

**SANTA CLARITA WATER DIVISION  
OF CASTAIC LAKE WATER AGENCY  
DEBT MANAGEMENT POLICY**

Santa Clarita Water Division (SCWD) has incorporated into the Debt Management Policy the following guidelines from the Castaic Lake Water Agency (CLWA) 2009 Strategic Plan, which states that the Agency will utilize reasonable debt financing, when appropriate, to fund long-term facility investments and thus ensure that existing and future users pay their fair share and that the Agency will maintain conservative reserve funding that covers at least three years of debt repayment and provides sufficient reserves. SCWD will maintain a separate debt reserve funding that covers one year of debt repayment and provides sufficient reserves. Along with the new debt reserve funding, SCWD already has two other reserve funds implemented in 2004:

Operating Expense Fund - 25% of Operating Expense  
Rate Stabilization Fund - 2% of Operating Revenue

SCWD is proposing to change the Rate Stabilization Fund from 2% to 5% of Operating Revenue based on Camp Dresser & McKee Inc. (CDM) Comprehensive Water Rate Study and Impact/Capacity Fee Analysis. Also SCWD is proposing to add a new Capital Project Reserve Fund based on 20% of the current Capital Improvement Program (CIP) to cover unforeseen emergencies such as fires and earthquakes. SCWD utilizes the 2008 Water System Master Plan to determine its long-term infrastructure and other projects needs for the next twenty-one years.

This Debt Management Policy includes SCWD's written guidelines and restrictions that affect the amount and type of debt issued, the issuance process and the management of the debt portfolio. This policy is designed to provide justification for the structure of debt issuance, identify policy goals and demonstrate a commitment to long-term financial planning.

**Purposes and Use of Debt**

SCWD will utilize reasonable debt financing, when appropriate, to fund long-term investments and thus ensure that existing and future users pay their fair share. Long-term investments include the acquisition of land, facilities, works, improvements to existing system and equipments. These investments are typically included in SCWD's CIP and Water System Master Plan. Bond proceeds can be issued to fund the planning, design, land acquisition, construction, attached fixtures or equipment and movable pieces or equipment, or other costs as permitted by law.

The Board of Directors approved the Resolution Setting Retail Water Rates for 2010, 2011 and 2012 on September 9, 2009 based on 20% pay-as-you-go CIP with the remaining 80% through bond financing. SCWD will finance 20% of the CIP through annual rate increases and the remaining 80% through debt financing.

SCWD will not use short-term borrowing to finance operating needs except in the case of an extreme financial emergency which is beyond its control or reasonable ability to forecast.

**Types of Debt**

Revenue Bonds, Certificates of Participation, capital leases and lease-purchase financing will be treated as debt and subject to these same policies.

**Debt Capacity**

There is no specific provision within the California Government Code that limits the amount of debt that may be issued by SCWD. SCWD's future borrowing capability is limited by the debt coverage ratio required by the bond covenants. These covenants require that SCWD maintain reserves that provide one time debt service each year.

**Debt Issuance Process**

SCWD will seek to maintain and improve its bond rating to minimize borrowing costs and to ensure its access to credit markets. SCWD will maintain good relations with financial and bond rating agencies.

Each bond proposal will be accompanied by an analysis that demonstrates conformity to SCWD's debt policy. This analysis will discuss the purpose for which the debt is issued and the proposed debt structure.

**Use of Credit Enhancements**

Credit enhancement instruments include bond insurance, letters of credit and other such items. SCWD will use credit enhancement instruments in instances where the use is cost effective for marketing purposes.

**Variable Rate Debt**

Variable rate debt products are rolling series of short-term investments that are resold periodically and are therefore priced at the short-end of the yield curve at low interest rates. If an issuer accepts the risks inherent in variable interest rates, the issuer can take advantage of some of the lowest rates available on the market. Variable rate debt may be appropriate for the SCWD's portfolio, especially in an environment where increased interest earnings on invested funds offset the increased cost of variable rate debt. Variable rate debt products include variable rate demand obligations, commercial paper, and auction rate securities.

SCWD may consider the use of variable rate debt products to achieve a lower cost of borrowing or for short-term borrowing.

In determining whether or not to use variable rate debt, SCWD will analyze the risk associated with the variable rate debt and the impact on SCWD's overall portfolio.

The notional amount of variable rate debt products, including derivative products, shall not exceed 25% of total SCWD outstanding debt.

**Use of Derivatives**

The use of derivatives is covered by CLWA's Interest Rate Swap Policy adopted in August 2003. This policy states that it has been developed to guide the Agency in its use of interest rate risk mitigation products such as interest rate swaps and other such financing techniques. These financing products can increase Agency financial flexibility and provide opportunities for interest rate savings or enhanced investment yields. Careful monitoring of such products is required to preserve Agency credit strength and budget flexibility. Swaps will not be used to speculate on perceived movements in interest rates. The notional amount of derivative products shall not exceed 15% of total SCWD outstanding debt. More detailed information is contained in the policy.

**Disclosure**

SCWD performs full disclosure by communicating with bond rating agencies to inform them of SCWD's financial condition.

**Investment of Bond Proceeds**

The investment of bond proceeds is covered by SCWD's Investment Policy.

**Refunding Policy**

SCWD will issue refunding bonds only if the net present value of debt service savings exceeds three percent of the amount of the refunded bonds.

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**SANTA CLARITA WATER DIVISION  
OF CASTAIC LAKE WATER AGENCY  
INTEREST RATE SWAP POLICY**

This policy has been developed to guide the Castaic Lake Water Agency (CLWA) in its use of interest rate risk mitigation products such as interest rate swaps and other such financing techniques. These financing products can increase CLWA financial flexibility and provide opportunities for interest rate savings or enhanced investment yields. The use of these financing products should be integrated into CLWA's overall debt and investment management policy. Careful monitoring of such products is required to preserve CLWA credit strength and budget flexibility.

Swaps will not be used to speculate on perceived movements in interest rates.

**PURPOSES FOR WHICH INTEREST RATE SWAP FINANCING PRODUCTS WILL BE USED**

Interest rate swaps can be structured differently, such as to create variable rate exposure through a fixed-to-floating interest rate swap or to create fixed rate exposure through a floating-to-fixed interest rate swap. In any situation, CLWA will only undertake such a financing product to achieve one or more of the following objectives:

- ◆ Interest rate swap financing products may be used to lower interest expense of CLWA debt, for a particular financing or for the overall debt portfolio.
- ◆ Interest rate swap financing products may be used to reduce exposure to changes in interest rates.
- ◆ Interest rate swap financing products may be used to achieve an appropriate asset/liability match.

**PURPOSES FOR WHICH INTEREST RATE SWAP FINANCING PRODUCTS WILL NOT BE USED**

- ◆ Interest rate swap financing products may not be used for speculative purposes.
- ◆ Interest rate swap financing products may not be used where they would create extraordinary financial leverage or financial risk.
- ◆ Interest rate swap financing products may not be used if they lack adequate liquidity to terminate at an acceptable market price, or
- ◆ Interest rate swap financing products may not be used if there is provide insufficient price transparency to allow for fair market valuation.

**ANALYSIS OF RISK ASSOCIATED WITH INTEREST RATE SWAP FINANCING PRODUCTS**

CLWA will evaluate all financial products with respect to the unique risks they present. A specific determination must be made that the proposed or alleged benefits exceed the identified risks by an adequate margin over those available in the traditional cash market. The analysis will assess the risk associated with the following factors:

**Amortization Risk**

Amortization risk is defined as the mismatch of the expiration of the underlying obligation and its hedge, the swap agreements. Amortization risk is the possibility that, as the

result of early redemption of the underlying variable rate bonds, the repayment schedule of the bonds differs from the underlying notional amount of the swap agreements. This risk will only arise if CLWA wants to redeem the variable rate bonds ahead of schedule. This is not expected for CLWA financings.

### **Basis Risk**

Basis risk refers to the mismatch between the actual variable rate debt service and variable rate index used to determine the swap payments. Different swap indices will be evaluated as part of the analysis of the swap agreement. The analysis will identify the amount of basis risk that may result from various indices.

### **Credit Risk**

Credit risk refers to the credit worthiness of the counterparty. CLWA will only do business with highly rated counterparties. CLWA will structure swap agreements to protect itself from credit deterioration. CLWA will only enter into transactions with counterparties with a credit rating of AA or better. In the event that the credit rating falls below AA during the transaction, the policy includes remedies. For lower rated (below AA) counterparties, CLWA should seek credit enhancement in the form of:

- ◆ Contingent swap counter party providing support;
- ◆ One-way collateral;
- ◆ Ratings downgrade triggers; and,
- ◆ Minimum rating threshold of 'AA'. If the counter party's rating falls below 'AA', the deal should contain termination procedures.

### **Counterparty Risk**

Counterparty risk refers to the failure of the counterparty to make its required payments. This risk can be minimized by establishing strong minimum counterparty credit standards and diversifying CLWA's exposure to counterparties.

### **Rollover Risk**

Rollover risk refers to the potential need to find a replacement counterparty as part of the overall plan of finance if the interest rate swap does not extend to the final maturity of the underlying variable rate bonds. The rollover risk can be minimized through the initial plan of finance by not relying on the execution of future swap agreements.

### **Tax Events Risk**

Tax events risk is defined as the risk created by potential changes to the Federal and State income tax codes on the interest rates to be paid by CLWA on its variable rate bonds. Tax events risk is a form of basis risk. The evaluation should analyze the potential impact of changes in marginal tax brackets as part of its analysis of basis risk.

### **Termination Risk**

Termination risk refers to the possibility that, upon a default by the counterparty, CLWA may be required to make a large payment to the counterparty if the swap agreement is terminated prior to its scheduled maturity pursuant to its terms. For certain types of swaps, a payment by CLWA may be required if interest rates have fallen causing the market value of the remaining payments to be in favor of the counterparty.

## **INTEREST RATE SWAP FINANCING DOCUMENTATION**

CLWA will use standard International Swaps & Derivatives Association (ISDA) swap documentation including the Schedule to the Master Agreement and a Credit Support Annex. CLWA swap documentation should include the following terms:

- ◆ Downgrade provisions triggering termination of the swap should be bilateral.
- ◆ Governing law for swaps will be New York, but should reflect California authorization provisions.
- ◆ The specified indebtedness related to credit events in the master agreement should be narrowly drafted and refer only to specific debt and in no case provide recourse to CLWA.
- ◆ Eligible collateral should be limited to Treasuries and Federal Agencies.
- ◆ Collateral thresholds should be set on a sliding scale reflective of credit ratings.
- ◆ Termination value should be set by “market quotation” methodology.
- ◆ CLWA will only enter into transactions with counterparties with a credit rating of AA or better. In the event that the credit rating falls below AA during the transaction counterparties rated below ‘AA’, the transaction will use a credit support annex to document swap termination value collateralization procedures.
- ◆ Include downgrade trigger.

## **FINANCIAL CONSIDERATIONS**

### **Savings Targets**

Interest rate swap financing products should have higher savings targets, due to the greater complexity and higher risk. In calculating the prospective savings against the target for implementing a fixed-to-variable swap, the cost of re-marketing, in addition to the cost of credit enhancement and liquidity fees must be added to the projected average variable rate. The specific targets are as follows:

- ◆ Financial transactions, using swaps or other derivative products, intended to produce the effect of a synthetic advance refunding, must generate 3% or greater present value savings than the benefit threshold in effect for fixed-rate bonds.
- ◆ The notional amount shall not exceed 15% of total CLWA outstanding debt will be in interest rate swap financing products.

### **Reporting and Accounting**

The agency shall report all interest rate swap financing transactions in accordance with Governmental Accounting Standards Board and Financial Accounting Standards Board statements.

### **SWAP Procurement**

The General Manager is authorized to solicit interest rate swap financing products proposals from firms that meet or exceed the following criteria:

- ◆ The interest rate swap financing transaction provider shall have a credit rating of AA or better.

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**SANTA CLARITA WATER DIVISION  
OF CASTAIC LAKE WATER AGENCY  
BUILD AMERICA BONDS COMPLIANCE POLICY**

**Introduction**

The Board of Directors of the Castaic Lake Water Agency recognizes its responsibility to ensure the compliance with all Federal laws and regulations (Federal Requirements) associated with the issuance of tax-exempt debt and tax-advantaged direct pay bonds, commonly referred to as Build America Bonds (BABs). The purpose of this policy is to provide guidelines and establish procedures for the compliance with Federal Requirements in connection with the issuance of Build America Bonds. This policy applies to the Castaic Lake Water Agency and the Santa Clarita Water Division.

**Procedures**

At least five business days before distributing a preliminary official statement in which the Agency contemplates offering BABs for sale, the Agency will provide a written notice that none of the maturities which represent BABs can be issued with more than a *de minimus* amount of premium as required by section 54AA(d)(2)(c) and that costs of issuance cannot exceed 2% of the proceeds of the sale to the following parties associated with the proposed transaction:

- Bond or special counsel
- Disclosure counsel
- Financial advisor
- Underwriter and its counsel

Prior to executing any purchase contract, the Agency will require written confirmation from the underwriter that none of the maturities which represent BABs have been sold with more than a *de minimus* amount of premium as required by section 54AA(d)(2)(c) and that costs of issuance do not exceed 2% of the proceeds of the sale.

At least five business days before distributing a preliminary official statement in which the Agency contemplates offering BABs for sale, the Agency will hire an independent consultant to review the daily records of the secondary market trading activity for the BABs between the sale date and the closing date. The independent consultant will be required to provide a written report of each trade and its date and further identify the principal amount and the price at which the BABs traded. Such report will be a condition of closing the BABs maturities.

The Treasurer or designated financial employee will provide a monthly written report to the Board of the expenditure of proceeds derived from BABs showing the amount of expended in the prior month, the total amount expended from the date of the closing of the transaction; that the expenditure was for capital projects (as defined by BABs standards), the amount remaining to be spent and the amount remaining invested in a reasonably required reserve fund, if any.

At closing the Agency will execute documentation covenanting to comply with Federal rebate and arbitrage requirements. The Agency will engage a consultant, annually, to calculate and report the arbitrage rebate liability of the Agency. Every five years the Agency will file with the IRS the appropriate documentation and supporting calculations demonstrating arbitrage rebate liability and provide payment of at least 90% to the U.S. Treasury for arbitrage rebate liability, if any.

At least 67 days before an interest payment date, the Agency will calculate, or cause to be calculated: the interest amount due on the next interest payment date and the refundable credit to be reported on Form 8038-CP.

At a Board meeting at least 45 days prior to an interest payment date for outstanding BABS, the Treasurer or designated financial employee will provide a written report to the Board of the calculation described in the paragraph above, the proper party to whom the refundable credit is due, and a completed and executed 8038-CP. The Treasurer is hereby designated as the staff person responsible for the Agency's compliance with this policy.

(Adopted April 28, 2010)