



ZONE 7 WATER AGENCY POLICY AND PROCEDURE

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APPROVED BY: BOARD OF DIRECTORS	REVISION:	EFFECTIVE DATE: SEPTEMBER 28, 2016

1. POLICY STATEMENT

Zone 7's mission is to provide a reliable supply of high-quality water and effective flood control in a fiscally-responsible way. A key element of prudent financial management is to ensure that sufficient funding is available for current operating, capital, and debt service needs. Additionally, fiscal responsibility requires anticipating the likelihood of, and preparing for, unforeseen events. Zone 7 Water Agency ("Zone 7" or the "Agency") will at all times strive to have sufficient funding available to meet its operating, capital, and debt service obligations. Reserve Funds ("Funds") will be accumulated, designated and maintained to allow Zone 7 to fund operating expenses and capital expenditures in a manner consistent with its budget and capital improvement plan, respectively, and avoid significant customer rate fluctuations due to changes in cash flow requirements. Further, Zone 7 will endeavor to designate funds for all forms of potential disasters, emergencies and unforeseen events to ensure that funds are available to cover the costs associated therewith.

The Zone 7 Board of Directors (the "Board") adopted a Financial Management Framework (the "Framework") on November 16, 2011 (Resolution Number 11-4137) which includes planning for current operating and capital resource needs to ensure it can achieve its mission by providing for financial stability and health of the Agency. This Final Reserve Policy has been developed in keeping with the Framework after evaluating the efficacy of an Interim Reserve Policy adopted in 2013. One of the Framework's goals is to be able to respond to changes in the economic environment and service demands with minimal impact on its customers while maintaining the financial integrity of Zone 7. A fundamental purpose of this policy is to link what must be accomplished with the necessary resources to successfully do so.

The Policy directives outlined in this document are intended to ensure Zone 7 has sufficient funds to meet current and future needs. The Board shall designate specific funds and maintain minimum fund balances consistent with definitions and funding levels outlined in the Policy.

2. FUNDS

Zone 7 maintains financial assets in separate funds that are clearly identifiable, and segregated for specific purposes in accordance with laws and regulations. The Agency shall not commingle funds that are established under different functions of the Agency nor shall it commingle developer fees with operational funding.

This Policy establishes Reserve Funds for each of the following major funding areas.

Water Enterprise Operations and Capital Projects Fund (Funds 100 and 120)

These funds account for enterprise operation and administration, emergency and support services, variable State water charges, water facilities maintenance and operation, water facilities, water resources and water supply planning, and renewal, replacement and system-wide improvement types of capital projects.

State Water Project Fund (Fund 110)

This fund is used for fixed State Water Project charges, including State Water Project bonded indebtedness.

Water Enterprise Capital Expansion Fund (Fund 130)

Expansion is funded by water connection fee revenue imposed on new development to fund new development's fair share of capital projects necessary to accommodate growth. These water connection fees are subject to the provisions contained in the California Mitigation Fee Act (Government Code § 66000 *et seq.*)

Flood Protection Operations Fund (Fund 200)

This fund provides for general administration and regional flood control services, including renewal, replacement and system-wide improvement types of capital projects to ensure the controlled runoff of the Valley's excess stormwater runoff.

Flood Protection Development Impact Fee Fund (Fund 210)

Expansion is funded by development impact fees imposed on new development to pay for new development's fair share of the acquisition, construction, engineering and improvement of the flood protection and/or storm water drainage elements of the Stream Management Master Plan of Zone 7, or to reduce the principal or interest of any bonded indebtedness thereof. Development fees are collected in accordance with the California Mitigation Fee Act (Government Code § 66000 *et seq.*)

3. RESERVE FUND DEFINITIONS

Restricted Reserves: Restrictions on the use of these funds are imposed by an outside source such as creditors, grantors, contributors, laws, or regulations, for example water connection fees or flood protection developer impact fees per the California Mitigation Fee Act.

Designated Reserves: Funds set aside for a specific purpose determined by Zone 7's Board of Directors as documented by minute order, resolution or ordinance. The Board of Directors has the authority to redirect the use of these funds as needs of the Agency change.

Unrestricted Reserves: Have no imposed restrictions as to their use.

4. GENERAL PROVISIONS

Purpose of Reserve Funds

Reserves are established to:

- Comply with applicable statutory requirements
- Finance future capital facilities, finance improvements, and repair and replacement of existing assets
- Assure cash flow requirements are met
- Provide for economic uncertainties, local disasters, and other financial hardships or downturns in the local or national economy
- Provide for contingencies, emergencies or unforeseen operating or capital needs
- Meet bond covenant requirements

Segregation of Funds

The Agency will not transfer moneys between reserve funds that are established under different functions of the Agency. The Agency may complete interfund borrowing between reserves of different functions of the Agency at current market rates. The Board shall approve any reallocation of funds or any transfers among Reserve Funds.

Periodic Review Dates for Balances

Fund balances and target levels will be reviewed by staff, the Board and the public during the development and approval of each budget, annual financial audit and periodic water rate discussions.

5. POLICY COMPLIANCE

The Minimum established for each reserve represents the target that is acceptable from both risk and long-range financial planning perspectives, as well as demonstrating financial stability to the rating agencies and lending institutions. Maintaining fund balances at appropriate levels is a prudent, ongoing business process that consists of an iterative, dynamic assessment and application of various revenue generating alternatives and cost management measures. To ensure reliable service to its ratepayers and to maintain fiscal responsibility, in every fiscal year Zone 7 will maintain balances in its Reserve Funds that are financially prudent.

Upon Board adoption of this policy, necessary actions will be taken to comply with this policy. Periodic reviews will ensure that reserves are in compliance with policy. In the event that a reserve has fallen below the minimum, and other reserves are above minimum and/or maximum, a transfer(s) shall be made from other reserve(s) within that fund to bring the non-compliant reserve to the minimum level. If reserves are depleted, the reserves shall be replenished within the two (2) year budget period to the established or re-established target through revenue generating alternatives and/or cost management measures. If cumulative reserves within a fund exceed maximum levels, a report will be made to the Board and alternative solutions considered.

Revenue-generating alternatives and cost management measures (either alone or in combination with each other) include, but are not limited to:

- rates, fees and charges
- capital financing
- investment of funds
- grants
- energy efficiencies
- pooled services/equipment agreements
- chemical purchase consortiums
- deferral or acceleration of capital projects, as appropriate

6. RESERVE FUND TARGET LEVELS AND MANAGEMENT

The following section describes Zone 7 reserves, target levels and management of funds.

WATER ENTERPRISE OPERATIONS FUND RESERVES

The Water Enterprise Operations fund has four reserve categories:

- A. Operating Reserve
- B. Emergency Reserve
- C. Drought Contingency Reserve
- D. Rate Stabilization Reserve

A. OPERATING RESERVE

The Operating Reserve is designated by the Board to maintain a reserve for current operations and to meet routine cash flow needs. The amounts in this reserve will fluctuate depending on the annual operating expenses of Zone 7. Money on deposit in this reserve may be used for unanticipated operating expenses, daily cash flow requirements and minor emergencies such as unanticipated infrastructure failures.

Minimum Level

Funding shall be targeted at a minimum amount equal to sixty (60) days of the Agency's budgeted total operating expenses.

Target Level

Zone 7 shall strive to maintain a target balance equal to ninety (90) days of Agency's budgeted total operating expenses.

Maximum Level

The maximum amount shall not exceed one hundred twenty (120) days of the total budgeted operating expenses.

Events or Conditions Prompting the Use of the Fund – This reserve may be routinely utilized to cover temporary cash flow deficiencies caused by timing differences between the receipt of revenue and actual expenses or extraordinary decreases in revenues and unexpected increases in expenses.

B. EMERGENCY RESERVE

Funds in the Emergency Reserve can be used for any operating or capital purpose (i) to begin repair of the water enterprise system after a catastrophic event or disaster, such as, but not limited to, an earthquake, fire, terrorist event, or storm while insurance claims are being processed or (ii) in the event of severe financial events that impact the financial soundness of Zone 7. The Federal Emergency Management Agency (FEMA) may provide reimbursement to utilities after a catastrophic event; however, the reimbursement may take up to three years. It is important to have immediate funding available for the repairs, especially given the seismic vulnerability of the region and potential multi-year delays in reimbursement.

Minimum Level

Funding shall be targeted at a minimum equal to two percent (2%) of the capital assets of the Agency's water enterprise system to provide cash on hand for emergency repairs, particularly due to the seismically-active location of the Agency.

Target Level

Zone 7 shall strive to maintain a target balance equal to two and one half percent (2.5%) of the capital assets of the Agency's water enterprise system to provide cash on hand for emergency repairs, particularly due to the seismically-active location of the Agency.

Maximum Level

The maximum amount shall not exceed three percent (3%) of the capital assets of the enterprise system to provide cash on hand for emergency repairs, particularly due to the seismically-active location of the Agency.

Events or Conditions Prompting the Use of the Fund – The Board may designate use of this reserve after establishing that conditions exist as called out in the definition and purpose of the fund and declaring a local state of emergency. Funds will be transferred to the appropriate capital or operating fund as necessary.

C. DROUGHT CONTINGENCY

The Drought Contingency Reserve supplements losses to water sales revenue resulting from impacts of drought conditions due to hydrologic, regulatory or State and Federal mandated reductions in supply. On March 16, 2016, the Zone 7 Board adopted the 2015 Urban Water Management Plan (UWMP), including the Water Shortage Contingency Plan (Resolution Number 16-122). The plan established four stages of action for the purposes of water supply shortage contingency planning, ranging from minimal shortage to critical shortage. It identifies actions to be taken upon declaration of a

shortage, including consumption reduction and financial recovery measures. In the event that a declared water shortage stage generates a reduction in water usage and corresponding sales, Zone 7 will use this reserve (and the Rate Stabilization Reserve, as needed) and water shortage surcharges as needed to maintain fiscal health. This reserve will cover a percentage of the revenue loss and the remainder of loss not covered through reserves will be generated through a water shortage surcharge.

Minimum Level

Funding shall be targeted at a minimum balance equal to five percent (5%) of the budgeted amount of water sales revenue. This reserve may be fully depleted during a drought.

Target Level

Zone 7 shall strive to maintain a target balance equal ten percent (10%) of the budgeted amount of water sales revenue.

Maximum Level

The maximum amount shall not exceed twenty percent (20%) of the budgeted amount of water sales revenue.

Events or Conditions Prompting the Use of the Fund – Funds may be utilized to cover operating expenses when revenue does not cover the cost of providing services (operating expenses and Asset Management Program transfer) due to losses resulting from the aforementioned conditions. The need for funding drought contingency measures may be reviewed at any time during the course of any fiscal year should the need arise. Use of this reserve requires Board approval.

D. RATE STABILIZATION RESERVE

The Rate Stabilization Reserve will serve as a means to temper the need for significant water rate increases and to meet debt service coverage requirements. The reserve will accumulate revenues for use during periods of unanticipated fluctuations in treated water rate revenues and cost of service in order to offset significant increases in water rates. This reserve would be used in any year when revenues are not sufficient to meet debt service coverage ratios as required by bond covenants. Funds on deposit within this reserve may be treated as revenues for the purpose of computing debt service coverage ratios. This reserve may also be used in conjunction with the Drought Contingency Reserve during a water shortage as specified in the 2015 UWMP Water Shortage Contingency Plan (Resolution Number 16-122).

Minimum Level

Funding shall be targeted at a minimum balance equal to ten percent (10%) of the budgeted amount of water sales revenue.

Target Level

The Agency will strive for target balance equal to fifteen percent (15%) of the budgeted amount of water sales revenue.

Maximum Level

The maximum amount shall not exceed twenty percent (20%) of the budgeted amount of water sales revenue. Any amount above the minimum, target and/or maximum level may be drawn down to smooth rate increases as authorized by the Board during the rate-setting/budget process and treated as revenues for the purpose of computing debt service coverage ratios.

Events or Conditions Prompting the Use of the Fund – To determine whether and in what amount money from this reserve should be used to offset any proposed water rate increase in excess of two times the CPI for the San Francisco Bay Area, Zone 7 will consider and analyze the following factors:

1. the annual CPI for the San Francisco Bay Area;
2. the annual increase in construction costs as provided by the Engineering New Record or alternative source for such data;
3. the projected rate increases for the next succeeding five fiscal years of the Agency;
4. the actual rate increases for the previous five fiscal years of the Agency;
5. the projected capital expenditures for the next succeeding five fiscal years of the Agency;
6. the funds on hand to spend on capital projects over the next succeeding five fiscal years of the Agency;
7. the amounts on deposit in each of the other Reserve Funds covered under this policy; and
8. bond covenant requirements

WATER ENTERPRISE RENEWAL & REPLACEMENT AND SYSTEM-WIDE IMPROVEMENTS RESERVE

The Agency has employed a pay-as-you-go funding strategy to minimize debt borrowing and interest expenses. Therefore capital reserve funds are accumulated to provide for current and future funding needs of the various capital programs and to facilitate completion of multi-year projects. The amount on deposit in the Water Enterprise Renewal & Replacement and System-Wide Improvements Reserve is earmarked by the Board of Directors for capital projects to meet regulatory requirements, replacement

needs and system reliability of Zone 7's water enterprise. These capital projects are included in the ten (10)-year Water System Capital Improvement Program and the Asset Management Program (AMP), both of which are reviewed and approved by the Board of Directors periodically.

Within this fund is a separate reserve to be used for a portion of the acquisition of the Agency's administrative-engineering building (the "Building Sinking Fund"). Contributions are made to the Water Enterprise Renewal & Replacement and System-Wide Improvement Sinking Fund at the discretion of the Agency and money therein is designated for the purpose of acquiring the Agency's future administrative-engineering building. At such time that the administrative-engineering building is acquired by Zone 7, the Building Sinking Fund may be closed at the discretion of the Agency. The Renewal & Replacement System-Wide Improvements Reserve funds capital projects, including the renewal or replacement of water system infrastructure as it reaches the end of its useful life and system-wide improvements and upgrades such as those related to regulatory changes.

Minimum Level

Funding for the Water Enterprise Renewal & Replacement and System-Wide Improvement Reserve shall be targeted at a minimum amount equal to 100% of the estimated capital budget for the fiscal year immediately succeeding the then-current budgeted fiscal year.

Target Level

Not applicable

Maximum Level

Zone 7 will not have a maximum target for this reserve, but rather the fund shall accumulate sufficient reserves to pay for future projects set forth in the AMP and the reserve balance shall be consistent with the reserve balances forecast in the most recent Asset Management Plan and the current Capital Improvement Plan. Funds on deposit in the Building Sinking Fund shall not be considered in connection with the calculation of minimum levels.

Events or Conditions Prompting the Use of the Fund – Staff will recommend that assets be constructed, replaced, upgraded and/or repaired during the development and approval of the annual budget. Funds will be appropriated from the Water Enterprise Renewal & Replacement and System-Wide Improvement Reserve for renewal, replacement, or system-wide improvement capital projects.

WATER ENTERPRISE CAPITAL EXPANSION RESERVE

The Agency has employed a pay-as-you-go funding strategy to minimize debt borrowing and interest expenses, therefore capital reserve funds are accumulated to provide for current and future funding needs. Money in the Water Enterprise Capital Expansion Reserve is earmarked by the Board of Directors for capital projects to meet additional demands created by development. In furtherance of meeting such needs the Agency incurred certain non-discretionary financial obligations associated with capital expansion projects. Within this fund are three separate reserves to be used for:

1. A portion of the acquisition costs for the Agency's administrative-engineering building, (the "Building Sinking Fund");
2. The construction of improvements and enlargements to the South Bay Aqueduct (the "SBA Sinking Fund"); and
3. The Future Contractors' share of the South Bay Aqueduct construction (the "FCSBA Sinking Fund").

Contributions are made to the Building Sinking Fund at the discretion of the Agency and moneys therein are designated for the sole use of acquiring the Agency's administrative-engineering building.

At such time that the administrative-engineering building is acquired by Zone 7, the Building Sinking Fund may be closed at the discretion of the Agency. The Water Enterprise Capital Expansion Reserve is used for the funding of capital projects to accommodate development.

Minimum Level

Funding for the Water Enterprise Capital Expansion Reserve shall be targeted at a minimum amount equal to 60% of the estimated non-discretionary amount budgeted annually.

Target Level

Not applicable

Maximum Level

Zone 7 will not have a maximum limitation for this fund, but rather the fund shall accumulate sufficient reserves to pay for future capital expansion projects as set forth in the capital improvement plan. The Agency may satisfy the minimum amount through the use of lines of credit, interim inter-fund borrowings or other financing arrangements. Funds on deposit in the Building Sinking Fund, SBA Sinking Fund and FCSBA Sinking Fund shall not be considered in connection with the calculation of minimum or maximum levels of the Water Enterprise Capital Expansion Reserve.

Events or Conditions Prompting the Use of the Fund – Staff will recommend new assets to be constructed during the development and approval of the annual budget. Funds will be appropriated from the Water Enterprise Capital Expansion Reserve for expansion capital projects.

Periodic Review Dates for Balances – Fund balances and projected capital projects will be reviewed by staff, the Board and the public during the development and approval of each budget.

FLOOD PROTECTION OPERATING RESERVE

The amounts in the Flood Protection Operating Reserve Fund will fluctuate depending on the receipt of property taxes and the annual operating expenses of Zone 7. The Flood Protection Operating Reserve is designated by the Board to maintain a reserve for current operations and to meet routine cash flow needs.

Money on deposit in this fund may be used for unanticipated operating expenses, daily cash flow requirements and emergencies.

Minimum Level

Funding shall be targeted at a minimum amount equal to twenty percent (20%) of the Agency's budgeted total annual flood protection operating expenses, excluding capital.

Target Level

Not-applicable

Maximum Level

The maximum amount shall not exceed 50% of the total budgeted operating expenses, excluding capital.

Events or Conditions Prompting the Use of the Fund – This fund may be routinely utilized by staff to cover temporary cash flow deficiencies caused by timing differences between revenue and expenses and/or shifts in the allocation of property taxes to Zone 7.

FLOOD PROTECTION CAPITAL PROJECT RESERVE

The Flood Protection Capital Project Reserve holds the balance of funds once the Flood Protection Operating Reserve Fund achieves levels that are consistent with this Policy on an annual basis. The amount on deposit in the Flood Protection Capital Project Reserve is earmarked by the Board of Directors for capital projects to meet Zone 7's flood protection needs. These capital projects are included in the current Flood Protection Capital Improvement Plan and in the Stream Management Master Plan and any related updates. Within the Flood Protection Project Reserve is a separate reserve to be used for a portion of the acquisition of the Agency's administrative-engineering building (the "Building Sinking Fund"). Contributions are made to this fund at the discretion of the Agency and money therein is designated for the purpose of acquiring the Agency's administrative-engineering building.

At such time that the administrative-engineering building is acquired by Zone 7, the Building Sinking Fund may be closed at the discretion of the Agency.

Minimum and Maximum Levels – This Reserve will not be required to have a minimum or maximum balance.

Target Level

Not applicable

Events or Conditions Prompting the Use of the Fund –The Flood Protection Project Reserve may be used at any time for flood protection maintenance or improvement projects not related to development.

FLOOD PROTECTION AND STORM WATER DRAINAGE DEVELOPMENT IMPACT FEE PROJECT RESERVE

The purpose of the Flood Protection and Storm Water Drainage Development Impact Fee (DIF) Project Reserve is to ensure that Zone 7 is able to meet current and future needs for Flood Protection facilities and is intended to provide funding for any Flood Protection facilities required to mitigate the impacts of new development. This Reserve will hold development impact fees in connection with Flood Protection improvements related to development. Within this fund is a separate reserve to be used for a portion of the acquisition of the Agency's administrative-engineering building (the "Building Sinking Fund"). Contributions to the Building Sinking Fund are made at the discretion of the Agency and money therein is designated for the sole use of acquiring the Agency's administrative-engineering building. At such time that the administrative-engineering building is acquired by Zone 7 the Building Sinking Fund may be closed at the discretion of the Agency.

Minimum and Maximum Levels – This Reserve will not be required to have a minimum or maximum balance.

Target Level

Not-applicable

Events or Conditions Prompting the Use of the Fund – This Reserve may be used at any time for flood protection projects required to mitigate the impacts of new development.

STATE WATER FACILITIES OPERATING RESERVE

The amounts in the State Water Facilities Operating Reserve Fund will fluctuate depending on the receipt of property taxes and the annual expenses of Zone 7 related to fixed charges for the State Water Project. The State Water Facilities Operating Reserve Fund is designated by the Board to maintain a reserve for fixed costs related to the State Water Project that are not tied to development and to meet routine cash flow needs. This fund may be used for unanticipated operating expenses, daily cash flow requirements and emergencies related to State Water Project fixed costs.

Minimum Level

Funding shall be targeted at a minimum amount equal to fifty percent (50%) of the following year's projected annual operating expenses.

Target Level

Not applicable

Maximum Level

The maximum amount shall not exceed 100% of the following year's projected annual operating expenses.

Events or Conditions Prompting the Use of the Fund – This fund may be routinely utilized by staff to cover temporary cash flow deficiencies caused by timing differences between revenue and expenses and extraordinary decreases unexpected increases in expenses.

VEHICLE REPLACEMENT RESERVE

The purpose of this reserve is to fund planned replacement of vehicles and equipment that have reached the end of their useful lives. This reserve is funded by direct charges to departments for actual maintenance and operation costs, interest earnings and net proceeds from the sale of replaced vehicles and equipment. The reserve will be drawn down as replacement vehicles and equipment are purchased. This reserve shall have no minimum, maximum or target.