SOUTH FEATHER WATER & POWER AGENCY

TO: Board of Directors

FROM: Jennifer Slinkard, Finance Division Manager
Michael Glaze, General Manager

DATE: September 8, 2006

RE: Strategic Financial Plan – Water Division - 2007-2012
Agenda Item for 9/26/06 Board of Directors Meeting

The purpose of this report is to provide the Board with information to facilitate Water Division budget planning through 2012. This six-year planning period was selected because it is short enough to ensure relative predictability, but also long enough to incorporate the revenue changes that will come in 2010 when the present power-purchase contract with PG&E terminates and the next contract is implemented.

The present power-purchase contract with PG&E has been in existence since 1960 (with an amendment in 1983 when Sly Creek Powerhouse was built). It is referred to as a "hell-and-high-water" contract because it requires PG&E to bear all project costs: routine operation and maintenance, required and necessary capital improvements and repairs, as well as all debt service. This type of contract was prudent for OWID at the time the South Feather Power Project was built. OWID had a valuable hydroelectric resource that needed to be developed, but no funds with which to make it happen. The contract with PG&E allowed the project to be financed, built, and operated with minimal risk for the District. Further, by the end of the contract (2010), all project financing will be defeased.

The negative side of the hell-and-high-water contract is that there was no significant revenue coming to the District from the sale of its power. That changed nominally when Sly Creek Powerhouse was built, and after the tailwater-depression system was installed at Woodleaf Powerhouse. Subsequent to those two events, the Agency has enjoyed an annual income from the hydro project of $1 - $1.5 million. Those funds have been used to subsidize water rates (primarily for irrigation customers) and capital improvement projects.

Aside from the fixed income from power sales, and the revenue coming in from sporadic water transfers (used to fund our ongoing relicensing efforts), the Water Division has been dependent on revenue from the retail sale of water to domestic and irrigation customers, together with limited property tax revenue and fees for customer-requested services, to fund the operations and maintenance of its water system.

The Agency's financial structure will change significantly after FERC relicensing is complete and a new power-purchase contract is in effect. While we do not know the details of that future contract, nor with whom the Agency will be partnered, we know with reasonable confidence what the South Feather Power Project will produce in the way of income for the Agency.

In September 2005 the Board retained McDonald Partners to provide the Agency with energy advisory services. Subsequently, Michael and Sandra McDonald prepared a preliminary valuation assessment using historical production data, current industry practices and regulatory constraints, and future pricing projections. Based on their valuation – with consideration for the 2005 Agreement with Yuba County Water District (50/50 sharing of net proceeds, consumptive-use diversion allotments, etc.), reduction in generation capacity that will result from increased environmental-water releases mandated in the new FERC license, and capital improvements that will be requirements of the new FERC license (rehabilitation and expansion of recreation facilities, etc.) – I am estimating an average annual income from the Power Project after 2010 of $10 million.

This new source of revenue will significantly improve the Agency's ability to maintain its existing water-distribution infrastructure at a dependable level of serviceability, as well as provide for the community's growth. Funds will then be available to provide expanded treatment and storage facilities, expand domestic-water distribution infrastructure into areas that are appropriate for residential, commercial, and industrial development, as well as drastically reduce the amount of unaccounted water in the raw-water distribution system by lining and/or piping gold-rush-era earthen ditches and canals still in operation.

Although the present PG&E power-purchase agreement will be in effect for another four years, now is the time to plan a strategy for transitioning to the Agency's post-2010 economic structure to ensure that rates and budgets over the next four years are adequate, and to optimize and prioritize planning for needed capital improvements. The purpose of this report is to provide information and recommendations that will facilitate the Board's ability to make appropriate decisions in that regard.

FINANCIAL FORECAST

Attached is a spreadsheet entitled "Water Division Financial Forecast from 2007 through 2012." The format of this forecast is the same as the one you see in the annual Water Division budget process. The values shown for 2004 and 2005 are the actual results of a data download direct from the Agency's Springbrook Financial Software. The 2006 estimate is the result of an account-by-account, year-to-date update, with consideration given for non-linear account activity that could affect that account's activity through the end of the year.

Revenue projections for 2007 through 2012 assume average water-years with no rate increases. Water sales revenues in the 2006 budget were used as the starting point for the 2007 forecast. Each year thereafter revenue was increased by 0.6%. This conservative increase assumes a small number of new service connections, rather than making the forecast dependent on a larger growth rate. With this methodology, any additional growth can be used to offset decreased revenue from less-than-average water years. TWD (tailwater-depression system) revenue was estimated at $250K per year through 2010, and all PG&E related revenues remaining flat through June 2010. All other water-service charges and non-operating revenues were estimated at a value close to the average for the most recent three-year period.

Expenses were estimated using an average of the most recent three-year period where appropriate. All payroll-related expenses were increased annually by at least 3% from the 2006 estimates. Increases in insurance, health care, and fuel costs were estimated on the basis of prior years' actual values. The majority of the other expense-category estimates were based on the values in the 2006 projections.

Debt-service compliance coverage is shown at the bottom of the forecast spreadsheet. You will see that there is more-than-adequate coverage from now through 2012 for our debt service covenants which require that our net revenue be 125% of debt service obligations. For 2007 through 2012, excess revenue ranges from $368K to $8.8M. These funds would be available for capital projects or augmenting reserves.

RECOMMENDATIONS – 2007 through 2010

In 2002, in conjunction with adoption of the 2003 Water Division budget, the Board approved the staff-recommended rate structure shown below.

	DOMESTIC			IRRIGATION	
	Volumetric Rates		Monthly Service Charge	Volumetric Rates (per acre-foot)	Monthly Service Charge
YEAR	First 10K ft^3	Over 10K ft^3			
2003	$ 0.64	$ 0.25	$ 15.00	$ 45.00	$ 17.50
2004	$ 0.64	$ 0.25	$ 15.00	$ 45.00	$ 17.50
2005	$ 0.64	$ 0.25	$ 15.00	$ 45.00	$ 17.50
2006	$ 0.64	$ 0.25	$ 15.00	$ 45.00	$ 17.50
2007	$ 0.64	$ 0.25	$ 15.00	$ 45.00	$ 17.50
2008	$ 0.65	$ 0.26	$ 15.00	$ 45.00	$ 17.50
2009	$ 0.67	$ 0.28	$ 15.00	$ 45.00	$ 17.50
2010	$ 0.70	$ 0.31	$ 15.00	$ 45.00	$ 17.50

Given the current economic health of the Agency as demonstrated in the attached Financial Forecast, the significant post-2010 increase in hydro-generation revenue, and the recent California Supreme Court decision concerning Proposition 218 (subjecting rate increases to majority protest), we are recommending that the rate structure, above, be modified to reflect a continuation of the 64¢ - 25¢ domestic volumetric rate through 2010 (i.e., no rate increases).

For similar reasons we are also recommending that the monthly backflow maintenance charges be held at their current values as shown below. This would effectively suspend the automatic annual increase in theses charges in accordance with the Engineering News Record's National Construction Cost Index.

Presently, monthly charges for maintenance and testing of backflow prevention devices are as follows:

Size:	¾"	1'	1½"	2"	3"	4"	6"	8"	10"
Charge:	$4.72	$7.07	$9.46	$10.63	$23.63	$28.34	$41.34	$50.00	$58.00

RECOMMENDATIONS – After 2010

As has been discussed above, the Agency's revenue from hydro generation will increase significantly after 2010. There are many capital improvement and expansion projects for which those funds will be needed for many years thereafter. However, it seems reasonable that a portion of those proceeds should be used to offset the cost of water for the Agency's ratepayers. At the same time, it seems reasonable to take advantage of the opportunity to simplify our rate structure to eliminate what will then be unnecessary concessions for unique classes of users.

The following recommendations, if adopted and implemented in 2011, would necessitate dedication of approximately 9.1% of the anticipated hydro-generated revenue in 2011 (while the Contingency Reserve Account is being funded), and approximately 6.4% of the anticipated hydro-generated revenue thereafter..

Domestic Water Rates – reduce to 30¢ per unit (all usage, including amounts above 10K ft^3)

All domestic customers presently pay 64¢ for every 100 cubic feet (one unit) of water they consume until they exceed 10,000 cubic feet. Thereafter, although the cost to treat and deliver the water does not decline, the rate they are charged for the water drops to 25¢ per unit. During the winter of 2005/06, an average of 39 out of approximately 6,700 domestic customers exceeded 10,000 cubic feet of consumption during any single month. During the months of July through September of 2005, an average of 440 customers exceeded 10,000 cubic feet of consumption.

If the rate for all water consumed is set at 30¢ per unit, almost all customers will experience a 53% reduction in their commodity rate during the winter time. In the summer, an average of 440 customers will have their rate go up 5¢ per unit for all water they consume after the first 10,000 ft^3. For these 440 customers, they will still experience an overall reduction in the cost of their water until they exceed 78,000 ft^3. Only 62 customers exceeded this amount during the recent excessively hot month of July.

For comparison purposes, California Water Service in Oroville presently charges $1.08/unit, and has recently filed an application with the CPUC which, if approved, would escalate that rate to $1.64/unit by July 2009.

Irrigation Water Rates – reduce to $30 per acre-foot (miners inch and metered accounts)

Reducing irrigation rates by $15/acre-foot would be a 33% savings for irrigators. While not as large a reduction as proposed for the domestic system, irrigation water rates have received a much greater subsidization for many years than domestic rates.

Monthly Service Charge - $15 per month for Domestic and Irrigation accounts

The monthly service charge ensures that low-volume users are charged enough to at least help defray basic operation-and-maintenance expenses. Thus, the recommendation is to leave the monthly service charge for domestic customers at its current $15/month, and conform the monthly service charge for irrigation customers down from $17.50 to $15/month.

Again, for comparison purposes, if the CPUC grants California Water Service's request, its Oroville customers will begin paying a monthly service charge of $26.52 by July 2009 (up from its present $16.42).

Monthly Backflow Maintenance Charge – Eliminate monthly charge

Presently, over 1,000 connections have backflow devices installed. As growth occurs, backflow devices will be incorporated into a majority of accounts. Post-2010 rate adjustments should incorporate the cost of backflow maintenance as a component of all other O&M expenses that are funded via water rates as part of efforts to simplify the rate structure.

Oversized Meter Charges – Eliminate discount for not water during the day

Customers with oversized meters (all meters larger than the standard ⅝ residential meter) pay a monthly charge in addition to the regular monthly service charge as follows:

Size:	1'	1½"	2"	3"	4"	6"
Charge:	$6.00	$16.00	$20.50	$50.00	$72.50	$105.00

The Rules and Regulations allow for a 50% reduction in these charges "if all watering is done between the hours of 9:00 PM and 6:00 AM." This recommendation proposes the elimination of the present after-hours water discount that is being claimed presently by 22 customers. Water treated and delivered after hours is not less expensive than that treated and delivered during the day. In fact, the Agency's storage reservoirs are refilled each night when electricity prices are off-peak to supplement the following day's demand. Although a full analysis has not been performed for this report, it may be that supplying large quantities of water at night for irrigation purposes from Miners Ranch Treat Plant – thus reducing the amount available to send to storage – generates additional expense, rather than savings. Incentivizing after-hours irrigating is probably not in the Agency's best interest.

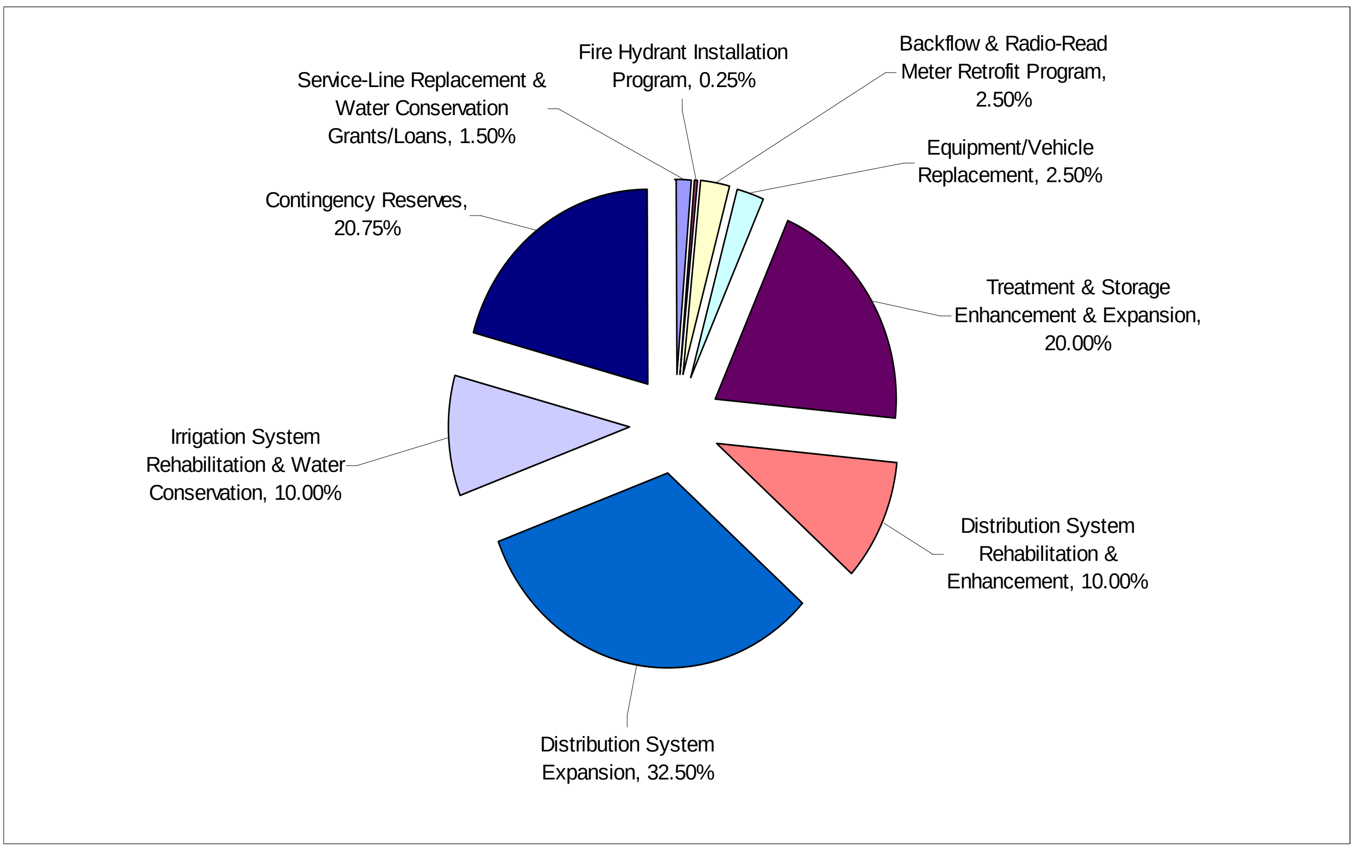
Distribution of Net Revenue

The 2005 Agreement between Yuba County Water District and South Feather Water and Power Agency specifies that any net power revenues will be distributed on a 50/50 basis to the two agencies after June 30, 2010. However, the Agreement also specifies several conditions that affect how much net revenue is available in the first several years for the 50/50 distribution: (1) a "minimum working capital balance of 15% of the budgeted annual operation and maintenance expenses" of the Power Project must be established before net revenue is distributed; (2) a $15M "Contingent Reserve Account" must first be established before net revenue is distributed; and, (3) SFWPA's relicensing expenses (except those relating to Sly Creek Powerhouse – 10.8% of total) will be paid to SFWPA in five equal annual installments before net revenue is distributed. The Agreement allows for a minimum distribution to each agency for the half year from July 1 through the end of 2010 in the amount of $354,500, and $709,000 in subsequent years, subject to the availability of funds for "budgeted operation, maintenance, administrative and regulatory expenses" of the Power Project.

With consideration for the 2005 Agreement's specifications for distribution of the Power Project's net revenue, and for the rate reductions discussed above , it is anticipated that SFWPA will have $5.8M available in 2011, and $8.8M in 2012 (as well as thereafter) after all Water Division O&M and debt-service expenses are paid. It is this report's recommendation that the Board establish a distribution policy for this excess revenue. An example of such a policy is shown below (dollar values are based on a post-2011 net revenue of $8,761,295).

DISTRIBUTION OF NET REVENUE

0.25% -	Fire hydrant installation program ($21.9K annually)
1.50% -	Grants/loans to customers to retrofit old service lines ($131K annually)
2.50% -	Backflow and radio-read meter retrofit program ($219K annually)
2.50% -	Equipment/Vehicle Replacement ($219K annually)
20.00% -	Treatment plant and storage enhancement and expansion ($1.75M annually).
10.00% -	Distribution system rehabilitation ($876K annually).
32.50% -	Distribution system expansion ($3.07M annually).
10.00% -	Irrigation system rehabilitation ($876K annually).
20.75% -	Water Division Contingency Reserve Account ($1.82M annually).



CONCLUSION AND REQUESTED ACTION

As stated above, the purpose of this report is to provide the Board with information to facilitate Water Division budget planning through 2012. The financial forecast incorporated herein demonstrates that the Agency's fiscal health is good, and will be improving significantly after 2010.

The basic recommendation of this report for the next four budget cycles (2007 – 2010) is not to raise water rates and to suspend the automatic escalator in the monthly backflow maintenance charges.

The recommendations for post-2010 are:

- Set the domestic water rate at 30¢ per unit;
- Reduce volumetric irrigation water rates to $30 per acre-foot;
- Conform domestic and irrigation monthly service charges at $15;
- Eliminate the monthly backflow maintenance charge;
- Eliminate the oversized-meter charge discount for after-hours watering;
- Establish a net-revenue distribution policy.

Because this is a planning document, the Board is not being asked to formally adopt the recommendations. Rather, the Board should proceed to give staff directions regarding the next steps it wants taken. At the very least, we would like to know if you agree that the 2007 Water Division budget should be developed on the basis of the no-rate-increase recommendation. Next, although the remainder of the recommendations would not be affected until 2011, we would like to know if you favor the post-2010 recommendations conceptually and, if so, if you would like to inform the Agency's customers now of what you are considering for the future. If not, how would you like to continue this discussion to facilitate a future financial strategic plan that might better reflect the Board's consensus?