a balance amount above or below the calculated target, or by changing the ten percent contribution rate factor used herein.

### **Accounting for Reserves**

The Capital Infrastructure Reserve will be recorded in the financial records as a Board designated capital infrastructure improvement reserve. The Capital Infrastructure Reserve will be funded in cash or cash equivalent funds which will be commingled with the general cash and investment accounts of the District. All investment accounts will be in accordance with the District's Investment Policy, which is reviewed and approved annually.

### **Funding of Reserves**

The Capital Infrastructure Reserve will be funded with surplus unrestricted cash generated from operations. The Board of Directors may from time to time direct that a specific source of revenue be set aside for the Capital Infrastructure Reserve.

### **Use of Funds**

The use of the Capital Infrastructure Reserve will be for the capital maintenance, repair or replacement of qualified capital infrastructure assets. Staff will identify the need to access the reserves and will submit written requests to the Board at a public meeting. The funds can only be used with specific Board approval. Reserve fund requests will include the amount of funds needed, confirmation that the use is consistent with the purpose of the reserve funds as described in this Policy, and a description of the capital asset. Use of Capital Infrastructure Reserve funds for another specific purpose may also be requested and approved by the Board during the budget process, at the discretion of the Board.

A schedule of approved reserve funds requests will be maintained by the District Accounting Manager.





# Monterey Regional Waste Management District

## **RESERVE POLICY**

Adopted November 2002 (amended February 2009 to 20%)

### **Policy**

The District has a reliable cash flow and a solid historical basis for reasonably accurate revenue projections. Future expenditures are less predictable especially in later years. Staff's five-year financial projections, presented as part of the annual budget, will provide staff and the Board information to assess, and if needed, alter rate changes. Staff recommended and the Board adopted a minimum reserve policy of 90 days (25%) of operating cash.

### **Background**

The District has two types of reserves: Restricted Reserves and Unrestricted reserves. Restricted reserves are determined by legislative or contractual action. Unrestricted reserves can be designated by the board for a particular purpose, but for accounting reports are still considered unrestricted.

Since the mid 1990's, the District has been operating under an unwritten reserve policy of building up reserves and then using these reserves for operational and capital expenditures in lieu of rate increases. Determining prudent cash reserves generally takes into consideration the following:

- 1) anticipated monthly cash receipts
- 2) known cash obligations
- 3) contingencies for unexpected expenses

Almost half of the District's cash comes from just three customers: Waste Management, Monterey Disposal, and PG&E. While the disposal companies are not likely to stop paying their bills, and the delayed PG&E payments were for unusually high electricity prices, it is appropriate to take into consideration the possibility of a short delay in payments when determining a minimum cash reserve.

Future revenue projections in the District's budget use tonnage figures based on consistent historical trends. The annual budget for the District includes a projected five-year budget with accompanying cash flow analysis. This provides the District with the means to project cash obligations and provide for an annual analysis of reserve levels. Projected outlays may change and setting low minimal reserve levels may hinder timely implementation of worthwhile projects.

Tied to the issue of reserve balances are two financial ratios the District must maintain to comply with the terms of our bond. The first is that annual revenue minus maintenance and operating costs must equal or exceed 100% of annual debt service on the bond (plus any new bond debt service). The second ratio is very similar – annual revenues plus any necessary transfers from the rate stabilization fund must equal or exceed 125% of annual debt service on the bond (plus any new bond debt service). The impact of this is that even with a high reserve balance, we may need to raise rates for revenues to exceed operating and maintenance costs. This possibility is projected in advance with our 5-year budget.

Minimum cash reserves are usually presented as a percentage of annual operating expenditures. Percentages vary among jurisdictions but the majority seem to be between 15 and 25 percent. Standard & Poor's prefers to see enterprises like the District have 30 – 90 days (8% - 25%) of operating cash on hand.

While annual rate increases have a smaller annual impact on customers, unless jurisdictions pre-approve annual increases for the haulers, this becomes a major administrative burden for the haulers to annually apply to the jurisdiction for rate increases. Also, while many of the jurisdictions permit haulers to apply for a rate increase annually, based on cost of living increases, this is often not done to generate goodwill within the community and avoid the extensive administrative effort for a small increase. With annual tipping fee increases, the haulers will be forced to apply for the annual rate increases. A rate increase planned to last several years is administratively much simpler but does have a larger initial impact on customers.