SUMMARY NOTES OF THE FINANCE COMMITTEE
ZONE 7 BOARD OF DIRECTORS

April 23, 2015
4:00 p.m.

Directors present:	Sandy Figuers Angela Ramirez Holmes Sarah Palmer
Staff present:	Jill Duerig, General Manager Hossein Golestan, Financial Consultant Tamara Baptista, Finance Manager Amanda Rogers, Administrative Assistant

Director Figuers called the meeting to order at 4:04 p.m.

1. Public Comment - None

2. Reserve Policy Discussion

General Manager Jill Duerig introduced Robert Porr, a financial consultant from Fieldman, Rolapp and Associates, who put together Zone 7's reserve policy.

Mr. Porr gave an overview of the reserve policy. He explained that the reserve policy is a financial foundation that establishes a savings plan and is linked to Zone 7's budget and capital improvement program. Director Figuers asked if Zone 7 has a problem with money not coming in on time. Mr. Porr replied that money is going out faster than it is coming back into the reserves.

Mr. Porr said that the reserves are going to fluctuate from year to year; and each year the reserves must be scrutinized based on current status, changes from previous years, and future agency goals. The objective is to establish a reserve policy that meets Zone 7's three service functions: flood control, fixed costs for the State Water Project, and the water enterprise. Different reserve funds were created based upon the expected use of those reserves. In the policy, minimum and maximum levels are established as a warning signal. If a fund has reached its maximum level, flexibility is built into some of those funds which allow for movement to other funds that might be closer to their minimum.

Mr. Porr continued his presentation with an overview of the fund structure. On the liquidity side, the operating reserve was designed with a minimum of 32 days and maximum of 90 days, which is considered fairly strong by the rating agencies. The emergency reserve is based on Zone 7 assets that come from FEMA. They recommend 1% to 2% of net assets be set aside for an emergency fund. Mr. Porr said that 1% to 2% was a little low. They recommended a minimum of 1% and a maximum of 3% with a target of 2% of assets set aside in the emergency fund. Director Ramirez Holmes asked if the FEMA number has changed. Mr. Porr replied that it has not.

Director Palmer requested a correction to the reserve policy overview. The overview states that maximum guidelines of 3% are based on current FEMA guidelines; however, current FEMA guidelines are from 1% to 2%.

Mr. Porr continued his presentation explaining that the rate stabilization fund's purpose is to offset lowered revenues or higher expenses based on new regulations or something that's going to impact revenues and expenses over a long period of time, allowing step-increases in rates to be adopted instead of sudden big jumps. Director Figuers asked what is considered long term. Mr. Porr replied that for the operating reserve, it's a year. For the rate stabilization fund, it's greater than two years. The rate stabilization fund is based on a percentage of revenues.

Mr. Porr stated that the drought contingency reserve was designed to be between 7% and 20% of budgeted annual water sales. Director Figuers asked if the drought contingency includes other natural disasters such as earthquakes and floods. Mr. Porr replied that it does. Director Figuers questioned the need for other natural disasters to be included in the drought contingency reserve since Zone 7 already has reserves for other natural disasters such as floods. Mr. Porr replied that the drought reserve was designed classically for the drought and was described in the Urban Water Management Plan as the agency's financial backup for lost revenues should conservation be needed.

Mr. Porr discussed the capital improvement reserve fund, stressing that dollars set aside for future improvements should be invested to receive interest that is very close to inflation. If it's not, an additional funding gap is created which must be closed with the rate base. Under the California Government Code, districts and agencies are restricted to U.S. treasuries and highly-rated corporate notes. Ms. Duerig clarified that Zone 7 doesn't do the investing. The county does it on Zone 7's behalf.

Director Palmer stated that there's always the potential for losing money if you're investing. Mr. Porr replied that there is that possibility, but the Government Code is fairly strict on what government agencies in California can invest in. It's very conservative. Director Ramirez Holmes asked if there are conservative investments getting more than 1% at this point. Mr. Porr replied that there were not very many, unfortunately. Director Palmer asked if there are investments that are considered safe and that do keep up with inflation. Mr. Porr replied that in normal economic environments, yes, but since the Feds reduced interest rates, short-term rates are near a quarter to zero percent to help the economy recover. Director Figuers asked what was considered normal interest rates. Mr. Porr replied that before the Fed intervened, interest rates were closer to 4 ½%.

Director Ramirez Holmes asked if Zone 7's reserves were adequate for debt financing. Mr. Porr responded that based on Zone 7's 2004 CIP, the repair and replacement, system-wide improvement fund is inadequate for the expected project capital expenses. Zone 7 is down to approximately $79 million in reserves. This will affect Zone 7's standing with rating analysts in the future; and will require Zone 7 to provide specific details on how the agency intends to complete its capital projects.

Director Ramirez Holmes questioned a financial plan provided by Feldman, Rolap & Associates back in September of last year that stated that Zone 7 had a favorable credit rating. Mr. Porr said that it was just a sample, which Tamara Baptista, Finance Manager, confirmed. Ms. Duerig stated that previously the Board had asked if they would like a similar report generated by staff rather than bringing in a consultant. However, because of being staff light, Zone 7 has not been able to do that; nor is it known if staff can do it or has the expertise. No action had been taken to bring a consultant in per the Board's request.

Director Figuers questioned the need for minimum amounts since the money sits there and can never be touched. He also asked why there are multiple funds instead of one big fund. Mr. Porr stated that the minimums are there to provide additional liquidity in case a second event occurs. If funds were to go to zero, there would be no reserve funds. Director Figuers suggested raising rates if that happened. Mr. Porr replied that there could be a significant period of time between when rates are raised and when those monies started to come in, and there would be no money in the interim. Director Figuers suggested tapping other funds such as flood control, which would be a more efficient use of the agency's funds.

Mr. Porr indicated that when rating analysts look at the agency from a credit perspective, they want to see a minimum amount of cash on hand at all times to cover the next emergency, however unlikely that might be. Director Ramirez Holmes questioned if the agency's $122 million was enough and asked which funds can be lumped. Mr. Porr replied that because Zone 7's philosophy is to never borrow money, the reserve policy has been designed with a lot of money in capital reserves and much less in operational liquidity since capital projects are very important to the agency. Zone 7 does have the flexibility to move funds between its capital fund and operational liquidity reserve within the water enterprise.

Director Ramirez Holmes asked if flood control's reserve can be touched. Hossein Golestan, financial consultant, replied that because flood control is funded from two sources (a percentage of property taxes and developer impact fees), flood control money cannot be used for other purposes. There are restrictions. Because of those restrictions the reserves are not necessarily where they should be. The agency doesn't have the flexibility of lumping them together into one or two big pots. Mr. Golestan pointed out that while the agency has no direct or bonded debt, the fixed charges from the state have to be paid. That makes Zone 7 heavily leveraged in a different way.

Director Ramirez Holmes said that Fund 120's reserve minimum was $9.8 million dollars last year. This year it is at $31.9 million. That is a huge jump and because of it the agency is now under the minimum. She questioned whether minimum is enough. Director Figuers suggested getting rid of the term minimum and using the term working value. Mr. Porr said that the reserve policy was created as a flexible document to meet capital needs, so if moving projects forward or new regulations such as chromium six arise, then increased rates are designed so that the dollars are available to meet these capital needs.

Director Ramirez Holmes asked about the length of time for which an interim policy is kept. Ms. Duerig replied that staff had proposed an interim policy because they wanted to try it out for a few years. She suggested that until the agency gets an AGM Finance who is able to focus on this, the policy should not be finalized. The financial plan is needed first, but that shouldn't preclude modifying the policy based on what staff is learning.

Director Figuers asked how often the agency gets mandates handed down from local government that cost the agency money. Ms. Duerig responded saying that it is never known which regulations are going to hit the agency, but there's probably a regulation for a new water quality parameter or a new treatment or distribution requirement every two to three years.

Director Figuers asked what these past impositions roughly cost the agency per occurrence. Ms. Duerig answered that if we're talking treatment changes, it's in the $30 to $50 million dollar range for a big process change at one of the treatment plants. Mr. Porr added that it probably includes increased O&M expenses as well. It's just not a one-time capital expenditure but, also, ongoing increases in expenses to operate and maintain the new process or system.

Direct Ramirez Holmes asked if funds from Fund 130 can be transferred to Fund 120. Mr. Golestan replied that money from Fund 130 cannot be transferred. Director Ramirez Holmes asked what that money is used for. Mr. Golestan replied that it is used to serve new development. Projects that serve both new and existing customers share the expenses between the funds based on the relative benefits.

<u>Public Comments:</u>

Dan Martin, City of Pleasanton, said that the recent Capistrano case shows that when establishing rates, a clear line must be drawn back to cost of service. A grey area arises when trying to explain to the customer how they must pay now for a project that they may or may not benefit from down the road. That goes back to pay-as-you-go versus debt financing. Who's really paying for the service they receive? Pleasanton doesn't charge customers for projects that don't benefit them. They do debt financing. Mr. Martin is wondering if Zone 7 is able to draw that nexus and if the agency is comfortable with where it is positioning itself with the reserve policy and ratepayer equity on that issue. Ms. Duerig responded that the Capistrano case was based on a tiered-rate structure by a retailer. It was a very different case. In that case the water agency refused to cooperate with the court. Ms. Duerig said she had discussed with General Counsel and expressed doubts that the Capistrano case applies to Zone 7's pay-as-you-go policy.

John Archer, DSRSD, commented that DSRSD is going through these same issues now. They are looking at when they are asking people to pay for future projects; but reserves are needed to get started. There's a balancing act. DSRSD isn't quite there yet, but it's a discussion they're having right now. Commenting on the capital plan, DSRSD was using a two-year budget cycle window but now they are looking into an even longer window. Mr. Archer added that he would never go to zero because it leaves one vulnerable if another emergency arises.

3. Possibility of Cawelo Refinance

Ms. Duerig said the Cawelo refinance idea came from Mr. Golestan and Ms. Baptista to refinance, taking advantage of the low interest rates and possibly saving Zone 7 money. Fieldman, Rolapp & Associates was brought in to do a double check and provide additional advice.

Mr. Golestan provided background information on the Cawelo agreement for water storage and banking. Cawelo issue a $21 million dollar bond with the agreement that Zone 7 would reimburse them for the debt service on those bonds. Annually, Zone 7 pays approximately $1.3 million to Cawelo. The bonds will mature in 2035. The interest rates range from 4% to 4 ½ %. Wells Fargo, underwriter for the original bonds, did an initial analysis which revealed potential savings. Cawelo has been agreeable to the refinancing. Of the original $21 million, $17 million of the debt is outstanding. Zone 7's payments are the only security for that debt, therefore, rating agencies are interested in Zone 7's financial strength.

Ms. Duerig said bond insurance can be used to strengthen ratings. Ms. Duerig asked Mr. Porr to explain that. Mr. Porr explained that there are insurance companies that provide guarantees on principle and interest on municipal bonds. The underwriter has contacted three of these companies. Two have AA credit ratings, which is the highest of any of the bond insurers. Inquiries are being made as to whether the insurance companies would provide bond insurance for the transaction without requiring Zone 7 to get an independent credit rating from one of the rating agencies. A response is expected by Friday, May 1, as to whether the bond insurer is agreeable.

Director Palmer asked about the advantage of getting the bond insured as opposed to straight refinancing. Mr. Porr answered that in the event that Zone 7's rating was less than AA, there could be a benefit to paying the insurance premium, purchasing the bond insurance, and selling the bonds with a AA rating. Director Palmer asked who would be buying the bond insurance. Mr. Porr replied that technically it would be Cawelo. This option offers an advantage because there is the possibility that the agency may not get a AA credit rating, which would make refinancing not cost effective.

Director Ramirez Holmes stated that if the agency is looking at getting financing for capital projects down the road, we will have to get a rating anyway. So why not get one now? Mr. Porr replied that there is a possibility that because of reserves being spent down over the last few years, Zone 7 might not get a rating in the single A category or better. Staff wants to see if the bond insurers would provide the bond insurance without the rating. That gives Zone 7 a year or two to shore up its credit.

Director Ramirez Holmes asked if Zone 7's credit rating was in jeopardy. Mr. Porr said that Zone 7 does not officially have a credit rating. In 2006, the agency was given an assessment by Standard and Poor's of a medium grade rating, which translates to possibly a BBB or A- rating. Ms. Duerig commented Zone 7 will not pursue this course if it doesn't save the agency money.

Mr. Archer commented that DSRSD had similar debt in 2009. DSRSD found out that the ratings are only as good as the insurance carrier. If the insurance carrier fails, there is the possibility of running into trouble with the debt. There is a risk. Mr. Porr asked if DSRSD had floating-rate debt. Mr. Archer confirmed that it was a floating rate.

Mr. Porr said that the agency is contemplating fixed-rate debt. With floating-rate debt, interest rates change every week as opposed to fixed-rate debt where the interest rate is fixed for the life of the bond. The demise of the insurance carrier in a fixed-rate coupon scenario becomes the investor's risk, not the agency's. The qualitative concern is the drought, so a new water agency coming to rating agencies now is going to have a difficult story to tell. Considering that, it is advantageous to consider this option with the bond insurers to see if they will do it without the rating. At issue right now is the negative attitude held toward California water by the rating agencies; so the agency would need time to craft its story before applying for a credit rating. Ms. Duerig added that the insurers do the equivalent of an internal rating. Mr. Porr confirmed that and said there is a possibility that they might assign a higher rating than the credit rating agencies.

4. FY 15/16 Proposed Budget

Mr. Golestan said that his presentation is for a preliminary budget for fiscal year 2015/2016. The objective of this presentation is to have an early discussion with the finance committee. The budget is still under review by executive management so it is not yet in its final form to go to the Board. The numbers in the budget are preliminary. Included in this presentation is a budget schedule, which is also incomplete at this time. The major factors affecting the budget are: 1) the drought, 2) water conservation, 3) state water project charges, 4) the local economy, and 5) the Asset Management Program (AMP).

Director Figuers asked why it's projected that Zone 7 will sell more water this year than last year. Mr. Golestan replied that one reason might be because the agency has a higher allocation from the state than last year. Ms. Duerig added that it's an educated guess. A budget is a plan.

Mr. Golestan continued the discussion giving budget highlights. Tamara noted that one of the slides was incorrect and that the emergency reserve is actually $2.2 million.

Director Ramirez Holmes expressed concern that the labor and overhead category is over budget every single year. Mr. Golestan said staff would research that. Ms. Duerig noted that this is not the first year of the drought, so staff is being pulled from capital projects to work on drought-related issues. The same amount of labor is there; it's just shifted from one fund to another.

Mr. Porr noted that on slide 11 there is a structural deficit in FY13/14. Revenues are less than expenses. Also, in FY14/15 year-end projections, revenue is $31.6 million and expenses are over $46 million. He stated that staff is proposing a budget deficit as well, which will amount to a third consecutive year with a structural deficit. With respect to the rating agency process, one of the things they look at is cash flow. They typically expect expenses to exceed revenues by maybe 25%. That's an important credit feature to the rating agencies. They also look at the fact that Zone 7 is using reserves instead of raising rates. This is exasperated when they look at what the agency is paying in fixed charges. They look at what the agency's ratio is between net revenues versus debt service or fixed component charges. That is a key metric.

Directed Figuers interjected that the rating agencies treat Zone 7 like a business, expecting the agency to make a profit every year no matter what is spent, even if it's been saved up for decades. Mr. Porr replied yes, that is the foundation of credit.

Director Palmer left at 6:30 p.m.

Director Ramirez Holmes asked about the replenishing plan. Ms. Duerig replied that Zone 7 has already reduced storage in Cawelo, Semitropic, and the local groundwater basin. These will need to be replenished. This budget item assumes that Zone 7 starts replenishing, that next year is a normal year, and that water is available from either an increased allocation, through multi-year pool purchases, or through the Yuba Accord. But we can't keep taking out of the water banks without replenishing it. Director Ramirez Holmes asked if the agency is required to put back 26,000 AF in FY15/16? Ms. Duerig replied that there is no requirement. It's prudent water management.

Director Figuers commented that it sounds like Zone 7 has no more outside storage available to us. Ms. Duerig replied that Zone 7 hasn't depleted Semitropic and Cawelo completely, but the storage has been diminished, as has the local groundwater basin. They are all lower than they were five to ten years ago, depending on whether this is considered a four-year drought or a nine-year drought.

Director Figuers asked what percentage of Cawelo and Semitropic storage was reduced from their maximum that we're allowed to have or what we've had max historically in the past. Ms. Duerig replied that Cawelo was only started in 2006. The capital improvements are not completed, so Zone 7 has not achieved maximum storage to date. The agency has taken out less than it has put in. Since 2006 – in nine years – which have been mostly drought years, Zone 7 has only been able to put in a little water. Zone 7's goal with Cawelo was to be in a filling mode after storage was purchased. Semitropic let us put more water in the bank than our contract amount allowed. Part of that was because they had not fully allocated the banking space, so since we were an existing contractor, we were allowed to put more water in under the same terms.

Director Figuers asked how much Semitropic has been reduced. Ms. Duerig replied probably about a third. The local groundwater basin is at about 56% of operating storage level.

Director Ramirez Holmes expressed concern about Fund 100 reserves dropping to $3.3 million but then showing a shortfall because more had been spent than approved. So where did the other expenses come from? Ms. Baptista replied that the other expenses came from DWR cash flow issues that were announced the same day the budget was adopted so they weren't included. So Zone 7's expenses are $3 million dollars higher than what was planned.

Director Ramirez Holmes said Fund 120's proposed budget passed by the Board was $7.5 million, then there is an amended budget. Is that the carryover for budgets? Ms. Baptista replied that the budget includes the adopted budget plus any carryovers and any additional appropriations that went to the Board.

Director Ramirez Holmes questioned why the CIP fund seemed high since the agency is not getting all its projects done in time. Ms. Baptista explained that at the end the year, anything that isn't spent gets carried forward into the next year.

Director Ramirez Holmes asked how much money Zone 7 really needs for capital projects when we are overly optimistic in how much we can get done. Ms. Duerig replied that it's an iterative process. If we had planned on borrowing money, for instance, and can't borrow it, we're going to have to figure out projects to defer. Our CIP plan assumed that we'd have to borrow money. There will have to be a discussion.

Director Figuers asked what time of year or approximate date that the FY14/15 end-of-year projection was made. Ms. Baptista said they were working on it all the way to April. It's not continuous. When we present the budget it stops at a certain point in time. Director Figuers asked when is the FY14/15 amended budget sort of completed? Ms. Baptista replied that it can be all the way up to June as long as the Board approves any additional appropriation that budget can change. Director Figuers said so this number is basically as of a day or two ago. Ms. Baptista replied, yes, correct.

Director Figuers asked if the FY13/14 audited number were from October of last year? Ms. Baptista clarified that it's audited after the auditors do the presentation to the Board, meaning in

December of last year. Mr. Golestan added that the numbers are as of June 30. These do not change except for accrual expenses or revenue related.

Director Ramirez Holmes asked for an explanation about the huge jump in the budget over the last few years. Ms. Duerig explained that there are lots of reasons. We've seen chemical costs and power costs going up. Even more than that DWR's costs are going up. Director Figuers asked if we should anticipate in the range of $100 million in unanticipated expenses every five years or so and Ms. Duerig responded in the affirmative.

Director Ramirez Holmes noted that the Board approved a budget of $107 million and the end-of -year projected expenses were $116 million. Director Figuers clarified that we had about a 9% increase. Director Ramirez Holmes commented that those are not controlling costs. The board did not approve the $116 million, they approved the $107 million. Ms. Baptista said that it's a combination of additional appropriations from this year plus carryover from last year. So the approval was done last year when the Board approved the budget for FY13/14 and then unspent balances for capital projects and any open purchase orders and encumbrances get carried forward on all funds.

Director Palmer returned at 7:04 p.m.

Director Figuers asked if staff could amend the monthly budget report with a notation stating when budget amendments were made.

Director Ramirez Holmes asked what the professional services line item includes. Ms. Baptista responded that it includes accounting services as well as financial management services, auditor services, drafting services, surveying services, engineering type services, all professional service including legal.

Director Ramirez Holmes asked why training and travel are going up. Ms. Duerig answered that Zone 7 is trying to grow staff. We have staff approaching retirement over the next five to ten years and we're trying to provide more training to staff so they can step into those positions.

Director Ramirez Holmes asked what is included in special department expense. Ms. Baptista responded that water conservation is in there so all the rebate programs are in there, as are the election expenses.

Public Comments

Dan Martin, City of Pleasanton, said that one of the obvious results of the drought is reductions in revenues. Everyone is experiencing that. It's necessary to reprioritize projects.

5. Verbal Reports - None

6. Adjournment

Since there were no further issues or comments, the meeting was adjourned at 7:12 p.m.