



Cash Management Policy

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TITLE: Cash Management	REVISION DATE: November 25, 2020
SECTION: Finance	AUTHORITY: Board of Directors
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PURPOSE

To manage the retention of cash for specific purposes, to set targets for the specific use of cash and to define measures to safeguard cash for business investment purposes.

POLICY STATEMENT

Aquatera Utilities Inc. maintains cash as working capital for operating purposes, manages restricted cash accounts and cash set aside for future obligations, manages in-trust funds, manages cash invested in short and long term securities, defines the parameters for spending cash on capital expenditures including the level of debt to equity, sets targets for the payment of dividends to its shareholders and sets measures to safeguard cash for future business investment purposes.

RELATED INFORMATION

BALANCE SHEET:

Cash and Working Capital:

Cash is required for operating purposes. Cash, accounts receivable and inventory make up the current assets and accounts payable the current liability in calculating the current ratio for liquidity purposes. The current ratio target should be 2:1 where current liquid assets are twice the current liquid liabilities. Utility companies normally retain a level of cash to achieve a working capital target of 12.3% of annual sales (45 days). Aquatera should retain sufficient liquid cash to meet the greater of these two targets.

Restricted Cash:

Cash and cash equivalents are internally restricted for amounts received and for liabilities booked for future obligations of Aquatera. (See Restricted Cash Policy No. 304)

In Trust Funds:

Cash and cash equivalents are held in trust for amounts received as customer deposits for utility and bulk water accounts. (See In Trust Funds Policy No. 305)

Capex Savings:

Cash designated out of cash flow from operations is set aside in savings for future capex purposes.

Growth Fund Savings:

Cash designated out of cash flow from operations is set aside in savings for future investment in business growth initiatives.

Investments:

Cash is invested in short and long term securities to provide the greatest return while maintaining cash levels sufficient to cover restricted cash requirements. The balance of these funds increases with the receipt of cash and decreases with the funding of capital expenditures from these sources. (See Investment Policy No. 302)

Capital Assets:

Capital assets consist of Land, Engineering Structures, Buildings, Equipment, Fleet Vehicles and Mobile Equipment.

Capital Expenditures (Capex):

Cash generated from operations, some forms of internally restricted cash, government grants, developer contributions and cash secured through long term debt facilities are used to fund Capex. The primary sources of funding for Capex are debt and excess cash flow from operations.

Long Term Debt:

Cash is secured for Capex through negotiating the most economically advantageous debt or quasi-debt instruments through the bank or other sources.

Equity:

For cash management purposes Equity includes Common Shares, Preferred Shares and Retained Earnings.

Debt to Equity Ratio:

Aquatera's Unanimous Shareholder Agreement (USA) requires the company to limit its debt to a Debt: Equity Ratio of 1:1. These cash management strategies are in place to ensure the 1:1 target is met.

Retained Earnings:

Annual net income less dividends paid are retained in this account and form part of Equity. However, in the event of an asset transfer from a shareholder, a stock dividend is declared and preferred shares are issued for the total of the retained earnings in the proportion of the common shares held. For the purpose of the Debt: Equity ratio, stock dividends have no effect since both preferred shares and retained earnings are Equity.

Dividends:

Preferred stock dividends triggered by asset transfers result in the full distribution of retained earnings. Mandatory cash dividends of 5% of Class D preferred shares are paid annually.

Special (discretionary) cash dividends on all shares may be paid annually.

The USA limits the total annual dividends to 60% of net income.

NET INCOME:

International Financial Reporting Standards (IFRS):

Aquatera is required to report its net income under IFRS commencing January 1, 2012.

Net income may include in revenue amounts not previously included, offset partially by a recurring expense related to future landfill obligations. Cash dividends paid on preferred shares are deducted as interest expense in the calculation of net income. The USA sets the ceiling for dividends at 60% of net income. Net income is redefined under IFRS.

INCOME TAX:

Aquatera Utilities Inc. is a for-profit business corporation incorporated in the Province of Alberta.

Aquatera operates under the authority of the Alberta Municipal Government Act and the Aquatera Utilities Inc. Regulation.

Aquatera is a tax-exempt corporation and as such is not subject to Federal or Provincial corporate income tax because:

- a) Aquatera is owned by four municipalities: The City of Grande Prairie, the County of Grande Prairie, the Town of Sexsmith, and the Town of Wembley and
- b) 90% or more of Aquatera's income is earned from activities within the geographical boundaries of these municipalities.

CASH FLOW:

Cash Flow from Operations:

Non-cash items and non-operating items are removed in the reconciliation of net income to cash flow from operating activities.

Fluctuations in the net income from year to year may be removed. Cash flow from operations represents an amount to which cash management targets can be meaningfully set. This cash management strategy considers cash flow from operations the key indicator for setting targets.

Dividends:

The target for the payment of annual dividends is 20% of annual cash flow from operations.

Debt Servicing:

The ceiling for the payment of principal and interest on debt is 50% of annual cash flow from operations.

Capex:

Cash in the amount of 10% of annual cash flow from operations is designated for capital expenditures and placed in savings for future Capex.

Business Growth:

Cash in the amount of 5% of annual cash flow from operations is designated for business growth purposes and placed in savings for future business investment.

Excess Cash:

Until the maximum target for debt servicing is reached the free cash flow generated from operations may be divided between Capex (no maximum) and Business Growth (up to a maximum of 50%) and placed in the respective savings accounts.

BUSINESS GROWTH:

To safeguard cash for business investment purposes the following parameters are considered in making business

investment decisions:

Weighted Average Cost of Capital (WACC)

A calculation of Aquatera's WACC should be made annually and reviewed by the Audit and Risk Committee.

WACC plus a factor for risk as determined depending on the nature of the investment are used to evaluate the return on investment (ROI) for business decisions. Cash flows are discounted at WACC plus a premium for risk to determine the Internal Rate of Return and net present value (NPV) of a project.

Internal Rate of Return (IRR)

The IRR, sometimes referred to as "economic rate of return (ERR)", is the discount rate used to evaluate competing projects. It is the rate of return determined when the NPV equals zero. When using an unlevered IRR (that removes effects from separate capital structure decisions) the ability to compare across investment options is greatly enhanced. Generally speaking, the higher a project's IRR, the more desirable it is to undertake the project.

PURCHASING:

Cash expenditures and authorities for spending are monitored by the Board through its purchasing policy. (See Purchasing Policy No. 303)

FINANCIAL MONITORING:

Financial planning, budgeting, reporting and auditing are monitored by the Board, through the Audit & Risk Committee.

REVIEW:

This Cash Management Policy is reviewed annually by the Board, through the Audit and Risk Committee.

DEFINITIONS

Capital Expenditure - CAPEX

Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations. These expenditures can include everything from repairing a roof to building a brand new factory. For Aquatera it includes a major upgrade to the Wastewater Treatment Plant.

The amount of capital expenditures a company is likely to have depends on the industry it occupies. Some of the most capital intensive industries include oil, telecom and utilities.

In terms of accounting, an expense is considered to be a capital expenditure when the asset is a newly purchased capital asset or an investment that improves the useful life of an existing capital asset.

If an expense is a capital expenditure, it needs to be capitalized; this requires the company to spread the cost of the expenditure over the useful life of the asset.

If, however, the expense is one that maintains the asset at its current condition, the cost is deducted fully in the year of the expense. Aquatera uses the term "major maintenance" to describe this type of expense.

Cash Flow to Capital Expenditures – CF to CAPEX

A ratio that measures a company's ability to acquire long term assets using free cash flow. The CF to CAPEX ratio will often fluctuate as businesses go through cycles of large and small capital expenditures.

As the CF to CAPEX ratio increases, it is usually a positive sign. If a company has the financial ability to invest in itself through capital expenditures (CAPEX), then it is thought that the company will grow.

This is an industry specific ratio and should only be compared to a ratio derived from another company that has similar CAPEX requirements.

CF to CAPEX is calculated as:

$$\text{Cash Flow to Capital Expenditures} = \frac{\text{Cash Flow from Operations}}{\text{Capital Expenditures}}$$

Weighted Average Cost of Capital - WACC

A calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All capital sources – common stock, preferred stock, bonds and any other long-term debt – are included in a WACC calculation.

All else equal, the WACC of a firm increases as the beta and rate of return on equity increases, as an increase in WACC notes a decrease in valuation and a higher risk.

Businesses often discount cash flows at WACC to determine the Net Present Value (NPV) of a project, using the formula: NPV = Present Value (PV) of the Cash Flows discounted at WACC.

The WACC plus the risk premium becomes the Hurdle Rate – the minimum ROI to be achieved by the business case for an investment decision. The Hurdle Rate will vary depending on the nature of the investment. Investments with more risk will have higher risk factors and a higher Hurdle Rate. The Hurdle Rate will be determined prior to the investment being approved. The Hurdle Rate for an Aquatera directly controlled project will be lower than that for an acquisition, having greater uncertainty of risks and rewards – for example.

Broadly speaking, a company's assets are financed by either debt or equity. WACC is the average of the costs of these sources of financing, each of which is weighted by its respective use in the given situation. Taking a weighted average determines how much interest the company has to pay for every dollar it finances.

A firm's WACC is the overall required return on the firm as a whole and, as such, it is often used internally by company directors to determine the economic feasibility of expansionary opportunities and mergers. It is the appropriate discount rate to use for cash flows with risk that is similar to that of the overall firm.

The WACC equation is the cost of each capital component multiplied by its proportional weight and then summing:

$$\text{WACC} = \frac{E}{V} * Re + \frac{D}{V} * Rd * (1-Tc)$$

Where:

Re = cost of equity

Rd = cost of debt

E = market value of the firm's equity

D = market value of the firm's debt

V = E + D

E/V = percentage of financing that is equity

D/V = percentage of financing that is debt

Tc = corporate tax rate

Internal Rate of Return - IRR

The discount rate often used in capital budgeting that makes the net present value of all cash flows from a particular project equal to zero. Generally speaking, the higher a project's internal rate of return, the more desirable it is to undertake the project.

IRR can be used to rank several prospective projects a firm is considering. Assuming all other factors are equal among the various projects, the project with the highest IRR would probably be considered the best and undertaken first.

IRR is the rate of growth a project is expected to generate. While the actual rate of return that a given project ends up generating will often differ from its estimated IRR rate, a project with a substantially higher IRR value than other available options would still provide a much better chance of strong growth.

IRRs can also be compared against prevailing rates of return in the securities market. If a firm can't find any projects with IRRs greater than the returns that can be generated in the financial markets, it may simply choose to invest its retained earnings into the market.

RESPONSIBILITIES

Aquatera Board of Directors will review and approve any revisions to this policy.

Chief Executive Officer will review and approve any procedures related to this policy.

Aquatera Administration will carry out the policy based on the established procedures.