REPORT FROM

OFFICE OF PUBLIC ACCOUNTABILITY

Date:	March 3, 2017
To:	The Board of Water & Power Commissioners David Wright, General Manager, Department of Water & Power
From:	Frederick H. Pickel, Ph.D., Executive Director/Ratepayer Advocate Frederick H Pickel
Reference:	Authorization to Submit a Financing Application to the Southern California Public Water Authority to Issue up to $772 Million of Rate Reduction Bonds

OPINION

The Office of Public Accountability/Ratepayer Advocate (OPA) **supports** the requested authorization to submit a financing application to the Southern California Public Water Authority to issue up to $772 million of rate reduction bonds, using a new Joint Powers Authority (JPA) for the Water Division of the Department of Water and Power (DWP).

This support is based on the following assumptions and representations that are likely to be met, as best as OPA can determine at this time:

1. Assurances by the DWP that the costs of administration and issuance (including fees typically paid from bond proceeds) will be less than OPA's "worst case" savings estimate of $4M per year;

2. Assurances from the DWP that no extra-ordinary costs can be anticipated should third-parties fail to use the JPA over time; and

3. The DWP Board, and its formal public record, will be kept up to date on which assets, in particular, did in fact use these funds, raised by the issuance of rate reduction bonds.

BACKGROUND: TOPICS INVOLVED IN UTILITY SECURITIZATION

In general, the decision-makers that review and set rates understand that securitization is exchanging better financing terms for less flexibility in the future. Securitization, therefore, can be done in a conservative or imprudent manner, and is not in and of itself a bad or good financial tool. DWP's proposed securitization is like a mortgage without a down payment, wherein the banker gets a priority in obtaining the home-owner's income.

At this time, terms and conditions of the issuance are not yet final, and market conditions are relatively untested. As such, OPA examined DWP's proposal on a "worst case" basis, which is more of a risk management approach to the issues below.

Utilities that practice securitization seek to:

1. Reduce the **risk** that future rate increases will be too low, by locking-in some of the revenue required;

2. Reduce the **regulatory uncertainty** of changes in industry standards or revenue collection, by issuances that are unaffected throughout a bankruptcy process; and

3. Reduce **debt service coverage** investors require because "secured" debt service would have a priority, and because the collection from customers cannot be altered or by-passed.

Securitization has been used effectively as a tool in major industry restructuring, in bankruptcy work-outs, and in highly unstable or unpredictable rate setting contexts.

"Excessive" securitization has the *potential* to "kick the can down the road" by inappropriately allocating current capitalization costs to future ratepayers, removing leverage limits, and driving future rate increases even higher than they otherwise *might* be. Securitization typically involves evaluation of bankruptcy as a contingency, and the degree to which important efficiencies might be lost.

DWP's securitization is motivated to a degree by unfunded mandates, which are coinciding with replacement of aging infrastructure. Funding is straining the balance between rate increases and asset growth.

DWP uses off-balance sheet financing for the Power Division, and has done so for a long time. However, that form of securitization is substantially different. The Power Division has a full-service coverage obligation, for assets both on and off balance sheet. The proposed Water Division securitization does not move assets off the balance sheet: funded projects are paid for by a legally protected revenue stream. A particular right to this revenue stream is the "property," and this adjusts the way ratings agencies view the total debt.

This form of securitization has limits in the form of market acceptance and price for the issuance. In other words, excessive use of securitization is, in general, constrained by the terms and conditions the bond market will accept.

EXPLANATION OF OPA's ASSUMPTIONS

Reasonable professionals apparently differ about the prudence of using 100% debt to finance utility assets. The essence of securitization transactions involves comparing the alternative, standard revenue bonds. This comparison produces an estimated effect on the rate revenue required to service debt of particular assets.

The lifecycle revenue requirement DWP estimates with water revenue bonds is $1281.9 million, and with the JPA is $1,171.5 million, a difference of $110.4 million over 30 years.[1] As such, OPA's "worst case" annual savings of approximately $4 million is more of a classical assessment of DWP's proposed savings, reflecting the low 0.10% "conservative" spread in interest rates assumed for the comparison.[2] DWP's newly adopted, water conservation decoupler has produced some of the lowest interest rates DWP has ever experienced. This has lowered the savings originally identified when the JPA was first considered for the Water Division.

In this "worst case" analysis, OPA does not count as savings the $270.2 million of cash "saved" by exceeding the Board's current 65% debt limit.[3] Market limits for this initial $772 million authorization appear to be unlikely.[4]

1. Preserving Savings

OPA's first assumption is merely an acknowledgement that prudent management will re-assess savings as estimates become accomplished facts. Ordinarily, a Board would receive advice that circumstances have changed if and when the value of a transaction is not as initially forecasted.

OPA is thus recommending a relatively low hurdle for that Board advice to be triggered, in the interests of maintaining transparency at a time when the Board and City Council are relinquishing flexibility for their successors.

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[1] Navigant, "Independent Bond Study," January 25, 2017, page 20, Table 4-5.

[2] Id., p. 19, Table 4-4.

[3] Id., p. 20. While this is a tough standard, it prevents any assertion of inter-generational inequity: current ratepayers under-paying for investment, which burdens later ratepayers. The general industry consensus is that 100% financing of utility projects is not prudent, and the exceptions tend to prove this rule. No fiduciary decision-maker would allow a utility to be put in distress by something as easily expected as a business cycle or weather variation. DWP's plan to use 100% debt for some water projects will be a de facto relaxation of the Board-adopted maximum debt ratio of 65%.

[4] DWP represents a limit defined as a "percent of the water bill," which it believes can be observed from experience others have had with securitization in general, and is approached when the line item on the bill reaches approximately 20% of a bill. DWP expects the current proposal would not exceed 5% of the 2016 system average rate for water.

2. No Extraordinary Costs

A new JPA faces many uncertainties. Many other water infrastructure projects and adjacent cities may ultimately come to value this financial tool, but that cannot be determined now.

OPA's second assumption acknowledges that decision-makers might rationally forego small savings, if the non-participation of other cities in this JPA *could* lead to extra-ordinary costs. In theory, those might take the form of a penalty for early retirement, a claw-back of alleged interest rate arbitrage, or some other form of payment not typically incurred in the course of DWP's current debt management practices.

In the "worst case" situation, wherein the JPA lacks participation by some other eligible entity, DWP could, at that time, need to suddenly raise the $270 million of additional cash funding. This could present a shock, either to planned capital projects or rates, due to factors not within DWP's control. Other than issuance and administration costs, DWP states it does not foresee any other form of extraordinary costs at this time.

3. Transparency Over Thirty Years: Avoiding Drift Over The Long Run

Unlike the request DWP is making, a broad securitization on an entire network of utility assets can impair flexibility so much that decision-makers decline to do it. These types of securitizations are observed when the transfer of power in government is not stable, or firms are exiting bankruptcy, without other options. They involve broad, ***intended*** losses in rate regulation flexibility. DWP clearly **does** seek to finance particular assets, and not the water system as a whole network.

Appendix A to DWP's Board report is necessary, but not sufficient. This list of projects supports the size of the issuance and authority sought. The projects could be constructed over a duration that is not now specified. DWP's Capital Improvement Plans (CIP) are continually modified and adjusted. Hiring more DWP workers, or raising the labor costs beyond those expected in the rate review, could require DWP to substantially decrease the pace of its CIP, and the plans it now expects for projects in Appendix A.

A critical assumption OPA makes is that a **formal Board record** will exist indicating which assets were, in fact, funded by this authorization. The Board should be kept up to date as projects are built with the proceeds. Otherwise, depending on how the JPA evolves, future Boards could find themselves drifting with changes in management into a different balance of securitization benefit and burden than the one contemplated today.

CONCLUSION

OPA recommends the Board approve the requested authorization.

OPA suggests that the Board discuss with the management how its public record can be kept current with the actual use of these bond funds on particular water utility projects and assets.