EXECUTIVE COMMITTEE MEETING
THURSDAY, MARCH 13, 2008
ADVISORY BOARD OFFICE
8:30 A.M.

MINUTES APPROVED AT THE APRIL 11, 2008 MEETING.

Present: John Sullivan, BOSTON; Jay Fink, LYNN; Ron Seaboyer, MELROSE; Katherine Haynes Dunphy, MILTON; Carol Antonelli, SOMERVILLE; Zig Peret, WILBRAHAM.

Also in attendance, Andrew Pappastergion, MWRA BOARD OF DIRECTORS; Joseph Favaloro, Cornelia Potter, Matthew Romero, Christine Hevelone-Byler and Mary Ann McClellan, MWRA ADVISORY BOARD STAFF.

I. Welcome

Chairman Katherine Haynes Dunphy called the meeting to order at 8:38 a.m.

II. Update: Sub-Prime Crisis Impacts on MWRA

MWRA Advisory Board Executive Director Joseph Favaloro said the sub-prime crisis is having significant and critical impacts on the Authority and other non-profits. In the past, variable rate debt was always a guaranteed way of growing the Authority's surplus at the end of the year because staff budgeted conservatively and the payments were always significantly lower. Because of this situation, MWRA is not growing their surplus because of the differences in the variable rate debt and is negatively impacted by the rates that are being set by defaults; this problem appears to be worsening. The Authority has been aggressive and has laid out an approach to resolve the sub-prime issues by early May.

Cornelia Potter stated the Authority is in a better position than many because it has a strong credit rating. Additionally, the Authority has a Commercial Paper Program with a certain amount of capacity in it and it has good advisors. MWRA is positioned to take the steps that need to be taken to try to unwind the link to the bond insurers and to at least minimize the damage. At Board meetings in February and March, staff asked the Board to approve several steps to improve this situation.

The Authority has authorized the use of certain commercial paper notes to refund certain secured bonds, which will allow the faster reissue of existing bonds in some cases for those particular bonds that are subject to the more frequent resetting that is causing the most immediate cost increases for the Authority.

The Authority has authorized the issuance of up to $575 million of subordinated bonds followed yesterday by an increase of another $725 million. Not only were the Authority's auction rate securities at issue, but their variable rate demand obligations do not have the

same limits in terms of additional interest rate costs that even the auction rate bonds did. Now the variable rate bond debt service is set at an even higher interest rate. As a result, the Authority increased the authorization to refinance virtually all of its exposed subordinate debt for a total of $1.3 billion of new variable rate bonds. MWRA plans to reissue all of that subordinate debt as soon as possible, with a goal of completion by May 1. It takes forty-five days to go through the whole series of steps, including the adequate notifications. The point of doing this is to remove the bond insurance features of the existing variable rate debt, namely the bond insurers, who themselves have compromised their AAA ratings by having invested in sub-prime mortgage obligations.

The Authority awarded four contracts to four liquidity banks to provide standby bond purchase agreements, which is the only form of credit enhancement for the reissued variable rate debt that is in a "safe place" that makes the bonds of the Authority somewhat stronger but gets the bond insurers out of the picture.

MWRA is in the process of notifying every bank and letter of credit issuer that it has lined up. Each of the rating agencies must be contacted and asked to rate each subordinate issue separately. In the past the rating agencies were able to rate the subordinate debt as a group. The Authority has been fortunate in having in its financial advisors good contacts that move the Authority to the head of the line for these meetings and reissue of the ratings on each of these issues so that they can be refinanced.

Chairman Dunphy asked what the scope of the transaction costs will be. Ms. Potter stated there are several pieces. The Authority's actions to line up the banks for the standby bond purchase agreements is about $220,000 per year for a three-year period for just that one step. There will be costs for the financial advisors who are paid by the hour. Beyond that, the costs of reissue have not been specifically cited, but there will be costs. The Authority has to leave on the table the bond insurers costs, which they have already paid when those bonds were originally issued.

The Authority staff also report that the weighted average of the current variable rate interest rates being paid by the Authority is now nearly 6.6%; otherwise, the Authority would have been paying close to 2% or 2.25%.

Zig Peret said it sounds like the issue is because of the bond insurers. Ms. Potter said the Authority's bonds were enhanced by the inclusion of bond insurance on the issue for the Authority. In other words, the Authority was "AA" rated and the bond insurance presence made the Authority's bonds trade at "AAA" resulting in a lower interest rate to be paid by the Authority.

Mr. Peret asked if the Authority would still have its "AA" rating. Ms. Potter said the MWRA's rating will be "AA", which has already been confirmed by the rating agencies. Various analysts have said the Authority would be trading at a more advantageous interest rate without the bond insurers.

The re-issuance of the Authority's bonds will, in effect, unwind the Authority's involvement with the bond insurers. There will be some credit enhancement and that is what these standby bond purchase agreements provide. It provides some form of additional liquidity thereby strengthening the Authority's position in the market.

Mr. Peret asked if the Authority is maintaining some insurance policies; would those premiums go up? Are all insurance carriers in trouble? Ms. Potter said the insurance carriers are being rated differently; in fact, some have been downgraded. The trouble is that the two most significantly downgraded insurers are the ones the Authority used for its subordinate debt issues. The whole point is the entire bond insurance industry has been called into doubt so even though some insurers have not been downgraded, in general, the market distrusts the presence of bond insurers and in effect has caused the downgrade of the coupled bond issues to the point where large institutional investors cannot invest in the downgraded bonds and that is why there is no market anymore. That is why it is called a liquidity crisis because nobody will buy these bonds in the secondary market.

Chairman Dunphy asked if the premiums were paid to the insurance companies in advance. Ms. Potter said yes; that is one of the points the Authority makes when it describes the situation as painful because it has to leave its money on the table.

Chairman Dunphy said if the Authority is returned to a “AA” rating, will that mean there are categories such as pension funds that will not be able to buy them. Ms. Potter said that a “AA” rating is fine.

Chairman Dunphy asked if MWRA staff has given a scope of what interest costs for this year will be. Ms. Potter stated that the Authority will be doing a spring revisit on the proposed FY09 budget on this matter. Even as the Authority moves to resolve this situation before the end of this fiscal year, it still does not know where the markets are going to settle out and what sort of range of conservatism that they may want to build into their budget for next year meaning that the 4.25% for variable rate debt that they have assumed for the FY09 budget may have to be raised. MWRA budgeted 4.7% in FY08.

Chairman Dunphy asked if MWRA will keep a substantial amount in variable rate debt or will it go to more fixed rate long-term bonds. Ms. Potter said for the most part the MWRA will retain this level of variable rate debt. There is about $200 million that is not in question, along with the $1.3 billion to be reissued, which will result in $1.5 billion in variable rate debt, less the use of the Commercial Paper Program. MWRA has indicated, but has not executed, a plan to use $77 million in Commercial Paper as a way to quickly draw down a piece of the debt in question; that transaction is a temporary one and will need to be included in the next issue of new borrowings later this spring. The liquidity crisis has created pressure on the fixed-rate market as well, so long-term rates are rising too.

The Authority has given an estimate that every 100 basis points is worth $5 million in variable rate debt service. Across an entire year the 4% difference between the 6.6% being paid versus the 2.25% that had been estimated could be worth, on an annualized basis, $20 million. The Authority has revised its projections for year-end surplus and lowered them by $3 million, which means there are measurable multi-week costs of having to pay higher interest rates until the problem is resolved.

Mr. Peret asked how this information is obtained; is it gathered from going to Board of Directors meetings or does financial staff provide it? Does the Advisory Board staff hear the behind the scenes discussion of what is going on? Ms. Potter said Authority staff has given the Advisory Board periodic updates, although our staff does not have access to the

financial advisors. The Advisory Board relies on the Authority staff itself, the materials sent to the Board and the public press. To some degree, information is gathered at Board meetings based on questions asked at the meetings as more information is drawn out. Authority staff and the financial advisors have participated in a presentation to the Board.

Mr. Peret asked if all of the Board was in concurrence. Board member Andrew Pappastergion stated that presentations were given to the Board in February. Actions taken at the March meeting were based on the presentation. The Board had a lot of discussion and there was very little disagreement with the plan of attack. Mr. Favaloro said additionally, because staff wants the Board to be fully aware, they are reconvening a committee comprised of MWRA and Advisory Board staff and members of the Board of Directors that had previously looked at restructuring/refinancing opportunities. The Committee will review whether there are potential opportunities to restructure the $1.3 billion for some savings, as well as fully apprising the members of the steps they are taking to deal with the sub-prime crisis and the issues around them. Executive Committee members would be welcome.

Ms. Potter said since the Authority's last major transaction, which was January of last year when the Authority restructured a significant portion of its existing fixed-rate debt, the Advisory Board has been monitoring the conditions of the market, particularly as long-term rates came down over the course of the spring and the summer, to see whether the Authority could revisit again any new opportunities for restructuring. Even with that important transaction last January, the Authority still faces significant dollar increases over the next eight to twelve years before a turn in the rate of rate increases in the early 2020s will be seen.

With the appearance of the sub-prime crisis and short-term rates rising, along with the volatility in the market, the Advisory Board has asked the Authority to look again at the potential for this opportunity and certainly not go out for this refinancing without having given it consideration to see if it is advantageous or not.

III. Parameters for FY09 CEB Review

Mr. Favaloro stated that the Advisory Board's comments on the FY09 Current Expense Budget (CEB) will be before the Executive Committee at the May meeting. The FY09 proposed budget has a 5.9%, or $30 million, increase from the FY08 CEB. Rate revenue requirements between now and FY12 are expected to increase dramatically, with an increase of $143 million predicted between FY09 to FY12. It is a significant and steep increase with more difficult years coming.

While other numbers are going up, Debt Service Assistance (DSA) is going down. For FY09, the Governor's budget included $15 million for the statewide DSA Program. Advisory Board staff has had discussions with House Ways & Means Chairman Robert DeLeo and have received his commitment of no less than $15 million in the House Budget. Staff has advocated on the Senate side to match the House Budget. If DSA ends up in Conference Committee, with $15 million in the House Budget and $10 million in the Senate Budget, the MWRA could end up with a compromise of $12.5 million.

The Governmental Accounting Standards Board has issued Statement No. 45 (GASB 45), which addresses how state and local governments should account for and report their costs and obligations related to post-employment healthcare and other non-pension

benefits. The MWRA's GASB 45 exposure, according to an actuarial study, is $252 million (assuming no pre-funding of obligations).

GASB 45, as designed today, could bankrupt the whole public sector if there is an expectation to fully fund these obligations. Advisory Board staff has kept this issue alive by asking pertinent questions. The Authority had planned to establish an irrevocable trust with $8.4 million, which was their FY08 number based on the actuarial study. Advisory Board staff met with the Authority and its financial advisors this week and there has been some softening on the MWRA's position. Staff is looking at options with significantly more flexibility than an irrevocable trust.

Investment income is another number that staff would like to see go up. Like DSA, $34 million was what was assumed for the FY08 budget; $20 million is the assumption of what interest income is in the FY09 budget, a $14 million difference; it is significant. These are all factors that are impacting the Authority's budget and must be taken into consideration during the CEB review.

Electricity costs have gone from $12 million up to $19 million just in the turn of this decade. The Authority and the Advisory Board cannot lose sight of the fact that for every dollar the Authority gets it is one less dollar that exists for other important issues within communities. Yet the Authority's investments in infrastructure must be taken care of. The Authority must maintain its bond rating. For every 100 basis points it is $5 million; when you have the amount of borrowings that the Authority still has to do, it has a significant impact.

Staff talked about engaging the Board of Directors earlier in the review process. A few years ago Chairman Dunphy and Advisory Board staff met with Board members John Carroll and Vincent Mannering to discuss goals. One member of the Board has strong opinions on levels of growth within the direct expense budget. Staff wants to gauge the temperature of where that discussion is going and see what role the Advisory Board can play in it, as well as dealing with other issues to ensure that the rate increase for FY09 represents what is reasonable and what is responsible. Any significant reductions in FY09 will make FY10 and FY11 and beyond that much more difficult.

Some of the certainties the Authority had with levels of surpluses, due to the sub-prime crisis, are not sure things any more. With the Authority's adjustment of its interest rate assumptions, the reality is that over the next four years all of the Authority's funds will be utilized to just keep rates in that 6% range.

Ms. Potter added with regard to reviewing the FY09 CEB, it is the first time that so many of the significant components of the budget could go up. For example, diesel fuel, the Authority increased its per gallon assumption from $2.00 per gallon in this year's budget to $3.00 per gallon in next year's budget. The nationwide average for diesel is now $3.83 per gallon. A full dollar increase to $4 translates into another $1 million in just that one line item. Interest rate costs, chemical costs, electricity costs, etc. are putting pressure on the budget.

Chairman Dunphy asked if the MWRA will be able to hold the rate increase at 5.9%; I know they would like to get it to 4.9%. Ms. Potter said it is a tough question right now; much of the assumptions swing on the interest rate assumptions for investment income and for variable rate debt.

IV. Update: CIP Review

A decade ago the Advisory Board's role in the capital budget review process would have identified hundreds of millions of dollars in different approaches and reductions to the budget. Much of the focus and the dollars in savings came from the Advisory Board's review processes.

Today's review is significantly different; bigger, broader issues have become the heart and soul of the review. Out of the Advisory Board came the discussion of the capital spending cap, which is working; the Authority lived within its five-year cap. The Authority is now proposing a new five-year cap.

Another initiative of the Advisory Board focused on restructuring debt. In addition to January's restructuring actions, Authority staff will restructure and refinance $1.2 billion of variable rate debt as a means of settling out on the sub-prime crisis.

Another key issue for the Authority is how to determine what its capital needs are going to be. The Advisory Board was a major advocate to put into place a Master Planning process. The next five-year cap will be an offshoot of what the MWRA sees its Master Planning needs are going to be.

The Advisory Board's document is going to look significantly different; it is going to recognize and discuss these components.

Mr. Favaloro noted that the Advisory Board pushed for the variances on Combined Sewer Overflows (CSOs) to allow the Authority to pause and see the results of what CSOs are going to accomplish before the Authority invested more money. Staff believes the establishment of the variances with DEP and EPA are a huge victory to slow things down.

One of the major themes for FY09 that the Advisory Board would like to bring forward, because CSOs escalate every year, is to have a cap on CSOs within the capital spending cap. It would specifically hone in on community managed CSO projects, which have increased significantly.

John Sullivan commented if you delay any of these CSO projects it costs a lot more money because construction costs are increasing. The Authority has to be careful how long it stretches these projects out.

Ms. Potter added one of the points the presentation is trying to convey is the Authority itself, in reports to the Board in February and March, is pointing out that not only has the cost of the overall CSO program increased by more than $30 million between the final FY08 budget in June and the proposed FY09 budget in January, but between that time and what the final FY09 budget may look like this June the CSO program costs are projected to go up by another $80 million.

John Sullivan said the Authority told BWSC that the South Boston project would cost BWSC $50 million; BWSC believes it will cost $80 million. Someone sitting in an office that knows how to use a calculator is giving $50 million as a planning number versus a full design that is priced out. Ms. Potter said that is what is happening here; all of the projects

for which these costs have gone up are projects that are moving quickly toward construction, far enough that these numbers are particularly much more clear.

Mr. Favaloro said the Authority, in its annual report to the Judge, has put on the table that they may consider revisiting these projects because the numbers have changed so dramatically. John Sullivan noted at the very least, goals should be set and presented to a judge to achieve a certain portion of a project within five years rather than delaying the entire project.

It is fair to say that the costs associated with any CSO project are more complicated and expensive; at the very least there should be more time for those projects to be accomplished.

V. Legislative Update

Mr. Favaloro stated an initiative that began with the Advisory Board regarding the Payments in Lieu of Taxes (PILOT) for the South Sudbury watershed lands (which are now no longer part of the watershed area) has been resolved. The Authority has determined that, beginning with the FY09 budget, those funds will no longer be allocated into those communities for watershed payments. It does not mean that these communities will not get PILOT payments from the Commonwealth of Massachusetts through another piece of the Department of Conservation & Recreation, but they will not be getting it from the MWRA.

The Advisory Board's initiative related to double PILOT payments for communities in the Quabbin area is still in play.

It appears the House Budget will be released sometime in mid April.

At the March 20 Advisory Board meeting, the Advisory Board will present its "Legislator of the Year" awards to Senator Anthony Pettruccelli and Representative Rachel Kaprielian to recognize their efforts on behalf of ratepayers.

VI. Approval of the Advisory Board Agenda for March 20, 2008

A Motion was made **TO APPROVE THE ADVISORY BOARD AGENDA FOR THE MARCH 20, 2008 MEETING.** It was seconded and passed by unanimous vote.

VII. Adjournment

A Motion was made **TO ADJOURN THE MEETING AT 9:40 A.M.** It was seconded and passed by unanimous vote.

Respectfully submitted,

Edward Sullivan, Secretary