DISTRICT OF COLUMBIA WATER AND SEWER AUTHORITY

BOARD OF DIRECTORS

Joint Meeting of the Audit and Finance and Budget Committees

Thursday, April 28, 2005
9:00 a.m.

MEETING MINUTES

BOARD MEMBERS	WASA STAFF
Glenn Gerstell (via conference call)	Jerry Johnson, General Manager
Anthony Griffin	Paul Bender, Chief Financial Officer
Mohammad Akhtar	Avis M. Russell, General Counsel
David J. Bardin	Michelle Cowan, Director, Finance & Budget
Paul Folkers	Linda R Manley, Secretary to the Board
Howard Gibbs	

Chairman Gerstell convened the meeting by conference call with other Board members present in the WASA Boardroom. At the Chairman's request, Anthony Griffin called the meeting to order at 9:13 a.m. and led the discussion.

Mid-Year Financial Report

Michelle Cowan reported that at the end of the second quarter, financial performance remains generally on track with budget. With 50 percent of the fiscal year completed, operating receipts are two percent ahead of budget; operating expenditures are six percent below budget and capital disbursements are substantially below original projections.

Operating Receipts

Ms. Cowan reported that with 50 percent of the fiscal year complete, receipts are at 52 percent, or two percent ahead of budget. The primary reason for this performance is because of the conversion of large commercial and multifamily accounts from quarterly to monthly billing, resulting in additional receipts of approximately $3.5 to $4 million. Excluding the one-time impact of this conversion, we are right on track with budget. Ms. Cowan reported all other revenue categories are on track with budget, with one exception, municipal receipts, which are four percent under budget due to continuing issues with St. Elizabeth's.

Operating Expenditures

Ms. Cowan reported that with at the end of March, with 50 percent of the fiscal year completed, operating expenditures totaled $122.3 million (including debt service and the right of way and PILOT fees), or 44 percent of the FY 2005 Board revised operating budget of $278.1 million. Personnel services, contractual services and water purchases from the Washington Aqueduct, which account for 80 percent of the operations and maintenance budget (excluding PILOT and right of way fees and debt service), are on track or less than budget. WASA faces spending pressures in the chemicals and utilities categories, as discussed in more detail below.

Debt service accounts for 20 percent of the total operating budget. Year-to-date debt service payments total $22.7 million, or 40 percent of the budget with 50 percent of the fiscal year completed. Performance on WASA's $295 million of auction rate securities continued to be strong compared to budget. The ten-year plan assumes a four percent average interest; the average interest rate fiscal year-to-date is 1.70 percent, resulting in significant savings.

In providing additional operations and maintenance budget details, Ms. Cowan reported that personnel costs are 46 percent of budget with 50 percent of the year completed. Year-to-date personnel cost savings are the result of higher than budgeted vacancies in the major operating departments; however, year-end spending will be closer to budget as just under 90 positions are under recruitment. Overtime spending is on track Authority-wide with 46 percent of the $4.7 million budget spent by mid-year.

At the end of the second quarter, contractual services expenditures total 44 percent of the budget. The contractual services category covers a wide range of services. The single largest budget item is biosolids hauling with an annual budget of $16 million; this item is right on track with budget. Another large item in this category is insurance premiums and workers compensation claims payments; as discussed with the Committee last month, our new third party administrator contract and public officials' liability premium costs are less than prior years and less than budget. In addition, workers' compensation claims payments continue to decline. All other significant contractual services expenditures are generally on track or slightly less than budget.

Year-to-date chemicals and supplies expenditures total 45 percent of the budget with 50 percent of the year completed. Spending in this category has accelerated over the last two months due to price increases for chemicals that were included in the Council of Governments (COG) chemical contracts that began this winter. Ms. Cowan noted that at this time we expect existing contingency in this category to accommodate the price increases. In addition, lower levels of spending for supplies will result in savings that should partially offset chemical-related spending pressures.

In the utilities category, year-to-date expenditures total 48 percent of the budget with 50 percent of the fiscal year completed. Ms. Cowan reported that spending in the last two months has been higher due to increased power costs. Daily spot electric prices have averaged $47/MWH since we signed our contract with Hess for service beginning in January and February. We will need to average less than $46/MWH for the remainder of FY 2005 to meet our $20.75 million electric budget.

Capital Expenditures

Ms. Cowan presented a detailed report on mid-year capital spending projections. Management currently projects that year-end spending will total $240.8 million, or $49.5 million less than the original FY 2005 capital disbursements budget. Ms. Cowan noted that that this level of capital spending is in line or slightly higher than spending over the past two years, with spending in FY 2004 totaling $238 million and spending in FY 2003 totaling $204 million. In March 2005, spending for WASA's capital program totaled $17.8 million; year-to-date disbursements total $101.3 million, or 34 percent of budget. All service areas are projected to end the year under the original disbursements budget, with the largest variances in dollar terms experienced in Blue Plains projects, water pumping and DDOT projects, and sanitary sewer system projects.

Mr. Griffin asked whether management expects some of the expenditures originally anticipated for FY 2005 to occur in FY 2006. Ms. Cowan responded that for projects where construction has been delayed, recovery of spending may extend beyond FY 2006 into FY 2007. Mr. Johnson added that approximately $6 million of DDOT construction project delays would not necessarily be recovered in FY 2006. Mr. Johnson offered to provide the Board with a detailed project review, however the Committee determined that the Environmental Quality and Operations Committee's detailed review of the quarterly capital program report would suffice.

Leonard Benson reported to the Committee that two projects experiencing delays include nitrification and biological nutrient removal processes where research is being conducted to prepare for Chesapeake Bay Program changes over the next few years, with WASA's permit expiring in 2008. As a result, spending on these projects will be recovered in FY 2007 rather than in 2006.

Cash Reserve and Investments

Ms. Cowan reported that in March the yield on the Authority's investment portfolio was 2.49 percent as compared to the budgeted rate of 2.25 percent. We are lagging the three-month U.S. Treasury bill benchmark of 2.80 percent. As described to the Committee over the past two months, we are lagging behind the Treasury bill rate because of the two-year discount notes that WASA entered into last summer when rates were relatively low.

Electricity Update

Paul Bender discussed the status of current prices and WASA's next procurement for electricity service beginning in January. In terms of cost, daily spot electric prices have averaged $47/MWH since we signed our contract with Hess in January. In addition, ancillary services such as capacity, transmission and other costs range from $8 to $10/MWH. We will need to average less than $46/MWH for the remainder of FY 2005 to meet our $20.75 million electric budget. Mr. Griffin asked what the probability is that prices will average less than $46/MWH. Mr. Bender responded that the probability is greater this week than it was last week as oil, gas and futures prices for electricity have declined as compared to two months ago when prices were increasing. In discussing the volatility of the electricity market, Mr. Bender cautioned the Committee that the market fluctuates based on both international and electrical network pressures and explained the direct correlation of oil and gas prices to electricity prices.

Mr. Bender further advised the Board that if electric prices continue at the current levels we will need to increase the $20.8 million contract authority contained in the Board resolution, as current projections show us slightly above the ceiling. We would plan to do that in July 2005.

Mr. Bender reported that staff has also been working on the next power procurement. As a general strategy, staff believes that continuing with the existing structure is advisable, where rather than locking in a fixed price for one to two years (subjecting WASA to the variability of pricing on the one day we accept bids), we monitor the markets regularly and when prices fit within our budget, lock in for blocks of power then. Our existing contract with Hess allows us to do this, but it terminates in January, so we cannot currently buy blocks of power beyond this time. Staff recommends putting in place a longer-term contract (e.g., three to five years) with this same type of flexibility that would also provide for termination options if WASA chooses to pursue a different strategy in the future.

Mr. Bender noted that another option is to jointly pursue power procurement with other jurisdictions. Over the past two months, staff has discussed electric procurement ideas with WSSC, the Washington Aqueduct, the Fairfax County Water Authority, and with Metro. Staff also talked with the Virginia Joint Power Association and were informed that participation under their existing agreement is limited to Virginia political subdivisions. Based on our discussions with all of these entities, it appears the only possibility for a joint procurement in the short term is with WSSC.

WSSC has a contract with Constellation who runs competitive auctions for all of its block power purchases, and WASA could potentially ride off this contract. A second option is for WASA to independently solicit proposals for a provider to run auctions for WASA, charging a fixed price for the auction service, and to the degree that WASA chose not to lock in pricing for blocks of power, the provider would supply power at PJM Western Hub index rates. The contract would have a longer term, allowing WASA to lock in power purchases for beyond our current contract expiration date with Hess of January 2006.

Mr. Bender reported that there are many benefits to pursuing a joint contract with WSSC, including sharing of market and pricing information. However, it appears that a few of the non-energy components of our electric costs would be higher under their contract than we are currently paying Hess. In addition, we are not certain that we can legally ride off the WSSC contract, which is an amendment to a State of Maryland contract. WASA's General Counsel is in the process of reviewing the WSSC contract. Because of these issues, staff recommends that WASA pursue an independent RFP process. An RFP would be put on the street in May, with Committee review scheduled for June and Board action in July.

Mr. Bardin asked about the principal drivers of the market value of electricity, both short- and long-term. Mr. Bender responded that international issues such as demand for electricity in China and instability in Middle East are major drivers for future prices instability and that oil and fuel prices also drive pricing. Short-term drivers are dictated by local events, such as local power plants being taken out of service.

Mr. Griffin asked staff to evaluate alternative energy sources including solar panels.

Extension of Letter of Credit on Commercial Paper Program

Mr. Bender reported to the Committee that the existing letter of credit with WestLB on WASA's commercial paper program expires in November 2006. The ratings on WASA's commercial paper program are based on WestLB's ratings. However, WestLB's sovereign backing by a German state government will terminate in July 2005, which will have an impact on WestLB's ratings in the long term.

While WASA's existing letter of credit will be grandfathered into the sovereign-backed ratings through November 2006, we have evaluated our long-term options for the letter of credit in light of these changes. These options include: 1) rebidding the letter of credit in FY 2006; 2) rebidding the letter of credit now; or 3) extending the existing letter of credit as proposed by WestLB. WestLB has proposed a five-year extension (with a subsequent five year renewal period at both parties' option) that would be grandfathered into WestLB's sovereign-backed ratings and that WASA is interested in pursing as pricing is advantageous. Mr. Bender also noted that the costs of issuance and timeframe associated with extension of our existing letter of credit vs. procuring a new letter of credit are substantially less.

Barbara Bisgaier, WASA's independent financial adviser with Public Financial Management, provided a detailed overview of WestLB's proposal and background on the development of WASA's commercial paper program. Ms. Bisgaier noted that WestLB's proposal is essentially a ten-year proposal, although WestLB has the option to terminate the letter of credit at the five year anniversary. Conversely, WASA has the ability to terminate at any time (with a notice period). WASA's commercial paper would continue under the grandfathered sovereign rating, giving it the highest short-term ratings available to WestLB. Ms. Bisgaier reported that the pricing proposed by WestLB was excellent: 12.5 basis points on the unused portion of the facility and 24 basis points on the used portion, a savings of between $25,000 and $45,000 per year. In addition, it is advantageous that there is no commercial paper currently outstanding which simplifies logistics.

Mr. Griffin inquired about any potential downsides to the potential agreement. Ms. Bisgaier responded that there are two potential negatives: 1) overall letter of credit costs decline beyond the pricing proposed by WestLB; and 2) the potential for an interest rate pricing penalty on WASA's commercial paper because of confusion about paper that carries the state guarantee (and thus higher ratings) and paper that does not (thus lower ratings). On the first issue, this pricing is very aggressive compared to historical pricing over the last ten years. In addition, if pricing does drop substantially lower, WASA can terminate the facility with WestLB at its option at any time. On the second issue, WASA and PFM have spoken to the broker-dealers on the program and they believe that investors understand the difference. In addition, it appears that there will be very few, if any, new letters of credit issued without the guarantee. We will continue to monitor the markets and if it appears that WASA can get a better deal elsewhere, WASA will terminate the WestLB facility.

Chairman Gerstell stated that he was very pleased with this proposal and commended all who worked on it. He noted that the pricing is very favorable, and that there are tremendous advantages for WASA to undertake the extension now, not only because we do not have any commercial paper outstanding making the logistics much easier, but also because we do not know what our credit picture will look like when WASA's letter of credit expires in 2006. Mr. Gerstell asked if there is any ability to negotiate a further term beyond the initial five year period. Ms. Bisgaier responded that staff discussed this with WestLB and negotiated a five year term; WestLB had initially proposed a three year term. WestLB has also indicated that five years is the maximum term they had given to any client, and few received it. Mr. Gerstell noted that in the event WestLB terminates after five years, we need to be careful that we are not soliciting new proposals when a large number of other issuers are doing the same, thus driving up demand and prices. Mr. Gerstell also asked that the documents provide that that WestLB provide as long of notice as possible to WASA before it exercises its termination option so that WASA has sufficient time to procure a new facility. Mr. Griffin recommended that one year prior to the five year expiration, staff determine whether or not it is in WASA's interest to terminate the agreement.

Mr. Bardin asked which German state provided the guarantee. Ms. Bisgaier responded that she believed it was Bavaria. She also added that the rating is not their long-term credit rating but rather their short-term credit rating. They could experience some deterioration in the long-term credit rating and still maintain the highest short-term credit rating. Mr. Bardin asked if Germany's potential recession will threaten the ability of WestLB (and Bavaria) to stand by these commitments. Ms. Bisgaier responded that unless it threatens their absolute solvency, the recession should not be an issue.

After additional discussion by the Committee, Mr. Bender reported that staff will provide documents to the Board in May for the Committee's recommendation with Board review and action in June.

Workers Compensation Commission Self Insurance Approval

Mr. Bender referred to the draft resolution in Attachment 3 of the report. As discussed with the Committee last month, the District of Columbia Department of Employment Services has approved WASA's status as self-insured for the first $1 million per claim for workers' compensation. This approval is contingent on the posting of security in the form of cash reserves in an amount of $1 million to ensure fulfillment of the Authority's annual workers' compensation obligation to its employees. The Committee endorsed the resolution and it will be forwarded to the Board for its approval at its May meeting.

External Auditor Selection

Mr. Bender reported that we issued a competitive procurement through the GSA schedule and sent out requests for proposals to 36 firms on the GSA schedule. We received seven proposals in response to our request for proposals. WASA's selection committee evaluated the proposals and interviewed the top three firms. Mr. Bender reported that we are recommending a one-year term contract with TCBA with a three-year renewal options. Mr. Bender noted that there is a District law that that requires auditor rotation after five years, and WASA's General Counsel has concluded it does not apply to WASA. Although WASA is not subject to that law, staff will review this issue with the Board in the next three to six months and formalize a policy on auditor rotation for WASA. It appears that the industry practice is to look at partner rotation as opposed to firm rotation. Management recommends that TCBA be selected as our external auditor. The Committee endorsed the staff's recommendation and will forwarded the action item to the Board for its approval at its May meeting.

Mr. Gerstell asked Mr. Bender to conduct a survey of comparable jurisdictions, both utilities and governmental entities, and their practices on firm or auditor rotation.

Mr. Bardin asked staff to revise the fact sheet to include a statement concerning TCBA providing WASA auditing services over the past 4 years.

Hearing no further business from the Committees, Mr. Griffin adjourned the meeting at 10:25 a.m.