SUMMARY MINUTES OF THE FINANCE COMMITTEE
ZONE 7 BOARDS OF DIRECTORS

August 29, 2011
4:00 p.m.

Directors present:	Sandy Figuers	Zone 7 Staff:	Jill Duerig, General Manager
	A. J. Machaevich		John Yue, Asst. General Manager, Finance
	Chris Moore		Tamara Baptista, Financial & Systems Service Manager
			JaVia Green, Staff Analyst
			Amparo Flores, Associate Civil Engineer
			Judy Rector, Board Secretary

President Figuers called the meeting to order at 4 p.m.

1. Public Comment – None

2. Preliminary 2012 Treated and Untreated Water Rates

John Yue, Assistant General Manager, Finance, pointed out that the water enterprise fund has been running at a deficit for the past three years. Zone 7 has used about $4.3 million in reserves plus is projected to use $3 million in additional reserves. He stated that we can't continue using a deficit spending pattern indefinitely, especially since Zone 7 is faced with another round of economic uncertainty. Staff feels compelled to point out the importance of preserving reserves and critics will say how much in reserves is enough? Meeting our reserves policy, given the uncertain times right now, may not be enough. We know we are in a slow recovery at least for a couple of years but we need to be sure we have sufficient reserves to come through successfully at the end.

Staff has looked at some of the comparable local agencies as far as actual reserve balances. Critics may say we are already meeting our reserves and we may have reserves in excess of our policy. But in reality, when looking at the most recent financials for other agencies, a lot of them actually have an excess of available funds. This is the result of an informal survey of some of that financial information:

- The City of Pleasanton show that they have $9+ million in reserve in their water enterprise fund which is 51% coverage for their annual operating expenses;
- Dublin San Ramon Services (DSRSD) has a coverage of 52%;
- Alameda County Water District has a coverage of about 61%;
- Contra Costa Water District has coverage of 80%.

Director Figures asked if the reserves are defined as a percentage of operating expenses, a ratio, so you are basing everything on operating expenses. Mr. Yue replied that of the three scenarios prepared for the coming year's water rate, Zone 7 is at the low end of those examples. Alternatives 1, 2 and 3 are at 54%, 52% and 53% so respectively so are in the ballpark.

Tamara Baptista, Financial & Systems Services Manager, talked about reserve levels and reserve policies. As they were developing the water rates, the water rates consist of:

A. Revenue based on the retailer's 5-year water delivery request.
B. Operating expenses adopted FY 2011-2012 budget plus preliminary FY 2012-13 budget. Both were used in the analysis for the water rate for calendar year 2012.
C. Water rate contribution to capital fund (annual transfer from Fund 72, Renewal/Replacement System-Wide Fund to Water Enterprise) as adopted by the Board in June 2011 as part of the AMP approval.
D. Financial Management/Planning – Staff used a water rate model that takes a 10-year time period snapshot to try to avoid rate spikes, smooth out water rates, have small incremental increases, and minimize water rate increases as much as possible. Staff also applies reserve management, reserve policies, and reserve levels. The rate stabilization reserve is currently at $5 million and Zone 7 also has emergency operating reserves which are 20% of our operating expenses.

President Figures asked if there has been no change in housing stock, how do you have the same number of buildings out there when you have had people losing homes. Are we saying that conservation is actually taking hold?

General Manager Jill Duerig said part of it is the hydrology. Spring 2010 and Spring 2011 were both very wet springs so people did not turn on their sprinklers as much. We also had two cool summers so what we are seeing so far may or may not reflect conservation in the true sense.

Ms. Baptista continued to explain that in 2011, Zone 7 projects that they will deliver 38,040 acre feet to the retailers; 2012 projections are 38,214 acre feet of water. Take the numbers with conservation and add a 5 percent discount based on historical trends and usage patterns; that is how staff arrived at the revenue number for 2012. Every year the retailers submit a 5-year delivery request schedule/ The numbers they submitted in 2010 for 2012 were higher; the new demand projection is 8% less.

Dan Martin from City of Pleasanton said that we currently have "a perfect storm: commercial vacancies, recent rate increase, and a ramp up in conservation."

Darren Greenwood, City of Livermore, asked if retailers buy more water, is there a correlation between hot summers and revenues? Ms. Baptista answered that if we buy more water and sell more water, expenses and revenues go up. If we buy more water and don't sell it, expenses go up but revenue doesn't.

Ms. Baptista stated that in order to develop the 2012 water rate, we have to develop a preliminary 2012/2013 budget which is $300,000 less than the 2011/2012 budget. Decreases included Bay Delta related expenses, the demin facility, water purchases, chemical costs and utility costs.
Transfers are in all water rate models. Revenue should be enough to cover operating expenses and transfers.

She noted a comparison of Zone 7 counterparts, Contra Costa Water District, Dublin San Ramon Services District, etc. The current Zone 7 Operating Emergency Reserve Policy is 20% of our operating expenses and the average is 25% of the water districts listed on a slide in her presentation. She stressed that reserve policies are not the same as reserve levels.

President Figuers asked what if we go into deficit? Mr. Yue responded that if we start spending the reserves then later we may run out of money for operations. President Figuers asked wasn't that the purpose of the reserves? Mr. Yue said if you know that things are going to bounce back, and you have a good handle on when it will bounce back, then there would be confidence in using certain amounts of those reserves. But when going through a period of slow recovery and then have another hiccup of uncertainty that adds to the unknowns so staff feels that should be pointed out. President Figuers asked if reserves are strictly for short-term losses. John Yue noted that with rate stabilization, for example, without dipping into those reserves, then hopefully there will be better times in the next few years so we can begin to rebuild those reserves. If we don't have those turn around periods, then we will constantly be at a deficit and eventually not be able to even meet the reserve policy.

President Figuers countered that in some respect the City of Livermore's objections are correct. If we are into a long-term slowdown, we have to adjust our rates to cover our expenses and therefore do not need such a large reserve because the reserve is just for the short-term emergency. Why do we need a large reserve? For the long term we can't dip into the reserves because we don't know how long it is going to be, so we have to maintain a reservoir, the dead pool at the bottom you can't touch. Increase rates to maintain what you have and you don't have to maintain as large of a reserve because the whole purpose is for a short time period.

Ms. Duerig clarified that when we say revenue covers operating expenses, the budget that was adopted for the current year has a built-in dip into the reserves. Deficit spending will continue even if we use Alternative 1 and it will be the fourth year running and we, as staff, are concerned that this deficit spending approach has already been approved for the fourth year.

Lori Rose, DSRSD, commented that reserves are a risk management tool. It is extremely difficult for DSRSD elected officials to raise water rates. Last time they did 60% of the rate increase and they don't do them every year. They may have CIP increases every year but those do not cover the costs. Zone 7 has four customers that pay their bill every month and retailers have customers that do not pay so they are taking on a much greater risk so they can pay Zone 7. In talking about reserve levels, she says that it makes sense that their reserve levels would be higher than Zone 7 reserve levels. The retailers all have reserve policies for that reason, but Zone 7 reserves are still in excess of the reserve policies so the point the retailers are trying to make is that it is a risk management and cash flow management tool and Zone 7 has more collectability for short term cash.

Director Moore feels that the Board is hawkish on trying to keep rates down even with operating expenses going up so retailers don't feel the hit. We need to find balance and get to the point where we need to be without going in excess of the reserve policy.

Ms. Baptista continued by explaining the alternatives considered by staff:

Alternative 1: Revenue covers Operating Expenses and AMP funding levels (10% water rate increase). In order to have no deficit from 2013 forward.

Alternative 2: Use of Reserves. (5% water rate increase as projected). Multiple years of deficit where revenues do not cover operating expenses and the transfer.

Alternative 3: Midpoint between Alternative 1 and Alternative 2 (7.5% water rate increase). Balance a water rate increase with reserves.

Staff's recommendation is Alternative 3.

Director Machaevich asked what would we lose if we said 0% raise, what would we have to cut? What are we telling the public we would have to cut if we don't raise rates?

John Yue responded that staff had done a scenario of what if 0% came about for 2012 and subsequent increases will have to be 12% for 2013 and 2014.

Director Machaevich added that it is important to consider if cuts may bring infrastructure failures; we have to show the customers what could happen if we didn't raise rates.

Director Moore noted that the Asset Management Plan (AMP) Board policy just came out in June and that Board Members just went through this. The Finance Committee Board Members did advise the Board and came up with that policy this year. Everybody acknowledges that the AMP is a good thing for the future but how much are we going to do now? It is always going to be a case of how much now and down the road?

Ms. Duerig added that when the Board was considering the AMP policy, staff talked about different options of jumping up to that level right away since we haven't done that since 2004 or ramping it up. We came up with a ramp up policy with projected percentages, the ramp up policy is going to mean for water rate increases every year, and Alternative 3 is right in the range.

Mr. Yue said even if there was a change in the AMP target of $11.4 in 2011 dollars, because we are still in the beginning periods of ramping up from $5 million towards that goal, in the short run in the next two years, water rates probably wouldn't be affected downwards because, for example, next year we are transferring $6.6 so we are nowhere near that target of $11 million.

President Figuers said he is not worried about short-term transfers. The difference between the last meeting and this meeting is a "spooky" diagram on connection fees. That is where a lot of our money comes from as well as water use and the assumptions that are built into that are wildly inaccurate. If that doesn't occur, what is going to happen to us? Water rates are controlled by the number of connections. If you only have 1,000 connections, that controls your water rates. But if you have 2,000 connections, you have a lot more income coming in and we are selling a lot more product, too. Is there a relationship between the cost of producing a gallon of saleable water to our customers and the number of connections?

Ms. Duerig explained that when we get the demand projections for the next five years from the retailers and they predict what we can actually expect, that is the only piece that comes in to the water rate calculation.

President Figuers asked if the retailers think that by 2018 the number of connection fees per year will almost equal the highest amount we had three years ago? We are trying to project in the future where we are going to have money because the future has gotten murky. If we start raising rates noticeably to customers, we better have a good reason to say this is why we are doing it because if we don't do it, things could happen; we are providing cover for you so you as the retailer can say, "Yes, we are passing it through, but this is why this is occurring because five years down the road, you are going to turn on your tap and 'something different' may come out" to put it in stark terms.

Ms. Baptista again summarized that Alternative 1 is 10% where our revenue covers our operating expenses and the AMP funding levels; Alternative 2 is 5% that was recommended (which is the same as the projected at budget time in April 2011); and Alternative 3 is mid-point. Staff recommends Alternative 3 because it is prudent to identify our reserves and also in this time of economic uncertainty, and it shows that with our Operating Reserve Policy, we are at 20% of our policy versus the average of 25% and, as Ms. Duerig said, it is within the range of the water rate increases discussed when the Board adopted the AMP funding requirements.

President Figuers asked how much is available today in reserves. As of June 30, 2011, it is estimated at $19.9 million, so reserves would be dropped $1.8 million but we would still be left with sufficient reserves. How often do you dip into the Rate Stabilization reserves? Ms. Baptista responded that action needs Board approval to dip into Rate Stabilization reserves and we have never had to do it. He then asked how many years has that $11 million been sitting there? Ms. Baptista replied it has been 20% since 2005 when the Board adopted the reserve policy.

When Director Moore noted that these are Board choices, not staff choices, President Figuers responded that those choices were made in a different economic time period. The big use of those reserves in the short term would be if we have a major earthquake and needed to put our system back together again, we would use those reserves more but that would also mean FEMA funds and a whole bunch of federal government funds that would be available to us.

Ms. Duerig noted that rate stablilization allows us to make up for a dry year. We have not had to use that fund yet because we haven't had to demand 20% rationing which was the purpose of it. In answering President Figuers question regarding when the fund was created, she responded shortly after '89-'92 but it was established because of the hydrology of California. We felt that we needed to have that during times like now when we have average or wet hydrology and if that happened and it started another major drought, we would not have to pass that through as a rate increase.

President Figuers asked if it is time to revisit old concepts for reserves, what is the concept behind them, and what do we need them for?

Darren Greenwood, City of Livermore, handed out copies of notes regarding a 0% scenario. The Tri-Valley Water Retailers do not support a proposed rate increase due to the economic crisis and want to be vocal so silence does not equal support. They do support a comprehensive review of planned projects and expenditures given current economic conditions.

- Recommend: Hold 2012 rates constant (0% increase)
- Conduct a review of system-wide improvement projects (Ozone T&O) to identify savings and confirm project feasibility and public support
- If Ozone T&O project is eliminated, reduce Fund 72 accruals accordingly

He asked that the Finance Committee ask the Board recommend that the Board step back and take a look at projects again before going forward (Altamont Treatment Plant, Water Quality Management Program, Salt Management, Groundwater Management, 3rd phase of Demin). If the Ozone T&O Project is confirmed as essential, Tri Valley Water Retailers Group will work with Zone 7 staff to develop acceptable rate proposals.

Director Moore stated that it is very helpful to have the retailers' input. There are some questions that are going to come up regarding Board decisions on policies just passed and the T&O project, but the Board has a timeline to decide the treated water rate. He asked if the decision could be deferred until another meeting. It was determined that there was time to have another Finance Committee meeting before the September 21 Board meeting,

President Figuers felt it was an incredibly valuable discussion because he is contemplating the need to look at the whole concept of what the Board policies mean and imply about various reserve funds; what is their purpose, what are their levels. They were set up years ago in a different environment and now we are seeing the results of that and staff can only respond to what the Board has told them to do and they are doing it well but they can't go outside the box. President Figuers stated that this has been one of the better Finance meetings.

It was decided to table the decision and schedule another Finance Committee meeting before the September 21 Board meeting.

Ms. Baptista concluded her presentation with a brief explanation of staff's recommendation for the 2012 untreated water rate which is $92 per acre feet, a 5% decrease over last year. President Figuers moved to recommend it to the Board and Director Moore seconded it. The motion was approved by all three Board committee members.

3. FY 12/13 Draft Capital Improvement Plan

JaVia Green, Staff Analyst, said the CIP looks at renewal/replacement and expansion needs over a 10-year horizon and it is updated every other year; the last CIP was adopted by the Board in 2009 and since then there have been various studies at Zone 7 including an Asset Management Plan Update as well as a new Water Supply Evaluation. Many of the findings from these studies have been integrated into the CIP.

An Engineering study for the Connection Fee Program which is periodically reviewed was also done this year and we adjusted our connection fees. Some of the findings we found in terms of fiscal impacts are that the renewal/replacement system-wide improvement projects proposed over the next 10 years are consistent with the Asset Management Plan targets adopted by the Board in June and the ones we talked about in detail at this meeting. The new engineering study recommends an inflationary adjustment to the connection fees based on the change in the ENR from September 2010 to September 2011 and looking at increase from August to August, it was about 2.6% so the September increase will likely be roughly the same. Will know in a few weeks when ENR publishes the data. We also have Dougherty Valley Facility Use fee which is a buy-in fee from Dougherty Valley developers to pay for Zone 7's existing infrastructure. This is revenue that goes to Fund 72, Renewal/Replacement Fund, and per agreement with DSRSD to provide services to Dougherty Valley; this fee is updated every five years.

The sources of funds for CIP are property taxes for flood control general fund; for Fund 72 – Renewal/Replacement System-Wide Improvements – transfer from Fund 52 (water rates). Per the AMP resolution, connection fees pay for expansion projects and development impact fees pay for flood protection and stormwater drainage projects that are funded from Fund 76. The

Urban Water Management Plan, Asset Management Plan, Water Supply Evaluation, Stream Management Master Plan and Development Impact Fee report studies have input into the CIP.

Assumptions for revenue: Fund 50 (property taxes) use baseline of $5.75 million and assume a growth rate of 1.5%. For Fund 72, the study assumed the Board-adopted targets. For connection fees, the study used information from retailers as part of the Urban Water Management Plan update and from that study, 32,070 new dwelling units which are equivalent to 5/8" meters that will be connected to our system through 2040; close to 45% are from DSRSD with the remaining coming from the other retailers. Credits and pre-paid connections offset the revenue we will receive from the 32,070 which turns into 30,476 net connections that will result in revenue to balance it.

President Figuers said that if Zone 7 decides not to build some projects, it will directly affect the cities and they won't be able to build houses because Zone 7 will not be able to supply the water. If we don't collect money to build things, it delays retailer growth and their ability to pay, too. He would like retailers to continue to attend meetings because the Committee will need their input.

Ms. Green explained that our ability to pay off the ISA as well as our non-discretionary expenditures will be impacted if connections do not materialize as projected. Starting in FY 2011-2012 through FY 2014-2015, we started to project 3,030 connections over the next four years. We looked at the minimum amount of connections to allow us to pay for our non-discretionary expenditures. A variance of up to 500 connections would provide sufficient funding to pay for our non-discretionary obligations as well as paying off the ISA. This is achieved by deferring discretionary expenditures that are planned over that time frame. If actuals vary by more than 500, then in drawing the ISA, we may have to look at other things such as drawing from sinking funds (our sinking fund balance for FY 13-14 when we need to pay off the ISA will be about $9.5 million) potentially borrow from other Zone 7 funds, or re-negotiating the terms of the ISA with Wells Fargo. Staff provides a quarterly report on Fund 73 so we will continue to communicate it to the Board and if we notice any significant connections, we will tell the Board and not move forward with discretionary projects.

Director Moore asked how many equivalent connections are coming out of the new outlet mall?

Ms. Duerig responded that it is hard to say since there are credits being used for big projects. In the past, instead of borrowing from a bank, we borrowed from developers and then gave them credits. We have been seeing a lot of requests showing up when we least expect it. It affects the cash flow. We do not know how many will be used, if any, for this project.

President Figuers asked if you start looking at the dwelling unit equivalents projected to about 2015, you are only looking at about 650-800 per year, so we could withstand 100 per year or 20% (a total variance of 500).

President Figuers asked if any of the flood projects are controlled by long-term weather patterns or are these based on development?

Ms. Duerig responded that this particular fund is the development fee scale. If you talk about Flood Control in general, that is related to long term hydrological factors and development impacts such as new impervious surfaces when new development comes in.

4. 2011 Draft Treated Water Connection Fee Update

Amparo Flores, Associate Civil Engineer, in Integrated Planning, stated that the connection fee planning horizon goes through build out so it starts in FY 2013 through FY 2039-40. Expenditures through build out are anticipated at $985 million in program costs with $100 million in a 10% program contingency given the long planning horizon. We also have $8.6 in connection fee administration which is essentially remitted to the retailers. When they send us their connection fee revenue, they keep remit 1% to cover their own costs.

Major projects coming up to serve the water system expansion include projected fee connections. General notes on how they account for projections: Zone 7 has about $30,500 in pre-paid connections for a revenue stream, we create sinking fund contributions through FY 2029-30 for big projects on the list, and we are able to cover payments for these projects. If no connections occur after that time, we can insure we are able to make payments. Target of maintaining minimum fund balance of 50% of the following years on discretionary obligations and we are using a pay-as-you go model.

The shift we use for growth cycling incorporates some of the uncertainty. We also show a peak number of new DUEs in one year. For our projections, we have this a peak projection of 2,800 connections happening around FY 2017.

Staff recommends a 2.6% increase in the connection fee. Dougherty Valley has a different connection fee which has not been adjusted in five years. The Dougherty Valley connection use fee is set up as a buy-in for Dougherty Valley residents to buy into the system and the recommendation is to adjust the fee by 17.7%. representing five years of inflation. .

General Manager Jill Duerig said that although the connection fees can be increased every year, based on inflation, about every five years we do the more detailed engineering analysis. This is particularly critical this year because the Urban Water Management, the Water System Evaluation, and some others studies were used to complete engineering analysis. Even though things shifted around, we are still only recommending an inflation increase.

President Figuers suggested deferring a recommendation until the next meeting because a piece of the CIP affects the water rate increase.

5. Verbal Reports - none

6. Adjournment

Since there were no further issues or comments, the meeting was adjourned at 6:15 p.m.