Orange County Sanitation District
Budget Control and Fiscal
Discipline Policy

Summary Policy Statement

The Orange County Sanitation District (OC San) will prudently manage the public funds that it collects. It will take a long-term planning approach to its facilities and rate setting that provides a stable setting program, prudent reserves, and pay as you go philosophy for operating and replacement capital expenses.

Background

OC San manages nearly $500 million annually. These funds support OC San's Operating, Capital, and Debt expenditures. OC San focuses its fiscal policy around three distinct areas, (1) Revenues, (2) Portfolio Management and (3) Debt Management and these areas are described in the Budget, Investment Policy and Debt policy all of which are updated annually.

Current Situation

1) REVENUES

Most of OC San's revenue is generated by user fees and charges. Currently, OC San fees are in the lower third of its comparison agencies'.

OC San's revenues come from three general areas: Fees and Charges (74%), Property Taxes (21%) and other smaller revenue sources (5%).

Fees and Charges: User fees are ongoing fees for services paid by Single Family and Multifamily customers connected to the sewer system. Also included in this category are Permit Fees (User fees paid by large industrial and commercial business owners connected to the sewer system and Capital Facility Capacity Charges (CFCC) (a one-time charge imposed at the time a newly constructed building or structure is connected to the OC San system. The OC San policy has been to focus on cost recovery while keeps fees as low as possible.

Property Taxes: OC San receives a share of the basic property tax levy proportionate to what was received in the 1976 to 1978 period less $3.5 million allocated to school districts. These funds are dedicated to the payment of debt service.

<u>Other Revenue:</u> Other Revenue includes Interest Earnings, Intra-District Transfers, and small revenue sources.

2) PORTFOLIO MANAGEMENT

The OC San Investment Policy is governed by three tenets:

A. **Safety:** The safety and preservation of principal is the foremost objective of the investment program. Investments shall be selected in a manner that seeks to ensure the preservation of capital in the overall portfolio. This will be accomplished through a program of diversification and maturity limitations.

B. **Liquidity:** The investment program will be administered in a manner that will ensure that sufficient funds are available for OC San to meet its reasonably anticipated operating expenditure needs.

C. **Return on Investments:** OC San's investment portfolio will be structured and managed with the objective of achieving a rate of return throughout budgetary and economic cycles, commensurate with legal, safety, and liquidity considerations.

OC San's investments are separated into two distinct portfolios, Long-term and Short-term, with a primary focus on the Long-term portfolio.

The Long-Term portfolio always focuses on four elements, duration, sector allocation, term structure, and security selection.

Duration

- Typically, OC San keeps the duration of a portfolio 'close' to the benchmark duration as we feel the benchmark duration is consistent with the risk tolerance of the strategy.
- The investment policy of OC San stipulates the average duration must not exceed 60 months and be within 80-120% of the benchmark.
- Historically the deviation of the long-term portfolio versus the benchmark is close to 5%. Large deviations in the duration of the portfolio compared to the benchmark are an anomaly.

Sector Allocation

- OC San takes an active approach to asset allocation, differentiating our holdings versus the benchmark, with typically a modestly higher risk exposure compared to the benchmark.
- Some of the asset classes we find more attractive in the current investing environment include Corporate notes, Asset Backed Securities, and Treasury notes relative to the Agency and Supranational sectors.

- The sector allocation of the portfolio will evolve over time as our outlook for the various eligible investment options changes.

Term Structure

- OC San manages the term structure of the portfolio by focusing on either a bullet, ladder, or barbell structure, relative to the benchmark.
- For most of 2019 the structure was gravitating towards more of a bullet structure in light of the change in the sharp of the yield curve, with short term interest rates moving higher at a greater velocity than longer maturity securities.
- Currently, with the yield curve very flat, we are migrating back towards more of a barbell structure, with new purchases focused at the short and long end of the eligible maturity distribution. We also find the middle to the maturity distribution, near the three-year maturity point, to be the most expensive from an absolute and relative value perspective, further supporting the barbell structure.

Security Selection

- Within the Corporate and Asset Backed sector, the Chandler team focuses on adding stable to improving credits to be consistent with the overall investment objective of safety, liquidity, and return.
    - As a Corporate holding becomes more seasoned, with a short maturity, it is often utilized as a ‘source of funds’ to facilitate new holdings in the portfolio.
    - Typically, Asset Backed securities are held to maturity, but in the event of a liquidity need and/or a deteriorating credit situation we would look to reduce the exposure.
- OC San allocates to the Agency and Supranational asset classes when we find the spread over a like maturity Treasury notes to be attractive.
    - Considering the lack of issuance in the Agency sector since the financial crisis, the relative value of the sector has become more challenging.
    - OC San has a core view the Supranational Asset class should offer a modest spread concession to the Agency sector, and the team is typically active in the sector when the additional spread pick-up is compelling.
- Across all asset classes, OC San will remove exposure to a security that is faced with a deteriorating credit situation and/or trading at an irrational valuation where

a swap into an alternative security will be beneficial to the portfolio over a reasonable investment time horizon.

3) DEBT MANAGEMENT

Due to the magnitude of the capital improvement program, OC San has utilized a combination of user fees, property taxes and debt to meet its total obligations and maintain generational equity.

It is OC San's policy not to issue any new additional debt for any existing obligations. However, OC San will actively review opportunities to refinance existing debt where possible provided the new refinancing results in a lower total cost and/or shortens the length of the obligations.

The primary debt financing mechanism used is Certificates of Participation (COP) COPs are a repayment obligation based on lease or installment sale agreements. As of July 1, 2020, the total outstanding COP indebtedness was $940 million with a blended interest rate of 3.05%. It is anticipated that the debt will be paid off by 2044.