SUMMARY MINUTES OF THE FINANCE COMMITTEE
ZONE 7 BOARDS OF DIRECTORS

September 13, 2011
4:00 p.m.

Directors present:	Sandy Figuers A.J. Machaevich Chris Moore	Zone 7 Staff:	Kurt Arends, Asst. General Manager, Engineering John Yue, Asst. General Manager, Finance Tamara Baptista, Financial & Systems Service Manager JaVia Green, Staff Analyst Judy Rector, Board Secretary

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

1. Public Comment – None

2. Preliminary 2012 Treated Water Rates

John Yue, Assistant General Manager, Finance, reminded the Finance Committee that the purpose of the meeting was a continued discussion on the Treated Water Rate recommendation. The untreated water rate recommendation was approved at the August 29th meeting by the Finance Committee. New materials were also included in the presentation to address comments heard in discussion items from the previous meeting.

Tamara Baptista, Financial & Systems Service Manager, repeated the three alternatives presented at the August 29th meeting:

Alternative 1:

Revenue covers both Operating Expenses and transfer -10% water rate increase in 2012 will use the previously approved $1.8 million in reserves in 2012 and no further use of reserves beyond 2012. Water rate increases proposed are 6.75% for 2013, 7% for 2014, 1.0% for 2015 and 8.25% for 2016.

Alternative 2: Use of Reserves - 5% water rate increase for 2012 (using $2.5 million in 2012, $1.7 million in 2013, $1.8 million in 2014 and $0.8 million in 2015 of reserves) and 7% increase each year through 2016.

Alternative 3: Midpoint between Alternative 1 and Alternative 2 - 7.5% water rate increase for 2012 through 2014 and 5% for the next two years using $2.1 million in 2012; $0.7 million in 2013 and $0.5 million in 2014 or reserves).

Staff's recommendation is Alternative 3, the midpoint. Although not fully funded (still using reserves) it does not deplete reserves as much as the 5% water rate.

Update from the August 29th Finance Committee

Retailers had some comments including: (1) questioning the Asset Management Plan (AMP) funding levels adopted by the Board on June 15, 2011; (2) retailer comments on the Taste & Odor Project (in the CIP called the Ozone Project) and they feel Zone 7 should not consider this project in the current difficult economic times; and (3) retailers feel Zone 7 reserves are above the current Board policy for reserves.

The Committee also had comments: (1) questions on Zone 7 reserves and what our reserve levels used for; and (2) what cuts are needed to make a 0% increase for FY 2012 water rates? During the 2011 AMP study, Zone 7 had multiple meetings including a March 10, 2010, Kick-Off meeting for the AMP study and all retailers were present; and in July 2010 and March 2011, there were two stakeholder workshops where all retailers were present. In April 2011, DSRSD requested a meeting to discuss funding analysis for AMP. In that meeting DSRSD discussed funding analysis including moving the water conservation program to the operating budget; removing the third demin project from the funding analysis; debt finance larger system-wide improvement projects (i.e., Ozone project); and balance water quality expenditures with economic climate (i.e., Ozone project).

In May there was a Finance Committee meeting on the AMP and all retailers were present except Cal Water. At the Finance Committee meeting, the retailer funding analysis was discussed and addressed.

At the June 15, 2011, Board Meeting, all retailers were present except for Cal Water, and the recommendation adopted by the Board incorporated two out of the four retailer comments. Those two are moving water conservation programs to the operating budget, which was done, and moving the demin project from the funding analysis, which was also done. The third and fourth recommendations having to do with debt financing and water quality expenditures, specifically the Ozone Project, doesn't have any impact on the near term water rates.

The ultimate annual AMP transfer target is $11.4 million in 2011 dollars (to be adjusted for inflation and other revenue sources). Based on retailer discussion, Zone 7 adopted a schedule ramping up to the $11.4 million level meaning that only $6.6 million for FY 12/13 will be transferred; $8.5 million for FY 13/14; $9.5 million for FY 14/15; and $10.5 million for FY 15/16 followed by $11.4 million for FY 16/17 and beyond.

John Yue added that since we haven't reached the recommended level, the Ozone Project and debt financing of it doesn't play into the new rates.

During the May 2011 Finance Committee meeting, staff had a presentation slide that showed that the Ozone Project (Taste & Odor) is about $1 million of the $11.4 million which would bring the target level down to $10.4 million. If you did take out the Ozone Project, that would hypothetically bring the AMP funding requirement to $10.4 million which would not be reached until FY 15/16. That is why the Ozone Project does not have an impact on near-term water rates because we are not getting to the AMP requirement until FY 16/17. Even if $1 million was removed for the Ozone Project, Zone 7 will still not reach the funding target until FY 15/16; therefore the Ozone Project does not have an impact on near-term water rates.

John Yue said that possibly by that time if the economy changes, then, following up on one of the comments made at the last Finance Committee meeting, retailers might desire to re-evaluate the Ozone Project during the next AMP update. Bottom line is that in terms of the next three years with the water rates, whether that project is in there or not, it wouldn't make a difference on the water rates because of the slow ramping up of the AMP contribution over the next few years.

Board comments included a question by President Figuers on the use of reserves. Ms. Baptista showed a chart indicating explained how $12.3 million dollars (assuming a 7.5% increase) will be used in reserves since FY 01/02 through FY 11-12.

President Figuers asked about the four reserve funds listed in the Reserve Fund Policy attachment to the agenda and if these are the funds we currently use?

- Rate Stabilization (drought contingency) in case of unforeseen hydrologic events
- Emergency/Operating Reserves – provide for emergencies and cash flow requirements
- Designated Reserves – to provide for increases in operating expenses in excess of the target provided by the Board
- Capital Projects and Contingencies Reserve – for capital improvements in the future and can also be used to fund unanticipated capital projects.

The policy says: "Zone 7 will maintain fund emergency expenses, cash flow requirements, and capital improvement plans, while avoiding significant rate fluctuations through the changes in funding needs." He assumes they are being used for those purposes.

John Yue responded that the first three pertain to the water fund operating budget and the last one does not because it pertains to capital projects.

President Figuers asked what is the minimum balance on these four funds and is there any policy, written or unwritten, which says the fund will not be allowed to drop lower than a certain level. What would happen to the rate increases if we didn't have the AMP?

Mr. Yue said that would be a total restructuring of the rate structure because the AMP funding coming out of the water rates is to maintain the infrastructure so it has always been built into the water rates as a source of funding to be sure that pipes don't break or blow up and the plants continue running. Ms. Baptista said that they do a transfer for the AMP to the Renewal/Replacement Fund so the main revenue is from the transfer of the water sales. That is how our existing infrastructure is funded. There is no policy on the minimum balance of the various reserves.

Mr. Yue added that all three funding scenarios presented so far continue to use available reserves; it is just a matter of how deep and how long we go into using the reserves. Director Moore asked what sources of reserves were used to fund those amounts. Mr. Yue responded that in this particular case, staff did not differentiate between those three types of reserves, namely Emergency Operating, Rate Stabilization, or Designated. It is a combination of those three plus any excess general undesignated reserves.

Director Moore clarified that Zone 7 has co-mingled the reserves so if we are funding the AMP with reserves, you are just moving one reserve over to fund any future liability. Do we have minimum amounts in all three? If so, we should be telling the public that we are using this amount for reserves and what reserve pot they are coming from so we can discuss when it is appropriate to use what reserves when, should they be put together, and if not, at what level should we keep each? Ms. Baptista said that is revisiting the reserve policy.

President Figuers asked if we could pull more money out of the reserves and how much would we have left in reserves between all of them?

Ms. Baptista talked about the Board-designated reserves for the Zone 7 water enterprise fund which has the Undesignated Reserve plus the three Board-designated reserves: Rate Stabilization, Emergency/Operating Reserves and Designated Reserves. Policy states that the Operating /Emergency reserves is 20% of operating expenses. The Rate Stabilization reserve is currently at $5 million. The Designated reserve for the increases in the operating expenses balance right now is $0.

Director Moore asked if we had ever used the Rate Stabilization reserve for anything and was told that Zone 7 has not used it since 2005. But Ms. Baptista said it does not continue to grow, it remains at $5 million. Mr. Yue said the policy did not specify a minimum or maximum. Ms. Baptista stated that in 2005 the balance was around $4 million and it was increased for two years to bring it up to $5 million. This was based on research for industry-standards for rate stabilization which was 10% of revenue. Staff's target was to get to that point but it was not reached so it stayed at $5 million and has continued to stay at that amount.

Director Moore asked where the money was coming from for the reserves the last four years and was told it was the excess. Ms. Baptista compared it to a checkbook balance where the money was appropriated and it goes back into the fund balance if not used and the same for the next year if not used. Mr. Yue clarified that the excess is beyond what is designated by the Board.

Budgeted Reserves for FY 2011-12 and FY 2012-13 using the 7.5% staff recommendation. What's in there?

- Operating and Emergency reserves: 20% of operating expenses
$6.7 million for FY 2011-12
$6.6 million for FY 2012-2013

- Rate Stabilization: $5 million (every year, no additional money)

- Undesignated: $6.0 million for FY 2011-12
$5.4 million for FY 2012-2013

Mr. Yue used "buckets" as an analogy for reserves. For example, the Designated "bucket" is empty so it is not shown.

President Figuers asked if he said he wanted a check written for the balance of all the reserves we have right now, would it be over $15 million? Mr. Yue answered "Yes. $17.7 million." But Mr. Yue went on to explain that one of the reasons why it works out this way is because there isn't a minimum and a maximum. The undesignated portion is being used to keep those "buckets" full where Operating/Emergency and Rate Stabilization reserves are being used more for unforeseen events. The bottom line is how these total reserves, regardless of how many buckets there are, compare to someone else?

President Figuers asked if every year these reserves are re-funded and do they ever actually go to "0?" Mr. Yue replied that we actually have been using reserves.

Director Moore reiterated that the Rate Stabilization Fund has not been touched so if you take that out of the mix, all you have left is Operating/Emergency and Undesignated and that is what has been funding those last four years in whatever combinations. The Board has a policy of 20% which is lower than some, higher than others, but given the fact that we are a service – maybe we should take the undesignated reserves, put it in the Operating/Emergency reserve, and set that percentage as higher than 20% or pick that rate rather than have a bunch of different funds that are combined. Right now we are over the 20%.

President Figuers commented that we have never used the Rate Stabilization reserve that is for rate stablilization and we are not pulling anything out of that $5 million fund that is not designated to do anything.

Director Moore said we have had a couple of drought years but not a sustained drought where the rates were going to go up so it is probably smart to have a fund to dip into for dry years and having a reserve fund is good, but having two reserve funds is confusing. We should change our policy to move away from that. It might be clearer to the retailers in the room who question year after year about what is our reserve policy and what do we need to maintain it?

Ms. Baptista tried to clarify by saying when they look at the water rates, they look at revenue, operating expenses, and a transfer for AMP, and make sure there is enough money to fund the Operating/Emergency and Rate Stabilization reserves per the Board policy. They make sure the fund balance never dips below the $6.7 million and $5 million so these two are always within our planning models. The Undesignated is the remaining balance.

President Figuers asked what would happen to us if those numbers were "0," we didn't have those reserves, and we have an emergency? Ms. Baptista replied that Zone 7 wouldn't have money to pay for repairs but could do an emergency water rate increase and raise rates to cover it depending upon the market climate but it would take a while. Mr. Yue stated that if it is a natural catastrophe, and we set aside enough to cover the entire infrastructure in case of a major event, reserves would be so high that it doesn't make sense. If it is a significant-enough event, everyone would look towards FEMA for reimbursement. Since that works on a much delayed basis, we still need to be able to have some money up front for repairs.

President Figuers asked about insurance. Mr. Yue said the cost would be comparable to self-insurance which is what we are doing.

Director Moore said he is trying to figure out the reserves and how we got there and maybe recalculating it and calling it something different. The Undesignated piece seems to stick out as an "extra."

President Figuers said it is the staff's best estimate that approximately a $12 million lump sum is what you evaluate Zone 7 needs in case of some kind of catastrophic failure in the Operations/ Emergency Fund, coupled with Rate Stabilization (which was put in for that rare event of a temporary drought to avoid raising rates), but by definition we would have to re-fund that rate. We would still be raising rates but all we would have to do is a shock absorber and present a rapid 30-40% rate increase. In '91 we put a surcharge in lieu of rate stabilization but it was voted out later. What we are facing now is trying to even out rates. It is still a 6-8% per year rate increase.

Mr. Yue added that because different agencies define their "buckets" of reserves differently, staff thought the most comparable platform was looking at total reserves. A common measure of that is what total reserves are as a percentage of operating expenses.

Zone 7 reserves, based on a 7.5% increase in 2012, are 53% of our operating expenses for FY 11-12 and 51% for FY 12-13. Ms. Baptista used DSRSD for comparison purposes. DSRSD has a minimum and a maximum range for their reserves and in the middle is a target for their Board reserve policy. This budget-to-budget comparison confirms that Zone 7 is "in the ballpark" using the 7.5% scenario. Even with the 7.5% scenario, it is not a situation where we are not using reserves at all so the trend from the first year and second year is a decrease in the percent coverage. Looking at DSRSD's budget documents for those two same years, they were planning on a 52% coverage in FY 11-12 and then going up slightly in the following year.

Randy Werner, City of Livermore, repeated that Zone 7 has a rate stabilization fund to smooth out rates in case there is a drought. We went through a drought and rates went up 8.5% in 2008, 16.2% in 2009, and 9.25% in 2010. The $5 million has never been used.

Darren Greenwood, City of Livermore, asked how big of a drought do you need before it triggers using the rate stabilization reserves. Zone 7 has a groundwater basin and unless it is significant, we are going to rely on the basin. If it is catastrophic, it is going to be a number of years and you only have to cut back and ration water. So for the first few years of any kind of supply interruption, the idea that Zone 7 needs higher rates is a fallacy because the retailers will raise the rates to make up for the reduction.

President Figuers asked what type of emergency would cause significant problems physically to Zone 7 for us to start pulling money out of the $5 million Rate Stabilization reserve? President Figuers restated that Zone 7 has $15 million in funds and we are ramping up to pay for infrastructure over a 20-year time period. This is not an emergency but we are using these "emergency" funds for a completely different purpose. We have a mismatch between what they are called and what they are defined to be and what we are actually using them for.

Mr. Arends agreed that the name is different but the purpose for them is "unexpected." The intent was not to be used for annual budgeting purposes as much as when you're off on your budget projections.

All agreed that the remaining balance is for discretionary use. Director Moore said that there are no objections to the Operating fund, or the Rate Stabilization, but the Undesignated reserve is the problem.

President Figuers feels the whole topic of reserves is worth a separate issue for the Board. It can be revisisted over the next six to nine months and we have time to work on it. We can accept current reserve usage, revisit it for next year, but recognize that it impacts the current rate increase discussion now.

Randy Werner, City of Livermore, commented that Zone 7 has four reliable customers in their retailers for treated water cash flow reflected by how well everyone does their estimates on how much water is going to be used and how much to buy. As long as those are accurate, Zone 7 should be in good shape because they have a reliable source of income from the retailers.

Mr. Yue said that in the dry year example, in a drought, water sales volume-wise go down because of a potential need to conserve. On the other hand, Zone 7 may be paying out to DWR for unplanned expenses, so suddenly you have a big stretch between revenue dropping below revenue budget levels and expenses going up way above budgeted levels. It has absolutely nothing to do with revenue cash flow from the retailers because you will continue to pay your bill even in a drought situation. The amount of revenue coming in is reduced because of the lower volume potential in that situation.

Ms. Baptista returned to the Board's question from the last Finance Committee meeting on what cuts are needed to make a 0% increase for the 2012 water rate? Zone 7 can:

- <u>Reduce operating expenses</u>. The current budget and the preliminary budgets are $2.2 million to $2.5 million less than the FY 2010-2011 budget so operating expenses have been reduced by cost-saving initiatives (such as the soft-hiring freeze and a shift of contract maintenance work to in-house staff) resulting in a decrease in costs. Some of the reduction is due to being part of the chemical consortium to purchase chemicals. The bulk of cost saving is due to a soft-hiring freeze ($1.8 million) per year. There is not much room for further reductions without significant impact to service levels.

- <u>Lower fund transfer contribution to the AMP</u>. For FY 2011-2012, the AMP transfer is $5 million whereas last year the contribution was $5.4 million so the transfer is already less $400,000. Furthermore, the recent Board-adopted AMP funding targets reduced the FY 2012-13 contribution to $6.6 million. The required funding level is $11.4 million in 2011 dollars and Zone 7 doesn't reach that until FY 16-17 because we are ramping up to that funding level. The fund contribution is already lower than the 2011 and 2012 recommended levels.

- <u>Reserves</u>. There has been a deficit of $4.3 million from FY 08-09 to FY 2010-2011 so we have been using $4.3 million of our reserves.

Director Moore confirmed that the Board just voted on a $6.3 million increase three months ago for the AMP. The AMP is a transfer from Water Enterprise to the Renewal/Replacement fund because the capital fund for our existing infrastructure is funded by a transfer from Water Enterprise.

Alternative 1 (10% water rate increase) would use $1.8 million for the current year FY 2011-12 and then $0 thereon. Altenative 2 (5% water rate increase) the total for that water rate model would be an additional use of $6.3 million from reserves. Alternative 3 (7.5% water rate increase) Zone 7 would use $4.3 million in reserves.

Zone 7's revenues <u>will not</u> be covering operating expenses. All alternatives still use reserves (Alternative 1 uses them for the first year only). If Zone 7 did have a 0% water rate increase for FY 2011-2012, we would need 18.5% for FY 2013.

Director Machaevich asked what if we did not use reserve dollars, what are we losing? Are we going to lose the ability to fund our infrastructure? He wants to tell the public what Zone 7 would not have and if we don't raise rates, this is what could happen. He is considering a fully funded, 10% increase so Zone 7 does not have future increases. There is not going to be that much difference between a 7.5% and a 10% increase and he would rather be financially responsible and clean for future years and not have increases every year.

Ms. Baptista stated that a water rate model was done but if you look at operating expenses, it would be roughly a $3.5 million reduction every year ongoing. Mr. Yue said a $3.5 million difference could come from either operating expenses or a reduction in the AMP. If there is a reduction in the AMP, then the ability to continue to maintain the infrastructure goes down.

Director Machaevich asked what if the AMP was reduced 20% or 50%? He wants to make sure it is on record and that the Board has a chance to talk about it.

Director Moore asked what would be the dollar amount for a 0% increase? Ms. Baptista says it would wipe out the Unrestricted reserves for the first year. He said you have "X" amount of money and this is what the budget is so you cut the expenses, which was done. The Board just did the AMP and if this Committee recommends undoing it, we could make the recommendation to take all money put into the AMP so that we could go to $0, just basically funding the budget so we didn't have to raise rates. He is not sure that is the wisest course either, so is there something where we don't wipe out completely the unrestricted reserve but we reduce it by a couple of million dollars and reduce the rates to something, maybe not zero, but something closer to 2.5%. This is the discussion we had last year. The Finance Committee talked about not having the burden of giant rate increases.

Director Machaevich asked about last year's projections and what were the projected numbers?

John Yue replied this time last year when reviewing the 2011 water rates, there were several different assumption changes; however, setting those changes aside, the Board adopted a 2.5% rate increase in 2011.

Director Moore said last year the Board considered a double digit increase and came in at zero. Same discussion just another year with more data, and yet we reduced our reserves further. What we were told then was if the Board approved 2.5% last year, what we would realistically need to do next year is 5% which is Alternative 2.

Ms. Baptista then showed a slide in her presentation that Darren Greenwood, City of Livermore, had asked for that showed historical data for other agencies. The average of all agencies surveyed was 48% and Zone 7 is close to the average.

Ms. Baptista reminded the Committee members that Alternative 1 does not include water rate smoothing.

Dan Martin, City of Pleasanton, asked at what point in the process were the system-wide improvement projects brought into this process relevant to the repair/replacement, the timing. After that, at what point did we start talking dollars and cents as money because you have no comments at the first three steps because neither system-wide improvement or funding were discussed at those points. When you see a lot of retailer reaction and involvement is when, at the eleventh hour we see the other shoe which is informing them that Zone 7 is doing system-wide improvements and this is what it will cost. He tried to vocalize at the last Board meeting that he had concerns about that vote. Then there was a discussion four months later about funding because we talked about dollar amounts before but we did not say and this is a 10% “hit” on the ratepayers in October. They said we would talk about that later and we said, please be careful, we will be back when you start talking about the hit we will have to take, and here we are.

Director Moore said for purposes of this meeting and the Committee’s recommendation, the concerns are out there and we all heard the discussion so it is a decision at the Board level. To the extent that it affects next year’s rate, we have had a good airing of the issues. He is comfortable recommending 5%, Alternative 2, because he is concerned that the Board just voted on AMP and then are cost saving measures that could be cut even more.

Director Moore moved and Director Machaevich second a motion to recommend a 5% water rate increase to the full Board. All three Committee members approved with a voice vote of 3-0.

3. FY 12/13 Draft Capital Improvement Program and

4. 2011 Draft Treated Water Connection Fee Update

John Yue introduced the next agenda item as a biennial exercise outlining projects for the next ten years and then an update of the 2011 Draft Treated Water Connection Fee Update. Staff Analyst JaVia Green said she was not giving a presentation but the action had been deferred until the Committee resolved the water rate issue. She asked for the Committee’s concurrence to move forward with making presentations to the full Board on September 21 for information and discussion. In October Zone 7 staff will ask for adoption of the connection fee as well as the 10-year CIP.

Director moved to recommend adoption to the full Board and Director Machaevich seconded the motion. All three Committee members voted for approval with a voice vote of 3-0.

5. Verbal Reports - none

6. Adjournment

Since there were no further issues or comments, the meeting was adjourned at 5:10 p.m.