VERNON PUBLIC UTILITIES

FINANCIAL RESERVES POLICY

AUGUST 2024

Executive Summary

The Vernon Public Utilities (VPU) Financial Reserves Policy (FRP) is designed to define overall cash reserve levels that are reasonable, prudent, and necessary to provide adequate liquidity to ensure the ongoing operations of VPU. The FRP will help to enhance not only VPU's long-term financial stability but also the ability of VPU to maintain competitive and affordable rates.

The FRP supports VPU's strategy to strive to achieve its goal of having one of the lowest electric rates in California by 2030.

VPU is subject to many types of risk that can be mitigated by having sufficient cash reserves to ensure adequate and reasonable liquidity. The major areas of risk are the risk that budgeted revenue is not realized, the risk of sudden increases in commodity costs (i.e., natural gas and power), the risk of a major equipment or utility asset failure, and the risk of unexpected increases in operating costs. These risks are defined in more detail within the FRP. The FRP also establishes funds to reduce the amount of debt that the utility would otherwise be required to issue to maintain or expand its capital infrastructure. The funds will also be used for additions and replacement of major electric utility assets.

The funds defined in the FRP, and the targeted balances of these funds are based upon rating agency guidelines, staff assessment of the probability of certain risks associated with the Electric Fund, historical volatility in revenues and expenses, and review and analysis by NewGen Strategies & Solutions, LLC. (NewGen), VPU's electric rate consultant.

The specific Reserve Funds to be established in this Policy include the following:

1. **Rate Stabilization Fund**
   a. Funded at an amount to help protect VPU's overall liquidity and includes Revenue Risks, Commodity Risks, and Counterparty Credit Risks. It is used to temporarily absorb permanent increases until decisions are made to adjust rates, if necessary. This type of fund avoids "rate shock" to customers.
2. **Operating Reserves Fund**
   a. Funded in an amount to ensure adequate liquidity to meet VPU's ongoing operations, including any unforeseen event(s), which are temporary increases.

3. **<u>Capital Reserve Fund</u>**
    a. Provides for future capital expenditure needs for planned capital improvement projects and provides a contingency for unexpected capital funding needs.

FINANCIAL RESERVES SUMMARY – ELECTRIC FUND

	Recommended Funding Levels by 2030 In Million ($)	
Reserve Type	**Minimum**	**Target**
Rate Stabilization Fund	$ 70.2	$ 135.5
Operating Reserves Fund	$ 26.9	$ 53.9
Capital Reserve Fund	$ 21.7	$ 65.1
Total Financial Reserves	**$ 118.8**	**$ 254.5**

The FRP also defines the specific events and uses of the type of reserve. It also defines a process and timeframe for replenishing each reserve type if it falls below the minimum requirements.

The FRP defines minimum and targeted levels of liquidity for each type of reserve. The FRP recognizes that there could be times when liquidity will fall short of targeted amounts due to the variance between budgeted and actual revenues and expenses. When the targeted levels cannot be realized, the FRP defines minimums for adequate liquidity and ensures the ongoing operations of the utility without significant financial degradation and potential customer rate shocks.

The FRP should be reviewed annually as a part of VPU's financial planning and budgeting process and more often as material changes in VPU's risk profile occur.

The following table represents the most recent ratings and Days Cash on Hand (DCOH), for SCPPA electric utilities that are comparable to Vernon Public Utilities.

	Moody's	S&P	Fitch	DCOH Unrestricted Cash As of June 30, 2023	DCOH with Unrestricted and Restricted Cash As of June 30, 2023
Anaheim Public Utilities	Aa3	AA-	AA-	78	370
Burbank Water and Power	Aa3	AA-	AAA	93	319
Glendale Water and Power	Aa3	A+	AA-	135	428
Imperial Irrigation District	Aa3	AA-		122	240
LADWP	Aa2	AA-	AA-	158	357
Pasadena Water and Power		AA	AA	510	614
Riverside Public Utilities		AA-	AA-	267	409
Vernon Public Utilities	Baa1	A-		282	365

I. INTRODUCTION

VPU's FRP is designed to identify prudent reserve levels to mitigate risk while promoting long-term financial stability. The FRP is not intended to create reserves for its own sake; instead, it is designed to ensure that VPU has adequate and reasonable reserve levels and to be able to provide its customers with utility rates that are competitive and as stable as reasonably possible.

The utility industry is subject to significant volatility and legislative and regulatory change. As a result, VPU will revisit the established reserve levels every year as a part of the financial planning and budgeting process. The FRP should be re-evaluated more often if there are material changes in VPU's risk exposures. The FRP is intended to provide guidelines that can impact budget, other policy, and decision-making issues, and to serve as a tool in promoting VPU's long-term financial and operating strategy. The FRP is not intended to be all-inclusive since there are several factors outside the FRP that can impact VPU's future rates, risk, and overall financial stability. Some risks and risk probabilities are so remote that it would not be prudent to have financial reserves.

As we know, there are competing objectives in developing a prudent FRP including the funding of the appropriate level of reserves. In developing the FRP, it is intended to recognize that there will be competing pressure to avoid rate increases while simultaneously funding reserves. Levelized rates will help VPU maintain its competitive position in the statewide utility industry to attract and retain a robust customer base. At the same time, funding reserves promote financial stability by mitigating operating, capital, and volatile energy market risks.

The FRP ensures that VPU will always have sufficient funding available to meet its operating, capital, energy resources, and emergency requirements. The FRP is an integral part of the VPU financial planning and rate-setting process. Compliance with the FRP will be reported by the Planning and Analysis Manager to the VPU General Manager as part of the financial planning, reporting, and budgeting process. The Planning and Analysis Manager will recommend to the VPU General Manager necessary actions, including the redirection of reserves, as needed.

II. PURPOSE OF FINANCIAL RESERVES FOR UTILITIES

Publicly Owned Utilities, such as VPU are cash-driven utilities and ensure short and long-term financial stability by maintaining enough cash after operating expenses to meet debt service, support infrastructure investment, provide working capital, and fund other cash needs. In addition, utilities such as VPU are subject to a broad array of risks, which vary from small temporary business disruptions to substantial events, which could result in significant adverse financial consequences for VPU and its customers. Financial reserves help VPU mitigate these risks and reduce volatility in financial performance and customer impacts. Industry practice shows that the proper FRP can address both the operating cash needs and risk mitigation opportunities facing utilities.

Cash reserve balances are also a critical element in reviewing a municipal utility's financial health by rating agencies such as Standard and Poor's (S&P) and Moody's. These reviews lead to the agency providing a rating on the creditworthiness of the utility which, in turn, affects the cost of borrowing for the municipal utility. VPU utilizes S&P and Moody's for the credit ratings reviews and both agencies have publicly available rating methodologies that address desired cash reserve levels that support certain ratings (i.e., S&P: AAA or Moody's: Aaa). As the ratings for a utility increase (i.e., going from a "B" rating to an "A" rating), the cost of issuing debt decreases, thus pursuing higher ratings will lead to lower costs for customers. Based on Moody's and S&P's ratings frameworks and methodologies, typical cash liquidity metrics and cash reserve balances for "A" rated utilities range from 90-250 days of cash on hand with higher-rated utilities typically closer to the higher end of the cash levels.

While rating agencies have published general guidelines for reserve levels, management understands the liquidity needs of its utility. We believe that the FRP meets the general guidance provided by the rating agencies. Within this framework, the specific cash reserve levels are determined by utility management. As part of the 2023 Electric Cost of Service Analysis and Rate Design Study, VPU and NewGen established minimum balances that are attainable and protect VPU due to the cyclical variation in monthly cash flows. The FRP has targeted reserve levels that are attainable over a period that will provide reassurance to bond investors, rating agencies, and customers that the utility will not have a liquidity shortfall.

Rating agencies also encourage utilities to specifically identify the reasons that each fund can be drawn upon and develop a plan for rebuilding the fund if it falls below the minimum levels identified in the reserve fund policy. The FRP meets these criteria and adds reporting criteria as well.

III. AREAS OF RISK

Utilities such as VPU are subject to a broad array of risks, which vary from small temporary business disruptions to substantial events, which could result in significant adverse financial consequences to VPU and its customers. The FRP identifies and responds to the larger, broader areas of risk that are not likely to be addressed by either insurance or other VPU policies. These broader risks are then aggregated to determine an overall risk profile and corresponding reserve levels.

A. **Revenue-related risks** arise primarily from reduced demand or loss of a customer(s), which may require VPU to spread its costs over a smaller customer load profile or revenue base. Situations can also come from events, such as weather due to climate change, or business issues of a long duration, such as a protracted economic slowdown or recession.

B. **Commodity risks** may come from circumstances where there is a failure in VPU's power supply because MGS may be shut down for an unplanned outage, which may require VPU to purchase replacement power. Volatile natural gas or energy commodity costs that are unhedged will also impact VPU's budget and may result in higher-than-planned costs. VPU may also have a potential risk due to the default of credit counterparties.

C. **Operating risks** reflect the financial impact of other events and circumstances that can affect VPU's operating budget and subsequently impact cash flow requirements. The objective of setting aside funds against operating exposures is to provide sufficient working capital to insulate the utility and its customers from temporary and other short-term events that can adversely impact VPU.

   Operational events may include:

   1. Impacts of new environmental regulations (which can impact either VPU's operating or capital budgets).

   2. Unexpected increases in the operating budget (such as a large claim, or the cost of a major repair or replacement of an asset, especially MGS).

   3. Catastrophic events including earthquakes, droughts, or other climate-related risks.

IV. RESERVE FUND TYPES

The FRP identifies desired cash reserve levels for operations and responds to the larger, broader areas of risk that are not likely to be addressed by either insurance or other VPU policies. These desired operating cash levels and broader risks are then aggregated to determine an overall risk profile and corresponding reserve levels. These cash levels support an improved credit rating and result in a stabilizing effect on rates for VPU.

1. **Rate Stabilization Fund (RSF)**

   a) **Revenue-related risks** arise primarily from reduced demand or loss of a customer(s), which requires VPU to spread its costs over a smaller customer load profile or revenue base. Situations can come from short-term events or there can be business issues of a longer duration, such as a protracted economic slowdown or recession.

      Guideline for Revenue Exposure:

      Minimum: 90 Days of revenue loss**: $37.4 million**

      Target: 180 Days of revenue loss**: $74.9 million**

   b) **Commodity risks** may come from circumstances where there is a risk due to costs associated with volatile or unhedged natural gas to meet demand or the default of credit counterparties. VPU also has risk exposure to its power supply costs if MGS may be shut down for a forced outage which requires VPU to purchase replacement power.

      Guidelines for Natural Gas Exposure:

      Minimum: 90 Days of Natural Gas Expenses: **$6.0 million**

      Target: 180 Days of Natural Gas Expenses: **$12.1 million**

      Guidelines for Replacement Power Exposure:

      Minimum: 90 Days of Market Purchases: **$19.3 million**

      Target: 180 Days of Market Purchases: **$38.5 million**

   c) **Counterparty Credit Risk** may come from the potential default of a counterparty. The following guidelines are based on Class II medium-risk counterparties with a Maximum Credit Exposure of $10 million and a term not to exceed thirty-six (36) months.

      Guidelines for Counterparty Credit Default:

Minimum: **$7.5 million** (75% of Maximum Credit Exposure of $10 million for medium-risk counterparties as outlined in the Energy Risk Management Policy)
Target: **$10.0 million** (100% of Maximum Credit Exposure of $10 million for medium-risk counterparties as outlined in the Energy Risk Management Policy)

2. Operating Reserves (Working Capital)

These risks reflect the fiscal impact of other events and circumstances which can affect VPU's operating budget and subsequently its cash flow. The objective of setting aside funds against operating exposures is to provide sufficient working capital to insulate the utility and its customers from temporary and other short-term events that can adversely impact VPU and customer rates.

This category of reserves allows VPU to respond to risk in other areas:

- Emergencies
- Insurance risk management
- Enterprise risk management
- Regulatory compliance
- Climate Change Risk

Guidelines for Working Capital Exposure:

Minimum: 90 Days of O&M expenses less Natural Gas and Energy Market Purchases: **$26.9 million**

Target: 180 Days of O&M expenses less Natural Gas and Energy Market Purchases: **$53.9 million**

3. Capital Reserve Fund

This fund provides for future capital expenditure needs for planned capital improvement projects and provides a contingency for unexpected capital funding needs. By using this pay-as-you-go funding method, VPU will reduce additional debt for its capital expenditures. This effectively lowers VPU's fixed costs by the amount of the avoided debt service obligations for capital expenditures.

Guidelines for the Capital Reserve Fund:

Minimum: One year or **$21.7 million** of the Electric Fund Five-Year Capital Plan

Target: Three years or **$65.1 million** of the Electric Fund Five-Year Capital Plan

V. FUNDING STRATEGY

A. Purpose

The purpose of this section is to develop a more comprehensive funding plan for the targeted reserve levels. Furthermore, the FRP establishes the following funding priority from existing and future cash sources.

1. To meet the targeted level of reserves in the Operating Reserves Fund (Working Capital);

2. To meet the targeted level of reserves in the Rate Stabilization Fund; and

3. To meet the targeted level of reserves in the Capital Reserve Fund.

Settlements, fees, charges, etc. that are designated for specific uses should be accounted for separately and are not subject to the funding priority.

B. VPU's Financial Reserves can be funded by:

1. Cash balances and the Expense Stabilization Fund (ESF). Any excess Operating Reserves (Working Capital) as determined by the VPU Planning and Analysis Manager will follow the strategy outlined in Section V(A), unless the VPU Planning and Analysis Manager provides an alternative recommendation, including transfers from the ESF to other reserve funds, to the VPU General Manager, which may be implemented.

2. Transfers that are included in VPU's most recent Cost of Service and Rate Design study. These transfers will follow the funding priority as outlined in Section V(A), unless the VPU Planning and Analysis Manager provides an alternative recommendation to the VPU General Manager, which may be implemented.

3. Non-recurring sources of funds (for example, litigation settlements). These transfers will follow the funding priority as outlined in Section V(A) unless the VPU Planning and Analysis Manager provides an alternative recommendation to the VPU General Manager, which may be implemented.

C. Additional Recommendations:

In addition to the recommended reserve levels, the following strategy should apply to VPU's FRP.

1. Establish a replenishment plan for any withdrawals of one to three years, which may include rate adjustments, expense and capital reductions, or deferrals as recommended by the VPU Planning and Analysis Manager to the VPU General Manager.

2. Plan to revisit and re-evaluate the funding categories and recommended levels annually or as needed during the year depending on the financial and operating conditions of VPU. Since reserve targets are based on certain assumptions and risks for VPU, the FRP should be reevaluated more often if there are material changes in VPU's risk exposures.

3. Recognize that any reserve funding strategies are not a permanent means of addressing any short or long-term financial impacts. Those can only be addressed through the overall financial plan, which includes key financial metrics and financial reserves.

VI. REPORTING

A. General Requirements

VPU will continue its ongoing internal financial reporting, including:

1. Operating revenues and expenses;
2. Capital Expenditures;
3. Cash Flow; and
4. Funding and recommended levels of each type of financial reserve created by the FRP, funds created by bond ordinances, and other legally created funds.

B. Material Events

The VPU Planning and Analysis Manager will report to the VPU General Manager any material event(s) affecting operating revenues, operating expenses, and/or capital expenditures as soon as the event is deemed to be material with a recommendation regarding the action to be taken and the use of the appropriate financial reserves fund, if necessary.