

MINUTES
NORTHEAST OHIO REGIONAL SEWER DISTRICT
BOARD OF TRUSTEES SPECIAL MEETING
MAY 17, 2016

Meeting of the Board of Trustees of the Northeast Ohio Regional Sewer District was called to order at 1:05 p.m. by Darnell Brown.

I. Roll Call

PRESENT: D. Brown
R. Sulik
W. O'Malley
J. Bacci
T. DeGeeter
S. Dumas
R. Stefanik

The Secretary informed the President that a quorum was in attendance.

II. CEO Comments on Consent Decree Requirements & Financial Obligations

Mr. Brown thanked staff for facilitating the meeting, which was a result of concerns and questions around the proposed rate increases over period of 2017 through 2021. This working session will be part of a continuing process to achieve a level of comfort in terms of what should be adopted as a proposed series of rate increases for facilitating the financial needs of the District.

CEO Ciaccia noted that Carol Malesky and Andrew Baker from Hawksley would go through the various scenarios.

CEO Ciaccia stated that the Board is on the same page as it relates to the District's obligations under the consent decree but some externally would suggest pulling back from or disregarding it; for the purposes of discussion they have analyzed the implications of that action. Penalties are built into the consent decree which could cost between \$256 million and \$1 billion depending on how the Environmental Protection Agency (EPA) and the U.S. Justice Department would choose to enforce them.

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Pulling back from the consent decree would also result in additional legal costs. From 2004 through 2011, when the consent decree was finalized, the District spent \$5.7 million in litigation. Further costs would be incurred through escalation in terms of delaying construction projects in the amount of \$90 million per year, and over \$400 million in additional costs from 2017 through 2021.

CEO Ciaccia made clear that this scenario is not under consideration.

The District issues tax-exempt bonds and has trust indentures that govern them and the obligations. Two key indicators are the debt service coverage ratio which is 1.05 times for all debt and 1.15 for senior debt, which are bonds. The District must meet those obligations or go into default. In addition, operating cash must be a minimum 90 days. No rate scenario will compromise these factors.

The District is an AA-rated utility based on the key indicators of revenue bond coverage, all debt coverage, days of cash on hand and operating reserves per the trust indenture.

CEO Ciaccia explained that the implications of dropping from an AA utility would be higher interest rates and other costs associated with being competitive in financial markets. Maintaining the current rating requires a 2.00 revenue bond coverage ratio, 1.5 all debt coverage ratio and over 250 days cash.

The Board adopted policies around these metrics of 1.25, 1.05, and 90 days operating reserve. Staff's perspective is to continue to strive to be an AA-rated utility because of the financial benefits but Board policy is a little out of sync with that and should be revisited at a later date.

CEO Ciaccia stated that another assumption is not deferring non-consent decree capital and maintenance.

The last assumption is to manage the implication of future rate periods, because the rate structure adopted for the period of 2017 through 2021 will significantly impact the next five-year rate period.

One scenario staff does not recommend includes shutting down all capital improvement (CIP) projects and finishing those in progress. Such an action would put the District in violation of the consent order but reduce the rate increase to only 9%. In addition, this scenario would use up a lot of cash which would result in cash deficiencies and a minimum 15% per year increase during the next five-year period.

III. CFO Review of Current Assumptions & Proposed Scenario

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Jennifer Demmerle, Chief Financial Officer, advised that the assumptions used when determining the average annual rate increase included a 2% decrease in annual consumption the next five years. The previous five years have had a 3% decrease.

The next assumption is a 96% collection rate and to increase affordability program participation.

The District has four reserve accounts: operating reserve, equipment repair replacement, insurance reserve and debt service reserve. Staff also has a rate stabilization account and does not plan to touch reserves. That account currently has \$18 million ~~per year~~ placed in it which will be drawn down but replenished to existing levels at the end of the five-year period.

Mr. Brown inquired whether there will be discussion around the various reserves to see the levels. CFO Demmerle indicated that there is \$25 million in the insurance reserve, \$55 million in the equipment repair/replacement reserve, \$32 million in operating reserve, \$28 million in debt service reserve, and \$18 million in the rate stabilization account, or in total \$150 million.

The District currently has 600 days of cash on hand because of the capital account. Whenever there is a surplus it is transferred to the capital account to offset any future borrowing to pay cash for projects. That account is being drawn down to the minimum target of 400 days and is \$100 million off that account.

CFO Demmerle stated that operating expenses in the 2016 budget is the baseline and there are escalation factors in cost categories that are an average of 3%. The highest escalation is 9% in healthcare benefits and the lowest is the billing fee and collection paid to billing agents, which is 2%.

The operating expenses on average are projected for a 4% annual increase. The last five years it has been about 9%. Staff projects \$10 million per year in additional operation and maintenance costs associated with new assets coming on line as well as a backlog of deffered maintenance.

The capital program is projected to spend \$1.4 billion during the next five years. Over 80% is already committed based on projects already under construction or awarded. Staff will reduce the planned capital program by 10% of its cash flow based on historical spend.

Ms. Dumas was now present.

Moving to funding of the program, CFO Demmerle advised that staff is assuming \$50 million in awards per year through the Water Pollution Control Loan Fund (WPCLF). In the past that figure was \$35 million. They intend to utilize more of these funds because of changes in the program and extending maturities that provide a favorable impact on rates because of the lower interest rate and administrative costs.

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In total the District will probably issue debt of \$1 billion in a mix of bonds and loans. Staff would like to cash finance 25% of the program but will not get to that point until 2026.

Participation in the Homestead and affordability programs is currently 50% and staff hopes to achieve 80% over the next five years.

This year staff would like to apply the affordability discount to the fixed fee. Currently it is only on the ~~value-volumetric~~ metric charge. The District also intends to fund the Member Community Infrastructure Program in 2017 with \$7 million and gradually increase it to \$30 million by 2023.

The final assumption is smooth rate increases.

Mr. Brown noted that the capital plan over the next five years is \$1.1 billion and another \$1.4 billion brings the total to \$2.5 billion in the first 10 years of a 20-year program. He stated that it seems to be front-loaded and most likely impacts future rate increases. He inquired whether there are scenarios that show the impact of not front loading this capital. CEO Ciaccia explained that the consent decree and some milestones were front-loaded but there is some advancing of projects.

CFO Demmerle clarified that the figure is the total capital program, not just mandated CSO projects. Mr. Brown requested breaking that out so the Board understands.

Devona Marshall, Deputy Director of Engineering & Construction, stated that in regards to the CSO program through 2015 the District has spent \$462 million. From 2016 through the end of the rate cycle in 2021 another \$1.7 billion is estimated to be spent which will leave \$1.1 billion remaining.

Mr. Brown reiterated that he would like to see scenarios of what would happen if the District did not front-load capital during the first ten years.

IV. Prepared Alternative Rate Scenarios

CFO Demmerle explained that all scenarios are accompanied by the pros and cons associated with each. The current proposed 9.5% average annual increase results in a typical customer's bill of \$56.12 in 2017 increasing to \$80.59 over the five-year period.

The cost drivers are mandated CSO projects, investing in existing infrastructure and maintaining assets that come online.

This scenario meets all financial metrics and continues to maintain a strong financial position. The Member Community Infrastructure Program (MCIP) will be funded. This scenario ~~and it~~ enables Operations to catch up on the backlog of maintenance while maintaining new assets.

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The District would meet consent decree requirements and timelines. The scenario would allow for higher rate increases in the second five-year period of 9.8% and does not leverage the full potential of the loan program by borrowing only \$50 million per year.

Carol Malesky advised that the first scenario removes the Member Community Infrastructure Program. The average rate increase is 9.3% and by 2021 the typical bill would be \$79.87 per month. This scenario maintains all current target scenario requirements with the exception of the MCIP. There are minor savings in the rate increase in the first rate period and the second, which would be 9.0%. The problem is not funding the MCIP is a missed opportunity to serve the community and solve issues related to inflow and infiltration.

Ms. Dumas questioned why removing the MCIP was selected to reduce the rate. CEO Ciaccia indicated it was because the program has not been yet been adopted by the Board and it shows the program does not have a huge impact on rates.

Ms. Malesky advised that the next scenario delays CSO projects to the consent decree milestones, some of which are past the rate period. This scenario results in 9.3% average rate increase for the first five years, and a typical bill of \$79.87 by 2021. The next rate period's rate increases would be 9.6%. The next five years are projected to be higher rate increases due to rescheduling projects. Pushing projects back can result in higher program costs because of inflation and increases the risk of not meeting consent decree dates due to unforeseen circumstances.

This next scenario results in a lower bill in 2021 due to assuming ~~instead of the~~ \$100 million per year in WPCLF loans, which has a lower borrowing cost than revenue bonds, achieves all target goals and allows the MCIP program to begin in 2017. Rate increases of 9% are projected for the first 5-year rate period; however, for the second rate period the increases go to 9.7%.

Mr. Brown stated that it looks like the community infrastructure program would comprise almost 0.5% of the bill. CFO Demmerle clarified that the percentage is how much of a typical bill goes towards the MCIP; 5% of a typical bill goes towards the MCIP, not necessarily the percentage increase in the rates.

Referring to the WPCLF loans, Ms. Malesky added that there is a possibility that the WPCLF requires different ways to purchase equipment and acquire contractors.

Mr. Sulik questioned the possibility of getting \$100 million per year in WPCLF loans. CEO Ciaccia stated that the original proposal of 9.5% increases had \$50 million per year in loans, which is historically where the District has been. He indicated he spoke with the director of the Ohio Water Development Authority Board and his CFO and they assured him the money the District needs for the foreseeable future would be available if the District wanted 100% loans from the State. They changed their policies to allow for issuing 30-year loans, more flexibility

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and lower interest and issuance costs. He added that there is risk of additional costs as it relates to requirements but he was comfortable with such a scenario.

Ms. Malesky advised that the next scenario assumes affordability program participation maintained at 50% of eligible households. This scenario achieves current target scenario goals except for the increase in affordability participation; it allows the startup of the MCIP in 2017 and results in nearly constant rate increases through 10 years of 8.8% in the first five years and 8.9% in the next five years.

Ms. Malesky stated that this scenario would likely result in a negative misperception in the community if the District did not reach out and possibly an increase resistance to green infrastructure programs where the targeted communities are located. Those who are least likely be able to afford rate increases would be impacted more if they are not participating in the program.

Mr. Sulik inquired how confident staff is that it can increase participation to 80% Ms. Haqq stated that she was very confident that level could be achieved with metrics provided by Cleveland Water and Cleveland Housing Network.

Ms. Malesky advised that the next scenario combines current affordability participation with the removal of the MCIP program. All other target scenarios are met and the first five-year rate period results in 8.8% increases, but the second rate period is 8%.

The next scenario is front-loaded and in the first year sets rates to a level that achieves all goals for the five-year period and has a moderate inflationary increase for the remaining years. The rate increase in 2017 would be 33.7% but from 2018 through 2021 would be 3% per year. Ms. Malesky indicated that she did not suggest this scenario because there is a high probability of rate shock the first year.

The next scenario takes all eligible capital improvement projects for WPCLF loans and funds them entirely. A maximum amount was placed on those dollars because some projects would not be eligible. The others would either be funded with cash or a revenue bond. The result is 8.5% rate increases for the five-year period and a typical bill projected in 2021 at \$76.99 per month. This scenario achieves all current target scenario goals and pushes WPCLF loans to \$100 million in some years. The con is that in the second rate period we're projecting 9.2% rate increases. They think it will increase the need for staff to administer these loans and a probability that not all projects will be nominated for funding. Contract costs could increase due to state revolving fund loan requirements.

CEO Ciaccia stated that the cons of this scenario are not high but they are risks.

Ms. Malesky stated that the next scenario removes incremental operations & maintenance expenses for the backlog and maintenance of new CIP projects brought online. The impact for 2017 through 2021 is an 8.5% increase and by 2021 a typical bill will be \$76.99. This scenario achieves all target scenarios except for allowing for the operations & maintenance backlog to be completed and maintaining new assets.

The second rate period projects increases from 8.5% to 9%, fails to account for operations & maintenance associated with new assets and does not allow for operations & maintenance for replacing assets, which will lead to quicker deterioration.

Ms. Dumas questioned whether new assets cannot be maintained. Ron Czerski, Deputy Director of Operations & Maintenance, advised that during the last rate period assets increased by 27% but there was no additional staff to maintain it. Consequently, the backlog just for electrical work for Southerly is over 400 persons. The District will add an additional 35% in assets over the next five-year period. It is not a matter of maintaining the assets; they cannot be run.

Mr. Czerski stated that choosing not to maintain assets could save money but will cost more over time. He also noted that no utility is ever caught up on maintenance and prioritizes based on criticality. In some cases staff makes a conscious decision to run less important assets to failure because it is cheaper than to replace.

Mr. Brown stated that there is also operations & maintenance costs for replacing existing infrastructure. Historically as modern facilities are brought online there is automation and refinement on level and types of chemicals. Staff must be retrained so it can continue with new technology.

Ms. Malesky explained that Scenario No. 10 combines 100% WPCLF loans with delaying CSO projects to the consent decree deadlines and a slower phase-in of the MCIP. This scenario results in 8.5% rate increases from 2017 to 2021 and 9.3% during the second five years. This scenario achieves most management goals, funds the capital improvement program entirely with loans and cash-funded for those not eligible. This scenario does not use rate stabilization funds.

Cons of this scenario are the ability to manage 100% loans for the projects and risks of delays in changes to the rules that would impact future funding. Contract costs could increase due to the 100% loan requirements during the second rate period.

Scenario No. 11 uses 100% WPCLF loans for eligible projects, delays CSO projects to consent decree dates but uses rate stabilization funds and launches the MCIP funding. This results in an 8.5% increase during both five-year rate periods.

Scenario No. 12 delays CSO projects to consent decree deadlines and any uncommitted CIPs to the second rate period. That results in an 8.4% rate increase and achieves all target scenario goals; however, the second rate period increase would be 10.8%.

Ms. Malesky advised that Scenario No. 13 includes 100% loan funding for eligible projects, delaying CSO projects, phasing in the MCIP and using the rate stabilization fund proactively to reduce rates. The result is the lowest rate increase for the first five years at 8%, and a typical bill in 2021 would be \$75.21. The second rate period projects a 9.9% rate increase. There could be difficulty managing 100% loans and there are risks of delays and contract cost increases.

Mr. Brown inquired what the average would be on what is spent towards the capital program the next five years. There is a difference between \$100 million in WPCLF loans versus 100% loans. COO Rotunno advised that it would be \$1.4 billion, or close to \$300 million per year.

Mr. Sulik noted that some projects may not qualify for loan program. CFO Demmerle affirmed but explained that there are large tunnel projects on the way and the loan would cover around \$200 million a year in the next five-year period, so she did not think there would be an issue reaching the loan amount staff would like. In 2015 the District awarded \$800 million in contracts.

Mr. Sulik questioned the impact on rates of increasing the loans to \$150 million. CFO Demmerle advised that the District currently has \$200 million in cash flow for the loan program. Going to 100% loans comes out to around \$200 million a year in loans.

Mr. Baker advised that Scenario No. 13 is the 100% loan scenario which does not necessarily mean financing all of them through loans immediately. The first year has approximately \$100 million of excess funds in the capital project account; rather than issuing new debt at the beginning of the rate period, it keeps the overall long-term rate increases lower by not paying interest on loans when cash is available.

The first year shows \$44 million of loans even though there is more than \$44 million in projects because it draws down on cash in an effort to lower the rate increase through the optimal capital funding mix. This scenario includes a revenue bond in 2022 because projects in 2022 and 2023 are large and will not be eligible for loans.

Mr. Baker explained that the process utilized to formulate the scenarios included three different variables: managing cash on hand, debt service coverage in every year for all debt and debt service coverage on revenue bonds.

Ms. Dumas clarified that the Board is only considering rates for the next five years and not the second five-year period. CEO Ciaccia affirmed and added that the second rate period was included for informational purposes in terms of the future impacts.

Ms. Dumas inquired whether there was concern over whether projects would qualify for loans if the District opted for 100% loans. CEO Ciaccia stated that he was very confident it is worth attempting to access as much of the WCPLF funds as possible. While it is more labor intensive to manage than bond funds, it is not significant when considering the advantages of the issuance cost and lower interest rates.

Mr. Brown requested a schedule of consent decree milestones because staff has made reference to delaying some CSO projects to the milestone dates. COO Rotunno advised that it could be provided and that Appendix I of the consent decree lays out the milestones by which all control measures must go online.

Mr. Brown stated that he was trying to reconcile the financial impact of project loading in terms of accordance with the consent decree milestones. COO Rotunno advised that the milestones prescribed in the consent decree are what govern the capital program and the order in which projects have been executed have not deviated that much. The District has on occasion had money available to move projects forward to take advantage of present day bidding conditions but the idea is to build float into the schedule for completion of projects.

Mr. Baker advised that Exhibit 12 shows the total amount and under the three capital scenarios and the breakdown between CSO and non-CSO projects.

CEO Ciaccia stated that although it does not affect the rate percentages, a fixed-cost recovery charge is a part of the rate structure and is planned to increase. CWD has the same fixed-cost recovery charge and justified it as meter type, by meter size, and by billing and administration.

The District began its fixed-cost recovery charge during the last rate period, tying it to inflow and infiltration. Staff also wanted to be consistent with CWD and tie it to billing and a portion of administrative costs. He explained that during a meeting with the local newspaper editorial staff they seemed to be confused by the administrative costs. The reason there is a fixed-cost recovery charge is to have a more stable revenue base and move away from revenue primarily from consumption charges.

CEO Ciaccia explained that the first year has a fixed-cost recovery charge that only covers 35% of billing and administrative costs. Staff must be careful to not raise it so high that it affects low-end users. He added that while the rate increases are small in terms of dollars, the percentages of the increases can be significant and draw attention. The other scenario alternatives have no effect on the typical bill because it would go back into the volume metric charge or fixed-cost recovery.

Mr. Brown questioned whether the affordability program would apply towards that fixed cost, to which CEO Ciaccia affirmed.

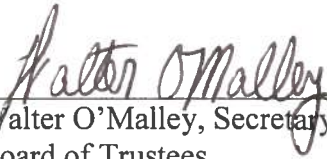
Ms. Dumas questioned whether the Board has to approve the fixed charge, to which CEO Ciaccia explained that it is a part of the whole rate structure.

CEO Ciaccia also clarified that the stormwater fee will not change and only the dates will be extended.


Mr. Brown noted for the record note that Mayor Bacci was present.

V. Adjournment

MOTION – Mr. Brown stated business having been concluded, he would entertain a motion to adjourn. Mayor Bacci moved and Mr. Sulik seconded the motion to adjourn at 2:34 p.m. Without objection, the motion carried unanimously.



Walter O'Malley, Secretary
Board of Trustees
Northeast Ohio Regional Sewer District



Darnell Brown, President
Board of Trustees
Northeast Ohio Regional Sewer District