Western Regional Water Commission

STAFF REPORT

DATE: July 20, 2009

TO: Chairman and Members, Western Regional Water Commission's Subcommittee on Consolidation/ Integration

THRU: Mark Foree, General Manager, Truckee Meadows Water Authority

Rosemary Menard, Director, Washoe County Department of Water Resources

FROM: Jeff Tissier, TMWA CFO and Project Manager

John Sherman, Washoe County Director of Finance

SUBJECT: Phase Two Financial Analysis and Business Risk Assessment

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Recommendation

Staff recommends that a plan to integrate Truckee Meadows Water Authority (TMWA) and Washoe County Department of Water Resources, Division of Water Operations (DWR) move forward as justified through analyses leading to further refinement of specific plans addressing the necessary operating costs savings and debt defeasance requirements. This plan is expected to achieve the goal of full consolidation within two to three years which at this time appears to be viable if certain business risks attendant to full consolidation are addressed. Although a significant portion of cost savings must come from operational changes within DWR and defeasance of a significant portion of DWR senior lien debt, it is recognized that potential opportunities exist within TMWA to meaningfully contribute to overall combined savings of a consolidated entity through attrition of staff as a result of retirements. Staff recommends proceeding with the integration project by preparing a draft interlocal agreement between the entities, which includes an implementation plan that maps the processes and steps necessary to accomplish consolidation of DWR and TMWA operations.

Background

At its September 12, 2008 meeting, the Western Regional Water Commission (WRWC) asked staff from the Truckee Meadows Water Authority (TMWA) and the Washoe County Department of Water Resources (DWR) to do the following:

> "Conduct a focused financial analysis to assess the feasibility of some form of utility integration using their joint bond counsel and financial advisors, Swendseid & Stern and PFM respectively. This focused financial analysis would:
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> > a) identify limitations or restrictions to utility integration resulting from existing debt (including bond/loan/note obligations) and applicable ordinances [Item completed in December 2008];

b) suggest possibilities for addressing any existing limitations; and

c) outline potential financial structures of an entity created by some form of integration, if a plan for moving forward were adopted. "

At the December 2008 WRWC meeting the Phase One Financial Report was presented which consisted of a Bond Analysis addressing certain limitations and restrictions resulting from existing debt and what opportunities were available. The conclusion of this analysis pointed out significant increases in costs to water customers if TMWA was not the surviving entity, however, the possibility of consolidating the Department of Water Resources (DWR) into TMWA exists, although there would also be costs associated with defeasing DWR's debt. In lieu of full consolidation in the near-term there are opportunities to integrating certain functional areas of TMWA and DWR with a goal to fully consolidate at a later date after certain conditions are met. For purposes of this report "consolidation" means full and complete consolidation of entities' facilities and their operation while "integration" is defined as combining certain operating or financial functions of both utilities.

Summary of Phase Two Financial Analysis

Significant business risks have been identified related to each entity, in regard to full consolidation at the present time, which translate to risks to all water customers of the region. To combine the water utilities without consideration to these identified business risks could be costly to all water customers. These risks should either be mitigated or a mitigation plan developed before full consolidation in order to manage those costs.

A high-level financial analysis of full consolidation has been completed for both revenues and expenditures. The following table presents the findings of that analysis for the Fiscal Year 2009/2010.

TMWA/WCDWR Integration Analysis
Projected Combination of Water Divisions Operating Revenues and Expenses

Final Budget Projections	WCDWR	TMWA	Combined Total	Eliminations Additions	Adjusted Combined Totals
Water Sales (1,2)	$ 13,242,385	$ 75,339,744	$ 88,582,129	$ (1,800,846)	$ 86,781,283
Hydroelectric	-	2,208,589	2,208,589	-	2,208,589
Other (includes GVR)	751,117	2,067,089	2,818,206	-	2,818,206
Total Operating Revenues	13,993,502	79,615,422	93,608,924	(1,800,846)	91,808,078
Wages Salaries & Benefits (3)	3,676,944	17,241,897	20,918,841	358,897	21,277,738
Professional/Contract Services (4)	737,421	8,207,084	8,944,505	703,477	9,647,982
Supplies	1,980,853	2,934,256	4,915,109	-	4,915,109
Utilities	1,729,196	6,954,436	8,683,632	-	8,683,632
Purchased Water (5)	2,332,848	-	2,332,848	(2,332,848)	-
Overhead and Other (6)	1,058,651	4,687,363	5,746,014	(750,971)	4,995,044
Total Cash Operating Expenses	11,515,913	40,025,036	51,540,949	(2,021,444)	49,519,505
Depreciation Expense	7,046,737	21,468,108	28,514,845	-	28,514,845
Total Operating Expenses	18,562,650	61,493,144	80,055,794	(2,021,444)	78,034,350
Operating Income (Loss)	$ (4,569,149)	$ 18,122,278	$ 13,553,130	$ 220,598	$ 13,773,728
Principal	$ 2,564,135	$ 9,335,000	$ 11,899,135		
Interest	3,129,215	21,840,105	24,969,320		
	$ 5,693,349	$ 31,175,105	$ 36,868,454		
Projected water rate increase	106.0%	104.5%			

NOTES:
(1) The revenue elimination reflects reduction of wholesale revenue received from WCDWR
(2) The DWR water sales budget is virtually the same as DWR customer demand calculated with TMWA rates
(3) Personnel transfer cost change estimates, assumes all WCDWR personnel, includes deferred comp match impact
(4) DWR only not STIMGID Water Customers to Vertex + Mailing which includes past due mailings. Vertex contract extends to Feb 25, 2013
(5) Eliminate DWR wholesale water purchases from TMWA
(6) Refer to adjustments below

Additional cost reductions need exploration as a result of defining additional operational efficiencies as well as infrastructure investment savings that may be achieved by an integrated utility. The financial impact of those opportunities will need to be included in forward looking financial analysis over at least a five year period in order to fully map out the impact of consolidation. In addition, certain significant financial risks that have been identified at this time include:

- DWR Water Division’s cost of service and proposed rate increases include only 20% of the approximately $5.7 million in annual debt obligations with an expectation that developer fees or certain cash reserves will fund the other 80%. This is a significant business risk because of the reliance on growth conditions to fund this obligation in light of current economic. Without growth, DWR customer rates will have to increase above the current rate increases to cover this debt payment. Defeasance of a significant portion of the total DWR senior lien debt would mitigate this issue. TMWA has refinanced a large portion of its 2001A debt so there are limited future opportunities for garnering additional savings.

- The General Fund of Washoe County still pays slightly over $1.0 million for certain water planning functions for DWR for fiscal year 2010 (Note: FY 2008 General Fund support was nearly $2.0 million). If this funding support disappears, other funding mechanisms will be required or some form of cost containment to compensate for this reduced funding must occur under the framework of a consolidated entity.

- The Water Division of DWR has borrowed over $5.2 million from other financial resources within DWR with an uncertain plan for repayment. It is expected that certain pre-payments from customers and bond proceeds associated with Special Assessment District 39 will mitigate a portion of this borrowing (approximately $1.5 million). In addition, DWR is exploring the use of certain existing unspent bond proceeds to further reduce the balance of the aforementioned borrowings. Further use of existing unspent 2005 A senior lien proceeds (approximately $1.5 million) will offset some potential benefits of defeasing the remaining balance of existing senior lien debt.

- If the entities were consolidated as they currently operate with their respective levels of staff it is estimated that a minimum of $2.1 to $3.0 million in operating expenses, on a combined basis, would have to be eliminated to be able to meet TMWA's projected financial goals. This assumes that there is a sufficient reduction in senior lien debt obligations otherwise more operational costs savings will have to be developed. The high end of this estimate reflects the loss of funding from the Washoe County General Fund for DWR water planning.

- TMWA's primary business risk is renewing its letter of credit that supports its tax-exempt commercial paper program. This can be accomplished but debt pricing will be challenging. TMWA will embark on the renewal process late calendar year 2009 and early 2010 which can provide sufficient lead time before the August 15, 2010 renewal date. TMWA has few demands on commitments to growth with adequate water rights and water system capacity. Activities related to consolidation efforts must consider and protect TMWA's ability to maintain its financial integrity and achieve its financial strategic goals. It is important to note that it appears a consolidated entity has a better opportunity to meet future TMWA and DWR-related infrastructure commitments to meet the demands of new and expanded water services than two separate water entities.

The following table highlights high-level financial performance under a consolidation framework and the potential, dilutive, accretive effects on senior lien bond coverage ratios of a fully consolidated entity. This is an important financial optic because a consolidated water entity will need to fund cost effectively a number of very significant water infrastructure commitments in the North Valleys, Verdi and the South Truckee Meadows in order to meet the needs of new and expanded services related to growth as well as meaningful rehabilitation of older portions of the consolidated water system. If all business risks are addressed meaningfully then a consolidated entity can position itself to be able to fund a number of infrastructure commitments in the future.

Scenarios of Combined Sr Lien Coverage w/o Developer Fees

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Water Sales	$ 86,781,283	$ 86,781,283	$ 86,781,283
Hydroelectric	2,208,589	2,208,589	2,208,589
Other Misc Sales	2,818,206	2,818,206	2,818,206
Investment Income	4,729,722	3,593,454	3,593,454
Total Gross Revenues	$ 96,537,800	$ 95,401,532	$ 95,401,532
Total Consolidated Cash Operating Expenses	49,519,505	49,519,505	47,419,505
Net Revenues	47,018,295	45,882,027	47,982,027
Sr Lien Debt	35,860,580	33,575,261	33,575,261
Sr Lien Coverage	**1.31**	**1.37**	**1.43**

NOTES:
a) All debt excluding DWSRF loan has a first lien, no issue is defeased, no operating cost reductions.
b) The DWSRF loan for the Longley Plant is subordinate and $40.0 million of $65.0 million 2005 bond issue is "defeased", no operating cost reductions.
c) Longley debt subordinated, $40.0 of $65.0 million defeased, $2.1million in reduced O & M expenses on a combined basis exclude water planning.

Because most of the DWR's debt is not covered by customer water rates, DWR must "defease" a significant portion of its first lien debt by using the remaining cash proceeds (approximately $35 million principal + $5 million accrued interest) of the $65.0 million bond issue (issued in 2005). It is imperative that a plan be developed for reducing combined operating expenses. These aforementioned issues highlight the most significant current challenges facing full consolidation. Staff believes that if the agencies and their governing boards are committed to full consolidation, these measures could be successfully addressed over the next two to three years.

In addition to the financial analysis, a preliminary, detailed list of contingencies and commitments is being developed that highlights future business challenges and risks that must be identified, addressed, and/or mitigated under a consolidation framework. This process is typical and necessary when undertaking merger analyses because of the various stakeholder interests and the requirement to undercover all potential and significant future risks to the consolidated entity.