Central Basin
Municipal Water District

MEMORANDUM

To:	Board of Directors
From:	Antonio J. Perez, General Manager
CC:	CBMWD Senior Managers, Arnold Alvarez-Glasman
Date:	September 9, 2014
Subject:	Analysis of Major Organizational Impacts of Dismissal of the General Manager

Purpose

As of September 8, 2014, there were two Directors who had asked for a special Board meeting including agenda items to evaluate and dismiss the current General Manager (GM), Antonio J. Perez. At 11:15 a.m. on September 8, three directors had indicated that they did not support the special meeting, and the meeting was never scheduled. Upon discussion with President Hawkins, I was directed to forward this memorandum to the Board to inform the Board of the potential consequences for dismissing the GM at this time. This memorandum attempts to serve as an analysis of the major organizational impacts that could and would be more than likely to occur if the GM were to be dismissed or substantially forced to resign at this time. Such an analysis was deemed to be necessary due to the potential and probable magnitude of the financial, operational, and reputational consequences to Central Basin that would result from such a dismissal. This analysis is to provide full disclosure to allow the Board to make such an important decision with all available information.

Financial Impacts

Direct GM Termination Costs

The GM was hired according to a contract authorized by the Board of Directors. This contract allows for the GM to be dismissed either "with cause", which calls for no severance payment, or "without cause" that would require a severance payment of $195,000 equal to 12 months of salary. Termination without cause is conditioned upon the agreement of the GM to sign a release of all claims against the District and thereby effectively agree to waive the right to bring a lawsuit against Central Basin for such a termination. Termination "with cause" is allowable only under specific findings as outlined in the employment contract. Generally, these findings would have to relate to gross negligence or mismanagement, fraud or embezzlement, moral turpitude, being convicted of a crime relating to offense or damage to the District or its customers, material insubordination to the directives of the Board, or substantial absenteeism.

The GM has the right to not accept the severance of $195,000, or if found to be terminated "with cause", to contest the findings as stipulated above and sue for the severance value plus attorney's fees. Lawsuits alleging wrongful termination, discrimination, harassment, and the like are also possible if not probable. Additionally, since the District is currently and has in recent past instigated investigations of alleged misconduct relating to Director's actions, and has been investigated by external authorities relating to Director's alleged misconduct, it is more than likely that the GM would also sue the District under a "whistleblowers" and/or retaliation claim. The defense of the District in such litigation is likely to cost $200,000 - $500,000 at minimum based on recent similar litigation against the District. If such litigation is successful against the District, cost for damages in additional to those of defending the District would likely be above $1,000,000, at a minimum, and could reasonably exceed current insurance limits. The District's current employment practices claim insurance is limited to $2,000,000 with a $100,000 deductible so that if the litigation cost is below the $2,000,000 limit the District's exposure would be limited to $100,000 of its own costs. In the event that related litigation is over $2,000,000, all costs would have to be borne by Central Basin.

Insurance Coverage Impacts

In April and May of 2014, the District faced significant difficulties in securing replacement employment liability insurance when ACWA/JPIA dropped this, as well as other, coverage after a string of claims arose from prior management employees stemming from a period which saw the transition through two Interim GM's prior to the current GM's appointment. As described in the attached assessment by the District's insurance broker, Keenan & Associates, in Exhibit "A", the challenge of overcoming the negative perceptions of potential insurance carriers of the District was overcome primarily by Keenan's ability to market the management stability and policy implementations that were the result of the new GM. If the GM were to be dismissed and the additional employment and whistleblower claims as described above were to materialize, it would be almost certain that the District would lose its insurance coverage by next May 2015 with a non-renewal, and it would be extremely unlikely to be able to secure any replacement insurance without drastic premium increases or coverage reductions. Without coverage, Central Basin would be directly responsible for all losses and would be in non-compliance with a number of contractual requirements with vendors, debt covenants, and on land leases that specify that the District must maintain minimal levels of coverage. Such non-compliance would jeopardize the continuance of services from those vendors and existing land leases used to operate the recycled water distribution system. The District does not have the reserves sufficient to adequately self-insure so that it could weather future losses and litigation, or property damages from natural disasters. Such a loss in coverage would weigh heavily upon the District's credit rating and almost certainly necessitate a singular or multiple downgrades. Additionally, the District would likely be in some form of default in relation to its debt if it cannot adequately insure the assets that the debt was issued to construct.

Debt Issuing and Related Costs

Additionally, the Board authorized staff in January of 2014 to proceed in the procurement necessary to prepare a debt issuance to bring back for Board approval. This debt issuance was to restructure existing debt in such a way to reduce the $1.5 million debt service payment spike in fiscal years 2018-2022. Such a restructuring is necessary to reduce debt payments to $3.3 million per year so that it is the same amount as a stable revenue source from property parcel charge assessments dedicated to such a purpose and thus providing as much certainty as possible that debt payments could be made in the future and thereby protect the District's creditworthiness. This would be essential to maintain the ability to issue any form of debt for future capital projects and to not be in default for existing debt.

The action to approve this debt refinancing is set to be brought before the Finance Committee and full Board this month for approval after having been rated by Moody's Investor Service as Aa3 earlier this week. The District's Financial Advisor, Fieldman Rolapp & Associates, detailed in Exhibit "B", an assessment that highlights the fact that Central Basin recently underwent two major credit downgrades and what would be the financial effect of future credit downgrades that would stem from management instability and potential litigation costs associated with the dismissal of the GM. Likewise, the District's Bond Counsel, Stradling Yocca Carlson & Rauth, noted to staff that any action with the GM would have to be disclosed and explained prior to the current debt issuance and financial performance projects amended to include the material anticipated financial impacts. If the financial impacts are anticipated to be significant so that financial performance is inadequate, the current debt issuance would either be delayed or would come with drastically increased interest cost.

Recently, Central Basin received downgrades by both Moody's and S&P that were directly related to missing the required financial performance goal of 1.15x debt coverage because of the lack of replenishment water sales and multiple years of significant legal costs without corresponding other operational expense cuts. Moody's, only in this last credit rating, raised Central Basin's outlook from "Negative" to "Stable" and did not assess an additional downgrade, which had been communicated as a strong possibility, based on forward looking improvements to the District due to the "District's new management and financial policies [that] will ensure…stability".

In the last fiscal year, the District underwent major cost cutting that resulted in an approximate 28% operating cost reduction* from the fiscal year prior to the current GM. These cost reductions were necessary to structurally balance the District's finances and stop the trend of deficit spending that had been the primary cause of the rating downgrades. In the same time period, imported water revenues dropped 9% due to ongoing trends relating to conservation and the drought. With the likely prospect of a water allocation from the Metropolitan Water District in the next calendar year, imported water revenues may drop well below budgeted projections depending on the drought severity through this winter. As such, any material litigation cost that may arise from

*Excludes Legal Costs

the termination of the GM would be especially significant as there is only an approximate $460,000 net revenue margin before the District would not be in compliance with meeting the required debt coverage ratio of 1.15x. If lower than anticipated water sales materialize, they would likely eliminate the entire $460,000 net revenue margin. Additional operating cuts would have to be made that would directly compensate for any additional costs. As these costs would almost certainly be multiple hundreds of thousands of dollars at a minimum, severe operating expense cuts would have to be made that would necessitate personnel related cuts due to other options being limited as other contractual and operating cost reduction actions have already been recently implemented.

At this time, not only are the rating agencies expecting that Central Basin be able to maintain the minimum 1.15x debt coverage ratio but also make forward progress in being able to average debt coverage between 1.5x and 1.7x and restore the District's reserve balance to at least $20 million from the current $14 million average within the next five years. If this does not materialize because of significant legal costs from the termination of the GM, loss of insurance coverage, or management instability that jeopardizes the organizations ability to quickly respond to declining imported water sales or move forward expediently on recycled water projects that are necessary to make sales projections, it is nearly certain that the District would lose its current high grade rating from Moody's of Aa3 and would likely lose it upper medium grade rating of A from S&P. See detailed figures and cost consequences of rating downgrades on Exhibit "B". Overall, depending on the severity of the downgrade, future debt issuances to fund capital projects are made more expensive or cost prohibitive, interest and letter of credit costs on current variable rate debt would increase a minimum of $135,000 per year. If the downgrades or digressing financial performance is severe enough, the letter of credit and/or SWAP agreement is likely to be revoked or not extended which would necessitate upfront payment of approximately $14-$15 million. A payment of this magnitude would completely eliminate the District's current reserves.

Operational Impacts

Impact of Executive Turnover in Staff's Morale, Attrition, Productivity, and Operations

During the time period of October 2012 through April 2013, staff's morale and engagement in the District plummeted with informal conversations looming about employees leaving the District. In addition to low morale, employee engagement and productivity dropped significantly because of the instability caused with the absence of leadership. Should the District go through another period of instability in top management, the District will likely be faced with increased low-morale, lower productivity and most significantly, high levels of employee turnover.

There is significant risk that another period of instability may lead to employee turnover of at least 50% of the workforce. The District runs its operations with a lean staff of 19 employees. Furthermore, 7 of the 19 staff are senior management that have very limited ability to cover any duties of other senior management positions should there be vacancies due to the highly specialized experience, skillset, and training of each position. It is certain that the District does not have enough staff resources to provide coverage if half of its workforce leaves in a short period of time. This level of attrition would create significant delays in daily operations and would be costly to the District in terms of institutional knowledge lost, including the costs of recruitment, hiring, and training new staff.

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As evidenced during the last period (October 2012 to April 2013) that the District had the absence of an executive, there is also increased concern that such instability may be the impetus to degradation of internal controls, policies, and processes. The instability that occurred in November 2012 helped fuel the contract overages that occurred in the Pacifica contract. The lack of contract oversight and contract overages forced the District to enter into two costly lawsuits that cost the District over $1.3 million.

Impact of Executive Turnover on Current Critical Water Supply Issues

Due to the historically severe drought conditions, the District is playing a crucial role in processes in the next several months that will determine available water supply for the service area for the next two to ten years. In this fall season, the GM and senior management will be working with the Metropolitan Water District (MWD) to represent Central Basin in two critical discussion on imported water supply. Namely, it is expected by the end of the calendar year that MWD will have finalized the Water Supply Allocation Plan that will govern how much water is to be reduced for each MWD member agency allowance in a time of allocation such as is expected at some degree in the next calendar year. If the drought substantially continues, and remains or becomes more severe, this plan will play a direct role in the water supply available to Central Basin's two million residents. Additionally, MWD is looking to decide on the fate of water purchase agreements required of member agencies by this December. Depending on the outcome of how, and if, the purchase orders are continued, this process will play a pivotal role in how much water Central Basin must commit to purchase in the future and how much is available to be purchased by its customers at lower Tier 1 rates. Lastly, the District is under current negotiations to extend the recycled water supply agreements from the Los Angeles County Sanitation District. Current contracts that ensure supply and determine pricing are sent to expire in 2016 and 2017. With current available recycled water production being quickly committed due to increased use for replenishment purposes, any delay in negotiations poses a risk of reduced supply over the next 25 years. Any turnover by the GM or senior management at this time may pose long lasting and significant risks to the success of any of these processes and negotiations.

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Reputational Impacts

County Report

In June, the County Board of Supervisors passed a motion directing their staff to deliver a report in 90 days regarding Central Basin's continued ability to deliver water. The concern stemmed from negative media reports and the District's loss of insurance. In response, the District proactively engaged the County Board of Supervisors, members of the Legislature and County Department of Public Works staff on the motion. In early July, Central Basin staff met with the Department of Public Works to discuss the County's concerns. County staff indicated that they were interested in Central Basin from an operational standpoint and our ability to meet the water needs of our constituents. They asked District staff to draft a report that would assist them in getting an overview of Central Basin from an operational point of view (Engineering, Finance and Water Resources). They also requested that the District be active members of the Greater LA IRWMP. Under the direction of the GM, the District drafted a 160 page report that addressed each of the County's concerns. Additionally, District staff met with several water industry stakeholder groups to discuss the issue. The District is hopeful that the report presented will be persuasive in convincing the County Board of Supervisors that the District is being competently managed, as it highlights the progress that Central Basin has made in the last 18 months. County staff has indicated that they plan on presenting their report to the County Board of Supervisors in early October.

The removal of the GM at this time would indicate that Central Basin is having issues with stability with respect to executive management of the District. It would add to the County's concern over Central Basin's ability to continue providing water to the 2 million residents in the Central Basin service area. The Board's action to remove the current GM may help fuel the perception that the District needs to be taken over by another agency. The pervasiveness of this negative perception may lead to actions by State legislators and the County Board of Supervisors to disband the existence and independence of the District and the Board of Directors.

Central Basin Standing in Water Community

The District has improved relationships within the water community under current leadership. This involves resolution of two major pieces of litigation with the Water Replenishment District, which was helpful in securing an agreement for the purchase of $60,000 Acre-Feet of Replenishment Water. This agreement will result in sales of over $40 million with $4 million in profit for the District. Additionally, the District has been an active member in local water industry groups such as the Central Basin Water Association, the Gateway Water Management Authority and the Greater LA IRWMP. Members of these groups have applauded the District's renewed efforts to build positive relationships in the water industry. In fact, during the last Central Basin Water Association, members of that group praised the District for the progress that has taken place under new leadership.

<u>Summary</u>

Although the impacts of the termination of the GM are difficult to quantify with any precision in certainty or specificity due to the number of factors involved, the potential likely areas that would materially impact the finances, operations, and reputation of the District revolve are several key areas. Namely, significant litigation costs from the GM may occur from the termination that would directly impact the financial performance of the District and in its ability to obtain insurance coverage. A degradation of financial performance or even a lack of progress would likely cause a rating decrease which would inhibit future debt and capital projects, substantially increase current bond costs, and may cause the District to pay a large upfront payout to pay off its variable rate debt and terminate its SWAP agreement. Such a payment would eliminate its reserve balance. The termination of the GM would also likely affect the morale and performance of staff in such a way that would cause 50% or more turnover in a relatively short amount of time. This turnover would directly limit progress on key water issues and processes current underway that will affect available water supply in the near and long term future, on the ability to uphold the integrity of process and procedures, and on the ability of the District to make any forward progress on finances, outreach, or capital projects. Lastly, the reputation and working relationship with other organizations and key individuals in the water community would likely be damaged. Especially in light of current efforts of the District to assure the County and State legislatures of its ability to continue to effectively provide water to its service area.

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Exhibit "A"

Keenan
Associates

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Riverside, CA 92505

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www.keenan.com
License No. 0451271

memo

To:	Dina Hidalgo
Company:	Central Basin Municipal Water District
Date:	September 5, 2014
From:	Vanessa Pena
CC:	David Rendeiro
Re:	Public Officials Management Liability / Employment Practices Liability Marketing Overview

The marketing of the Public Officials Management Liability/Employment Practices Liability coverage for Central Basin Municipal Water District was challenging due to the negative spotlight that the district was given resulting from the association with former California Assemblyman Tom Calderon in addition to the district's loss history for employment practices liability claims. For your reference, I've provided the following paragraph used in our executive summary to the markets in our formal submission.

At the onset of 2014, a Federal Grand Jury issued an indictment against State Senator Ron Calderon and his brother, Tom. The charges related to wire fraud, bribery and money laundering. CBWMD became a point of focus in the investigation due to its contract with Tom Calderon for consultative services. Central Basin has collaborated with the FBI in their data collection efforts, which are now nearing completion. In response to this investigation, CBMWD has spear-headed their efforts to usher in a new vision based on transparency and community involvement. The first goal achieved was an overhaul of their internal hierarchy, beginning with the senior staff including the General Manager position of Tony Perez. Tony joined the district last year, a water industry veteran, who has over 30 years of public and private professional experience.

This was a big point in our marketing efforts as we worked hard in presenting the submission to the markets in a positive light despite the negative perceived image. We were able to accomplish this based upon our relationships with the markets and by stressing the experienced senior staff is dedicated to assuring a new level of transparency within CBMWD. We emphasized the senior management team is on-point to accomplish a renewed strategic vision aimed at the creation of clear and concise policies and establishing a guiding and constraining force for the District's Board of Directors.

Any change within the senior staff may give the impression that the district has not yet established a level of stability and will further create a level of uncertainty with the markets which does have an impact on the overall pricing for Public Officials Management Liability/Employment Practices Liability.

As you know, Employment Practices Liability claims are on the rise and the defense costs for these types of claims can be extremely costly. The district's loss history for Employment Practices Liability claims have increased within the last 18 months for both frequency and severity. We are committed to working with Central Basin Municipal Water District in providing resources to address these loss drivers and reduce the overall severity with EPL claims. Our commitment to the district is to take a pro-active approach by providing training on EPL specific training

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through Keenan Safe Personnel offering a wide range of trainings that address harassment, discrimination and wrongful termination. For your convenience, I've attached a listing of EPL claim stats specific to public entities.

I hope you find this information helpful. Please do not hesitate to contact me directly should you have any question or concerns.

Best,

Vanessa Pena, AIS, CRIS
Senior Account Manager / Team Leader - Riverside
Keenan
Innovative Solutions. Enduring Principles.
[redacted]
[redacted] | w: [redacted]
4204 Riverwalk Parkway, Suite 400 | Riverside, CA 92505

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FIELDMAN | ROLAPP & ASSOCIATES

MEMORANDUM

To: Central Basin Municipal Water District

From: Robert Porr, Senior Vice President and Paul Pender, Vice President
Fieldman, Rolapp & Associates (Independent Financial Advisor)

Re: Financial Impacts to District of Credit Rating Downgrades

Date: September 4, 2014

The District has requested we quantify the financial impacts of 1) additional downgrades to its credit ratings and 2) an inability to complete the proposed restructuring of its 2010A COP indebtedness.

Credit rating downgrades would result in the following financial impacts and risks:

- Higher interest rates on restructuring bonds or future bond issues
- Higher fees on the letter of credit securing the District's 2008B COPs
- Termination payment on Interest Rate Swap Agreement
- Risk of higher / default interest rates on outstanding $13.5 million of 2008B COPs
- Risk of early termination or non-renewal for letter of credit for 2008B COPs

Item Impacted by Rating Downgrades	**Issue / Trigger**	**Estimated Cost Impact**
Bond Interest Rate for Restructuring Bonds	0.20% per 1 notch downgrade	**$17,000 (per year)**
Letter of Credit Fees	0.20% per 1 notch downgrade	**$27,000 (per year)**
Letter of Credit Fees (below A-/A3)	1.00% (below A- / A3)	**$135,000 (per year)**
Interest Rate Swap Agreement Termination	Below A- and A3	**$2,100,000 (up front)**
2008B COP Variable Interest Rate / Cost	Up to 12% default rate	**$135,000 (per year, each 1%)**
Letter of Credit Termination / Renewal Risk	COPs all due / 12% rate	**$13,500,000 (up front)**

The District currently is rated "A" (negative outlook) by Standard and Poor's and Aa3 (stable outlook) by Moody's. On September 3, 2014, Moody's removed their "negative outlook" for the District's rating and released a report stating the action was based primarily on "forward-looking improvements to the District's operations and financial profile," based on their expectation that "the district's new management and financial policies will ensure…stability for the district moving forward." If the District's financial performance falls short of these expectations for fiscal years 2015-2018, including debt service coverage of 1.5 – 1.7 times and a restoration of the District's cash position, credit rating downgrades are likely.

Failure to complete the 2010A restructuring would also result in a failure to meet forward-looking coverage. The District cannot structurally afford the existing level of debt payments coming due in fiscal years 2018-2022. An inability to restructure these payments will result in significant downward pressure on the District's credit ratings. The District has represented to the credit rating agencies that the restructuring would be completed by the fall of 2014.

The District's credit ratings have faced downward pressure due to poor financial results in fiscal years 2012 and 2013:

- In August, 2013, Moody's issued a "negative outlook" on the District.

- In April, 2014, S&P downgraded the District's rating significantly, from "AA" (stable outlook) to "A" (negative outlook).

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April 3, 2014

Tony Perez, General Manager
Central Basin Municipal Water District
6252 Telegraph Road
Commerce, CA 90040-2512

Dear Mr. Perez;

Please extend the JPIA's gratitude to President Hawkins and your legal counsel for taking the time to meet with JPIA staff yesterday. Let me take this opportunity to reiterate the discussion that took place and make very clear the JPIA's expectations of an agreement with your District.

1. As to the claim of Lopez vs. Central Basin Municipal Water District, the JPIA will continue to pay the legal counsel for the District and Director Apodaca up to, and including, the forth coming mediation. The District will assume responsibility for paying any negotiated settlement with Ms. Lopez. Should the matter not settle at the mediation, the District will withdraw its tender of this matter with the JPIA; thus accepting responsibility for the defense and any payments to Ms. Lopez and/or her counsel.
2. No claims against Director Apodaca will be tendered to the JPIA.
3. Central Basin Municipal Water District will not tender the present pending claim of Mr. Beilke to the JPIA.
4. Central Basin Municipal Water District will reimburse the JPIA for any legal fees incurred in the defense of the Qui Tam case.
5. Central Basin Municipal Water will remain in the JPIA's Property Program.
6. Central Basin Municipal Water District will remain in the JPIA's Employee Benefits Program.
7. Central Basin Municipal Water District will agree to a six month suspension of Employment Practice Liability (EPL) coverage. After six months, Central Basin Municipal Water District and the JPIA will meet to discuss full or partial reinstatement of EPL coverage. All other coverages under the Liability Program will remain intact.
8. Central Basin Municipal Water District will withdraw from the Workers' Compensation Program. Central Basin Municipal Water District may reapply for coverage in one calendar year.

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9. Central Basin Municipal Water District will renegotiate its contract with General Manager, Tony Perez, to provide language that termination of Mr. Perez must require four Board Members to vote in favor of termination.
10. A Central Basin Municipal Water Board Member and General Manager must attend both of the biannual ACWA/JPIA Conferences.
11. Central Basin Municipal Water District will designate an existing employee, with safety and risk management responsibilities, to work with a JPIA Risk Consultant.

Our goal is to work with your District to help you continue the fine work it has done in providing services to its ratepayers. We want the District to succeed in getting through this difficult time, but still minimize the risk to all of our member agencies.

The JPIA believes that this proposal will ensure protection to the people served by Central Basin Municipal Water District, but still impart how serious the JPIA views the recent actions of the Central Basin Municipal Water District's Board.

The services and training provided by the JPIA in areas such as risk control, safety, health and employment practices, could help you and your staff to continue to provide quality service to your ratepayers. The recommended changes to the General Manager's contract should assist in providing long-term stability to the management of District. Retaining your property and most of your liability coverages will allow both sides to continue, and hopefully enhance our working relationship.

After you have had the opportunity to review this correspondence, please contact me directly should you have any questions, comments, or suggestions.

Sincerely,

Walter A. Sells
Chief Executive Officer

WAS:bw

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