

Memorandum to: TD Finance Committee

Subject: Building Replacement Reserves

Background: There are 15 structures in the TD buildings portfolio with a total estimated replacement cost of ~\$71 million, of which \$54.9 million relates to structures and \$15.6 million relates to building components. The three largest structures are Trout Creek (\$11.2m estimated gross replacement cost including structure and components), Downhill Ski Lodge (\$11.1m) and Northwoods Club House (\$9.7m). The Downhill Ski Lodge and the Northwoods Club House both date from 1971/2 and are scheduled for replacement in the next 10 years. Trout Creek, along with Alder Creek (\$7.1m) and the Lodge (\$6.5m) are more recent and were all built/renovated in the past 15 years. The remaining 10 structures have an aggregate estimated gross replacement cost of ~\$20.6 million and are between 15 and 49 years old.

To date, there has been no reserving policy for the future replacement of these structures. The Replacement Reserve Fund uses a methodology for reserving against building components (e.g., roofing, windows, flooring) once it is determined that the remaining useful life of those components is 30 years or less. Once the components meet that test, they are picked up the Replacement Reserve Study which is refreshed every three years.

The Development Fund is used to reserve against the financing of capital improvement projects, which includes building upgrades and additions and “building replacements that do not qualify for funding from the Replacement Reserve Fund”. There is no explanation of what this phrase means. The Development Fund Policy goes on to state “While the Replacement Reserve Fund provides reserves for the replacement of individual building components, it does not provide funding for the functional obsolescence or structural replacement of existing facilities or new buildings.”

The Replacement Reserve Fund Policy states that the fund “is necessary to keep the Association’s amenities and operational infrastructure from deteriorating and becoming functionally obsolete...”

Issue 1: While the RRF and DVF policies are closely aligned, there is a gap between them that has allowed the future replacement of building structures to remain unreserved. It is not clear from the wording of the policies whether obsolescence to building structures is currently reserved. Such obsolescence could be caused by a change in the State’s building codes, e.g., energy efficiency or earthquake damage protection, or by a change in Federal laws, e.g., ADA.

Recommendation 1: That TDHOA changes its reserving policy to include the future replacement of building structures, to clarify where the reserving for structural obsolescence is to be done, and to decide whether the split between reserving for building components and structures continues to be helpful or whether to combine the reserves for both aspects into a single category.

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Issue 2: TDHOA could either expand the use of the existing Development Fund to include reserving for building replacements, or could create a new reserve fund specifically for building replacement reserves.

Recommendation 2: That TDHOA use the existing RRF and DVF reserve funds and that the FC prepare a proposal for revisions to each. If the outcome of Recommendation 1 is to combine both aspects of building replacements into a separate category, it would make the case for a separate Building Replacement Reserve Fund more compelling.

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Issue 3: While the building assets are included in fixed assets in TD HOA's balance sheet, and the capital components shown in the Annual Report for each amenity indicate the need to plan for and fund future replacements, the transparency about the reserving for building replacements and the resultant reserve adequacy is lacking.

Recommendation 3: That TD BOD request DFA Salmon to plan for equal transparency around the reserving for both portfolios of assets in the 2021 Budget Plan and the 2020 Annual Report.

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Issue 4: There are multiple ways in which the reserving could be done, the reserving percentage could be set and the amount of time to get into compliance could be established. The portfolio of buildings is such that there are periodic, large projects to be completed, e.g., Downhill Ski Lodge, Northwood Clubhouse which complicates the reserving plan.

Recommendation 4: That the TD Finance Committee appoint a small working group to work with DFA Salmon to develop a set of recommendations for the Finance Committee's June meeting to be forwarded to the TD BOD at the next available meeting. Some further discussion of the reserving options is included below in the Appendix.

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Issue 5: The likely outcome is for an increase in the annual assessment for all TD members starting in 2021, or in 2024 after the completion of the Downhill Ski Lodge replacement. Inevitably, this will be met with a vocal mixture of support and criticism, together with some confusion and disinformation.

Recommendation 5: That the working group appointed in 4 above, with input from the TD BOD and the TD Communications head, include in its recommendation a communications plan for how best the BOD and FC can begin to socialize the need to address the reserving for building replacements now that the average age of the buildings has increased, and for potentially an increased annual assessment.

Appendix

The spreadsheet on the next page¹ shows the portfolio of buildings owned by TDHOA, along with the age, the replacement costs net of component replacement costs, the projected spend for the next two decades assuming replacement occurs at the end of their estimated lives and some indication of reserving levels. The estimated replacement costs do not reflect any additional costs arising from either the need to increase the footprint of buildings to accommodate higher population and traffic levels, or from any future obsolescence created by building code or legislative changes. In most cases, there is no need to increase the footprints, e.g. golf maintenance or pump houses.

There are two large replacements scheduled for the next 10 years, Downhill Ski lodge and Northwoods Clubhouse. Downhill Ski Lodge is shown as a memo item from the perspective of defining the future reserving needs since it is already largely reserved, with a near term plan to complete the reserving by the time the replacement occurs. We are currently allocating \$550k a year to the Development Fund for this project.

In the second decade ahead, there are three smaller buildings that will reach the end of their estimated useful lives: the Tennis facility, the Campground building and the Marina & Day Camp hut.

The column titled Full Annual Reserve Charge shows, for each building, the annual reserve amounts derived from dividing the building's replacement cost by the number of years of its estimated useful life. This shows that the full cost of an ongoing stable reserving process would be \$863k/year excluding the Downhill Ski Lodge, or \$1,012k/year once we include the new lodge after the current replacement project is completed.

The final column titled 25% Reserving Level is intended to give a sense of the amount of building replacement reserves needed today to be in compliance with a 25% funding requirement, or \$4.265 million. That Reserving Level will, of course, increase by \$863k/year and by \$1,012k/year after completion of the Downhill Ski project.

There is no suggestion that 25% is the right level of reserving. It simply takes the methodology of the Replacement Reserve Fund and applies it to the building replacement reserving. The notable differences are that the RRF portfolio is much more diversified with nearly 3,000 individual assets and components, whereas the building portfolio has significant lumpiness, and the the RRF has a 30 year planning time horizon while the capital projects planning timeline has been 5 years with a goal of extending it to 10 years. With the RRF, there is more time to allocate additional resources to the Fund. Both differences suggest that 25% is too low a funding level for this portfolio. Multiplying the \$4.265 million by 2 or 4 will give the results for 50% and 100% reserving levels.

There are a range of possible options for the FC and Board to consider. These are *for informational purposes only* to help focus the discussion for a group to be able to pull together a recommendation for the Finance Committee to agree on and present to the Board. They are three central sets of choices which can be adjusted in \$ or timeframe to meet the agreed objectives.

Option 1: Take no action today on reserves or assessment levels, other than deciding to amend the DVF reserving policy to specifically include building replacements and obsolescence and

¹ The data was sourced from a spreadsheet prepared by Mike Salmon

agreeing to provide the necessary transparency in the upcoming financial reports and to putting in place a communications plan to explain the issue to the TD Membership.

The implications of this option are that the DVF building reserve allocation would be held constant and, once the Downhill Ski Lodge replacement project reserving is complete, the \$550k/year (\$85/member p.a.) would be moved to the future Northwoods Clubhouse replacement project for the 7 year period until the Clubhouse project starts. That would provide \$3.85 million, or 50% of the amount needed. The Board would need to take action at some point to close the reserving gap.

Option 2: Take action to ensure that the Northwoods replacement project is fully funded by the time the project is estimated to occur. This option assumes similar agreements on policy revisions, transparency and communications plans as with Option 1. The least disruptive path is to supplement the allocation of the \$550k/year for 7 years with an allocation of an additional \$390.3k/year (\$60/member p.a.) for 10 years starting with 2021. Adding a \$390.3k/year allocation to the DVF would require an increase in the Regular Assessment of \$60 per member, all else being constant.

The implications of this option are that there would be 2 years following completion of the Northwoods replacement when the \$940k/year building replacement allocation (\$550k+\$390K) could be transferred to the Tennis and Campground replacements, ensuring they are also fully reserved. However, by the time the Northwoods replacement is completed, the 25% reserve funding level for the portfolio would have increased to \$6.684 million, or double or quadruple that amount depending on the % reserve level desired.

Option 3: Take action to ensure that Northwoods is fully funded by the scheduled project time and that the Association can achieve a certain Reserve Level within a reasonable timeframe. Again, this option assumes similar agreements on policy revisions, transparency and communications plans as with Option 1.

Achieving a 25% Reserve Level for the policy by Year 10 would require an additional \$668.4k/year, or \$103 per member, each year for 10 years in addition to the \$390k/year (\$60/member p.a.) incremental allocation in Option 2.

Achieving the same 25% level over a 15 year period would require an additional \$530k/year or \$82/year per member. Getting to the same point over 20 years would require an additional \$460.7k/year, or \$72/year per member.

Using 25% reserve funding as an example is not meant to imply agreement that 25% is the right level. Achieving that level of reserves in the DVF over 10, 15 or 20 years would provide reserves of \$6.68 million, \$7.95 million or \$9.21 million, respectively.

Option 4: Take action to ensure annual allocations to the DVF are sufficient to balance the books over the full 40 year replacement cycle for the full portfolio of 15 buildings.

Looking ahead, the picture appears as follows:

Building Replacement Contributions by Decade	Starting Balance (\$'000)	Contributions (\$'000)	Project Costs (\$'000)	Ending Balance (\$'000)
2021-2030	\$6,050	\$9,400	\$15,321	\$129
2031-2040	\$129	\$9,400	\$1,540	\$7,989
2041-2050	\$7,989	\$9,400	\$17,480	-\$91
2051-2060	-\$91	\$9,400	\$19,046	-\$9,737
Total		\$37,600	\$53,387	

The lumpiness of the buildings portfolio presents both a challenge when large projects appear on the horizon but also an opportunity. There is a need to increase the DVF allocation now to make sure that Northwoods and Tennis are fully funded. However, the absence of large projects in years 13-20 means that the same level of annual allocation to the DVF can be maintained and used to increase the Reserve Level. At the end of the third decade ahead, it will be time for the replacement projects for the Lodge (\$5.17 million), Maintenance (\$3.35 million), Trout Creek (\$8.96 million), for a total of \$17.48 million.

There is a question of the fairness of allocations over time. Arguably, the TD Members over the past 50 years have not paid their full share of reserves, but they did pay for the construction of the buildings throughout that period during which no buildings have needed to be replaced.

By stepping up the annual allocation to the DVF to \$940k/year (\$145/member p.a.) in 2021 and holding it constant as in Option 3 above, we can effectively balance the books for the next 30 years and at the same time explain to Members that the allocation for this portfolio is fair and appropriate.

However, in order to balance the books for the next 40 years and complete the cycle of replacement for the full portfolio of 15 buildings, we would to allocate annually to the DVF \$1,334,700 or \$206/member p.a. Put another way, each of the 6,473 members would contribute \$8,240 over the full 40 year period.

Refreshing this exercise every 5 years should ensure that we stay on top of any changes, such as obsolescence, and have sufficient time to adjust as needed.

Terry Watson
March 2020

Building Replacement Funding								
Buildings:	Year Built	Est. Useful Life (Years)	Est. Remaining Life (Years)	Est. Replacement Cost (\$'000) (excl. components)	Cash Flow (Out) Next 10 years (\$'000)	Cash Flow (Out) Years 11-20 (\$'000)	Full Annual Reserve Charge	25% Reserve Funding Level in 2020
Northwoods Clubhouse	1971	59	10	\$7,753	\$7,753	\$0	\$131	\$295
NW Pool/Pump House	1990	70	30	\$56	\$0	\$0	\$1	\$8
Tennis	1971	61	12	\$1,120	\$0	\$1,120	\$18	\$225
The Lodge	2005	45	30	\$5,166	\$0	\$0	\$115	\$430
ACAC	2015	44	39	\$5,723	\$0	\$0	\$130	\$163
Maintenance	1972	78	30	\$3,354	\$0	\$0	\$43	\$516
TCRC	2003	47	30	\$8,960	\$0	\$0	\$191	\$810
Golf Cart Storage	1982	76	38	\$2,800	\$0	\$0	\$37	\$350
Golf Maintenance	1996	61	37	\$3,613	\$0	\$0	\$59	\$355
Campground	1972	63	15	\$336	\$0	\$336	\$5	\$64
Marina/Day Camp Hut	1972	68	20	\$1,624	\$0	\$1,624	\$24	\$287
Chalet	1991	65	36	\$470	\$0	\$0	\$7	\$52
Forestry	1991	64	35	\$4,592	\$0	\$0	\$72	\$520
DHS Top Shop	1995	59	34	<u>\$1,792</u>	\$0	<u>\$0</u>	<u>\$30</u>	<u>\$190</u>
<u>TOTAL</u>				\$47,359	\$7,586	\$3,080	\$863	\$4,265
Memo:								
Downhill Ski Lodge	1972	51	3	\$7,586	\$7,586	\$0	\$149	n.m.