

FALLBROOK PUBLIC UTILITY DISTRICT



DEBT MANAGEMENT POLICY MAY 2017

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Policy Statement

This Debt Management Policy (“Policy”) documents Fallbrook Public Utility District’s (the “District” or “FPUD”) goals and guidelines for the use of debt instruments for financing District water, wastewater and recycled water infrastructure, projects, and other financing needs. The District recognizes the need to invest in ongoing capital replacement and rehabilitation of its facilities to ensure future viability of services, and that the appropriate use of debt can facilitate the timely construction of such facilities.

The District expects to pay for infrastructure and other projects (e.g., water supply) from a combination of current revenues, available reserves, and prudently issued debt. FPUD recognizes that debt can provide an equitable means of financing projects for its customers and provide access to new capital needed for infrastructure and project needs. Debt will be used to meet financing needs (i) if it meets the goals of equitable treatment of all customers, both current and future; (ii) if it is cost-effective and fiscally prudent, responsible, and diligent under the prevailing economic conditions; and (iii) if there are other important policy reasons therefor. All District debt will be approved by the Board of Directors (“Board”).

To achieve the highest practicable credit ratings and endorse prudent financial management, the District is committed to systematic capital planning, and long-term financial planning. Evidence of this commitment to long term capital planning is demonstrated through adoption and periodic adjustment of the District’s Capital Improvement Plan (CIP) identifying the benefits, costs and method of funding capital improvement projects over the planning horizon.

Purpose of the Policy

The purpose of this Policy is to establish parameters for issuing debt; provide guidance to decision makers with respect to options available to finance capital projects and support other financing needs so that the most prudent, equitable and cost effective method of financing can be chosen; and promote objectivity in the decision-making process.

The District will adhere to the following legal requirements for the issuance of debt:

- The state law which authorizes the issuance of the debt;
- The federal and state law which govern the eligibility of the debt for tax-exempt status;
- The federal and state law which govern the issuance of taxable debt;
- The federal and state laws which govern disclosure, sale, and trading of the debt both before and subsequent to issuance; and
- Generally Accepted Accounting Principles (GAAP).

Purpose and Use of Debt

The District will utilize reasonable debt financing to fund long-term improvements and thus ensure that existing and future users pay an equitable and fair share of capital project funding requirements. Long-term improvements include the acquisition of land, facilities, infrastructure, and supplies of water; and enhancements or expansions to existing water, wastewater and recycled water capacity and facilities. Debt can be issued to fund the planning, pre-design, design, land and/or easement acquisition, construction, and related fixtures, equipment and other costs as permitted by law.

The District will not issue debt to cover operating needs.

The District may utilize short term financing (including leases) to finance certain essential equipment and vehicles. These assets range from service vehicles to laboratory equipment. The underlying asset must have a minimum useful life of one year or more. Short-term financings, including loans, on bill financing and capital lease purchase agreements, are executed to meet such needs.

The General Manager and Administrative Services Manager/Treasurer will periodically evaluate the District's existing debt and execute re-financings or prepayment (refunding) when economically beneficial. A refinancing may include the issuance of bonds to refund existing bonds or the issuance of bonds in order to refund other obligations, such as commercial paper or loans.

The General Manager and Administrative Services Manager/Treasurer shall be responsible for analyzing any debt financing proposal to determine if it is beneficial to the District complies with the District's long-term financial planning objectives, including maintaining or improving the current credit ratings assigned to outstanding public debt (if applicable) by the major credit rating agencies.

The proceeds of any debt obligation shall be expended only for the purpose for which it was authorized. Debt may only be issued upon Board authorization. No debt shall be issued with a maturity date greater than the expected weighted average useful life of the facilities or improvements being financed. The final maturity of bonds or State Revolving Fund (SRF) loan debt shall be limited to 30 years after the date of issuance, unless circumstances warrant otherwise (e.g. Federal funding programs that offer 35-year repayment terms).

Debt Management

The District will provide for a periodic review of its financial performance and review its performance relative to the financial policies outlined herein. These financial policies will be taken into account during the capital planning, budgeting, and rate setting process. Necessary appropriations for annual debt service requirements will be routinely included in the District's budget. The District will maintain proactive communication with the investment community, including rating agencies, credit enhancers and investors, to ensure future capital market access at the lowest possible interest rates.

The District's Debt Management Policy and Investment Policy are integrated into the decision-making framework utilized in the budgeting and capital improvement planning process. As such, the following principles outline the District's approach to debt management.

The proceeds of the bond sales will be invested until used for the intended project(s) in order to maximize utilization of the public funds. The investments will be made to obtain the highest level of safety. The District's Investment Policy and the specific bond indentures and/or loan agreements govern objectives and criteria for investment of bond proceeds. The Administrative Services Manager/Treasurer will oversee the investment of bond proceeds in a manner to avoid, if possible, and minimize any potential negative arbitrage over the life of the bond issuance, while complying with arbitrage and tax provisions.

Proceeds from bond or other debt issuance will be deposited and recorded in separate accounts to ensure funds are not comingled with other forms of District cash. The District's trustee will administer the disbursement of bond proceeds pursuant to an Indenture of Trust. Requisition

for the disbursement of bonds funds will be approved by the District's General Manager or Administrative Services Manager/Treasurer. The District's Engineering Department is responsible for reviewing expenditures and submitting for reimbursement from the State of California with respect to State Revolving Fund (SRF) Loans.

The Administrative Services Manager/Treasurer will monitor dedicated debt reserve fund balances and periodically review the advisability of prepayment or refunding of related debt. The financial advantages of a current refunding must outweigh the cost of reissuing new debt. A potential refunding will be assessed in combination with any new capital projects requiring financing, and the benefits of the refunding will be evaluated in relation to its costs and risks.

Debt can be refunded to achieve one or more of the following objectives:

- Reduce future interest costs; Restructure future debt service in response to evolving conditions regarding anticipated revenue sources; and
- Restructure the legal requirements, termed covenants of the original issue to reflect more closely the changing conditions of the Agency or the type of debt.

Debt Service Coverage Target

The District will not engage in debt financing unless the proposed obligation, when combined with all existing debts, will result in acceptable debt ratios. In determining the affordability of proposed revenue bonds, the District will perform an analysis comparing projected annual net revenues (after payment of operating and maintenance (O&M expense) to estimated annual debt service and estimated debt coverage ratio (DCR). DCR is the amount of cash flow available to meet annual interest and principal payment on debt.

Debt Instrument Rating

The Administrative Services Manager/Treasurer, in consultation with a financial advisor if appropriate, will assess whether a credit rating should be obtained for an issuance and make a recommendation to the Board. If it is determined that a credit rating is desirable, the probable rating of the proposed debt issuance is assessed before its issuance, and necessary steps are taken in structuring the debt issuance to ensure that the best possible rating is achieved.

Debt Structuring

In structuring a debt issuance, the District will manage the amortization of debt, and to the extent possible, match its cash flow to the anticipated debt service payments. The District will seek to structure debt with aggregate level principal and interest payments over the life of the borrowing. "Backloading" of debt service will be considered only when such structuring is beneficial to the District's aggregate overall debt payment schedule.

The Administrative Services Manager/Treasurer and/or General Manager will evaluate and recommend to the Board the use of a call option, if any, and call protection period for each issuance. A call option, or optional redemption provision, gives the District the right to prepay or retire debt prior to its stated maturity. This option may permit the District to achieve interest savings in the future through refunding of the bonds. Because the cost of call options can vary widely, depending largely on market conditions, an evaluation of factors, such as the call premium, time until the bonds may be called at a premium or at par, and interest rate volatility

will all be considered when determining the call option. Generally, 30-year tax exempt municipal borrowings are structured with a 10-year call at no premium.

Types of Allowable Debt

There are many different types of financing instruments available to the District. The following are brief summaries of the types of long and short-term debt obligations that the District may consider:

Revenue Obligations/Certificates of Participation. Long-term revenue obligations / COPs issued through the District, a financing corporation, joint powers agency or other entity should be used to finance and refurbish capital facilities, projects and certain equipment where it is determined to be cost effective and fiscally prudent. Long-term revenue obligations will not be used to fund operations of the District. The scope, requirements, and demands of the budget, reserve levels, and the ability or need to expedite or maintain the programmed schedule of approved capital projects, will also be factors in the decision to issue long-term debt. Revenue obligations / COPs will be structured to achieve the lowest possible net cost to the District given market conditions while balancing risks, considering the District's CIP, and the nature and type of security to be provided.

The District's debt capacity will not exceed legal or contractual limitations, such as rate covenants or additional debt tests imposed by existing financing covenants. Prior to the issuance of any new revenue obligations, the impact of debt service payments on total annual fixed costs will be analyzed.

As users of the District facilities will benefit from long-term capital investments in future years, it is appropriate that future revenues pay a share of the costs and more closely match the term of repayment to the expected economic useful life of the project being financed.

Commercial Paper. Commercial paper and similar financing products including revolving bank credit agreements and letters of credit are cash management programs that the District may use to provide interim and long-term funding for capital expenditures that will ultimately be funded from another source such as a grant or long-term debt. Such a program may be implemented directly by the District or through a financing corporation or other entity. If implemented through a financing corporation or other entity a tax revenue anticipation note or other instrument will be delivered by the District as security for the program. Periodic issuances or retirements of commercial paper notes or similar financing products within a Board approved program would not require further Board action once the program is implemented.

The Administrative Services Manager/Treasurer and/or General Manager is responsible for implementing and managing the District's commercial paper or similar financing program. The Administrative Services Manager/Treasurer will work closely with commercial paper dealers, if any, to develop a marketing strategy for the initial sale and subsequent roll-over of maturing amounts.

Fixed and Variable Rate Obligations. The District typically issues fixed-rate obligations. When appropriate, however, the District may choose to issue variable rate obligations (including Commercial Paper), or securities that pay a rate of interest that varies according to a predetermined formula or results from a periodic remarketing or auction of securities. Variable rate exposure can provide a means to enhance asset/liability management. The primary goal of

asset/liability management is to mitigate the impact of increased interest costs in a rising interest rate environment, and mitigate the impact of decreased interest income in a declining interest rate environment. The Administrative Services Manager/Treasurer and/or General Manager will review the net variable rate exposure of the overall debt portfolio on a quarterly basis and at any time that additional debt is issued.

In selecting and retaining remarketing agents for variable rate debt, the District should choose remarketing agents that diversify its exposure and foster competition. The Administrative Services Manager/Treasurer and/or General Manager will regularly review the performance of the individual remarketing agents in relation to other remarketing agents, similar programs, and market indices.

Grant Anticipation Notes. The District may issue short-term notes to be repaid with the proceeds of State or Federal grants if appropriate for the project and in the best interest of the District. Generally, grant anticipation notes (“GAN’s”) will only be issued if there is no other viable source of up-front cash for the project. Prior to embarking on selling GAN’s the District must identify a secondary source of repayment for the GAN’s in the event that expected grant funding does not occur.

Lease Financings. Lease obligations are a routine and appropriate means of financing certain types of equipment, but are generally not appropriate for long-term financing of capital assets such as land or facilities. Leases should be considered where lease financing will be more beneficial than funding from reserves or current revenues. The useful life of capital equipment, the term and conditions of the lease, the direct impact on debt capacity and budget flexibility will be evaluated prior to the implementation of a lease program. Cash flow sufficiency, capital program requirements, lease program structures and cost, and market factors will be considered in conjunction with Pay-As-You-Go strategies in lieu of lease financing.

State Revolving Fund Loans. The District may enter into loan agreements with the State Revolving Fund (SRF), which provides a low or zero interest loan program made available for specific construction projects. SRF loans are generally structured such that the District is required to contribute a percentage of the total project cost and receives loan proceeds from the State of California for the balance. The SRF loan interest rate is calculated by taking half of the True Interest Cost (TIC) of the most recent sale of State General Obligation Bonds. The term of the loans can be 20 or, if applicable, an extended financing term of 30 years. SRF Loans may provide additional assistance in the form of principal forgiveness. Principal forgiveness must be specified at the execution of the loan agreement for the amount forgiven to be counted against the total loan required to be provided by the SRF.

Water Infrastructure Finance and Innovation Act (WIFIA) Loans. The WIFIA program is a federal credit program administered by EPA for eligible water and wastewater infrastructure projects. The WIFIA program can fund development and implementation activities for eligible projects, including wastewater conveyance and treatment projects that are eligible for the Clean Water SRF; drinking water treatment and distribution projects that are eligible for the Drinking Water SRF; enhanced energy efficiency projects at drinking water and wastewater facilities; brackish or seawater desalination, aquifer recharge, alternative water supply, and water recycling projects; drought prevention, reduction, or mitigation projects; acquisition of property if it is integral to the project or will mitigate the environmental impact of a project. The minimum project size is \$20 million and a WIFIA loan can fund up to 49% of an eligible project cost with a

maximum final maturity date of 35 years after the date of substantial project completion. The District will evaluate the use and applicability of WIFIA for qualifying capital projects.

In addition to some of the long and short term financing instruments described above that the District may access, the District may also consider joint arrangements with other governmental agencies when a project serves the public interest beyond the District's boundaries. Communication and coordination will be made with other local, state, and federal governments regarding potential jurisdictional overlap, joint projects, tax issues, and other issues that may arise. If the potential does exist, then the possibility of grants or cost sharing will be explored, quantified, and specific financial arrangements and liabilities negotiated. Municipal issuers are authorized to join together to create a separate entity, a Joint Powers Authority (JPA), to issue bonds on behalf of the municipality. The Board may sit as the governing body of the agency or authority. Typically, joint venture debt is repaid through revenues generated by the project and if structured as a JPA, a debt issuance associated with joint venture arrangements does not require voter approval. The District will only be liable for its share of debt service, as specified in a contract executed in connection with the joint venture debt.

Credit Enhancement

Credit enhancement may be used to improve or establish a credit rating on a District debt obligation. Types of credit enhancement may include Letters of Credit, bond insurance or surety policies. The Board may be asked to authorize a credit enhancement if it reduces the overall cost of the proposed financing or if, in the opinion of the General Manager or the Administrative Services Manager/Treasurer, the use of such credit enhancement furthers the District's overall financial objectives.

Debt Service Reserve Fund

Unless there are extraordinary circumstances, the District will size the debt issuance such that a debt service reserve fund is established at the time of issuance. On a case-by-case basis, assuming there is no economic or credit disadvantage, the District may issue bonds without a debt service reserve fund or a reserve that is sized at a lower level.

Capitalized Interest

Generally, interest shall be capitalized for the construction period of a revenue-producing project, that debt service expense does not begin until the project is expected to be operational and producing revenues. In addition, for lease back arrangements, such as those used for lease revenue bond transactions interest may be capitalized for the construction period, until the asset is operational. Only under extraordinary circumstances, interest may be capitalized for a period longer than the construction period. Capitalized interest is sometimes referred to as "funded interest."

Credit Ratings

The District will seek to maintain the highest possible credit ratings that can be achieved for debt instruments without compromising the District's policy objectives. Ratings are a reflection of the general fiscal soundness of the District and the capabilities of its management. Maintaining the highest possible credit ratings allows the District to issue debt at a lower interest cost. To enhance creditworthiness, the District is committed to prudent financial management, systematic capital planning, and long-term financial planning. The District recognizes that

external economic, natural, or other events may from time to time affect the creditworthiness of its debt. Each proposal for new debt will be analyzed for its impact upon the District's debt rating on its outstanding debt.

Rating Agency Relationships

District staff shall be responsible for maintaining professional relationships with the rating agencies: including Standard & Poor's, Moody's Investors Service, and Fitch Ratings, as appropriate. This effort shall include providing periodic updates, both formal and informal, on the District's general financial condition and coordinating meetings and presentations in conjunction with a new debt issuance, when determined necessary. Written disclosure documents to the rating agencies shall be provided by District staff. The retention of a rating agency relationship will be based on a determination of the potential for more favorable interest costs as compared to the direct and indirect cost of maintaining that relationship.

Bond Ratings

District staff, working with the District's financial advisor, shall be responsible for determining whether a rating shall be requested on a particular financing, and which of the major rating agencies shall be asked to provide such a rating.

Method of Sale

The District will select the method of sale that best fits the type of debt being issued, market conditions, and the desire to structure maturities to enhance the overall performance of the entire debt portfolio.

Three general methods exist for the sale of municipal bonds:

- I. **Competitive sale.** Bonds are marketed to a wide audience of investment banking (underwriting) firms. The underwriter is selected based on its best bid for its securities. The District will award the sale of the competitively sold bonds on a true interest cost (TIC) basis. Pursuant to this policy, District staff are authorized to sign the bid form on behalf of the District fixing the interest rates on bonds sold on a competitive basis.
- II. **Negotiated sale.** District staff selects the underwriter, or team of underwriters, of its securities in advance of the bond sale. District staff works with the underwriter to bring the issue to market and negotiates all rates and terms of the sale. In advance of the sale, District staff will determine compensation for and liability of each underwriter employed and the designation rules and priority of orders under which the sale itself will be conducted. Pursuant to this policy, the General Manager or his designee (typically the Administrative Services Manager/Treasurer) will be authorized to sign the bond purchase agreement on behalf of the District, fixing the interest rates on bonds sold on a negotiated basis.
- III. **Private placement.** The District may elect to issue debt on a private placement bases. Such method shall be considered if it is demonstrated to result in cost savings or provide other advantages relative to other methods of debt issuance, or of it is

determined that access to the public market is unavailable and timing considerations require that a financing be completed.

Roles and Responsibilities

The primary responsibility for developing debt financing recommendations rests with the General Manager and/or the Administrative Services Manager/Treasurer. In developing such recommendations, consideration should be given to the need for debt financing and an assessment of the progress on the current CIP and any other program/improvement deemed necessary by the District. The Board will review, authorize and approve debt financing and/or debt service related recommendations and proposals.

All proposed debt financings shall be presented to the Board through the Fiscal Policy and Insurance Committee and subsequently approved by the full Board. Debt is to be issued pursuant to the authority of and in full compliance with provisions, restrictions and limitations of the Constitution and laws of the State of California Government Code (CGC) §54300 et seq.

Bond Counsel

The District will retain external bond counsel for all public debt issues. As part of its responsibility to oversee and coordinate the marketing of all District indebtedness, District staff shall make recommendations for approval by the Board on the retention of bond counsel.

Bond counsel will prepare the necessary authorizing resolutions, agreements and other documents necessary to execute the financing. All debt issued by the District will include a written opinion by bond counsel affirming that the District is authorized to issue the debt, stating that the District has met all state constitutional and statutory requirements necessary for issuance, and determining the debt's federal income tax status.

Financial Advisors

The District will select financial advisors who may either be independent financial advisors or firms who engage in municipal bond underwriting or brokerage services. While serving as the District's financial advisor, a firm may not also engage in the underwriting of the District's debt issuance for which that firm also acts as financial advisor. A firm may also not switch roles (i.e., from financial advisor to underwriter) after a financial transaction has begun. Financial advisors shall be selected through a competitive process.

During the contract term of any party acting as financial advisor, neither the firm nor any individual employed by that firm will perform financial advisory, investment banking or similar services for any entity other than the District in transactions involving a financial commitment of the District without the specific direction of District staff.

The financial advisor will advise the District on refunding opportunities for current outstanding debt, as well as assist in evaluating the merits of competitive, negotiated or private placement of new debt, and determining the most appropriate structure to ensure effective pricing that meets the District's near-term and long term cash flow needs. The financial advisor will work with all parties involved in the financing transaction, including the District's bond counsel, trustee, underwriters, credit liquidity providers, to develop and monitor the financing schedule and preparation of the Official Statement. The financial advisor will assist the District in developing and distributing bid specifications for desired services as, trustee and paying agents, printing,

remarketing and credit liquidity service providers, and assist the District in its review process. The District also expects its financial advisor to provide objective advice and analysis, maintain confidentiality of the District's financial plans, and be free from any conflict of interest.

Underwriters

For negotiated sales, the District will generally select or pre-qualify underwriters through a competitive process. This process may include a request for proposal or qualifications to all firms considered appropriate for the underwriting of a particular issue or type of bonds. District staff will determine the appropriate method to evaluate the underwriter submittals and then select or qualify firms on that basis. The District will not be bound by the terms and conditions of any underwriting agreement; oral or written, to which it was not a party.

Internal Controls Related to the Expenditure of Bond Proceeds

Bond proceeds will be deposited and recorded in separate accounts to ensure funds are not comingled with other forms of District funds. The District's Trustee or Fiscal Agent will administer the disbursement of bond proceeds pursuant to each certain Indenture of Trust or Fiscal Agent Agreement, respectively. To ensure proceeds from bond sales are used in accordance with legal requirements invoices are submitted by the Engineering Department and approved by the Finance Department for payment. Requisition for the disbursement of bonds funds will be approved by the District's Administrative Services Manager/Treasurer or designated alternate.

The District will fully comply with federal arbitrage and rebate regulations. Concurrent with this policy, District staff will take all permitted steps to minimize any rebate liability through proactive management in the structuring and oversight of its individual debt issues. All of the District's tax-exempt issuances are subject to arbitrage compliance regulations.

The District's Finance Department shall be responsible for the following:

- I. Monitoring the expenditure of bond proceeds to ensure they are used only for the purpose and authority for which the bonds were issued and exercising best efforts to spend bond proceeds in such a manner that the District shall meet one of the spend-down exemptions from arbitrage rebate. Tax-exempt bonds will not be issued unless it can be demonstrated that 85% of the proceeds will be expended within the three-year temporary period.
- II. Monitoring the investment of bond proceeds with awareness of rules pertaining to yield restrictions. Maintaining detailed investment records, including purchase prices, sale prices and comparable market prices for all securities.
- III. Contracting the services of outside arbitrage consultants to establish and maintain a system of record keeping and reporting to meet the arbitrage rebate compliance requirements of federal tax code.

To the extent any arbitrage rebate liability exists, the District will report such liability in its annual audited financial statements.

Continuing Disclosure

So long as the District has public debt outstanding, the District will meet secondary disclosure requirements in a timely and comprehensive manner, as stipulated by the Securities Exchange Commission (SEC) Rule 15c2-12 and consistent with the District's Standard Operating Procedure for Compliance with Security and Exchange Commission Rule 15c2-12. The Administrative Services Manager/Treasurer shall be responsible for providing ongoing disclosure information to the Municipal Securities Rulemaking Board's (MSRB's) Electronic Municipal Market Access (EMMA) system, the central depository designated by the SEC for ongoing disclosures by municipal issuers.

The District will keep current with any changes to the administrative aspects of its filing requirements and the national repositories responsible for ensuring issuer compliance with the continuing disclosure regulations. In the event of a 'material event' requiring immediate disclosure, the District will work with its Dissemination Agent to ensure dissemination of the information to the appropriate disclosure notification parties.

Compliance with Bond Covenants

In addition to financial disclosure and arbitrage compliance, once the bonds are issued, the District is responsible for verifying compliance with all undertakings, covenants, and agreements of each bond issuance on an ongoing basis. This typically includes ensuring:

- Annual appropriation of revenues to meet debt service payments
- Timely transfer of debt service payments to the trustee or paying agent
- Compliance with insurance requirements
- Compliance with rate covenants where applicable
- Compliance with all other bond covenants

On an annual basis, the District will prepare all required debt-related schedules and footnotes for inclusion in the District's audited financial statements. The audited financial statements shall describe in detail all funds and fund balances established as part of any direct debt financing of the District.

Policy Review

On an as needed basis, the Administrative Services Manager/Treasurer will be responsible for updating and revising this Policy, and present any recommended revisions to the Board.