

Agenda

Sacramento Suburban Water District Finance and Audit Committee

3701 Marconi Avenue, Suite 100
Sacramento, CA 95821

Monday, December 22, 2008
5:30 p.m.

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The public may address the Committee concerning any item of interest. Persons who wish to comment on either agenda or non-agenda items should fill out a Comment Card and give it to the General Manager. The Committee Chair will call for comments at the appropriate time. Comments will be subject to reasonable time limits (3 minutes).

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Call to Order

Roll Call

Public Comment

This is an opportunity for the public to comment on non-agenda items within the subject matter jurisdiction of the Committee. Comments are limited to 3 minutes.

Items for Discussion and Action

- 1. District Variable-Rate Demand Obligations (VRDOs).**
Review current status and discuss options for problems caused by the status of Facility Providers and Insurers on the District's VRDOs. Direct staff as appropriate.

- 2. Other Post Employment Benefit (OPEB) Funding to California Employer's Retiree Benefit Trust (CERBT).**
Receive staff report on OPEB funds deposited in the CERBT in 2008 and the amount planned for 2009.

Adjournment

I certify that the foregoing agenda for the December 22, 2008, meeting of the Sacramento Suburban Water District Finance and Audit Committee was posted by December 18, 2008 at the Sacramento Suburban Water District office, 3701 Marconi Avenue, Suite 100, Sacramento, California, and was made available to the public during normal business hours.

Robert S. Roscoe
General Manager/Secretary
Sacramento Suburban Water District



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Date: December 17, 2008

Subject: District Variable-Rate Demand Obligations (VRDOs)

Staff Contact: Dan Bills, Director of Finance

Staff and Mr. David Brodsly of Kelling, Northcross and Nobriega (KNN) public financial advisors will make presentations to the Committee. The subject material presented by staff is a brief history of the May restructuring and the current status of the Municipal Variable-Rate Debt Bond Market.

The material to be jointly presented by KNN and staff is an overview of the Variable-Rate Debt program, the status of the District's Variable-Rate Debt, a discussion of refinancing options available to the District, and a list of the next steps and key decisions the District should consider.

Mr. Brodsly of KNN will be joining the Committee meeting by conference call.

Staff presentation

May 2008 Restructuring of the District's Variable Rate Debt

At the beginning of 2008 the District had outstanding \$116,350,000 of adjustable-rate securities (ARS). The ARS market collapsed in the spring which forced the District to quickly restructure its debt. The District issued Variable Rate Demand Obligations (VRDOs), which required backing by a credit/liquidity facility. A brief history of the process, alternatives and quick solution available to the District last spring follows:

1. Of the major providers of credit/liquidity facilities, only Dexia Bank (Dexia) expressed an interest in providing a facility to the District.
2. Dexia was the largest provider of credit/liquidity facilities to municipalities.
3. Dexia had credit limitations on how much exposure to the District they could take including Dexia's existing insurance exposure on the 2004 bonds through their insurance entity, Financial Securities Assurance, Inc. (FSA). As a result, they would not provide a full credit/liquidity facility on the 2005 bonds. Citigroup obtained a commitment from Allied Irish bank to provide a credit/liquidity facility for half of the 2005 bonds.
4. At the time, Dexia and Allied Irish carried ratings in the highest short-term rating category by each rating agency (Standard & Poor's (S&P) and Moodys).

5. On the 2004 ARS Citigroup sought an S&P rating but S&P wanted a couple of changes in the Dexia/FSA legal documents and Dexia was unwilling to make the changes. It was going to take weeks (perhaps longer) to resolve these issues so rather than continue to pay the high ARS rates the District asked S&P to not rate the 2004 series and indicated that the District would come back to them in the future either at time of renewal of the Stand-by Bond Purchase Agreement (also referred to as a line of credit) or if the District replaced Dexia as its credit/liquidity provider. S&P agreed with this strategy.

Current Market for VRDOs

The primary buyers of VRDOs, money market funds, utilize both the short-term and the long-term ratings to determine eligibility for purchase. Money market funds must have Aa/AA category long-term ratings as well as VMIG-1 (Moody's) and A-1 (S&P) short-term ratings in order to trade. For corporate and other institutional investors they have no minimum long-term rating requirement and often only a rating in the highest short-term category is required. Currently, most of the corporate and other institutional buyers are on the sidelines so the money market funds are driving the variable-rate market.

Dexia's credit rating by S&P dropped to A+ in October and FSA was downgraded to Aa3 by Moody's.

When the Federal Reserve Bank (Fed) lowered its interest-rate on December 16th, the action threatened the recovery of the money-market-fund industry. The Fed cut its target interest rate to between 0% and 0.25% from 1%, the Fed's 10th cut in the past 15 months.

The Fed's move essentially pushed rock-bottom money-fund yields even lower. That is an unappealing prospect for investors, who have flocked to such funds in recent weeks as a refuge from the stock market's steep declines.

But now that trend is reversing, as investors flee low yields. Outflows from money market funds could intensify in coming months given that the Fed has signaled its long-term commitment to low interest rates.

Zero or near-zero yields are hugely problematic for money funds. Essentially, their business model breaks down at such low interest rates because they can't cover costs, let alone offer interest to savers.

Another corner of the money-fund industry that could see problems because of low yields is tax-exempt, or municipal, offerings. These funds have been under severe pressure this year as the bond insurers that guaranteed many of their securities have faltered or struggled with losses.

JOINT STAFF AND KNN PRESENTATION

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Sacramento Suburban Water District

Analysis of Variable Rate Program

December 22, 2008



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Overview of Variable Rate Debt Program DRAFT

District's Debt Portfolio

Issue	Par Outstanding	Credit Enhancement
2004 Adjustable Rate COPs	\$41,275,000	FSA insurance/Dexia line of credit (liquidity)
2005B Fixed Rate COPs	\$ 3,110,000	FCI insurance, No impact on District
2008A-1 Adjustable Rate COPs ¹	\$36,725,000	Dexia letter of credit
2008A-2 Adjustable Rate COPs ¹	\$36,725,000	Allied Irish letter of credit

¹2008 variable rate bonds are paired with a fixed-pay, variable receipt interest rate swap intended to create synthetic fixed rate debt.

- In May, 2008, when District restructured debt, FSA and Dexia were both premier names in credit markets.
 - Dexia owns FSA
- Over the late summer and early fall, both credits deteriorated and interest rates on variable-rate debt secured by FSA and Dexia rose dramatically.
 - Dexia downgraded by S&P on October 7 from AA- A+
 - FSA downgraded by Moody's on November 21 from Aaa to Aa3
- Many of the District's Dexia-backed bonds couldn't be remarketed, and were put to bank facilities at 12% rate.
- With credit markets still in relative disarray, no certain solutions, but several alternatives available to address challenge.



Status of Variable Rate Debt

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As of November 21

Variable Rate Issue	Credit Enhancement	Bonds Placed with Investors	Rate	Bonds Placed with Bank	Rate
2004	FSA/Dexia	\$24,400,000	4.15%	\$16,875,000	12.0%
2008A-1	Dexia	\$18,700,000	4.15%	\$18,025,000	12.0%
2008A-2	Allied Irish	\$36,725,000	0.57%	None	12.0%

As of December 17

Variable Rate Issue	Credit Enhancement	Bonds Placed with Investors	Rate	Bonds Placed with Bank	Rate
2004	FSA/Dexia	\$39,100,000	1.85%	\$2,175,000	12.0%
2008A-1	Dexia	\$36,725,000	1.10%	None	12.0%
2008A-2	Allied Irish	\$36,725,000	0.52%	None	12.0%

- After six months, bank bonds go into "term mode," and are amortized over five years.



Overview of Options

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Most Viable Options

1. Replace Citi as Remarketing Agent
2. Replace Dexia with another credit provider
3. Refund with one- to three-year note
4. Take no action and continue to monitor dealer performance

Less Viable Option

1. Drop FSA insurance from the Series 2004 bonds
2. Fixed-rate refunding of bonds to maturity
3. Use District liquidity to purchase its own bonds



Less Viable Options

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1. Drop FSA insurance from the Series 2004 bonds
 - District would need underlying ratings of AA to sell with only bank liquidity, and without credit support (i.e., a full letter of credit). Market rate would likely be higher.
 - Announced changes in Dexia policy towards FSA may help a little
 - Other options provide more return for the effort
2. Fixed-Rate Refunding to Maturity
 - Would accommodate issuance without Dexia or other credit enhancement
 - Would eliminate on-going market exposure
 - Long-term market is expensive
 - Economics of unwinding the swaps associated with the 2008 bonds even worse than they were in the Spring
3. Use District liquidity to purchase its own bonds
 - Lower Debt Costs
 - Not enough District liquidity to purchase more than about \$30 million of bonds
 - Only a temporary solution as this is not a long-term structural fix.



Update on Interest Rate Swap

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- 2005 COPs combined variable-rate auction rate securities with variable-receipt/fixed-rate pay swap with Citibank to create a net fixed rate obligation at expected lower cost than would have been obtained through traditional fixed-rate debt.
- After implosion of auction rate market, auction rate COPs were replaced with better-performing letter-of-credit backed variable rate demand obligations.
 - Swap left in place due to expense to unwind
- Key risks remaining from this transaction
 - Basis risk: underlying variable rate bonds behave differently from swap.
 - Allied Irish bonds performing well
 - Dexia bonds pricing 75 to 250 basis points above expected spread to Libor
 - Counterparty risk: institution on the other side of the transaction can't perform
 - Biggest risk is that Citibank goes bankrupt, and seeks termination (and payment)
 - Citibank currently rated Aa1/AA, but on negative outlook
 - Currently, District is "out of the money" since rates are lower now; on swap termination, would owe Citibank money
 - District could obtain a new swap counterparty, who would make termination payment on behalf of District and assume Citibank's role
 - In a prior experience (Lehman bankruptcy at EBMUD), district actually cleared \$200,000 from replacement transaction



Review of Viable Options

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- Replace Citi as Remarketing Agent on Dexia-backed paper
 - Citi's performance on District's outstanding variable-rate debt has been mixed
 - High relative spreads on Dexia paper placed with investors (i.e., the Dexia penalty seems particularly high)
 - High amounts and long term of bonds placed to the liquidity bank
 - Citi appears to have underperformed other dealers on Dexia-backed paper placed elsewhere
 - KNN solicited proposals from other dealers, and has two attractive proposals for replacement (from De La Rosa and from Barclay's)
 - Both firms have strong performance on placing Dexia-backed paper
 - Minimum amounts of bank bonds in the past
 - Anticipate that neither dealer would maintain bank bonds unless circumstances were extraordinary
 - Will require some cost to replace dealers
 - Transaction costs could range from \$75,000 to \$200,000
 - Each 5 basis points of interest rate savings equivalent to \$50,000 a year
 - Initial cost of \$10 million in bank bonds is at least \$100,000 a month.



Review of Viable Options

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- Replace Dexia with another credit provider
 - Dexia has been trading with a penalty.
 - Currently, appears to be 75 to 150 basis points above a "clean" letter of credit
 - Over last quarter of fiscal year, alternative credit facilities are virtually unavailable
 - Many expect letter-of-credit market to open up some after first of the year
 - New facilities will be more expensive
 - Current facilities cost around 50 bp
 - New facilities would likely cost 100 bp or more
 - Also a risk that any new credit provider will face trouble in the future
 - At the time of the 2008 refunding transaction, Dexia was still viewed as a top-tier credit
 - Modest additional expense to replace a liquidity dealer, most for legal documentation



Review of Viable Options

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- Refund with one to three year note
 - Pros
 - This would fix the interest rate for an intermediate period of time, eliminate interest volatility
 - Would produce relatively low interest rate due to steep yield curve
 - Would drop the Dexia credit facility
 - Relatively compatible with existing swaps
 - Cons
 - Net cost may be more expensive than staying variable
 - Would face market risk again in future
 - Transaction costs of around \$250,000-\$300,000
 - Refunding of note prior to term may require advance refunding, eliminating future opportunities for an advance refunding




Review of Viable Options

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- Take no action now
 - Pro's
 - Citi's performance recently improved
 - Dexia's trading value may improve
 - Avoids transaction costs and time
 - Essentially would defer decision while monitoring performance and market
 - Cons
 - Citi still maintaining bank bonds
 - Risk of bank bonds entering term mode (requiring amortization of principal over 5 years)
 - Same pricing on Series 2004 and 2008A bonds suggests the latter are at above market rates
 - In general, Citi's short-term performance in the market has trailed other dealers




Possible Next Steps and Key Decisions

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- Decide whether to remain in variable rate mode or fix out in an intermediate mode from one to three years
- If remaining in variable rate mode
 - Replace Citi on variable rate paper
 - Select De La Rosa or Barclay's
 - Obtain underlying rating of 2004 bonds (reflecting District's credit)
 - Monitor availability of replacement letter-of-credit and consider replacing Dexia
- If converting to intermediate term
 - Appoint investment bank
 - Determine preferred term on notes
 - Execute



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Date: December 17, 2008

Subject: Other Post Employment Benefit (OPEB) Funding to California Employer's Retiree Benefit Trust (CERBT).

Staff Contact: Dan Bills, Director of Finance

The Annual Required Contribution (ARC) for the District's OPEB benefits for 2008 is \$463,000. As current retiree OPEB benefits have been paid directly by the District this year, the amount sent to CERBT on December 18th was \$248,419.

For 2009 the ARC will be \$478,000, which is within the budgeted amount for 2009. Staff expects to send the full 2009 ARC to CERBT in January 2009.