

**MINUTES OF THE
SPECIAL MEETING OF THE
BOARD OF DIRECTORS
OTAY WATER DISTRICT
November 28, 2012**

1. The meeting was called to order by President Lopez at 3:35 p.m.

2. ROLL CALL

Directors Present: Croucher, Gonzalez, Lopez, Robak and Thompson

Directors Absent: None

Staff Present: General Manager Mark Watton, General Counsel Daniel Shinoff, Chief of Information Technology Geoff Stevens, Chief Financial Officer Joe Beachem, Chief of Engineering Rod Posada, Chief of Operations Pedro Porras, Chief of Administration Rom Sarno, District Secretary Susan Cruz and others per attached list.

3. PLEDGE OF ALLEGIANCE

4. APPROVAL OF AGENDA

A motion was made by Director Croucher, seconded by President Lopez and carried with the following vote:

Ayes:	Directors Croucher, Gonzalez, Lopez, Robak and Thompson
Noes:	None
Abstain:	None
Absent:	None

to approve the agenda.

5. PUBLIC PARTICIPATION – OPPORTUNITY FOR MEMBERS OF THE PUBLIC TO SPEAK TO THE BOARD ON ANY SUBJECT MATTER WITHIN THE BOARD'S JURISDICTION BUT NOT AN ITEM ON TODAY'S AGENDA

No one wished to be heard.

INFORMATIONAL ITEM

6. DISCUSSION OF SAN DIEGO COUNTY WATER AUTHORITY'S PROPOSED AGREEMENT WITH POSEIDON RESOURCE'S REGARDING THEIR CARLSBAD DESALINATION PROJECT

General Manager Watton introduced Sandy Kerl, Deputy General Manager, and Ken Weinberg, Water Resources Director, of San Diego County Water Authority (CWA) who would be presenting a powerpoint concerning the Carlsbad Desalination Project. Ms. Kerl thanked the board for the opportunity to attend the District's board meeting. She stated that they wished to present on the Water Purchase Agreement (WPA) that is being proposed with Poseidon Resources. The WPA will be presented to CWA's board for action tomorrow (November 29). She introduced Mr. Weinberg who would be providing the presentation.

Mr. Weinberg indicated that the first question he would like to answer is why CWA is proposing the agreement. It is the same answer that many member agencies answer when developing their local water supplies. He stated that there are challenges in ensuring supply reliability to the region due to uncertainty in the imported water supplies from the State Water Project in Northern California and the Colorado River. Allocations are being reduced because of the Endangered Species Act restrictions on the State Water Project and drought on the Colorado River. Though demand has been low in the last few years, projected future demand indicates that there will be an increase in demand for water due to growth and climate change.

He noted that in the last ten (10) years, seven (7) years have been dry for the Colorado River. He indicated that the allocation of the river water was done when water was abundant. Today there is more competition for the water available from the Colorado River.

He stated that the water from the State Water Project was reduced from 6 MAF (million acre feet) annually to 4.7 MAF through a decision from the State Water Board due to environmental concerns. Based on the future fish listings, if there is not a fix for the Delta, the water exported will be reduced to about half or 2 to 3 MAF annually which is not a sustainable level for Southern California. Further, if an earthquake were to occur in California, the water exported would drop to 1 to 1.5 MAF and it would take 1½ to 3 years for the levies to be repaired. He stated that the state's water supply resources are very vulnerable.

Mr. Weinberg indicated that the answer for the water authority board is to diversify its water portfolio to manage the risk of supply shortages. He reviewed the planned supply portfolio by 2020 which includes reducing the region's reliance on Metropolitan Water District to just 30% rather than 70%. Other supplies include the Imperial Irrigation water transfer (24% of region's supply), All American & Coachella

Canal Lining (10%), conservation (13%), recycled water (6%), groundwater (4%), local surface water (6%) and desalination (7%).

He reviewed the Carlsbad Desalination project and stated that it is expected to produce 50 MGD through reverse osmosis and will be located at the Encina Power Station. It has been in development by a private company, Poseidon Resources, for the last 10 years and CWA is proposing to take 56,000 AF annually from the project. The water from the plant will be the most reliable portion of CWA's portfolio and also the most costly.

He stated that CWA's 2003 Master Plan Program EIR identified the Carlsbad Desalination Project as a water resource and it is also included in their 2005 and 2010 Urban Water Management Plan (UWMP) as part of the region's verifiable local water supply. The project is fully permitted to commence construction and the initial operations will utilize the power plant's cooling water (ocean water) as a source to cool the plant equipment. However, in 2017 to 2020, the Encina Power Plant will no longer be able to use ocean water to cool its equipment and at that point the desalination project will need to operate on a standalone basis which will require upgrades to the ocean intake. This will add some additional operating costs.

Mr. Weinberg indicated that he is asked many times whether there is enough demand for desalinated water in the future. With local agencies developing additional local supplies, is there enough demand. He indicated that in reviewing CWA's Urban Water Management Plan, as we move forward to the future, the region will have enough demand. The region is also still significantly reliant on MWD for water supplies.

He stated that the Poseidon Project is basically the plant and the new conveyance pipeline. CWA is responsible for the improvements to its system to take and distribute the desalinated water. The parties to the agreement are Poseidon, Kiewit-Shea Joint Venture (plant engineering procurement and construction contractor) and IDE (process engineering and equipment; and they will also operate the plant).

He noted that CWA prefers a Water Purchase Agreement over building and operating the plant itself as it has no experience with desalination and there are inherent risks which are beyond CWA's experience. The risks transferred to Poseidon are:

- Construction and Operating Cost Overruns
- Timely Project Completion
- Regulatory and Law Compliance
- Regulated or Differing Site Conditions
- Capital Maintenance, Repair and Replacement
- Labor Supply and Relations

The risks retained by CWA:

- Changes in Law that Affect All Water Treatment Plant Operators or Wastewater Dischargers
- Cost of Encina Improvement Due to Expected Power Station Closure, Up to \$20 Million Capital and \$2.5 Million Annual Operating Costs (a change in law)
- Uninsurable Force Majeure Events
- Unusual Raw Seawater Water Parameters (no additional compensation)
- Retained Risks are “Uncontrollable Circumstances”
- Bond Financing Interest Rates
- General Price Inflation (CPI is forecasted at approximately 2.5% per year over the 30 year term)
- General Electricity Rates
 - He noted that General Manager Watton has asked CWA to do a number of analyses to determine the impact of general electricity rates as electricity is approximately 25% of the cost of desalination, which is significant. CWA indicated that they felt that the percentage of the total cost from electricity does not cause a large impact to the cost of desalination. The proportion of desalination to CWA’s total supply portfolio is not large, so its impact to rates will be limited. He stated that if electricity rates were really to increase, it would affect all water supply resources (State Water Project, etc.).

The WPA provides for specific performance guarantees for water quality, minimum annual water deliveries, and water ordering rights which allows CWA to adjust its delivery orders based on seasonal and daily demand changes.

He stated the total cost of the project is \$691 million for both plant and product water pipeline and the financing costs is \$213 million. The cost will be financed by tax exempt bonds issued by the California Pollution Control Financing Authority (82% or \$740 million) and cash equity from Stonepeak Infrastructure (18% or \$164 million).

It is estimated the operating and maintenance cost of the plant will be between \$48.8 and \$53.1 million annually depending on how much CWA purchases from the plant (48,000 AFY to 56,000 AFY). The cost per AF is between \$1,876/AF if CWA purchased 56,000 AFY and \$2,097/AF if CWA purchased 48,000 AFY. He stated that this is expensive, however, it is competitive and representative of what local supplies cost in this region.

He stated that the infrastructure to accept desalinated water from the Carlsbad Plant, Pipeline 3 and the Twin Oaks Valley WTP improvements, will cost approximately \$80 million. These improvements will add to the AF cost of desalinated water approximately \$153/AF (if CWA purchased 56,000 AFY) or \$179/AF (if CWA purchased 48,000 AFY). Additionally, administrative costs will

increase which will add another \$12/AF (if CWA purchased 56,000 AFY) or \$14/AF (if CWA purchased 48,000 AFY) for a total AF cost of \$2,041 or \$2,290 respectively.

The estimated impact of CWA's purchase of desalinated water to the retail water rate is an average increase of approximately \$5 to \$7/month (or 7% to 10% increase) if a customer used 15 units of water a month.

Mr. Weinberg indicated that they are currently discussing how the cost of the purchase of desalinated water will be allocated. Nothing has yet been decided and there will continue to be discussions on this issue going forward.

CWA's board also provided the member agency's the opportunity to purchase water from the Carlsbad Desalination Plant through CWA. The water would be treated similar to recycled or groundwater which would provide the agency additional allocations during times of shortage under CWA's drought allocation method. These agencies will be required to pay for full cost recovery for the desalinated water to move through CWA's system. Vallecitos WD and the City of Carlsbad have indicated their interest in purchasing 3500 AF and 2500 AF of desalinated water respectively. Their commitment to purchase desalinated water reduces the total project cost that would need to be recovered through CWA's rates and charges by approximately 10%.

Mr. Weinberg stated that the Carlsbad Desalination WPA will be presented to CWA's board for consideration tomorrow, November 29. Much of the required tasks have been completed with the exception of the initiation of a Cost of Service Study (COSS) to incorporate the cost of the desalinated water into CWA's rate and charge structure. CWA's board will be asked to adopt a resolution approving the WPA, pipeline design-build agreement, financing agreements, adjustments to CIP, supporting contracts and contract amendments, CEQA addendum to Carlsbad Desalination Project EIR and member agencies' commitment to purchase a fixed minimum purchase amount. Following CWA's board action, CWA will refer the rate structure alternatives to its cost of service consultant.

Chief of Engineering Rod Posada presented a slide showing the Carlsbad Desalination Plant and the CWA project components (Pipeline 3 and the Twin Oaks Valley WTP improvements). The desalinated water would provide for a new local drought-proof water supply and improved water quality (lower TDS). The proposed agreement is for 48,000 AFY with an option to take up to 56,000 AFY for 30 years. There is an early buy-out provision in the agreement where CWA may exercise the option to buy the desalination plant after the plant has been in operation for 10 years.

Staffs' presentation is divided into five (5) aspects:

- Power Cost
- Water Requirement for Drought Proofing

- CWA's Risks Associated with the WPA
- Financing True Costs
- Projected Rate Impact on Otay's Ratepayers

Electrical charges represent about 25% of the cost of desalinated water. The capital charge is a little over 50% and operating charges represent about 25%. Chief of Engineering Posada stated that any variation in the electricity charge will have a great impact on cost. He presented a slide (see attached copy of presentation) showing three scenarios for the future price for electricity for the desalination project:

- Low Growth Rate Increase of 1.2%
- Middle Growth Rate Increase of 2%
- High Growth Rate Increase of 2.4%

Staff disagrees with the factors that drive the low growth rate as the demand and actual costs in the last several years has been determined by SDG&E's rate which has been going up. The actual increase since 2003 is 8.3%. The California Public Utility Commission (CPUC) estimates that the rate increase for electricity is approximately 4.1% over the next eight (8) years. The desalination plant is expected to start operations in 2016. If the electricity rate increases by 2%, this translates into a \$50 cost increase per AF that will be transferred to ratepayers.

In early November, the Fallbrook Public Utility District (FPUD) prepared a presentation that was sent to CWA and all the member agencies entitled, "The Cost of Improving Regional Reliability through Desalination." FPUD outlined three scenarios:

- No shortage
- 20% MWD shortage
- 20% MWD shortage plus penalty fees

Comparing the cost of imported water versus desalinated water, if the worst case scenario were to occur, the cost of the purchase of 56,000 AF of desalinated water would cost \$114.4 million, whereas, imported water would cost \$53.5 million, which is less than half the cost of desalinated water. CWA claims that desalination is required to assure reliability. However, the increase in reliability for the shortfall between the two supply options is only 4,480 AF. The cost of this water for reliability is very expensive at \$13,582/AF.

He stated that CWA's projection of water demand is based on their 2010 Urban Water Management Plan and the 20% demand reduction requirement of SBX 7-7. The calculation, however, does not include reduced water consumption realized through conservation from 2009 to 2011 which is approximately 100,000 AF. The demand for this past year is similar to 2011 consumption savings and if demand is

projected out based on current per capita use, the demand projection is much lower.

CWA also has preferential rights of 220,000 AFY from MWD. With the decrease in demand of approximately 100,000 AF due to conservation (decrease in per capita use), the supply needed from MWD will be below the preferential rights level and, thus, desalination is not necessary.

Staff reviewed the WPA and provided CWA a list of 140 comments/issues with regard to the WPA. It is felt that CWA is taking on too much risk. The WPA indicates that CWA will cover the costs associated with future changes in the law or regulations. CWA must also pay up to \$20 million for the change to the intake system and \$2.5 million for the operations of new and enhanced facilities. These costs will impact rates. The WPA also provides for annual increases of 10% after the desalination plant becomes operational.

Chief Financial Officer Joe Beachem indicated that CWA does not include in their estimated retail water rate impact increase of \$5 to \$7 the \$20 million cost to change the Carlsbad desalination plant's intake system. He also noted that CWA is deferring interest costs which presents a better financial picture than actual. CWA is effectively deferring its debt payments and this initial deferral decreases the AF cost of desalinated water by \$352 in 2016. In later years (by 2046), CWA will be paying an additional debt cost of \$908/AF to compensate for the deferral of costs. Otay does not defer costs and feels that it is more conservative and responsible to have a level debt service. He presented a slide showing the cost difference for deferring costs versus level debt service and there is a cost savings of over \$300 million over the life of the WPA.

He presented a slide showing three different scenarios and the potential rate impact of the desalinated water to Otay's customers (see attached copy of presentation). The scenarios are:

- 2% Electrical Inflation with Debt Deferred
- 4.1% Electrical Inflation with Level Debt Payments
- Additional Intake Cost with 4.1% Electrical Inflation with Level Debt Payments

The impact to Otay's customer based on the above scenarios is a monthly increase of \$8.66 to \$16.09 for customers utilizing 14 units of water a month. Over a four year period, the cumulative percentage rate increase would be up to 45.1%

General Manager Watton stated that he was not critical of the job Ms. Kerl has done negotiating the WPA. CWA's staff has looked at the project cost from many different scenarios. The agencies may agree to disagree, but in the end, this is really a business deal. There is a lot of disagreement and discussion regarding the rate for the desalinated water.

He stated that it is very unorthodox to vote on a project without knowing what the rates impact may be. He indicated that he expects there will be a lot of discussion on how the rates will be determined at CWA's board meeting tomorrow.

He indicated that CWA is very involved in the design, construction and the maintenance of the desalination plant and this all comes at a cost and also transfers risks to CWA. In a private development, generally the plant just delivers water to its customer at a certain cost. The buyer is not involved in their plans, they just purchase the water. Additionally, in the future it is very likely that Poseidon will be facing renewals of some of their permits which will very likely change their cost structure.

He stated that the Colorado River Supply is very reliable as California has the highest priority right on the river water and the IID water transfer is the highest within the California priority. He indicated that it is unlikely that the State of California would get cut back from these supply resources.

General Manager Watton stated that he supports desalination and that the region needs to develop a more robust portfolio of local supplies that relies less on imported water. He indicated that he did not know, however, if this is the right project based on the cost.

Director Croucher thanked CWA's staff for attending the District's meeting. He stated, as a board member, he looks at the District's customers and in providing them quality, reliable and affordable water. He indicated that ratepayers are fatigued with regard to cost increases and he is concerned that the COSS has not yet been done. It is currently unknown how the cost of the desalinated water will be allocated to the member agencies and, thus, it is uncertain if costs will be fairly allocated among the agencies.

Director Robak thanked staff for their thorough business analysis of the Carlsbad project. He stated, from a business perspective, he did not see how the project would "pencil out." The estimated rate of \$2400 is much higher than was originally anticipated. He stated that it seems everyone is fatigued in the industry in hearing about the Poseidon Project. He indicated that it does not seem to matter what the facts are about the project, the agencies just want to push the project through. He stated this does not make for a good business decision.

Director Thompson indicated that he walked his division during his election campaign and the message he received from his constituents is how the District can keep water rates from going up higher than the rate of inflation. Customers felt if the District could not do this, then it has fundamentally not served them properly. The Carlsbad Desalination Project does not make sense financially and a COSS has not yet been completed. He asked the District's representatives to CWA to do whatever it takes to get CWA to delay their decision on the WPA. He indicated that

this project will not keep rates down and, thus, we would not be serving our ratepayers.

Director Gonzalez referenced a letter from one of the District's ratepayer complaining that their home was vacant for two (2) months, however, their water bill was approximately \$167 for the two (2) months that it was vacant. They indicated that \$15 of each bill was for actual water use and the remainder was for fixed fee charges. He stated that he felt this is a prelude to what will happen when this WPA is approved. He indicated that it seems the agencies are pushing for approval of the WPA because they are tired of hearing about the Carlsbad Project and they don't really want to hear/talk about it further. He indicated that he felt we need to be more conscious of our ratepayers and realize that it is not the time to approve the WPA as all the cost information has not been finalized.

President Lopez indicated that the District had been trying to request information concerning the project from CWA and the information was not received until two (2) weeks before CWA's board meeting. He stated that this was frustrating, as the District, could not get the information needed to assist in evaluating the viability of the Carlsbad Desalination Project. He stated the District is supportive of desalination or any project that will augment the region's water resources. He indicated he appreciates the board members' comments and as a representative of the District's customers he asks that the District's representatives vote "no" on the approval of the WPA.

General Manager Watton indicated that he supports the City of San Diego in requesting that the rate be reviewed. He indicated that he does not agree with everything the City has requested, but he felt that the rate should be reviewed by a professional consultant to assure that the proposed rate structure is fair to all the member agencies.

Director Croucher indicated CWA's Administration and Finance Committee met on Tuesday and the committee attendees all agreed that a COSS needs to be completed and all aspects of the project must be reviewed.

Director Thompson indicated that he wished to understand why CWA is borrowing on the future to fund this project. Ms. Kerl indicated that CWA has a very complex debt portfolio. CWA looks at structuring in the manner that the assets are not used within a short period of time (will be used over a long period of time) so there is a benefit to looking at wrapping that debt and having it paid in different increments over time. When you look at a portfolio such as CWA, you look at different tools in terms of spacing the debt. She indicated she fully appreciates the District's perspective and comments on the issue, however, it is a policy decision for the Board of Directors. She stated that she felt it was important for the District to know that CWA has put in an expensive amount of due diligence and effort into this project and CWA does not go into anything lightly. There is an extensive amount of study and effort, and what this truly gets down to, "is it worth the price to get that

additional increment of reliability.” This is the bottom line policy decision for the Board of Directors. She indicated that she wished to note that it is her understanding that CWA moved forward with projects, including the overall Capital Improvement Program, ESP, and QSA, with the COSS being completed following approval of the projects. She stated CWA’s process has always been a very thoughtful and involved when coming to a decision on how costs will be allocated and CWA clearly knows what the costs are. She indicated if CWA’s board approves the agreement and approves a COSS, there will be a workgroup set-up in which every member agency will be a participant. She stated CWA’s process has always been very iterative, and CWA has worked very hard to come to a consensus, which has then been brought forward to the board for consideration. Ms. Kerl thanked the board for the invite to attend the District’s board meeting and that she appreciated their time. The board thanked Ms. Kerl and Mr. Weinberg for attending as well.

7. ADJOURNMENT

With no further business to come before the Board, President Lopez adjourned the meeting at 5:30 p.m.

President

ATTEST:

District Secretary