CALL TO ORDER – PRESIDENT POLTL

ORAL COMMUNICATIONS

Persons wishing to address a matter not on the Agenda may be heard at this time; however, no action will be taken until the matter is placed on a future agenda in accordance with Board policy.

ITEMS FOR DISCUSSION

1. FITCH RATING – FITCH HAS AFFIRMED AA+ RATING WITH A STABLE OUTLOOK (pp. 1-4)

2. OLIVENHAIN WATER PURCHASE AGREEMENT (pp. 5)

*****END OF DISCUSSION ITEMS*****

OTHER BUSINESS

*****END OF OTHER BUSINESS*****

If you have any disability which would require accommodation in order to enable you to participate in this meeting, please call the Executive Secretary at 760.744.0460 ext. 264 at least 48 hours prior to the meeting.

AFFIDAVIT OF POSTING

I, Diane Posvar, Executive Secretary of the Vallecitos Water District, hereby certify that I caused the posting of this Agenda in the outside display case at the District office, 201 Vallecitos de Oro, San Marcos, California by 1:00 p.m., Thursday, August 4, 2011.

Diane Posvar
DATE: AUGUST 8, 2011
TO: BOARD COMMITTEE
SUBJECT: FITCH RATING - FITCH HAS AFFIRMED OUR AA+ RATING WITH A STABLE OUTLOOK

BACKGROUND:
In 2005, the Vallecitos Water District (District) issued $66.7 million in Certificates of Participation (COP's) to refinance 1998 debt from the first Twin Oaks reservoir, fund construction of the second Twin Oaks reservoir, and fund expansion and improvement of the Meadowlark Reclamation Facility. In 2007, the variable rate COP's were reissued at a fixed rate.

The original underlying rating was AA from Fitch and AA- from S&P (insured up to a AAA). Both agencies recalibrated the underlying rating to AA+ in 2010. Fitch completed a rate surveillance on July 26, 2011, and reaffirmed the AA+ rating with a stable outlook. The current balance is $58.5 million.

DISCUSSION:
Both S&P and Fitch periodically perform surveillance reviews to keep their rating current. Fitch last reviewed and reaffirmed the District's rating in July of 2009. S&P last reviewed and reaffirmed their rating in April of 2009.

The review just completed by Fitch identified both strong and weak points which are noted below:

Strong points:

- Strong financial performance after a period of economic and environmental stress (we passed the stress test)
- A service area with above average incomes and access to a large and diverse San Diego employment market
- Sound economic fundamentals
- Debt service coverage recovered to 2.1 in 2010 from a low 1.5 in 2009
- Diverse revenues including stable sewer fees
- Disciplined rate hikes and spending cuts
- Sound management of recent water supply cuts through conservation and rate hikes that protected financial margins
- Conservative projection assumptions including loss of Redevelopment (RDA) revenue
- Improvements in District water supplies and water sales
- Proactive attempts to diversify water supply - desalination
- Low rates hence/allows rate flexibility
Weak points:

- Above average debt levels that may increase
- Capital facility fees and property tax remain vulnerable to weaknesses in the housing market
- Reliance on imported water - vulnerability to reduced sales from supply curtailment
- Cash position - 250 days of liquidity, below 308 average among Fitch AA+ water and sewer utilities
- Projections include significant increases in construction activity
- Additional debt in 2014/15 given projection assumptions will not be supported with the current bond rating
- Reduced rate flexibility going forward

The strong points speak for themselves and recognize prudent Board fiscal policy and the efficient operation of the District. Discussion on the weak points follows for each of the points noted by Fitch:

None of the weak points are a surprise and we are aware of all of them. All are overcome or mitigated with the return of a good economy and growth, with the exception of our reliance on imported water. While we could mitigate most, the offset would intensify another weakness or deteriorate a strength (e.g., reducing reliance on debt by increasing rates leads to less rate flexibility, increasing our cash position by borrowing more money leads to even higher levels of debt, etc.). Adequate steps have been taken by the District in long term projections to accept the weak points at this point without taking steps to bolster the weak points that may be self-correcting.

Above average debt levels that may increase

We are aware that our debt levels are high and will increase. We compared our debt level to other agencies in relation to other financial attributes. As indicated in the 2011/2012 budget and rate presentations, “We need to recognize and communicate our current financial position.”

Growth – an increase in capacity fees will potentially reduce the amount we are projecting to borrow in 2014/15. When completing our future projections we can consider various combinations and assumptions of a higher rate ramp, more property tax revenue, more growth, additional budget cuts, and
elimination or deferral of capital projects. These measures need to be taken with caution as not to reduce our rate flexibility, still maintain conservative assumptions, and not to defer maintenance or eliminate valuable programs (e.g., I&I studies, valve repair/replacement, efficiency studies, etc.).

**Capital facility fees and property tax remain vulnerable to weaknesses in the housing market**

We are aware of the vulnerability and uncertainty of capital facility fees and property tax from past experiences such as the recent downturn in the housing market, past property tax revenue takeaways (ERAF), and the Governor's proposal on RDA elimination. Loss of RDA money is reflected in our budget projections and we plan to meet debt service coverage ratios without both capacity fees and property taxes. As mentioned by the Fitch analyst, this weakness is mitigated by conservative assumptions in our budget projections. The District could further mitigate the weakness by reducing the amount we project to receive in cap fees and property tax, but that may lead to the need to increase rates and an increase of debt issuance assumptions.

**Reliance on imported water - vulnerability to reduced sales from supply curtailment**

Past experiences along with the recent current supply shortage has made us very much aware of the risk of a sole source of water supply. Fitch analysts looked favorably on our efforts to diversify water supply by pursuing desalinated water. We should continue our pursuit of desal and involvement in the regional effort to maximize water recycling. We are currently drafting an RFP for a thorough Rate Analysis of the impacts of purchasing desalinated water directly from the Carlsbad facility in lieu of purchasing it as a melded supply from the San Diego County Water Authority (SDCWA).

**Cash position - 250 days of liquidity, below 308 day average among Fitch AA+ water and sewer utilities**

![Graph showing cash position](image)

We are aware of our cash position and liquidity that were reflected in the budget rate presentation. Constant monitoring of liquidity – comparing 3 and 12-month maturities to reserve levels are presented to the Board monthly in the investment report.

When our cash position improves, the Board may consider a policy change increasing the threshold of our reserves from five months to six months of operating expense and consider a shorter recovery period on replacement
reserve assumptions. Increasing the amount of debt assumed will help our cash position, but intensify scrutiny of already high debt levels.

Reducing our Other Post Employment Benefit (OPEB) Annual Required Contribution (ARC) is conceivable by using a higher discount rate in actuarial assumptions. The current actuarial study in process will use assumption of 7% and 6% discount rates for comparison purposes. This study will be presented to the Board for consideration and action when completed.

**Projections include significant increases in construction activity**

We don’t agree with this conclusion. It would appear this conclusion is a result of the starting point being so small that any increase results in a high percentage (e.g., you give your son a $1-allowance and increase it to $2 — that’s a 100% increase!). Additionally, the analyst was impressed with the conservative assumption that construction levels return only to the lowest levels of the valley in the previous cycle over a three year ramp-up period. We do not suggest adding more conservatism to our growth assumption.

**Additional debt in 2014/15 given projection assumptions will not be supported with the current bond rating**

We had already speculated that this would be the case but had hoped by planning to meet debt service coverage without cap fees or property tax we could maintain our current rating. We will assume less debt proceeds in our next projection to the extent that days of liquidity are within the range of the average AA+ utility after issuance.

**Reduced rate flexibility going forward**

We have been aware of the potential of more resistance to rate increases, especially considering the overall economic climate right now. We should continue to plan a rate ramp, but if reasonably possible, avoid double digit percentage increases. We should develop and pursue more effective outreach as to why rate increases are necessary (Grand Jury report).

**RECOMMENDATION:**
No policy changes are recommended at this time; however, staff will monitor the weak points noted with specific attention to the following areas:

- Consider all alternatives and revenue combinations and reduced debt proceeds from projected 2014/15 issuance.
- Continue pursuit of desalination and involvement with the North County regional water recycling project.
- Consider a 7% discount rate to calculate the OPEB ARC.
- Target an improving days of liquidity calculation in the next budget projection.
- Improve and expand outreach in anticipation of public rate hearings.
DATE: AUGUST 8, 2011
TO: BOARD COMMITTEE
SUBJECT: WATER PURCHASE AGREEMENT WITH OLIVENHAIN MUNICIPAL WATER DISTRICT

BACKGROUND:
The District's 2007 Integrated Water Resource Plan (IRP) identified various potential sources of water that the District should pursue to develop a diversified supply of water. We are currently 100% reliant upon the San Diego County Water Authority (SDCWA) for our water supplies.

One source the District has pursued is the Carlsbad Desalination project and has entered into a contract for the delivery of up to 7500 acre feet (AF) of water. This contract is temporarily on hold pending negotiations between the SDCWA and Poseidon Resources.

An additional source identified was the Olivenhain Municipal Water District (OMWD) Mount Israel storage and treatment plant project. While it does not now appear to be possible to purchase storage or actual treatment capacity, we may be able to take advantage of excess local treatment capacity to provide us with some delivery options.

DISCUSSION:
Staff has been meeting with OMWD staff over the past year to determine where we could potentially take the water when available and the quantity we can accommodate.

We are predominantly looking to obtain the water and deliver it in the southern end of the District in the San Elijo Hills area which can be done with minimal capital outlay and little changes in our water operations plans.

There are still numerous analyses that need to be accomplished to verify the costs and benefit, but this does appear to be a viable inter-agency connection that would benefit the District.

A draft agreement has been developed and is currently being reviewed by staff and Counsel.

FISCAL IMPACT:
To be determined.

RECOMMENDATION:
Provided as information and discussion item only; no action is required.