EXECUTIVE COMMITTEE MEETING
FRIDAY, DECEMBER 10, 2010
ADVISORY BOARD OFFICE
8:30 A.M.
MINUTES APPROVED AT THE SEPTEMBER 9, 2011 MEETING

Present: Katherine Dunphy, MILTON; Wiff Peterson, NATICK; Lou Taverna, NEWTON; Bernie Cooper, NORWOOD; Carol Antonelli, SOMERVILLE, John DeAmicis, STONEHAM; Walter Woods, WELLESLEY; Zig Peret, WILBRAHAM.

Also in attendance, John Carroll, Andrew Pappastergion and Joseph Foti, MWRA BOARD OF DIRECTORS; Fred Laskey, Rachel Madden, Tom Durkin, Kathy Soni, Matt Horan, MWRA STAFF; Joseph Favaloro, Cornelia Potter, Matthew Romero and Mary Ann McClellan, MWRA ADVISORY BOARD STAFF.

I. Welcome

Chairman Katherine Haynes Dunphy called the meeting to order at 8:34 a.m.

II. Report of the Executive Director

MWRA Advisory Board Executive Director Joseph Favaloro introduced the Advisory Board's newest staff member, Maggie Atanasov, who joined the Advisory Board on December 1 as the new Government/Media Coordinator.

Chairman Dunphy noted that while looking at the rates presentation we should be mindful of the $200 million that is not included in the budget for Battery D, which is due in large part to staff member Cornelia Potter who convinced people that the fourth digester was not necessary. We are fortunate that Ms. Potter is going to stay with the Advisory Board in a somewhat different position, but will have more time to spend with her family.

Chairman Dunphy presented Ms. Potter with an inscribed frame that featured a picture of the Deer Island digesters. Ms. Potter said the review that this office brought to the decision making at the time also influenced that decision. She thanked the Executive Committee for the gift and well wishes.

III. Special Presentation to the MWRA Advisory Board Executive Committee – MWRA Finance Staff

MWRA Director of Administration and Finance Rachel Madden said every year staff talks about its projected rate increases and, encouraged by the Advisory Board, the 1.49% increase for FY11 was the lowest rate increase since 1996. Additionally, staff kept with a multi-year strategy in the near term and brought FY12 and FY13's projected rate increases to 3.9%.

The challenge the MWRA faces from a rate revenue perspective is great. Ms. Madden said that Mr. Favaloro always notes that talking in percentages isn't real; you have to get the perspective about what the dollars are. In FY11, MWRA had a very low increase of $8.4 million that climbs to $48.6 million in FY14; there is a drop off in FY18 that has a residual effect of raising FY19 by $78.9 million. That is not what staff wants to see. Rather, the goal is for consistent, moderate rate increases. That is something that needs to be addressed and should be part of the dialogue with this committee.

Over the period of FY85 through FY20, there is a $900 million increase in the Rate Revenue Requirement. The "mountain" of debt that the MWRA has is a result of capital spending over a multi-year period, much of it court-mandated spending and when borrowed, there was an anticipation that Debt Service Assistance on a formulaic basis would be available to help pay this debt. Overall, as of June 30, 2010, the Authority is now indebted to the sum of $5.8 billion.

Treasurer Tom Durkin said that if we assume that from this point forward that $100 million more will be spent and borrowed each year and MWRA borrows at an interest rate of 6% for 40 years, it would be layered on top of the debt the MWRA already has.

The Authority issues two types of debt – Senior Debt and Subordinate Debt. The Senior Debt has reserves, which means there are dollars pledged to secure the interests of the investors of the senior lien; it isn't required of the subordinate lien. MWRA has, in practice, chosen to issue fixed-rate bonds on the senior lien and variable rate bonds on the subordinate lien.

The senior liens are the MWRA's fixed-rate bonds that are tax-exempt municipal bonds; they are time tested and are a basic way for public entities like the MWRA to acquire capital. The fixed-rate has a feature where once you have described where the maturities will layer out; for example, if the MWRA has to borrow $100 million for 20 years, it could be $5 million every year but it doesn't need to be $5 million every year; the MWRA has the option of saying $1 million this year, $1 million next year and more in other years and staff can structure those maturities, but once it is set and the interest rate that the MWRA has to pay and time are set, all of the other risks are avoided. This includes rising interest rates, inflation, housing starts and oil prices, which affect bond prices. All of that risk is taken off of the MWRA and placed onto the investor. However, when investors take on more risk, they are going to require more return.

The fixed-rate bonds are going to be a bit more expensive for the MWRA than another type where MWRA is keeping some of the risk, which brings us to the subordinate lien, which is the variable rate debt. MWRA takes on a certain measure of variable rate debt where the MWRA is, rather than the investor, exposed to the volatility of interest rates and inflation and general market conditions; therefore, staff does not want to take on too much of this type of debt. What is the right amount? This is the point that gets debated a lot in capital finance. One measure is what is the best industry practice? It seems to be within

15% to 25% of a portfolio can tolerate variable rate debt. MWRA is about in the middle at 21.5%.

The MWRA has Massachusetts Water Pollution Abatement Trust debt that comes from what is commonly referred to as the State Revolving Fund (SRF). Certain projects are accepted by the Department of Environmental Protection (DEP) and win approval for funding and the MWRA receives a less expensive cost of capital with those state-subsidized borrowings. For short-term needs, MWRA has commercial paper.

The variable rate program needs to be constantly managed. Of the $1.3 billion of variable rate debt, staff has broken it into series. For those series once a week, or in a couple of cases daily, there is periodic resetting of the interest rate. MWRA has a remarketing agent. In the case of the 99Bs, Bank of America remarkets that, acting as a broker, and they place those bonds with investors, typically large mutual funds, and those reset every week. They observe the market place and establish what the interest rate is. Do you want those bonds or don't you? The investors will keep them or if they don't, the remarketing agent will find another home for them.

In a case where there are difficult financial markets, which MWRA experienced in 2008, there are times when the investors don't want the bonds and they challenge the remarketing agent to make a market. For example, if Fidelity says they don't want those bonds either because of the difficulties in the market place or liquidity needs, they will challenge the remarketing agent to find a new home for those bonds. If the remarketing agent finds a new home, terrific; if they don't, the remarketing agency can buy those bonds in the sense that they are making a market for them. The remarketing agent keeps the bonds for the week. There are times when the remarketing agents don't want the bonds. The Authority has a contract with a liquidity facility provider who will then take those bonds as bank bonds. They provide a standby or "back stop."

The issue of the liquidity facilities has gotten some notoriety because their prices have increased. There was a time in 2008, prior to the upheaval, where MWRA was paying 18 or 20 basis points for that service or protection. MWRA did a procurement early in the process and received favorable rates but they were higher (30 to 45 basis points) to provide the same service. A year later, they were 100 basis points. Now they have come down and staff is doing a liquidity procurement currently and a number of banks bid, fortunately, and the prices have come down to the 50s and 60s. All of the costs that are associated with the variable rate must be considered. Interest rates have really come down. MWRA uses an index called the Securities Industry and Financial Markets Association (SIFMA) as its benchmark and SIFMA is in the high 20s. Twenty basis points of borrowing is good, it is not even 1%; but when you add on the liquidity facility and the remarketers get a fee it adds up to 7.5 basis points.

Derivatives are assets that derive their value from something else, typically an index. In MWRA's case, the swaps derive their value by the SIFMA index. MWRA pays a variable rate to its bondholders. The bondholders will get .29% this week, maybe .28% next week and it will flow; there can be volatility but, fortunately, there hasn't been recently. MWRA may want to swap its variable rate payments with a counter-party, who will then pay the variable rate. MWRA would enter into a contract with a counter-party, such as Morgan Stanley, Goldman Sachs, Citibank, etc., and they accept the volatility and will pay nearly exactly the dollars that are going to be required to pay the bondholders and the bondholders don't know any difference. MWRA pays the bank a fixed rate, referred to as synthetically fixed. MWRA is not totally immune from any volatility. For one, the counterparties could have trouble; MWRA experienced that with Lehman Brothers. So there is counterparty risk. The bondholders aren't paid exactly SIFMA, they are paid what the remarketer said was a fair price, which isn't the index. Typically MWRA is going to be a few basis points lower than the index and will trade through SIFMA a few basis points lower, or occasionally higher, depending on who the liquidity provider is and how the industry is looking at that liquidity provider.

There is a bit of risk there too. Back in 2008 when SIFMA was in the 3s, MWRA's bonds, because of the insurers who had made bad investments, were trading in the high 7s. So there was some real basis risk there. MWRA was paying its bondholders 7 but receiving SIFMA so there was a bit of a disconnect there. While MWRA doesn't have all of the risks put aside like it does with fixed bonds, this is very close and is why it is referred to as synthetically fixed.

MWRA's portfolio of $1.2 billion of variable rate is in a sense half synthetically fixed and half completely exposed to the variable rate market. It is that component of half of the $1.2 billion, $686 million in variable rate is purely exposed to the volatilities of the market but MWRA is able to hedge against that. The Authority has investments in money markets, which have rate changes as well. Though not perfectly correlated, with its debt, there is some correlation there. At the time MWRA is paying more on variable rate debt, it is also earning more in these money markets and that provides this hedge. MWRA tries to maintain industry best practice of between 15 to 25%.

John DeAmicis asked if MWRA is exposed to interest rate swap risks. Mr. Durkin said the short answer is no. There are lots of complexities that can enter into the derivative. One would be swaptions. In the financial market, any time you are giving something, you are going to receive a payment for it. Or if you are getting something, you are paying for it. In the case of the Massachusetts Turnpike Authority (MTA), they got the option to enter into a swap and for that they got an upfront payment. They got the upfront payment and the macro-economic conditions turned against them and the swaps weren't something that were advantageous for them but they had no choice. The lack of choice and a lot of complexities in their financial condition caused them to be in a place where they had no option except bad. MWRA does not have those kinds of options. MWRA is against anything higher than just a straight exchange of fixed rate for variable or variable for fixed.

Fred Laskey added that what the MTA did was to take a huge chunk of cash upfront to enter into this swaption that had a lot of risk in it. The market conditions changed and then when they had to "pay the piper," they really "took it on the chin." MWRA doesn't have anything like that. Ms. Madden said other authority types have had issues with swaps as well and that goes back to the component of being able to get a liquidity facility to back you. When they don't have high credit ratings or when there is the perception that there is difficulty, it is hard for them to get bids and pricing that will afford them the opportunity to move forward. MWRA is fortunate because it is in a category that they consider a lower risk and they were willing to afford the Authority the credit.

Mr. Laskey added that almost on a weekly basis, the finance houses come in with ideas and some of them are responsible. Tomorrow we could find someone that would give us a financing deal that would let us have rate reductions for three years; they have balloon payments and swaptions and every scheme under the sun but the Authority has resisted what it considers irresponsible or risky options. MWRA's last bond upgrade listed conservative fiscal management; that is because staff has been aggressive but very careful not to enter into any schemes that could come back to hurt the Authority.

Mr. Favaloro said the one part that is hard to buy into on variable rate debt is relying upon historical averages for budgeting purposes. The world has changed; there is no such thing as a ten-year average anymore. An average is not reliable. Mr. Durkin said Mr. Favaloro's comments are valid.

Mr. Durkin said we have set an interest-rate assumption for variable rate debt of 3.25%, which MWRA staff believes is prudent. The rating agencies watch these numbers because they recognize the risk associated with variable rate debt. Staff manages the MWRA's credit rating so that it has the opportunity to get liquidity.

The first risk management strategy is to buy insurance on the bonds, which MWRA did. Because of the actions of the insurers, they had problems and some went bankrupt. MWRA had to react to the investors who didn't want these bonds because they were tainted with that insurance. The investment community wanted no insurance and MWRA had to "scrub" off the insurance by doing a large refunding. Staff is watching all of the various components of variable-rate debt closely.

Ms. Madden said the strategy is to manage debt service, not just the debt portfolio. The preservation of a high credit rating is perhaps the most important of all the various tools that the MWRA has. It provides the MWRA the ability to ensure low cost of debt, access to the marketplace and competitive pricing.

When the MWRA does do a new debt issuance, staff traditionally makes sure it maintains options. The Authority may pay a little extra for it, but having a ten-year call option is of great benefit. MWRA could have a 30-year debt without this, but then it would not be able to do these other types of transactions; staff wants to make sure there is some flexibility so that future CFOs can do something with that debt. Because the MWRA has a very high credit rating, it does not pay a high price for that option.

Restructuring debt is a tool that the MWRA uses sparingly since it simply moves the debt; it is not a great pattern because you pay more when the debt is pushed out. It is not wrong to put debt out into the future for the types of assets that the MWRA has put into place; Deer Island is an asset that will have a long life. It is not wrong that future generations should contribute and pay toward the construction of an asset that they are still using but staff cautions against putting off the inevitable because the Authority will pay more in the long run.

The defeasance strategy is one that the Authority always employs. MWRA has consistently used its surplus funds to lower debt service costs in the future.

Ms. Madden said because MWRA was experiencing low rates and had budgeted conservatively for the variable rate, staff did something that it normally does not do. Staff accounted for and planned for a defeasance (ordinarily MWRA never predicates its budget on an assumption that there will be a defeasance) in order to get to the 1.49%; a $20+ million defeasance had been built in, coupled with doing a restructuring, to achieve the 1.49% for FY11 and 3.95% for FY12 and FY13.

Ms. Madden said the 2007 restructuring was done as non-callable fixed-rate debt, so it is locked in and cannot be touched. A committee that included Mr. Favaloro and MWRA Board Members participated in this restructuring. Because of the size of that restructuring, MWRA is limited as to what is available to be restructured in the near term. There is not much left to be able to restructure until we get to 2016. Restructuring in FY12 is not a tool that we can use in planning for the impending 7.9% rate increase.

The release of the nearly $140 million in reserves is not going to do much to reduce the mountain of debt that the Authority has so staff will work collaboratively with the Advisory Board and financial advisors to make sure that the best strategy to get the greatest reward for the use of these funds is applied.

Ms. Madden reminded members that when the debt was being incurred for Deer Island and the Boston Harbor Project, etc., the MWRA was planning on an ever-increasing Debt Service Assistance (DSA) to augment it. DSA dropped off in 2003 and is essentially non-existent at this time. That relief is just not there now. The Authority had to restructure to make up for the loss of these funds.

There are other long-term obligations looming ahead for the Authority that need to be addressed. Debt service has to be paid every year; these other liabilities give the Authority some flexibility. The Authority has to pay an assessment toward the retirement system every year. In FY11, the Authority was supposed to pay in $9 million to the pension based on an actuarial study. Staff knew that the market had done better and that the system had regained a lot of ground so staff went back to the Retirement Board and asked them to run the actuarial study again under the new economic condition and the contribution was lowered to $5 million.

For the OPEB liability, MWRA has done nothing other than acknowledging the obligation. Eventually that outstanding liability on the books is going to become a problem for the rating agencies. Putting it off will be costly over time. Mr. Favaloro noted that the Advisory Board has never said that the liability did not exist; however, staff does not want to get too far ahead of everyone else because this is not singularly unique to the MWRA. We should wait to see what everyone else is doing.

Mr. DeAmicis said he works on his Town's Finance Board and hardly anyone, including the state, has done anything with OPEB. Ms. Madden said the state has done something but not enough; some people are doing what they can but not nearly enough has been done. It is a universal problem. Mr. DeAmicis said that he doesn't believe that the MWRA should be the pace setter, especially when it is going to send rates through the roof. Ms. Madden said that message has been received but staff has to highlight it because it is real and it is looming. In 2008, the OPEB amount in the report was $180 million and MWRA didn't do anything; two years later it was $192.7 million and growing. Staff understands that FY11 was not the right time to do it but must remain cognizant of this liability.

Mr. Favaloro said he did not think there would be solid reductions over the next few years; what is the Authority looking at as a means of reducing or tweaking the budget? Ms. Madden said swaps could be an option but there is counterparty risk there. MWRA could do a variable rate on its next issuance and pay a low cost of debt and that might help for the near term. For the next two years there is not much opportunity for swaps and staff doesn't really have a plan for the tweaking. The proposed 3.9% increase, while higher than people wanted, is at least in the ballpark of a moderate and sustainable rate increase. Once the MWRA gets into 7.9% rate increases is when staff would have problems. Staff is looking at a multi-year strategy and is not skipping FY12/FY13, but there are bigger problems ahead. Ms. Madden said if we don't address those now, then there won't be tools available when we get there.

Wiff Peterson said two strategies that should be on the table are looking at a 1% extra rate increase at some point that takes up some of that increase. Mr. DeAmicis said no; that is the wrong answer. Mr. Peterson said the other thing is system expansion. If we can provide an incentive for new users to join the system, they can share in the 60% to 70% of the rate that is a fixed cost and buffer some of that for the existing users. MWRA needs to make it easier for new users to get into the system; forget about the entrance fee – 60 to 70% of their rate is going to be covering MWRA's costs. Sharing that fixed cost could be a huge help. Mr. Favaloro said we all agree we have to grow the system.

Mr. DeAmicis asked if the MWRA recognize that 7.9% to 8% increases aren't going to work. Ms. Madden said yes; I'd like to be able to come in here and put up on the screen that this is exactly what we are going to do. Staff doesn't just look at the following fiscal year; this mountain looms over the MWRA all the time. Staff is constantly looking at ways to carve the mountain down but at some point we have to get there. The mountain used to be taller but we have shaved off some of it. It is a reality and we do get it; we just don't have the perfect plan yet but there are a lot of tools that we will look at to use strategically; the release of the reserves will help but it is not a panacea. The Advisory Board has to be a participant in the planning process on where that relief is allocated to the best that we can have some discretion. You are the customers and the customer is always right.

Mr. Favaloro said the Advisory Board listens to the voices out there and incorporates that in its message. We want to provide the Authority with all the resources it needs to accomplish its mission but not give them more than they need.

Ms. Madden said with the limitations on the use of the released reserves, the maturities where these reserves can be utilized may not fit in the years that we want them to so there may be some strategies where we say that is the only year that we can use it and that lowers debt service by $20 million in that year but that creates a disconnect if next year we have a bigger mountain. Perhaps in the year that we got the huge release from the reserves we could raise rates a little more as an optional prepayment on the next year.

Chairman Dunphy said we are trying to go back to our mantra of predictable and sustainable. As the details become more refined, you have to look on a four to six year basis on how to spend the money in each particular year based on what can actually be done. We have to look at ways to control spending in those outer years. Projects should be reviewed to see when they can be done without causing problems in the short-term, with the short-term being defined as 10 to 20 years. MWRA should be spending money on the right things, not on things that can wait or are unnecessary.

Mr. Favaloro said he understands that the Authority needs to look at the mid-term and needs to take the future years into consideration but by the same token, people are hurting now. How to balance the two is the challenge we all have.

Mr. Favaloro noted that every year consumption is going down, which leads to less potential revenue for the communities; adding a delinquency rate for individuals that are not able to pay the bill because of the economy, it is a two-tiered problem. MWRA staff has done a remarkable job to put the Authority where it is today when you consider the borrowings and steps they have had to take in building an agency that is at the top of its class.

IV. Adjournment

A Motion was made **TO ADJOURN THE MEETING AT 10:21 A.M.** It was seconded and passed by unanimous vote.

Respectfully submitted,

Lou Taverna, Secretary