Attachment 2

Financial Policies Work Group

Meeting Notes from Dec. 16, 2009

Agenda:

1. Allocation of components of the rate and capacity charge
2. Capacity charge: Work through the connection fee methodology alternative with numbers.
3. Confirm 2010 meeting schedule

I. Capacity Charge Methodology Overview continued (Tom Lienesch)

Calculating the capacity charge involves aggregates. So breaking down the charge requires some estimating.
Handout: Allocation of Costs to Rate and Capacity Charge Revenues (based on 2008). $776 million present value (2003-2030) for capacity charge and $606.5 million for rate revenues. Growth related operating costs are paid out of the sewer rate. Shared capacity charge costs come of the rate only (e.g. CSOs). Capacity charge revenues pay for Brightwater because without this project (treatment and conveyance), the capacity charge goes to almost zero.
Q: If only part of the bonds have been sold for Brightwater, does the total cost for Brightwater include debt service for the full project? A: Yes.
The growth percentage of operating changes annually, up to 28 percent by the end of the period. Excess capacity does not show up in rate calculations. The capacity charge is approximately 56 percent of total revenues. CSOs and Reuse clearly belong in the rate. Conveyance is split between the capacity charge and the rate.
Q: Why is the cost of Brightwater shown as $715.6 million instead of $1.8 billion? A: Some of the cost for this facility has not been entered into the calculation yet because of the 2030 window. The estimated debt service for 45 percent after 2030 for Brightwater.
Q: Transfers to the CIP are associated with what? A: Growth related capital expenditures. For what types of projects? An example is some of the Brightwater conveyance. The amount for Brightwater? Probably half.
Q: Excess capacity means? A: Capacity that is available and will be absorbed by 2030 (only a portion is allocated to growth because it may serve customers beyond 2030).
Comment that $715.6 seems low for Brightwater, but may be okay because it's present value. Another comment that $1.8 billion is nominal and so discounted: probably appropriate given debt service through 2030 with the discount rate plus inflation.
For new customers, calculation is capacity charge revenues plus operating multiplied by .95 (already adjusted in the chart).
Q: How is the tail on the triangle graph accounted for? A: It's factored in that all costs are recovered by 2030.
Q: What happens if additional revenues are required in the near term from the rate? A: Capacity charge revenues recovered post 2030 should place downward pressure on the rate.
Handout: Connection fee alternative with the Brightwater facility as an example. $875 million to serve 110,000 RCEs. Take the project cost and divide by the number of RCEs

(no interest applied until debt is incurred). Handout shows what debt financing looks like if paid off in 10 years and uses current RCE projections. (110,000 RCEs is the weakest assumption because it converts MGD to RCEs).
Q: If you undercharge using the connection fee alternative, then does it become equilibrium and get subsumed into the rate? A: Overriding concern is building for debt service over time. Local agencies would not escalate costs, but have a fixed amount.
Discussed (1) length horizon and (2) debt service stream and revenue stream disconnect.
Q: How closely do you connect benefit/cost or debt service? A: WTD's methodology does not capture the entire time period (i.e., post 2030), but rather is based on debt service. WTD's methodology is, however, reconciled: projections are updated with actuals during the 3-year update.
Discussed whether growth is actually paying for growth. Under the applicable financial policies, yes, 95 percent of the costs of growth are being recovered from new customers through the capacity charge and the rate.
Discussed that keeping the capacity charge the same or decreasing requires a decision on what percentage of growth will the rate bear.
Comment that some local agencies use any "excess" to pay debt service, stabilize the rate or pay cash for the next round of improvements.
Next steps: give RWQC a status briefing, identify concerns/issues with the current methodology and list options (e.g., should the rate pay more of growth costs beyond 2030).

II. Jan. 13th Agenda

WTD staff to bring back information on how responsive the rate is to an increase/decrease in the capacity charge.
WTD to provide information on how much of the rate pays for growth.
WTD staff to talk with Bellevue and Soos Creek staff and others in the work group regarding the connection fee alternative.
Discuss what items should be discussed during January's checkin with the RWQC.
Identify any other questions regarding the capacity charge.

Financial Policies Work Group

Meeting Notes from Jan. 13, 2010

Agenda:
What are the guiding principles that would drive any change?
What does "growth pays for growth" mean?
Economic conditions and the political environment means we may not always achieve that goal.
New growth should pay representative costs for their service.
Do ratepayers subsidize growth? Not necessarily, depends on how much of the facility cost they should bear (e.g. 100%).
Capacity charge was never intended to be connection charge.

I. Capacity Charge discussion continued
Discussed whether this is this really about the capacity charge methodology or how high the rate will go?
Work group still needs to identify underlying issues for the capacity charge.
RWQC tasked the work group with reviewing the financial policies and determine if growth is paying for growth.
Handout: Ratemaking principles (Anne Weigle/Ron Speer). Comment that these guiding principles have to be balanced because they have inherent conflicts.
May want to look at whether the capacity charge methodology would benefit from simplifying the process: this would aid in transparency.
By adding the rate component, it adds great complexity that is perhaps needed because WTD builds to a higher service standard and provides enhanced treatment.
Q: When do new customers become existing customers? A: New customers become existing when they are done paying the capacity charge, but not really because the rate has new customer component.
Q: Should we look at allocations? A: Maybe not because we won't end up differently than what was decided in 90's.
Q: How do we account for increased rate components that everyone should bear and still include rate components for new customers?
Comment that some items the work group may want to look at are: the financial impact of sediment cleanup in the Lower Duwamish, the costs for more stringent nutrient removal standards, CSO costs (shared or not) and the impact of collecting 90 percent of the costs of new growth instead of 95 percent.
Some question as to whether the entire Brightwater cost should be allocated to new customers. Need to look beyond 2030. We have growth needs beyond 2030 that we need to recognize.
Discussed broadening the definition of capacity to a "gallon of capacity" rather than tying new capacity to a specific facility. Could move away from where new customers are located and instead look at things systemwide.
Perhaps Brightwater as a unique facility should be evaluated separately and apportioned between new and existing customers. This could prove too difficult (e.g., what happens

when more stringent treatment costs are incurred and the new customers at Brightwater are done paying but existing would need to pay their share).
Other issues: How high can the rate and capacity charge go? Group expressed a lot of concern. WTD should think about what follows the current capacity charge in the years 2030-2050. Next major capacity improvements would need to occur in the 2020's. The capacity charge would be less because fewer facilities spread over a larger number of people. Lot less than accurate, but our best guess. We have population projections, but do not have all of the identified capital projects. Still the capacity charge would likely go down because adding more people than projects.
Comment that it is important to forecast costs of sediment cleanup in the Lower Duwamish and more stringent nutrient removal costs and provide this information to the state and federal delegations, recognizing that the timing of compliance will impact the rate and capacity charge.
Other option to look at is how we finance debt. Shorter term debt (less than 1 yr) limited to 15% under FP-14. WTD would like to see this raised to 20 percent. Capitalize interest on loans. Looking for longer term bonds. Seek more federal low interest loans. Press for more stimulus.
Comment that when considering short or long-term debt, should disclose to policy makers what other expenses (capital projects) are likely during the life of the debt. (When you know you will have higher treatment costs, they should know that when considering debt terms for other projects so that they have the whole picture.)
Seattle concerned about raising variable debt limitation because of volatility.
Comment that the EPA affordability criteria revised.
Q: Is there an upper limit for the capacity charge? Should include capital needs and costs thru 2050. Compare the total amount of the capacity charge with other impact fees.
Work group members should get input from those they represent on what is the

II. Next Steps
1. Review the guiding principles.
2. Look at variables like the costs impacts of the results of EPA's upcoming review of WTD's long-term CSO control plan and the Lower Duwamish sediment cleanup. Also, look at capacity charge rates thru 2030 (maybe 2050).
3. Apply current conditions analysis by this group. List the policy choices/alternatives. Apply the guiding principles.
4. Share with elected officials.

Comment that group may suggest clarification of whether growth pays for growth and if it does not then what would it take to achieve that, recognizing that electeds may want to go with a different allocation. Yes, the capacity charge methodology does meet the definition of growth pays for growth as currently defined. So are we asking to reevaluate components of methodology?

Twice per year, WTD does 6-year estimates for the rate (e.g., 14% 2011, 9% 2012). The capacity charge increases each year at 3% inflation. WTD could do an alternative capacity charge thru 2050. WTD will bring back 6-yr capacity charge forecast and long-term forecast. One obvious change is to include 2030 thru 2050.

John Gibson to present Seattle's analysis/support for higher capacity charge.
Q Should WTD postpone its 3-year capacity charge update until 2011 (takes effect 2012)? Group says yes. Seattle and Council staff to check with principles.

Next meeting is scheduled for Jan. 27th, 11:30 to 1:30.
Look at other financial policies: what to schedule next. Need to know in advance which ones affect the rate?
Look at short term debt limitation and discuss benefits/disadvantages.
WTD will bring back 6-yr capacity charge forecast and long-term forecast.
WTD to bring back info: for a $10.00 increase in capacity charge, what does this do to the rate?

Financial Policies Work Group

<u>Meeting Notes from Feb. 10, 2010</u>

I. Short-term Debt Issues

Handout – Characteristics of Outstanding Variable Rate Debt
Variable debt – long term instrument from WTD's view, interest rate resets weekly (investor can get par plus any accrued interest and so very liquid, backed by letter of credit from bank). Promise of instant liquidity is key. Letter of credit ensures investor can be paid back quickly.
Q: Is this a policy change with long-term implications or is WTD intending to immediately issue short-term debt? A: 15% limitation uses long-term parity debt as a base, not total debt (excludes state revolving, loans, short-term debt). Current amount: $450 mill is cap and we're at $300 mill. Letters of credit do come at a cost -- annual program costs. Bond insurers went out of business in 2008, with the exception of maybe one.
Q: How often do investors in short term debt change. A: Happens all the time. Someone sells and somebody else steps in.
Discussed 2008 spike in interest rates for variable rate debt. WTD requested and received approval from the County's Executive Finance Committee for an interfund loan to get out of the market and pay off short-term.
Q: Does WTD use Build America Funds debt? For WTD, there are some complications with how Build America impacts long-term debt service coverage ratios. Seattle had some similar concerns, but sought legal opinion on this issue.
Even if the ceiling on short term debt is lifted, WTD would not necessarily max out. Seattle also has a 15 percent ceiling. Very unlikely that a change in the ceiling would impact the County's bond rating. Seattle converted from variable to fixed and debt service coverage ratio dropped from 1.7 to 1.55 (internal policy is 1.25). Bond rating companies are demanding that Seattle return to 1.7 which would require raising rates. WTD plans to 1.25 on parity, and 1.15 on total. WTD maintains 10% of annual operating expenses in reserve.
Even if the 15-percent ceiling is lifted, WTD will not be able to use for several years because there is a limit to how fast you can build back up.
WTD is close to the peak of its Brightwater debt issuance. When this borrowing peaks, we should be at approximately 13 percent in variable debt. This could be converted to fixed, but will experience costs of a "new" issuance.
Use 85-90% of fixed interest rate to calculate coverage for variable debt with respect to the rate. So you build cash, but this will be offset by investment returns, chemical costs, etc.
Work group seemed to recommend maximizing fixed interest because concerns over rising interest rates.
Reason to make the change would be flexibility. What's the risk?
Group does not recommend lifting the 15% ceiling.
Q: Why did WTD recently sell $100 mill in short-term? A: It's only part of WTD's debt portfolio. Converting to fixed though could impact the rate.

RWQC needs a briefing paper on the issue and why no change. County's financial advisor would have to write such a paper that should include description of risk and consequences and explain strategy (possible buy back if short-term rates spike). Executive and Council staff to weigh in. Keep short term debt issue on next month's FPWG agenda.

II. Capacity Charge

For a projection of capacity charge, take last year's plus 3 percent. (Base year plus inflation.)
Q: If you adjust the capacity charge, what is the impact to the rate? A: Handout – sewer rate and capacity charge illustrations. "Levelized" rate is average rate.
$89 in 2030 if costs and growth as predicted.
Q: What happens when RCE's down? Does the capacity charge increase in later years to cover any errors in projections? A: Yes, it could. Capacity charge projections are reviewed every 3 years.
A small rate increase will impact capacity charge.
Remember that if a facility is added or costs increase, the capacity charge covers the cost of that debt thru 2030 (not the life of the facility but that which is incurred within the period).
Discussion over statutory 10-percent interest debt limitation and whether you can increase the capacity charge by the rate of inflation past 10 yrs.
Q: Has WTD incorporated accelerated repayment of debt service? A: No, because we would not be paying back existing sooner. Debt service has been calculated and this does not affect operating budget (sewer rate).
In terms of timing, it was suggested that WTD complete its 3-year review of the capacity charge this year and it was recognized that this may require an adjustment next year if changes are made to the capacity charge based on recommendations from the work group. Should not wait until 2014 (the next 3-year review) to implement any recommended changes.

III. Next Steps

John Gibson briefly described Seattle's previous analysis of WTD's capacity charge methodology looked primarily at allocation decisions (e.g., Brightwater costs from 2002 should be allocated to growth according to Seattle). No need to present a detailed review of Seattle's analysis if work group not looking at revising the methodology and that has not been decided yet.

Discussion of future items and the consensus of the group on what, if any, changes to recommend for the capacity charge methodology. Some suggestions/questions on the capacity charge are:
What happens post 2030 with a lot of debt service still to be paid and no new growth cohort to pay.
Could look at allocations. Or new method that meets principles distributed at prior meeting.
Could explore a new methodology or tweak the existing methodology by adding policies that clarify existing method.

Discussion of check-in with RWQC.
Group will recommend this is where we are – RWQC will either concur or give different direction.
Group should explain policy and how implemented/calculated and make recommendation on policy.
Briefing should describe the complexity of issues: things have changed since policies adopted.