Topic: **Authority Board Agenda Item 5-3** **2018 May 21**

Subject: **Phase 2 Interim Financing**

Requested Action:

Discussion and possible direction to staff regarding recommended approaches to Phase 2 interim financing.

Detailed Description/Background:

In March 2018, the Sites Project Authority approved a contract with Montague DeRose Associates to provide municipal advisory services. The initial task was to develop financing options for the Project with a focus on the interim financing for Phase 2.

Prior Authority Board Action:

None.

Fiscal Impact/Funding Source:

None.

Staff Contact:

Jim Watson

Attachments:

Attachment A - Interim Financing memo.

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Memorandum

To: Jim Watson, Joe Trapasso

From: Montague DeRose and Associates, LLC

Date: May 14, 2018

Subject: **Sites Project - Initial Observations on Interim Financing**

We appreciate the time you have spent bringing our staff up to speed on the Sites Reservoir Project (the "Project") and we look forward to working with you to craft a plan of finance that will provide both the near-term and long-term financial resources needed for successful Project completion. The following are our initial thoughts regarding key considerations for the development of a plan for interim financing for the Project.

State and Federal Sources of Project Funding

The Authority is aggressively pursuing State Proposition 1 ("Prop 1") funding for the Project through the California Water Commission. It is our understanding that the Authority has requested approximately $45 million in Prop 1 funding for early Project development costs as well as nearly $1.6 billion for Project construction. A decision from the Water Commission on Prop 1 funding for the Project is expected by the end of July.

In addition to the Authority's pursuit of State Prop 1 funding, it will also pursue funding for the Project through the federal Water Infrastructure Improvements for the Nation ("WIIN") Act. It is not yet known if a potential WIIN Act commitment to the Project will be in the form of cash funding or a commitment to deliver a certain value of delivered Project costs via Bureau of Reclamation design and construction. It is also possible that WIIN Act funding commitments may be subject to annual federal budget appropriation, making them less certain than State Prop 1 funding.

The amount of State and federal funding secured by the Authority for the Project and more specifically, the amount of funding available for expenditure during the Project's Phase 2, will be a significant determinant of the amount of interim financing needed. In the coming months, we expect there to be increased clarity regarding State and federal funding for early Project development costs that will inform the design of the interim plan of finance.

Credit Structure Overview

As we work to develop interim and permanent credit structures for the Project that will be acceptable to the capital markets and commercial lenders, an important component of the pledged security to lenders and bond holders will be the legal rights and obligations of the various entities using the Project. Certain members of the Authority will have financial

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obligations to support the fixed costs of the Project and will have certain rights regarding the physical assets of the Project. Other participants may not have legal authority over the Project but rather ownership of the water being pumped into the reservoir for storage. Such participants will likely also be required to cover certain fixed costs ("take-or-pay") of the project in exchange for the rights to use the Project. The combination of these two groups will serve as the primary pledge to lenders and the financial community. As mentioned throughout this memorandum (see section "Take-or-Pay vs. Take-and-Pay"), a take-or-pay structure will be especially important in drought years when Project water storage levels may not be sufficient to meet demand.

To enhance the financial feasibility of the Project the Authority may allow other participants to join the Project as take-and-pay participants. These participants would not have the fixed right to storage capacity that will be enjoyed by the ownership and take-or-pay participants noted above. However, if storage is available in certain times and used by such participants, appropriate storage rates would be imposed on this group. Other revenue streams in this category could be related to water banking agreements and water exchanges.

Future questions related to the different participant groups will focus on which participants share in the benefits of the hydroelectric facility. This participant group could be limited to those groups responsible for the fixed charges of the Project or a shared benefit could be structured so that the costs of the hydro facility – or other project enhancements – would be shared with or between groups with ownership in the water or the Project. An additional consideration could be a structure whereby the Project or a large participant member such as the Metropolitan Water District of Southern California ("MWD") buys the water in wet years and sells the water in dry years in combination with storage agreements.

Project Credit Structure Options

The diversity in size and financial strength of the members of the Reservoir Committee (the "Project Participants"), as well as the number of agencies involved, creates both opportunities and challenges to the structuring of a marketable credit for the Project. At least one of the rating agencies views pooled credits with 20 or more participants, such as the Project, as stronger than smaller pools due to the credit diversification. However, given that the majority of the water agencies involved in the Project do not have credit ratings from any of the three primary rating agencies [1] (Standard & Poor's, Moody's Investors Service and Fitch Ratings), investors will be uncomfortable purchasing the Project's securities unless the stronger, rated agencies participating in the Project are obligated for a significant portion of the Project debt. This being said, we believe that there are at least two possible approaches to structuring the Project credit which can satisfy the credit requirements of potential investors.

1. **Public Water Agency Structure** - It may be possible to structure the Project credit with one or more of the strongest Participants "facing the market" and serving as the credit for the borrowing. These Public Water Agencies ("PWAs") would be obligated to make

[1] See Exhibit A for a list of Project Participants and their respective credit ratings.

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all debt service payments on the debt and would be reimbursed by the remaining Project Participants either through mechanics added by amendment to the Authority's Reservoir Project Agreement or through the execution of new funding agreements with each Participant. This is the approach that has been considered in connection with the financing of the proposed Cal WaterFix, with MWD serving as the PWA facing the market.

While convincing one or more of the stronger credits in the Project's participant pool such as MWD to serve as the PWA for the Sites Project would help with many of the credit challenges facing the Project, it would likely create other challenges that may be difficult to address. These include the considerable concessions the PWA member(s) may request in terms of Project entitlements in return for assuming liability for the Project's entire debt obligation, and the potential reduction in public support for the Project if the PWA members are primarily south-of-Delta agencies, causing the Project to be perceived as more of a Southern California urban water initiative.

2. **Pooled Credit Structure with Step-up Provisions** – The Authority can also structure the Project credit as a pooled credit with each Project Participant agreeing to pay its share of Project capital costs either on a pay-as-you-go basis or by paying its share of annual debt service on Project debt obligations. Given it is a primary objective of the Project to provide water storage and a reliable water supply for the agricultural and urban water users of the Sacramento Valley, we believe that a pooled credit structure will be the best approach for the Project. We also believe that a pooled credit can be structured to satisfy the investor community while retaining sufficient Project control and Project entitlements to satisfy local stakeholders.

   A key provision of a successful pooled credit will be the commitment of all Participants to "step up" to cover shortfalls in debt service in the event of the failure of other Project Participants to make timely debt service payments. These step-up provisions are designed to give investors comfort that in the event one or more of the weaker entities in the pool are unable or unwilling to meet their financial obligations, the remaining Participants will meet their obligations for them. In return for stepping-up, Participants would receive the entitlements forfeited by the defaulting agency. The rating agencies and investors will expect creditworthy, rated Participants to be required to cover a very high percentage of scheduled annual debt service (possibly as high as 95%) through a combination of their scheduled debt service payments and step-ups. Additional analysis will be required to assess the level of step-ups required to meet this threshold.

   Because larger, stronger credits can access the capital markets at lower costs, the Authority will need to manage the natural tendency for the largest, most creditworthy Project Participants to want to finance their portion of project costs separately from the balance of the group. Doing so would have the effect of leaving only the lower-rated and un-rated Participants in the pooled credit. Unless highly-rated Project Participants are responsible for a large portion of the Project's debt obligation and are part of the

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larger credit pool, we expect the Project's credit to be in the "A" rating category or lower.

It is also worth noting that, all other things being equal, Project Participants that have the ability to recover Project debt service costs through property taxes will likely be rated higher than Participants that rely solely on revenues generated from water charges for the payment of debt service obligations.

Other Credit Structure Options – We have also evaluated additional Project credit structure alternatives but do not recommend them for the following reasons.

1. **SWP or CVP Owned and Operated Facility** - While both the State and the Federal Government have the financial resources and infrastructure to develop and operate the Project, having either of them do so would not accomplish the overarching Authority objective of securing an acceptable portion of the benefits of the Project for Sacramento Valley interests. In addition, past experience would indicate that the timeline for completion of the Project if developed by either the State or the Bureau of Reclamation could be significantly longer than if the Project is developed by the Authority. Using a state or federal government-owned and operated approach would also reduce local public support for the project.

2. **Project Financed by Individual Project Participants** – The Authority could require each Project participant to provide its own financing for its share of Phase 2 and Phase 3 Project costs. This would effectively limit Project participation to those entities that have access to either the capital markets or access to significant commercial lending resources. It is our feeling that allowing only the strongest entities to participate in the Project fails to meet a core principal of the Authority which is to encourage and allow all Sacramento Valley interests to participate in the Project and receive its benefits. Using an individual participant financed approach would also likely require the inclusion of other highly rated entities in order to completely finance the Project. If those entities are south-of-Delta agencies it could change public perceptions about the Project and who it benefits most.

Take-or-Pay vs. Take-and-Pay

Discussions with municipal market participants regarding the credit requirements of the capital markets for a project such as the Sites Reservoir lead us to recommend that the Authority pursue water storage agreements that are based on the take-or-pay principal rather than the take-and-pay concept. The take-or-pay principal is the concept of each Project Participant having a contractual obligation to pay for its predetermined share of the Project's capital costs (i.e., bond debt service and other related costs) regardless of Project performance (i.e., amount of water actually stored or availability of water for delivery). This contrasts with the take-and-pay principal in which Project Participants' payments are contingent on the Project performance (i.e., payment is for actual water storage or water delivered). Take-or-pay contracts will be a cornerstone of the credit. Because investors are also interested in the viability of the Project's

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ongoing operations, we also believe they will expect similar take-or-pay agreements relating to water purchases.

Interim Debt Instruments

There are a number of debt instruments that could be used as interim financing vehicles for the Project. They fall into three categories 1) fixed rate notes, 2) floating rate notes and 3) commercial paper and revolving lines of credit. All three types of debt instruments can be sold via public sale in the capital markets or privately placed with a bank or other financial institution.

1. **Fixed Rate Notes** – The Authority can finance Phase 2 costs by issuing notes that pay interest semi-annually at a fixed rate and mature at the end of Phase 2. The Authority would issue long-term bonds to refinance the notes when they mature. The long-term bonds would also fund a portion of Phase 3 Project costs. Interest accrues on the total amount of notes issued even if the proceeds of the borrowing are not spent for several years. However, unspent note proceeds are invested until needed, thereby partially offsetting the impact of the interest being paid on the notes.

2. **Floating Rate Notes** – The Authority can issue notes that pay interest monthly with interest on the notes based on a specified interest rate index that is reset periodically. Historically, floating rate notes have provided borrowers with a lower cost of financing than fixed rate notes, but this result is not assured. As is the case with fixed rate notes, floating rate notes would likely be sold early in Phase 2 to cover all Phase 2 projected costs and would be structured to mature at the end of Phase 2. As with fixed rate notes, the floating rate notes would be refinanced with the proceeds of a long-term bond issue that would also fund a portion of Phase 3 Project costs and interest on the full amount of floating rate notes would accrue even though project costs may not be incurred until later in the Phase 2, with earnings on unspent proceeds offsetting to some degree the cost of the interest on the floating rate notes.

3. **Variable Rate Demand Bonds** – Similar to floating rate notes, variable rate demand bonds ("VRDBs") are variable rate instruments that have interest rates that reset periodically, typically either weekly or daily. However, unlike floating rate notes, VRDBs require bank credit and/or liquidity support to sell in the public markets. If a highly rated bank (i.e., "A" rated or better) will provide credit capacity to the project, VRDBs could be attractive as they combine the benefits of working with one or a small group of lenders with the low cost of financing available through the public markets.

4. **Commercial Paper and Revolving Lines of Credit** – The Authority can also establish a commercial paper ("CP") program to meet interim financing needs. CP programs are managed by CP dealers at the large investment banking firms and are usually supported by a bank credit or liquidity facility to ensure that buyers of CP are repaid when the CP matures. CP is placed with investors for periods ranging from one to 270 days. When CP matures, it is usually "rolled" or refinanced with a new CP issuance until it is

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refinanced permanently with long-term debt. In the Authority's case, all outstanding CP would likely be refinanced with long-term bonds at the end of Phase 2. One of the benefits of CP is that it can be sold by the Authority in multiple "tranches" as Project funding needs arise ("just-in-time" financing) rather than being sold upfront and incurring unnecessary interest expense. However, the Authority would not earn interest on any unspent proceeds as it would with Fixed Rate Notes or Floating Rate Notes.

Additionally, investment banks and commercial banks have created revolving line of credit products that have the characteristics of CP but can be placed directly with the bank. Since these bank products do not involve the investing public, they do not require bank credit or liquidity support, nor do they require public disclosure documents and ratings. Another difference is that bank revolving lines of credit generally require the borrower to pay current interest when due rather than rolling interest into the next issuance and eventually paying it when the principal is refinanced with long-term bonds. If Project Participants are not in a position to pay current interest during the interim financing period, a bank revolving line of credit may not be a good fit.

Before we can make a definitive recommendation regarding the optimal interim financing vehicle for the Sites Project, we will need to evaluate the projected Phase 2 expenditures to assess the impact of borrowing upfront vs. borrowing when needed. However, based on the preliminary information provided by Project staff, expenditures will not be level and spending will be heaviest in the third quarter of Phase 2. This spending pattern could favor a CP program or bank revolving line of credit approach to interim financing.

Public vs. Private Sale of Securities

The primary advantages of securing interim financing in the public markets are the transparency of the pricing process and the potential to achieve the lowest available all-in borrowing costs by accessing the broadest spectrum of investor demand. However, the disparate financial credits that make up the Project Participants and the significant uncertainties regarding environmental review; State and federal participation; DWR participation; validation; etc., will make it challenging to conduct due diligence, develop public disclosure, obtain ratings and convey the complicated story to investors. Even if acceptable public disclosure can be developed, the complexity of the credit story may reduce the cost advantages normally associated with the public sale of debt.

In contrast, a private placement of debt with a bank or banks could be accomplished without the need for a public offering document or bond ratings. Further, it is likely to be easier to convey the credit story to, and negotiate with, a small group of lending institutions experienced in complex credits. The main disadvantage of securing private interim funding is the potential for slightly higher interest costs than could theoretically be achieved with the public sale of debt and the reduced transparency of the pricing process. These disadvantages can be mitigated to a large degree by undertaking a competitive process to secure bids from several potential private lenders.

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Phase 2 Agreements

Before interim financing can be completed, the Authority will need to have negotiated and executed its Phase 2 Agreements with Project Participants. The Participant financing commitments and financing mechanics included in the Phase 2 Agreements along with the then current composition of the Participant pool will be the foundation for the credit package presented to potential investors and lenders.

It is our understanding that Project Participants are expecting to be able to assess their ability to participate in the Project prior to entering into Phase 2 and Phase 3 agreements and that "on-ramps" and "off-ramps" will be available for them to either increase or reduce their participation, or even potentially terminate their participation in the Project. Based on our preliminary research, as long as 1) the process for Participants to either increase or decrease their participation in the Project is clearly defined and 2) a Project Participant is only allowed to reduce or terminate its participation if another Project Participant or group of Participants is willing and able to assume that Participant's participation obligation, investors should be willing to provide interim lending for Phase 2 even if there is the possibility of the Project Participant mix changing prior to the beginning of Phase 3, when permanent financing is expected to occur. The Phase 2 Project Participants would of course need to commit to repay the interim financing in the event it is not refinanced by a Phase 3 financing.

Challenges to Interim Financing

DWR Participation – It is unclear what formal role, if any DWR will ultimately play in the Project. If DWR and the Authority conclude that the Project's costs can be billed to participating State Water Contractors through DWR's annual Statement of Charges process, the Contractors may be able to bill for Project-related costs using their court-validated local property taxing authority. This would improve the credit characteristics of the participating State Water Contractors for Project purposes and could enable these Participants to avoid putting Sites charges on the monthly water bills of their customers.

Validation – While joint powers authorities such as the Authority have broad authority under state law, the Authority will still need to determine with its Bond Counsel, when selected, if the Authority should be validating its authority to sell Project-related debt.

If there is any litigation outstanding related to the Project, it will be very difficult to secure interim financing.

Federal Participation – As discussed earlier, in addition to possible DWR or other State participation in the Project, it is also unclear how much federal participation there may be or in what form it may come (e.g., grants, loans or delivered Project components). The Authority and its legal and financial advisors will work to assure that the potential tax and other consequences of federal participation in the Project are understood and that decisions made by the Authority regarding federal participation will be informed decisions.

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Delays – The Authority's potential Prop 1 funding has specific scheduling requirements, for example, the project needs to have acquired its permits and ideally, its water rights before January 1, 2022 to remain eligible for funding. As such, project delays in Phase 2 could put the Prop 1 funding at risk.

It should also be noted that, even if it is determined that no validation of Project debt is required or recommended by counsel, any sale of public debt will still be subject to the risk of litigation based on legal and environmental claims and could therefore be delayed by court action. These delays could impact the Authority's ability to proceed with Phase 3 of the Project and refinance its interim debt with long-term debt. The risk of delays during Phase 2 will need to be carefully assessed and disclosed to potential interim lenders.

Environmental and Permitting Risks – Interim lenders will be concerned about lending to the Authority prior to all environmental permits being in place as this potentially transfers some of the risk associated with the Project to the lenders themselves. However, this is not to say that lenders will not consider lending in these circumstances, but they may require higher interest rates or stricter lending terms in order to do so.

Water Rights - Securing of water rights for the operation of the Project is obviously essential for Project feasibility. It is our understanding that in 1977, DWR filed claims for surplus water rights on a number of rivers in the state thereby potentially giving the State a priority claim on the water rights if and when needed. This pool or reserve of water rights rests with the State (not DWR specifically) and is controlled by the State Water Resources Control Board. We also understand that the Authority plans to petition the State Water Resources Control Board for a portion of these reserved water rights to supply the water needed for the operation of the Project. Project staff estimates that these water rights will be secured by 2021. Similar to assuming environmental and permitting risks discussed above, interim lenders may have difficulty lending prior to the securing of the needed water rights as it would require them to assume the risk that the water rights will be successfully secured.

Key Conclusions

Below are our preliminary recommendations in several key areas:

1. **Pooled Credit Structure with Step-ups** – For interim financing, we recommend a pooled credit approach with the Authority being the credit facing lenders or investors. This approach would also incorporate step-ups and would require all participants to join together for borrowing purposes. No separate financing by individual members should be permitted. This approach would not preclude the use of a different approach for the long-term financing of design and construction costs in Phases 3 and 4.
2. **Take-or-Pay Contracts** – The Authority should plan on requiring take-or-pay contracts with project participants (not take-and-pay) to provide the strongest possible security to lenders and investors.
3. **Credit Ratings** - Unrated participants requesting more than 20,000 acre-feet entitlements should be encouraged to secure credit rating indications.

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4. **Borrowing Approach** – Given the inherent complexity involved with educating potential lenders or investors regarding a pooled credit with dozens of participants, many if not most of whom are not rated, we recommend pursuing a private placement of debt for project interim financing rather than pursuing a public sale that would require educating hundreds of investors as well as the rating agencies. A private placement would also be more expeditious than a public sale, which will be important to keep the Project on schedule for Prop 1 funding.
5. **Interim Debt Instrument** – We believe that debt instruments such as commercial paper or a revolving line of credit are likely to provide the Authority with a combination of maximum borrowing flexibility and the lowest projected cost.
6. **Coordination of Borrowing and Phase 2 Agreements** – Because interim financing is expected to begin early in Phase 2, it will be imperative that all lending terms and provisions required by interim lenders are included either in Phase 2 agreements or a master project participation agreement that is executed by all participants. Therefore, there is a need to advance the development of the Phase 2 agreements concurrently with the interim financing.
7. **Project Participation will be Binding** – Because interim lenders will want to understand and evaluate the mix of credits involved in the Project pool of borrowers before making a lending decision, they will require some level of certainty regarding the which entities will be obligated for the loan. Therefore, participants executing Phase 2 agreements will only be able to "rebalance" (i.e., reduce their participation or exit the Project in the future) if there is another participant or an Authority-approved new participant that is willing to assume their interim financing obligations.

While these are our initial thoughts regarding Project interim financing, we look forward to working with Project staff and the Authority to further develop our analysis. Please let us know if you have any questions.

Exhibit A
Phase 1 Project Participant Credit Ratings

	Phase 1 Participants*			
Participant	**Moody's**	**S&P**	**Fitch**	**Notes**
DWR State Water Project Contractors				
Antelope Valley-East Kern WA	A1	AA	NR	
Castaic Lake WA	NR	AA	AA-	Recently merged with Newhall County W.D. to form Santa Clarita Valley W.A.
Coachella Valley WD	NR	NR	NR	
Desert WA	NR	AA	NR	
Metropolitan Water District of SC	Aa1	AAA	AA+	
San Bernardino Valley Muni. WD	NR	AAA	NR	
San Gorgonio Pass WA	NR	NR	NR	
Santa Clara Valley WD	Aa1	AA-	AA+	
Federal CVP Agriculture and M&I Contractors				
4M WD	NR	NR	NR	
Colusa County WD	NR	NR	NR	
Cortina WD	NR	NR	NR	
Davis WD	NR	NR	NR	
Dunnigan WD	NR	NR	NR	
La Grande WD	NR	NR	NR	
Orland-Artois WD	NR	NR	NR	
Placer County Water Agency	Aa2	AAA	NR	
Proberta WD	NR	NR	NR	
Roseville, City of	Aa2	AA-	NR	Water revenue bond ratings
Sacramento County	Aa3	A+	NR	Sacramento County Water Agency ratings
Westside WD	NR	NR	NR	
Federal CVP Agriculture Contractors				
Carter MWC	NR	NR	NR	
Glenn-Colusa ID	NR	NR	NR	
Maxwell Irrigation District	NR	NR	NR	
Reclamation District 108	NR	NR	NR	
Other Participants				
American Canyon, City of	NR	A-	NR	
California Water Service	NR	A+	NR	
Colusa County	NR	NR	NR	
Garden Highway MWC	NR	NR	NR	
Glenn County	NR	NR	NR	
Pacific Resources MWC	NR	NR	NR	
Sacramento, City of	NR	AA	AA-	Water revenue bond ratings
Santa Clarita Valley Water Agency	NR	NR	NR	
Tehama-Colusa Canal Authority	NR	NR	NR	
Western Canal WD	NR	NR	NR	
Wheeler Ridge - Maricopa WSD	NR	NR	NR	
Zone 7 WA	NR	AA+	AA	

*Participants listed reflect information posted on Sites Authority website as of April 12, 2018. Note that ratings are based on currently available public information and are subject to confirmation with participants.