

**MODESTO IRRIGATION DISTRICT
FINANCING AUTHORITY**

(A Component Unit of Modesto Irrigation District)

FINANCIAL STATEMENTS

Including Independent Auditors' Report

As of and for the Years Ended December 31, 2016 and 2015

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
(A Component Unit of Modesto Irrigation District)

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INDEPENDENT AUDITORS' REPORT

To the Utility Commission
Modesto Irrigation District Financing Authority
Modesto, California

We have audited the accompanying financial statements of Modesto Irrigation District Financing Authority, as of and for the years ended December 31, 2016 and 2015, and the related notes to the financial statements, which collectively comprise the Modesto Irrigation District Financing Authority's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Modesto Irrigation District Financing Authority's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Modesto Irrigation District Financing Authority's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Modesto Irrigation District Financing Authority as of December 31, 2016 and 2015, and the respective changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

To the Utility Commission
Modesto Irrigation District Financing Authority

Other Matter

Required Supplementary Information

Modesto Irrigation District Financing Authority has omitted the Management's Discussion and Analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

Baker Tilly Virchow Krause, LLP

Madison, Wisconsin
May 16, 2017

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY

(A Component Unit of Modesto Irrigation District)

BALANCE SHEETS As of December 31, 2016 and 2015

(Dollars in Thousands)

	<u>2016</u>	<u>2015</u>
ASSETS AND DEFERRED OUTFLOWS		
CURRENT ASSETS		
Cash and investments - restricted	\$ 3,400	\$ 3,401
Interest receivable	347	332
Current portion of debt service installment receivable	8,997	7,846
Total Current Assets	<u>12,744</u>	<u>11,579</u>
OTHER ASSETS		
Cash and investments - restricted	87,286	87,484
Interest receivable - restricted	306	183
Debt service installment receivable, less current portion	231,823	240,814
Total Other Assets	<u>319,415</u>	<u>328,481</u>
DEFERRED OUTFLOWS OF RESOURCES		
Unamortized loss on refunding	2,302	2,780
Deferred cash flow hedges - unrealized loss on derivatives	25,836	27,659
Total Deferred Outflows of Resources	<u>28,138</u>	<u>30,439</u>
TOTAL ASSETS AND DEFERRED OUTFLOWS	<u>\$ 360,297</u>	<u>\$ 370,499</u>
LIABILITIES AND NET POSITION		
CURRENT LIABILITIES		
Current portion of long-term debt	\$ 7,860	\$ 6,610
Interest payable	4,538	4,637
Total Current Liabilities	<u>12,398</u>	<u>11,247</u>
NONCURRENT LIABILITIES		
Long-term debt, net of current portion	311,645	319,505
Unamortized premium	10,942	12,713
Unamortized debt discount	(766)	(800)
Arbitrage liability	242	175
Derivative financial instruments	25,836	27,659
Total Noncurrent Liabilities	<u>347,899</u>	<u>359,252</u>
TOTAL LIABILITIES AND NET POSITION	<u>\$ 360,297</u>	<u>\$ 370,499</u>

See accompanying notes to financial statements.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY

(A Component Unit of Modesto Irrigation District)

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION For the Years Ended December 31, 2016 and 2015

(Dollars in Thousands)

	<u>2016</u>	<u>2015</u>
NONOPERATING REVENUES		
Debt service contributions	\$ 13,169	\$ 11,601
Interest income	784	397
Other nonoperating revenue	<u>1,343</u>	<u>1,323</u>
Total Nonoperating Revenues	<u>15,296</u>	<u>13,321</u>
NONOPERATING EXPENSES		
Interest expense	16,555	14,258
Amortization of debt discount	34	25
Amortization of premium	(1,771)	(1,428)
Amortization of loss on refunding	<u>478</u>	<u>466</u>
Total Nonoperating Expenses	<u>15,296</u>	<u>13,321</u>
CHANGE IN NET POSITION	-	-
NET POSITION - Beginning of Year	<u>-</u>	<u>-</u>
NET POSITION - END OF YEAR	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to financial statements.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY

(A Component Unit of Modesto Irrigation District)

STATEMENTS OF CASH FLOWS For the Years Ended December 31, 2016 and 2015

(Dollars in Thousands)

	<u>2016</u>	<u>2015</u>
CASH FLOWS FROM NONCAPITAL AND RELATED FINANCING ACTIVITIES		
Principal payments on long-term debt	\$ (6,610)	\$ (4,510)
Interest paid	(16,587)	(13,126)
Debt service payments received from the District	23,197	17,636
Proceeds from debt issued	-	75,711
Advances to the District for the construction of capital assets	(845)	(1,694)
Net Cash Flows Provided by (Used in) Noncapital and Related Financing Activities	<u>(845)</u>	<u>74,017</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Investments purchased	(38,520)	(7,893)
Investments sold and matured	987	-
Interest received	646	395
Net Cash Flows Used in Investing Activities	<u>(36,887)</u>	<u>(7,498)</u>
Net Change in Cash and Cash Equivalents	(37,732)	66,519
CASH AND CASH EQUIVALENTS - Beginning of Year	<u>74,984</u>	<u>8,465</u>
CASH AND CASH EQUIVALENTS - END OF YEAR	<u>\$ 37,252</u>	<u>\$ 74,984</u>
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO BALANCE SHEET ACCOUNTS		
Current assets - cash and investments - restricted	\$ 3,400	\$ 3,401
Other assets - cash and investments - restricted	<u>87,286</u>	<u>87,484</u>
Total Cash and Investments	90,686	90,885
Less: Noncash equivalents	<u>53,434</u>	<u>15,901</u>
CASH AND CASH EQUIVALENTS	<u>\$ 37,252</u>	<u>\$ 74,984</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH ACTIVITIES		
Change in valuation of derivative financial instruments	\$ 1,823	\$ 254
Bond proceeds used in refunding of debt	<u>-</u>	<u>(31,847)</u>

See accompanying notes to financial statements.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
(A Component Unit of Modesto Irrigation District)

NOTES TO FINANCIAL STATEMENTS
As of and For the Years Ended December 31, 2016 and 2015
(Dollars in Thousands)

NOTE 1 – ORGANIZATION AND DESCRIPTION OF BUSINESS

The Modesto Irrigation District Financing Authority (the “Authority”) was established in 1989 pursuant to a joint exercise of powers agreement between the Modesto Irrigation District (the “District”) and the City of Redding. The purpose of the Authority is to provide financing and contracting for capital improvements of the District. The District’s Board of Directors is designated to serve in the same capacity for the Authority. The Authority is a component unit of the District. The Authority is exempt from payment of federal and state income taxes.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements of the Authority have been prepared in conformity with accounting principles generally accepted in the United States of America. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The significant accounting principles and policies utilized by the Authority are described below.

MEASUREMENT FOCUS, BASIS OF ACCOUNTING AND FINANCIAL STATEMENT PRESENTATION

The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when the liability is incurred or economic asset used. Revenues, expenses, gains, losses, assets, deferred outflows of resources, and liabilities resulting from exchange and exchange-like transactions are recognized when the exchange takes place. The Authority’s accounts are included as a component unit in the financial statements of the District.

In February 2015, the GASB issued Statement No. 72 - *Fair Value Measurement and Application*. The statement addresses accounting and financial reporting issues to fair value measurements. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This standard was implemented January 1, 2016.

Presentation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

CONTRIBUTED SERVICES

The Assistant General Manager - Finance and the Controller of the District oversee the Authority’s administrative, management, and accounting functions. Costs for these services are borne by the District and are not charged to the Authority.

CASH AND CASH EQUIVALENTS

Cash equivalents include all money market funds and debt instruments with maturity dates of three months or less from the date of purchase.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
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NOTES TO FINANCIAL STATEMENTS
As of and For the Years Ended December 31, 2016 and 2015
(Dollars in Thousands)

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

INVESTMENTS

Generally, all investments are carried at their fair value, except for guaranteed investment contracts (GICs), which are carried at cost. Fair values are based on methods and inputs as outlined in Note 3. Fair values may have changed significantly after year-end.

RESTRICTED ASSETS

Mandatory segregations of assets are presented as restricted assets. Such segregations are required by bond agreements and other external parties. All current liabilities listed are payable from these restricted assets.

DEBT SERVICE INSTALLMENT RECEIVABLE

The District and the Authority have Installment Purchase Contracts whereby the District is obligated to pay to the Authority installment payments equal to the debt service requirements of the Authority's long-term debt. The debt service installment receivable represents the amount due from the District to meet the Authority's debt service requirements, which includes principal and accrued interest. The noncurrent portion is equal to the noncurrent portion of long-term debt less cash held by the trustee. The remaining balance is classified as current.

DEFERRED OUTFLOW OF RESOURCES

A deferred outflow of resources represents a consumption of net position that applies to a future period and will not be recognized as an outflow of resources (expense) until that future time.

LONG-TERM DEBT

Long-term debt and other obligations are reported as liabilities. Bond premiums and discounts are amortized over the life of the bonds using the effective interest rate method. Gains or losses on prior refundings are amortized over the remaining life of the old debt or the life of the new debt, whichever is shorter. The balance at year-end for premiums and discounts is shown as an increase or decrease in the liability section of the balance sheet. The balance at year-end for the loss on refunding is shown as a deferred outflow of resources on the balance sheet.

ARBITRAGE LIABILITY

Interest earnings on tax-exempt bond funds are subject to arbitrage rules of the Internal Revenue Service (IRS) if interest earnings on the unspent tax-exempt funds are greater than the stated bond yield on the tax-exempt debt. As of December 31, 2016 and 2015, the Authority has recorded a liability of \$242 and \$175, respectively, for a potential arbitrage rebate to the IRS. Arbitrage rebates are due five years from the issuance date of the tax-exempt debt.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
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NOTES TO FINANCIAL STATEMENTS
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(Dollars in Thousands)

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

CLASSIFICATION OF REVENUES AND EXPENSES

The Authority distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the Authority's principal ongoing operations. The Authority considers operating revenues and expenses in the statement of revenues and expenses and changes in net position to be those revenues and expenses that result from exchange transactions or other activities that are connected directly to the Authority's primary functions. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

NOTE 3 – CASH AND INVESTMENTS

The Authority's investment policies are governed by the California Government Codes and its bond Indenture, which restricts the Authority's investment securities to obligations which are unconditionally guaranteed by the United States (U.S.) Government or its agencies or instrumentalities; direct and general obligations of the State of California (State) or any local agency within the State; bankers' acceptances; commercial paper; certificates of deposit; time certificates of deposit; repurchase agreements; reverse repurchase agreements or securities lending agreements; medium-term corporate notes; shares of beneficial interest; mortgage pass-through securities; financial futures and financial option contracts; and deposits with the Local Agency Investment Fund (LAIF).

The Authority follows the District's investment policy. The District's investment policy includes restrictions for investments relating to maximum amounts invested as a percentage of total portfolio and with a single issuer, maximum maturities, and minimum credit ratings.

Deposits in each local and area bank are insured by the FDIC in the amount of \$250 for time and savings accounts (including NOW accounts) and \$250 for demand deposit accounts (interest bearing and noninterest bearing). In addition, if deposits are held in an institution outside of the state in which the government is located, insured amounts are further limited to a total of \$250 for the combined amount of all deposit accounts.

The Authority categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

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NOTES TO FINANCIAL STATEMENTS
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NOTE 3 – CASH AND INVESTMENTS (cont.)

The valuation methods for recurring fair value measurements include institutional bond quotes for U.S. agency securities and broker information for money market mutual funds. Fair value measurements include Bloomberg pricing for similar assets for derivative financial instruments.

Investment Type	December 31, 2016			Total
	Level 1	Level 2	Level 3	
US Agency Securities	\$ -	\$ 45,426	\$ -	\$ 45,426
Money Market Mutual Funds	33,852	-	-	33,852
Derivative financial instruments	-	(25,836)	-	(25,836)
Total	\$ 33,852	\$ 19,590	\$ -	\$ 53,442

Investment Type	December 31, 2015			Total
	Level 1	Level 2	Level 3	
US Agency Securities	\$ -	\$ 7,893	\$ -	\$ 7,893
Money Market Mutual Funds	71,568	-	-	71,568
Derivative financial instruments	-	(27,659)	-	(27,659)
Total	\$ 71,568	\$ (19,766)	\$ -	\$ 51,802

CUSTODIAL CREDIT RISK

Deposits

Custodial credit risk is the risk that in the event of a financial institution failure, the Authority's deposits may not be returned to the Authority.

As of December 31, 2016 and 2015, none of the Authority's bank balances are known to be individually exposed to custodial credit risk.

The District's investment policy does not address this risk.

Investments

For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Authority will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party.

At December 31, 2016, the authority had investments exposed to custodial credit risk in U.S. Agency Securities of \$45,426 which was neither insured nor registered and held by the counterparty. At December 31, 2015, the authority had investments exposed to custodial credit risk in U.S. Agency Securities of \$7,893 which was neither insured nor registered and held by the counterparty.

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NOTES TO FINANCIAL STATEMENTS
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NOTE 3 – CASH AND INVESTMENTS (cont.)

CUSTODIAL CREDIT RISK (cont.)

Investments (cont.)

The District's investment policy addresses this risk. All securities owned by the District shall be held in safekeeping by a third-party custodian, acting as agent for the District under the terms of a custody agreement.

CREDIT RISK

Credit risk is the risk an issuer or other counterparty to an investment will not fulfill its obligations.

As of December 31, 2016 and 2015, the Authority had the following investments that were not rated:

- LAIF
- Investment Agreement Contracts
- Money Market Mutual Funds

Investments in U.S. Agency Securities, implicitly guaranteed have a credit rating of AA+ by Standard & Poors.

The District's investment policy addresses this risk. The District limits investments to those allowed by Sections 53601 of the California Government code that address the risk allowable for each investment.

CONCENTRATION OF CREDIT RISK

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer.

At December 31, 2016 and 2015, the Authority's investment portfolio was concentrated as follows:

Investment Type	Percentage of Portfolio	
	2016	2015
U.S. Agency Securities, implicitly financed	7.91%	9.02%
Guaranteed Investment Contracts:		
FSA Capital Management Services	9.17%	9.15%

The District's investment policy addresses this risk and places limits on the amounts invested in specific types of investments.

INTEREST RATE RISK

Interest rate risk is the risk changes in interest rates will adversely affect the fair value of an investment.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
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NOTES TO FINANCIAL STATEMENTS
As of and For the Years Ended December 31, 2016 and 2015
(Dollars in Thousands)

NOTE 3 – CASH AND INVESTMENTS (cont.)

INTEREST RATE RISK (cont.)

Though the District has restrictions as to the maturities of some of the investments, it does not have a formal policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increases in interest rates. As of December 31, 2016 and 2015, \$79,277 and \$79,476 of the Authority's total portfolio is subject to interest rate risk, respectively. At December 31, 2016, \$33,852 of the balance had a maturity of one year or less and \$45,425 had a maturity between one to five years. At December 31, 2015, \$71,583 of the balance had a maturity of one year or less and \$7,893 had a maturity between one to five years.

NOTE 4 – RESTRICTED ASSETS

RESTRICTED ACCOUNTS

Certain proceeds of the Authority's debt, as well as certain resources set aside for their repayment, are classified as restricted assets on the balance sheet because their use is limited. The following accounts are reported as restricted assets:

- Redemption - Used to segregate resources accumulated for debt service payments over the next twelve months.
- Reserve - Used to report resources set aside to make up potential future deficiencies in the redemption account.
- Project - Used to report debt proceeds restricted for use in construction.

	Carrying Value	
	December 31, 2016	December 31, 2015
Restricted Accounts		
Project Fund	\$ 70,988	\$ 71,367
Reserve Fund	16,298	16,117
Redemption Fund	3,400	3,401
Total Restricted Accounts	\$ 90,686	\$ 90,885

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
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NOTES TO FINANCIAL STATEMENTS
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(Dollars in Thousands)

NOTE 5 – LONG-TERM DEBT

LONG-TERM DEBT

The following bonds have been issued:

Date	Issue	Final Maturity	Interest Rate	Original Amount	Outstanding Amount 12/31/16
6/26/07	2007F Domestic Water Revenue Bonds	9/1/37	Index Rate	\$ 93,190	\$ 93,190
6/23/10	2010A Electric System Revenue BAB Bonds	10/1/40	4.78 – 7.20%	60,325	58,035
6/23/10	2010B Electric System Revenue Bonds	10/1/32	5.00%	39,930	39,930
8/14/13	2013G Domestic Water Refunding Revenue Bonds	9/1/22	4.75 – 5.13%	43,270	30,870
7/15/15	2015A Electric System Revenue Bonds	10/1/40	4.00 – 5.00%	67,690	67,690
7/15/15	2015B Electric System Revenue Bonds	10/1/36	2.00 – 5.00%	30,190	29,790

The Domestic Water Revenue Bonds are collateralized by a pledge of payments made by the City of Modesto (the "City") relating to the District's water service to the City under the Amended and Restated Treatment and Delivery Agreement (ARTDA). The Authority also maintains a surety bond for the benefit of Domestic Water Bond Holders in an amount equal to the maximum annual debt service on the Bonds. The District provides wholesale urban water service to the City in connection with the ARTDA. The District supplies treated water from a domestic surface water treatment plant (Domestic Water Plant) to the City for use within its water system, and the City pays for all costs associated with the Domestic Water Plant. In accordance with provisions of the ARTDA, the costs paid by the City include the District's debt service obligations on the debt issued to finance the construction and costs incurred by the District to operate the Domestic Water Plant.

The net revenue of the District's electric system is pledged for repayment of the 2010 series A and B revenue bonds and the 2015 series A and B revenue bonds.

The Authority is in compliance with required bond covenants.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
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NOTES TO FINANCIAL STATEMENTS
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(Dollars in Thousands)

NOTE 5 – LONG-TERM DEBT (cont.)

LONG-TERM DEBT REPAYMENT

Revenue bonds debt service requirements to maturity follows:

<u>Year Ending December 31,</u>	<u>Principal</u>	<u>Interest</u>	<u>Interest Rate Subsidy</u>	<u>Total</u>
2017	\$ 7,860	\$ 16,262	\$ (1,293)	\$ 22,829
2018	8,210	15,902	(1,254)	22,858
2019	8,585	15,437	(1,211)	22,811
2020	8,985	14,984	(1,166)	22,803
2021	8,595	14,540	(1,118)	22,017
2022-2026	58,620	64,846	(5,333)	118,133
2027-2031	72,055	49,815	(5,333)	116,537
2032-2036	90,520	30,773	(4,634)	116,659
2037-2040	56,075	7,576	(1,488)	62,163
Total Requirements	<u>\$ 319,505</u>	<u>\$ 230,135</u>	<u>\$ (22,830)</u>	<u>\$ 526,810</u>

Pursuant to the requirements of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, certain automatic reductions were effective March 1, 2013 for qualified bonds including the District's 2010A series Bonds. The Authority received a reduced interest subsidy payment during 2016 and 2015 due to budget sequestration by the federal government. In 2016 and 2015, the Authority recognized \$1,343 and \$1,323, respectively, in revenues for its Build America Bonds, as a component of other nonoperating revenue in the statements of revenues, expenses and changes in net position. Federal subsidies for these bonds will be reduced by 6.9% through the end of the federal fiscal year (September 30, 2017) or convening U.S. Congressional action, at which time the sequestration rate is subject to change.

ADVANCE REFUNDING

On July 15, 2015, bonds in the amount of \$30,190 were issued with an average interest rate of 4.82% to advance refund \$29,800 of series 2006A outstanding bonds, originally issued by the District, with an average interest rate of 4.78%. The net proceeds were used to purchase U.S. government securities. Those securities were deposited in an irrevocable trust with an escrow agent to provide for a portion of the future debt payments on the old bonds. As a result, those portions of the old bonds are considered defeased for the liability for that portion of the old bonds has been removed from the balance sheet of the District.

The cash flow requirements on the old bonds prior to the current refunding was \$49,892 from 2015 through 2036. The cash flow requirements on the new bonds are \$48,544 and refunding receipts of \$1,564 from 2015 through 2036. The advance refunding resulted in an economic gain of \$1,870.

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NOTES TO FINANCIAL STATEMENTS
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NOTE 5 – LONG-TERM DEBT (cont.)

LONG-TERM OBLIGATION SUMMARY

Long-term obligation activity for the year ended December 31, 2016 is as follows:

	<u>1/1/16 Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/16 Balance</u>	<u>Due Within One Year</u>
Domestic water revenue bonds	\$ 128,380	\$ -	\$ 4,320	\$ 124,060	\$ 4,535
Electric system revenue bonds	197,735	-	2,290	195,445	3,325
Unamortized premium	12,713	-	1,771	10,942	-
Unamortized debt discount	(800)	-	(34)	(766)	-
Arbitrage liability	175	67	-	242	-
Derivative financial instruments	<u>27,659</u>	<u>-</u>	<u>1,823</u>	<u>25,836</u>	<u>-</u>
Totals	<u>\$ 365,862</u>	<u>\$ 67</u>	<u>\$ 10,170</u>	<u>\$ 355,759</u>	<u>\$ 7,860</u>
	<u>1/1/15 Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>12/31/15 Balance</u>	<u>Due Within One Year</u>
Domestic water revenue bonds	\$ 132,490	\$ -	\$ 4,110	\$ 128,380	\$ 4,320
Electric system revenue bonds	100,255	97,880	400	197,735	2,290
Unamortized premium	4,108	10,034	1,429	12,713	-
Unamortized debt discount	(469)	(356)	(25)	(800)	-
Arbitrage liability	133	42	-	175	-
Derivative financial instruments	<u>27,913</u>	<u>-</u>	<u>254</u>	<u>27,659</u>	<u>-</u>
Totals	<u>\$ 264,430</u>	<u>\$ 107,600</u>	<u>\$ 6,168</u>	<u>\$ 365,862</u>	<u>\$ 6,610</u>

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
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NOTES TO FINANCIAL STATEMENTS
As of and For the Years Ended December 31, 2016 and 2015
(Dollars in Thousands)

NOTE 6 – DERIVATIVE INSTRUMENTS

SUMMARY OF NOTIONAL AMOUNTS AND FAIR VALUES

The Authority also enters into contracts to hedge its exposure to fluctuating interest rates. These contracts are evaluated pursuant to GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, to determine whether they meet the definition of derivative instruments, and, if so, whether they effectively hedge the expected cash flows associated with interest rate exposures.

The Authority applies hedge accounting for derivatives that are deemed effective hedges. Under hedge accounting, the increase (decrease) in the fair value of a hedge is reported as a deferred cash flow hedge – unrealized gain (loss) on derivatives on the balance sheet. For the reporting period, all of the Authority’s derivatives meet the effectiveness tests.

For interest rate derivatives, the Authority subscribes to a financial information service that it uses to verify fair value estimates obtained from its counterparties.

The following is a summary of the fair values and notional amounts of derivative instruments outstanding as of December 31, 2016 (amounts in thousands; gains shown as positive amounts, losses as negative).

	<u>2016 Change in Fair Value</u>		<u>Fair Value, End of 2016</u>		<u>Notional</u>
	<u>Classification</u>	<u>Amount</u>	<u>Classification</u>	<u>Amount</u>	<u>(Thousands)</u>
Effective Cash Flow Hedges					
Interest Rate Derivatives:					
Pay-fixed swaps, interest rate	Deferred outflow	\$ 1,823	Derivative	\$ (25,836)	\$ 93,190

The following is a summary of the fair values and notional amounts of derivative instruments outstanding as of December 31, 2015 (amounts in thousands; gains shown as positive amounts, losses as negative).

	<u>2015 Change in Fair Value</u>		<u>Fair Value, End of 2015</u>		<u>Notional</u>
	<u>Classification</u>	<u>Amount</u>	<u>Classification</u>	<u>Amount</u>	<u>(Thousands)</u>
Effective Cash Flow Hedges					
Interest Rate Derivatives:					
Pay-fixed swaps, interest rate	Deferred outflow	\$ 254	Derivative	\$ (27,659)	\$ 93,190

OBJECTIVE AND TERMS OF HEDGING DERIVATIVE INSTRUMENTS

The objectives and terms of the Authority’s hedging derivative instrument that was outstanding at December 31, 2016 and 2015 is summarized in the next table. The table is aggregated by the credit ratings (using the Standard & Poor’s scale) of the District’s counterparties. For counterparties having multiple ratings, the rating indicating the greatest degree of risk is used.

The interest rate swaps are designed to synthetically fix the cash flows associated with variable rate bonds. The interest rate that the Authority pays on the 2007F bonds is 67% of LIBOR plus a spread. With the interest rate swaps, the Authority pays the counterparty a fixed rate and receives 67% of LIBOR. Netting out the LIBOR-based payments, the Authority’s effective interest rate is the sum of the fixed rate paid to the swap counterparty and the spread.

MODESTO IRRIGATION DISTRICT FINANCING AUTHORITY
(A Component Unit of Modesto Irrigation District)

NOTES TO FINANCIAL STATEMENTS
As of and For the Years Ended December 31, 2016 and 2015
(Dollars in Thousands)

NOTE 6 – DERIVATIVE INSTRUMENTS (cont.)

OBJECTIVE AND TERMS OF HEDGING DERIVATIVE INSTRUMENTS (cont.)

Type	Objective	Notional (Thousands)	Effective Date	Maturity Date	Terms	Counterpart y Rating
Pay-fixed swaps, interest rate	Hedge cash flows on the 2007F bonds	\$ 93,190	Jun-07	Sep-37	Pay 4.378-4.440%; receive 67% of LIBOR	A

RISKS OF DERIVATIVE INSTRUMENTS

Credit risk – Credit risk is the risk of loss due to a counterparty defaulting on its obligations. The Authority seeks to minimize credit risk by transacting with creditworthy counterparties. Interest rate swap counterparties are evaluated at the time of transaction execution.

Termination risk – Termination risk is the risk that a derivative will terminate prior to its scheduled maturity due to a contractual event. Contractual events include bankruptcy, illegality, default, and mergers in which the successor entity does not meet credit criteria. One aspect of termination risk is that the Authority would lose the hedging benefit of a derivative that becomes subject to a termination event. Another aspect of termination risk is that, if at the time of termination the mark-to-market value of the derivative was a liability to the Authority, the Authority could be required to pay that amount to the counterparty. Termination risk is associated with the Authority’s derivative up to the fair value amount.

HEDGED DEBT

Net cash flows for the Authority’s synthetic fixed-rate debt are shown below. These amounts assume that the interest rates of the bonds and the reference rates of the hedging derivative instruments remain at December 31, 2016 levels. These rates will vary and, as they do, interest payments on the variable-rate bonds and net receipts/payments on the interest rate swaps will vary. The table shows only the Authority’s effectively hedged synthetic fixed-rate debt, which is a subset of the Authority’s total debt. As of December 31, 2016, all of the Authority’s variable-rate debt is effectively hedged.

	Principal	Interest	Net Payment on Derivatives	Total
2017	\$ -	\$ 1,198	\$ 2,925	\$ 4,123
2018	-	1,198	2,925	4,123
2019	-	1,198	2,925	4,123
2020	-	1,198	2,925	4,123
2021	-	1,198	2,925	4,123
2022-2026	18,265	5,606	13,655	37,526
2027-2031	27,955	4,078	9,870	41,903
2032-2036	35,100	2,065	4,996	42,161
2037	11,870	116	280	12,266
Totals	<u>\$ 93,190</u>	<u>\$ 17,855</u>	<u>\$ 43,426</u>	<u>\$ 154,471</u>