ORANGE WATER AND SEWER AUTHORITY

A public, non-profit agency providing water, sewer and reclaimed water services to the Carrboro-Chapel Hill community.

MEMORANDUM

TO: **Finance Committee**
Heather Payne (Chair)
Quinton Harper
Dave Moreau
Amy Witsil
John Young (*ex-officio*)

THROUGH: Ed Kerwin EK

FROM: Stephen Winters, CPA

DATE: September 18, 2014

SUBJECT: Finance Committee Meeting – September 22, 2014

The Finance Committee will meet on Monday, September 22, 2014, at 5:30 PM in the OWASA Boardroom. The agenda will be:

- Review and discuss an opportunity to refund approximately $25 million of bonds resulting in about $2.4 million in interest costs savings over the next 1 fiscal years (see Attachment 1).

  Committee Action Requested: Discuss and decide whether to pursue the opportunity.

- Discuss OWASA's Strategic Plan initiative to evaluate our Financial Management Policy regarding financial reserves (see Attachment 2).

  Committee Action Requested: Review and discuss information and provide guidance to staff regarding next steps.

SWinters

Stephen Winters, CPA
Director of Finance and Customer Service

cc: Board of Directors
Ed Kerwin
Bob Epting

400 Jones Ferry Road
Carrboro, NC 27510-2001
Equal Opportunity Employer
Printed on Recycled Paper
Voice (919) 968-4421
www.owasa.org

Background Information for Potential Bond Refunding Discussion
September 22, 2014

Purpose

The purpose of this discussion is to provide information about an opportunity to refund approximately $25 million of OWASA's outstanding bonds at lower interest rates. The refunding would result in about $2.4 million in cost savings over the next 17 fiscal years.

The opportunity

In our effort to address affordability, we continually look for ways to reduce costs. One of our practices is to regularly monitor the bond market and we have an opportunity to reduce our interest costs by refunding (or refinancing) about $25 million of our outstanding bonds at lower interest rates. This refunding would save us about $225,000 each year from FY 2016 through FY 2020 and about $110,000 each year from FY 2021 to 2031 – roughly $2.4 million over the next 17 years. The savings are net of the costs of issuance.

Bond Series	Par Value	Net Present Value Percent Savings	Total Savings	Net Present Value Savings
2005	$8,930,000	6.14%	$0.579 million	$0.548 million
2006	$16,430,000	8.95%	$1.821 million	$1.470 million
Total	$25,360,000	7.96%	$2.400 million	$2.018 million

This opportunity results from interest rates that have been gradually moving in our favor over the last two years. Interest rates can change fairly quickly and these fluctuations make it important to take advantage of these opportunities timely.

Most of the costs associated with the transaction are incurred only if the deal ultimately goes through. If the market moves against us to the point that it doesn't make sense to go through with one or both of the refundings, none of the service providers will be compensated other than the three ratings agencies (which charge fees of about $20,000 each). The decision to cancel the transaction can be made up to essentially the last minute.

Series 2006 Refunding Analysis

The refunding of the Series 2006 Bonds is what is referred to as an advanced refunding which means we are refunding the bonds before they are callable. The savings on the transaction could potentially be greater if we waited until the date the bonds are callable or until a date closer to the call date: assuming that interest rates are not higher than they are today. The decision is one of timing and based upon what one expects to happen with interest rates. The estimated interest rate we anticipate incurring on the 2006 refunding bonds is 2.9%. Below is an analysis that may be helpful in making the decision.

Series 2006 Refunding Analysis				
Issue Date	**Estimated Net Present Value Savings if interest rates on the date of issue are the same as they are today**	**Additional savings**	**Approximate basis point increase necessary to negate additional savings**	**Interest rate necessary at time of issuance to negate additional savings**
Today	$1.470 million	N/A	N/A	N/A
7/1/2015	$1.680 million	$210,000	15	3.1%
7/1/2016 (call date)	$2.130 million	$660,000	55	3.5%

Series 2005 Refunding Analysis

For federal tax reasons, the refunding of the Series 2005 Bonds can only be accomplished as a current refunding which means that we are refunding the bonds when they are callable. Despite the fact that the Series 2005 Bonds are not callable until July 1, 2015, we could refund the bonds by locking into an interest rate today that becomes effective on July 1, 2015. Given that this rate would become effective a few months from now, it contains a "forward premium" to reflect that market risk. The savings on the transaction could potentially be greater if we waited until the date the bonds are callable to lock into the rate: assuming that actual interest rates do not rise more than this forward premium. The decision is one of timing and based upon what one expects to happen with interest rates.

If we lock in the savings on the Series 2005 Bonds available now, the result would be a net present value savings of $548,000. If we wait until July 1, 2015 when the issue is callable, assuming interest rates do not change, we would save an additional $97,000 for a total savings of $645,000. However, the additional savings of $97,000 would be lost if interest rates were to rise by 0.3% between now and July 1, 2015.

As with any financing transaction such as this, we will work with the North Carolina Local Government Commission (LGC) to obtain its approval. The LGC typically prefers to see savings of at least 2.5%. Based on current market conditions, the aggregate net present value savings on this potential refunding is about almost 8%.

Staff Recommendation

Staff recommends refunding the Series 2005 and 2006 bonds. 8% savings is significant and staff believes that the potential rewards of waiting until we are closer to the bonds' call dates is not worth the risk of losing the savings available to us now.

Next Steps

If the Committee agrees with staff's recommendation to go forward with the refunding, the Board would need to adopt a preliminary resolution at an upcoming meeting. Following that, there will be a number of other steps in the process including another OWASA Board resolution and obtaining the approval of the NC Local Government Commission. If we decide to go forward with the refunding, we could close the transaction in December or January of this fiscal year.

Action requested

Discuss the bond refunding and decide whether to recommend pursuing the opportunity.

Information for discussion of financial reserves
September 22, 2014

This memo is intended to provide context and background for the Committee's discussion about financial reserves. The purpose of reserves is to provide operational and financial stability. The amount of reserves should be based on risk and consequences. We believe there are essentially two issues for the Committee to address.

- Is the amount of our reserves appropriate to responsibly sustain the organization financially?
- Plans for our reserve balances that currently exceed the minimum targets set-forth in our Financial Management Policy.

Is the amount of our reserves appropriate to responsibly sustain the organization financially?

We collected information from other water and sewer organizations regarding financial policies and measurement targets they use to help guide their financial planning; the information is summarized in Table 2 at the end of this memo. We obtained some of the information from direct contact with other organizations and some through the University of North Carolina's Environmental Finance Center (EFC).

The information summarized in Table 2 includes the organizations' target for Debt Service Coverage Ratio, Debt Burden, minimum bond rating, and reserves. You will note that there is little uniformity across the different utilities. Five of the organizations represented, including OWASA, have financial measurement targets that are intended to result in a high degree of financial sustainability and high bond ratings. The other ten have lower targets and have not set goals related to a certain bond rating. As we have discussed, lower bond ratings typically translate into higher interest costs. Additionally when issuing bonds, organizations without adequate reserves are often required to purchase bond insurance.

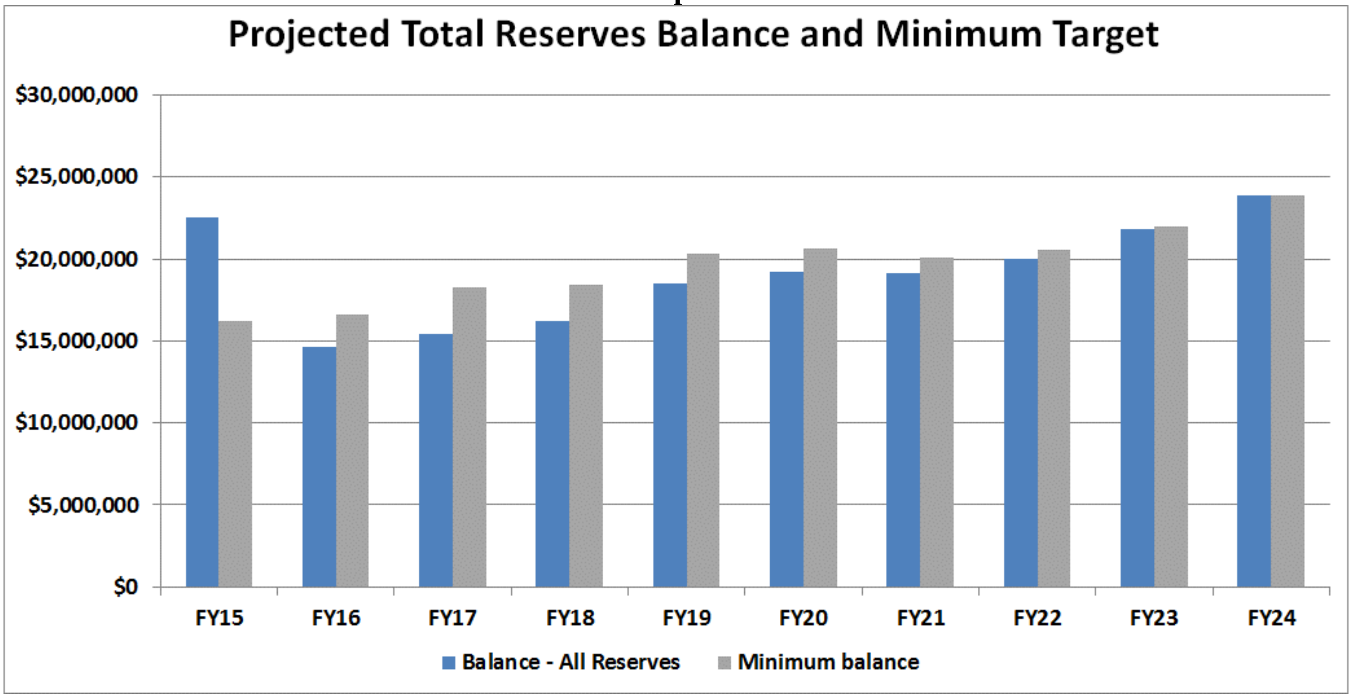
Plans for reserve balances that currently exceed the minimum targets set-forth in our Financial Management Policy.

<u>What is the amount our reserves are projected to be over the minimum targets?</u>

Under our current financial plan, our Capital Improvements and Rate/Revenue Stabilization reserves will not be fully funded until FY 2024 and FY 2016, respectively. We are contributing a fixed amount each year until the reserves reach their minimum targets.

At the end of FY 2018, the Working Capital and Rate/Revenue Stabilization reserves are projected to equal the minimum targets. At the current rate of funding, the Capital Improvement reserve is not projected to reach its minimum target until FY 2024; at the end of FY 2018, it is projected to be approximately $2.2 million under the minimum target of $5.8 million. We project that our reserve balances will be equal to our reserve minimums by the end of FY 2024. Graph 1 below shows the funding status through FY 2024.

Graph 1



The projected amount of reserves over our minimum targets at the end of FY 2015 is $6.3 million, as shown in Table 1.

Table 1

Projected Balances as of the end of FY 2015	
Minimum Target Balance	**Amount**
Reserve Fund	
Working Capital	$8,642,600
Capital Improvements	5,800,000
Rate/Revenue Stabilization	1,750,000
Total minimum target balance	16,192,600
Total projected reserve balance	22,500,000
Projected reserve balance over minimum targets	$6,307,400

What are our plans for reserve funds?

Under the current financial plan, the amount of reserve funds over the minimum targets will be spent by the end of FY 2016; the funds will augment annual revenues to pay for future capital investments.

The current financial plan includes anticipated annual rate increases of 3%. In estimating the need for future rate increases, the amount of our reserves has been considered in the calculation. Therefore, if we decide to use the reserve funds for any other purpose, future rate adjustments could be impacted.

Additional Questions

The following are additional questions Committee members have asked. We plan to discuss at these at the meeting.

- Should the amount by which our current reserve balances exceed our minimum targets be categorized as, for example, a "Large Capital Projects Fund?"
- How do reserves impact credit ratings?
- Should we continue to maintain three reserve categories? Should we simplify the structure?
- Is there redundancy in our current structure that could be eliminated?
- Our policy includes a stipulation that our total debt shall not be more than 50% of total assets. Currently, debt is 29% of total assets; is this an overly conservative position?
- What is the value of a restricted debt service reserve? Does a restricted debt service fund significantly impact credit ratings and interest costs?

Attachment 2

Table 2

Entity	Debt Service Coverage Ratio	Debt Burden	Min. Rating Goal	Reserves	Reserve Targets
OWASA	2.00	<50%	AA+	1) Working Capital 2) Rate/Revenue Stabilization 3) CIP	1) Greater of 33% of operating budget or 20% of succeeding 3yrs CIP budget 2) 5% of annual Water/Sewer revenue 3) 2% net capital costs
Alameda County Water District	1.25	NA	NA	1) Debt Service 2) Emergency/Rate Stabilization 3) Retiree 4) Self-Insurance 5) CIP and Contingencies	Not provided
Arlington (TX) Water Utiliites	1.50	NA	NA	1) Operating reserve 2) Rate Stabilization	1) 60 days cash on hand 2) 5% of total expenditure budget (operating, CIP, other)
Baltimore Dept of Publ Works	1.40	NA	NA	1) Operating reserve 2) Five others	1) 90 days cash on hand 2) Not provided
Beaufort-Jasper W&S	1.25	NA	NA	1) Restricted for Capital/Debt Svc 2) Unrestricted	Not provided
Birmingham Waterworks	1.50			1) Revenue 2) Capital Reserve 3) Demand Shorfall 4) Rate Funding	1) 12.5% operating expenses and debt service 2) 20% of average annual capital plan 3) 10% of operating expenses and debt service 4) 20% of annual capital plan
Charlotte-Mecklenberg Utilities	1.80	not provided	AAA	1) Operating 2) Debt Service 3) CIP	1) 100% of operating expenses 2) Not provided 3) Not provided
Clayton County Water Authority	1.50	NA	Best poss.	1) Debt Service 2) Construction 3) Renewal and Extension 4) Working Capital 5) Unrestricted	Not provided
Denver Water	2.20	<40%	AA	1) Operating/Insurance 2) CIP	25% of next years operating, average depreciation cost and 2% of current capital assess, 50% of annual debt service
Northeast Ohio Regional Sewer District	1.25	NA	NA	1) Working Capital 2) CIP 3) Insurance 4) Rate Stabilization	1) 90 days operating expenses 2) Identified through asset management 3) Flexible 4) Up to 5% or revenues
ONWASA	1.20	NA	NA	1) Unreserved	1) 50% of annual operating budget. Spend <= 85% of annual oper budget.
Raleigh Water Dept.	2.00	NA	AAA	1) Water & Sewer Operating 2) Water CIP 3) Sewer CIP 4) Bond	Not provided
San Antonio Water Dept.	2.00	NA	NA	1) System 2) Operating 3) Debt Service 4) CIP	1) Not provided 2) 2 months current year operating expenses 3) Not provided 4) Not provided
Water Dist No. 1 Johnson County	2.00	NA	AAA	1) Bond 2) Operating Contingency 3) Negative Cash Flow 4) Rate Stabilization	1) Not provided 2) 60 days operating expenses 3) Not provided 4) >$2 million
Winston-Salem Water Dept	1.2 - 1.5	NA	AA+	1) Working Capital	1) 1 times annual operating and debt service expeditures