BAWSCA Capital Cost Recovery Bonds

Report on Feasibility

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For the past several months, BAWSCA and its advisors have been exploring the possibility of issuing bonds to prepay the portion of its members' obligations under the Water Supply Agreement (WSA) relating to unamortized capital improvements pre-dating the new WSA. Approximately $367 million in capital cost recovery payments remain outstanding and are being repaid as part of the Wholesale Revenue Requirement (WRR) at an interest cost of 5.13%.

Based on the information available to date, BAWSCA and its advisors believe that completion of the bond issue is indeed feasible and, if interest rates remain low, would save participating agencies a significant amount. At current rates, the bond issue could generate no less than $20 million in present value savings, or approximately 6% of the outstanding capital recovery amount, assuming full participation. We recommend that BAWSCA continue to pursue the financing, aiming for a closing in January, 2013.

In this report we address a number of the threshold questions required for this program to work:

- Establishing a legal structure to secure the bonds;
- Establishing a credit structure acceptable to the bond market that maintains the current system of allocating costs based on the volume of water purchased;
- Determining a way in which a significant share of the bonds can be tax-exempt;
- Ensuring that the bond issue does not have unintended consequences, such as increasing the amount of debt that members must report on their balance sheets; and
- Accommodating less than full participation by member agencies.

1. Actions taken to date.

Several key steps have already been taken toward the implementation of a refinancing program.

- BAWSCA Staff and its financial advisor (KNN Public Finance) performed an initial analysis of the feasibility of the program last Winter and provided updates at the May and July Board meetings.
- BAWSCA selected Orrick Herrington & Sutcliffe, LLP as bond counsel following a competitive Request for Proposal (RFP) process.

- AB 2167, legislation to facilitate the refinancing of this obligation, has been signed by the Governor.
- BAWSCA determined that it is most advantageous to the Agency to issue bonds on a negotiated basis. Following a competitive RFP process, the Board appointed Goldman Sachs and De La Rosa & Co. as co-senior underwriters.
- Staff has commenced meetings with SFPUC leadership and finance staff to secure San Francisco's role in facilitating the prepayment to ensure a smooth transition for agencies and to maintain tax exemption on the bonds.

2. Establishing a legal structure of issuing bonds.

While it is possible for BAWSCA to issue bonds under its existing enabling legislation, BAWSCA seized the opportunity to introduce legislation that would clarify BAWSCA's authority to issue bonds for this purpose and to introduce provisions to create a stronger credit for investors. Assembly Bill 2167, introduced by Jerry Hill, will add provisions to the Water Code to explicitly expand BAWSCA's authority to include the issuance of bonds for the specific purpose of prepaying BAWSCA members' obligation to San Francisco, through their water charges, for the costs of the existing assets, either through a prepayment, or through the acquisition from San Francisco of its receivable for that purpose. The alternative legal authorities were designed to accommodate the widest array of potential debt structures.

AB 2167 also adds a provision for BAWSCA to impose its charges as a surcharge collected by San Francisco, a feature designed to further enhance the marketability of BAWSCA's bonds.

3. Establishing a credit structure acceptable to the bond market.

Currently, the capital cost recovery charge is one of many components used to establish the annual WRR. Under the SFPUC's historical rate making practice, the WRR is divided by an estimate of the amount of water to be purchased by Wholesale Customers to calculate the annual water rate for each 100 cubic feet of water purchased. Thus, the payment of the capital cost recovery charge, a component of the WRR, are allocated each year based on each Wholesale Customer's consumption of water for that year.

One of the considerations in developing this financing program was to preserve a volumetric allocation of costs, including the cost of debt service on the bonds. Doing so would correspond to how agencies are currently paying San Francisco. The challenge of volumetric pricing is that, in any given year, BAWSCA members are likely to buy either more or less water than planned. The WSA has a mechanism called the "Balancing Account," whereby San Francisco either retains surpluses or accounts for deficits on a year to year basis. The amount of credit or deficit is then factored into the subsequent year's WRR. Through the Balancing Account, San Francisco provides BAWSCA a mechanism for dealing with year-to-year volumetric variability. The BAWSCA financing team is currently exploring various alternative mechanisms for maintaining volumetric pricing while ensuring that debt service is paid to investors on a timely basis under all water sale scenarios.

Besides a volumetric pricing, the financing team is also considering approaches based on fixed charges. Fixing annual revenues removes the risk of total deliveries being under budget, and could potentially provide greater certainty and greater savings. The BAWSCA financing team will only recommend a departure from a volumetric charge if there is a compelling reason to do so.

The final legal structure and payment mechanisms will need to balance the needs of the bond market for assurance of timely repayment notwithstanding volatility in sales volume with the needs of BAWSCA members for an efficient structure comparable to the existing cost allocation under the WSA. The financing team will report on the final recommended structure when the bond documents are brought forth for approval by the BAWSCA board in November.

4. **Determining a way in which a significant share of the bonds can be tax-exempt.**

The lower the interest rates on BAWSCA's bonds, the greater the amount of savings that can be generated out of the prepayment. One way to lower costs is to maximize the amount of bonds that can be issued on a tax-exempt basis. There are two distinct major challenges in this regard: (1) Federal tax law restrictions on the use of tax-exempt bonds to finance prepayments; and (2) the fact that a private business, California Water Service Company (Cal Water), is the largest single customer.

Federal tax law generally prohibits the issuance of tax-exempt bonds to finance a prepayment for water. BAWSCA's bond counsel, Orrick, Herrington & Sutcliffe LLP, has advised, however, that BAWSCA's prepayment on behalf of its governmental participants can be financed on a tax-exempt basis to the extent the prepayment can be treated as a "loan" to San Francisco, the proceeds of which are used by San Francisco for capital facilities owned and used by San Francisco. BAWSCA's staff and bond counsel have had preliminary discussions with San Francisco staff and are optimistic that San Francisco will have a sufficient amount of eligible expenditures for which to apply the prepayment.

Issuing bonds to finance BAWSCA's prepayment for Cal Water and Stanford University as tax-exempt bonds would require satisfying additional requirements and would impose additional obligations and restrictions on the various parties that are likely to prove to be impractical. Consequently, if all BAWSCA members were to elect to participate in the prepayment, approximately 20% of the bonds would need to be issued as taxable bonds.

5. **Ensuring that the bond issue does not have unintended consequences.**

As noted above, it is the intention of the financing team to design a debt service collection program that mirrors the existing payment structure. The team anticipates that debt service costs will be allocated based on annual water purchases. To the extent that water purchases are below expectations or in the unlikely event a member does not pay, the shortfall will be reallocated in the subsequent years to members through an increase in the cost of water, as currently happens with San Francisco's rate-making under the WSA.

One question that has been raised is whether these bonds would create an obligation that would require new reporting in members' own financial statements. Based on a review of the current financial reporting of members, and on advice from BAWSCA's consulting accountant Jeff Pearson at the accounting firm of Burr Pilger Mayer, LLP, it is our view that the obligation does not change simply because of the bond issuance. Both the current WRR payments and the new surcharge (which is paying debt service on bonds issued to pay a portion of the WRR) should continue to be characterized as the cost of water and reported as operating expenses.

It is not necessary to amend the WSA to implement the financing. However, we anticipate that each participating BAWSCA member will be asked to adopt a resolution electing to participate in the prepayment and directing agency staff to assist BAWSCA in completing the financing.

6. **Accommodating less than full participation by member agencies.**

While we do not see any economic or risk management reason for a member not to participate, it is nevertheless possible for a member to make such a choice, or merely to fail to adopt the required resolution in time to participate. We have determined that BAWSCA can issue bonds for a partial prepayment, leaving non-participants with the obligation they have currently under the WSA, at the current interest rate of 5.13% and with no share in the savings expected to be achieved. The Underwriters have modeled the algorithm to implement partial participation if it becomes necessary.

7. **Schedule.**

The following is a summary of the expected tasks required to undertake this financing program

August-September	Policy Committee and Board consideration of this report, implementation of phase three of the bond counsel contract, appointment of disclosure counsel and authorization to commit resources for seeking preliminary bond ratings
September-October	▪ Finalize transaction structure ▪ Negotiate agreement with San Francisco ▪ Prepare initial bond legal and disclosure documents ▪ Meet with rating agencies regarding preliminary rating
October-November	▪ Policy Committee and Board consideration of resolution approving bond documents and delegated authority to staff to execute documents under certain parameters (e.g. the maximum interest rate) ▪ San Francisco approval of agreement with BAWSCA
Fall	BAWSCA members adopt member-agency resolutions
December	Receive ratings
January, 2013	Market, price and close bond issue

8. **Conclusion.**

Based on the efforts to date, all of the major challenges to BAWSCA's bond issuance to prepay its capital obligation have either been addressed or a plan is in place to address them. A great deal of work remains to develop a credit structure, meet with rating agencies, and negotiate the arrangements with San Francisco necessary to complete this project. In addition, the economic feasibility of the bond issue will be dependent on market conditions at the time of sale. To date, interest rates continue to be favorable.

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