December 14, 2016

Dear City Council,

As management of the Mountain Water system and longtime members of this community, we feel that we have an obligation to you and this community to identify a number of significant concerns we have with the proposed financing plan for the condemnation of the water system. Like you did with the water utility ordinance, we hope that you will take these concerns to heart and require that the administration brings you a plan that will not put the future of this community at risk. After watching the presentation from your financial consultant at the Committee of the Whole (COW) meeting on Nov 30, we once again find it important to provide you and the community with our view on what you are being asked to vote on. Please include this letter into the public record at today's meeting to discuss the financing of the water system.

Short-term Financing Is a Huge Risk. We have heard things said over the last three years that have taken us aback at times. What we heard last week was by far the most shocking. Like the rest of the community, we understood the water system was to be acquired through long-term financing. That had always been the type of financing presented to the courts and the community. To hear the city cannot acquire the acquisition under fixed interest long-term debt at 4% and instead is asking the council to approve short-term variable interest debt adjusted monthly, currently at 2.8%, was alone shocking. To hear this would be placed with private investors with no assurance it could be refinanced in 18 to 36 months was even more alarming. Mr. MacGillvray from Springsted even stated that the current long-term rates are at "historic lows". It defies logic to gamble this community's money that the rates will not increase during the term of the temporary variable rate financing over the next 18 to 36 months.

There are major flaws in the administration's financial model. We have looked at the actual projections Mr. Bickell put together for the council and presented at the earlier COW meeting on August 24, 2016 ("Aug. Projections"). These Aug. Projections assumed long-term debt, as opposed to your current short-term option, but still show how revenues will be used to operate the system and pay debt service. The presentation by Springsted made it clear that to get long-term financing in the future, the city would have to show it can actually operate the system. It is our opinion that with Mr. Bickell's Aug. Projections and using the proposed short- term financing, there is a very low probability the system can continue to operate as well as it has.

The water system revenues are overstated by at least $500,000 per year. Mr. Bickell's Aug. Projections overstate revenues significantly. The projections show Mountain's last three years of revenues for 2013, 2014, 2015. Those three years show a $1,000,000 revenue swing from a wet irrigation season to a dry season and are representative of typical revenue swings due to weather. However, Mr. Bickell cherry picked the driest of those years in his Aug. Projections, which puts the revenue projections $500,000 more per year than the three year average. Financial projections should properly reflect this known swing in revenues and should use the average year, not the best case year.

The water system expenses are understated by at least $1,250,000 per year. Mr. Bickell represented in his Aug. Projections that the operational costs he showed are representative of Mountain's actual operational costs. This is incorrect. The spreadsheet actually changes the first three years to numbers that are closer to what the city is projecting as ***future*** costs, not what Mountain's actual costs were. This creates very misleading comparisons. Mountain Water spends over $1,400,000 per year in maintenance and operation expenses. These costs are associated with maintaining all of our equipment, hydrants, repairing leaks, and building and software maintenance. Without explanation, the city projections reduce those expenses by over $800,000. Also the city testified that under city ownership at least $200,000 of what we call capital would be shifted to maintenance expense. Yet, the maintenance projections were not increased by that $200,000. Additionally, Bickell's Aug. Projections inexplicably eliminated payroll taxes and Department of Environmental Quality fees that Mountain pays and the city would continue to be responsible to pay, which is an additional $250,000 understatement in expenses. When totaled up, these understatements result in a total $1,250,000 understatement in expenses ($800,000 + $200,000 + $250,000).

In Summary, coupling the $500,000 overstatement in revenue with the $1,250,000 understatement in expenses, the Aug. Projections overstate net income by $1,750,000.

A 6% rate increase on Day 1 is not "de minimus". Mr. Bickell's Aug. Projections are assuming an immediate 6% water rate increase to the customers. Mountain's rates were decreased this year by the Public Service Commission to reflect low cost acquisition financing and pass those savings on to the customers; however the Mayor has stated the city will raise rates back to the previous levels. Although the Mayor stated this increase would be "de minimus" we believe a 6% rate increase should be taken very seriously. Mr. Bickell's Aug. Projections assume revenues will increase by 6%, or over $1,000,000 by implementing this 6% rate increase. However, elasticity in water usage has shown that a 6% increase in water rates typically does not result in a 6% increase in revenues. This means Mr. Bickell's estimates are likely even further off than what we explained above. We have not tried to estimate how high water rates would actually have to raise to gain back the 6% revenue increase that Mr. Bickell's projections are assuming. We do believe it is safe to say that to reach those revenue levels the rates would have to be increased more than 6%, especially if the city implements more conservation programs as it testified it would.

Cash shortage when principal payments begin. Even before the overstatement in net revenues is accounted for, the Aug. Projections show the water system will be short of cash by $4,100,000 per year in year three when principal payments begin. The utility begins to take on $5,000,000 in additional debt ***every year*** to make up for those ongoing cash shortages. By borrowing $5,000,000 per year and only paying $2,000,000 per year in principal as the Aug. Projections show, the city was projecting to take on additional debt load year after year. It was obvious from the Aug. Projections that long-term financing was not going to work. If it doesn't work under the current "historic low" interest rates, why would anyone expect it to work in the future with likely higher interest rates?

Short-term financing does not solve the financial issues. The fact that a revised financial model was not provided to you at the last COW meeting should be troubling and places you in a position of deliberating the largest debt instrument in the city's history, with just a portion of the information you need. Nobody can precisely project the future cash flow situation with adjustable rate interest. To assist your deliberation, below we calculate the impacts of financing the purchase, assuming a constant short-term rate at 2.8% (thus assuming ***no increase*** in short-term interest rates). We evaluate both the $116M and $140M total cost options presented at the recent COW meeting, then use Mr. Bickell's Aug. Projections adjusted for the net income overstatement described above. The projections had interest only payments in years 1 and 2 of $4,900,000 and the annual cash shortage was $2,300,000 in year 2.

Assuming the new short-term debt at $116,000,000, with the short-term interest only payments proposed in years 1 and 2, it would create a $1,700,000 savings annually as compared to the interest payments in the Aug. Projections. This reduces the annual cash shortage down to $600,000 in year 2. But taking into account the $1,750,000 overstatement in net income, the cash projections are short by over $2,350,000 per year. And, the variable interest rate risk would increase interest costs by an additional $1,160,000 annually for every 1% increase in short-term rates.

By comparison, if the city were to borrow the $140,000,000 at 2.8% for the short-term, that would create a $1,000,000 annual savings, offsetting the annual cash shortage down to $1,300,000 in year 2. However, after adjusting the projections for the $1,750,000 overstatement in net income, the cash projections are short $3,050,000 annually. And the variable interest rate risk would increase costs by an additional $1,400,000 annually for every 1% increase in short-term rates.

The financial projections look even worse in the long-term. By the third year both of these short-term options will require long-term financing with principal payments factored in. Even with the best case scenario that long-term rates remain at 4%, with the $116M option the water system will be operating at an annual cash shortage of $5,600,000 which is 30% of total revenues. Under the $140M option, the water system will be operating at an annual cash shortage of $7,000,000 which is 38% of total revenues. A 1% increase to interest rates can increase these annual shortages by $800,000 to $1,000,000.

Risks of Short-term financing fall to ratepayers and employees. It was made clear in the Nov. 30 COW meeting that the risk of this new debt will not be placed onto the taxpayer. Therefore, there are only two options to deal with revenue shortages: raise water rates, or reduce expenses. Again, this means any financing risk the city and you as council members take on will fall to the ratepayers and employees.

A representative from Springsted in testimony during the condemnation trial confirmed that the indenture for the bonds will require water rates to automatically increase or expenses in the water system to decrease if there is not enough revenue to cover the bonds. This will mean required rate increases to the customer, less money available to maintain the system, or a reduction in experienced staffing. Given that payroll is the primary and largest non-fixed expense, payroll is the most likely area to cut expenses, meaning these risks may fall directly on the employees' backs.

Short-term financing creates ownership risk. There is a significant additional concern to this short-term debt not being backed by the taxpayer. It was presented that in order to obtain long-term financing, the city will have to obtain more operational experience. Based on our long-term experience in operating the system, to continue improving and operating the system as well as it currently operates will require far greater financial resources than will be available under the city's projections. As managers of the water system, we fear being held responsible for a financial plan that was destined to fail from the beginning. If the city cannot get long-term financing, then what?

The water system assets are under-collateralized to a private investor. What happens if the financial situation of the water utility changes in the next 3 years: for example if interest rates become so high the system can't make good on its debt payments; or the city can't afford to refinance; or there are unforeseen increases in expenses, such as a new requirement for enhanced water treatment, a significant health or pollution event, or a significant infrastructure failure? If the taxpayer is not backing the debt that means the water assets collateralize the debt. As presented at the Nov. 30 COW meeting the debt will be placed to private debt holders. Therefore the private debt holders will hold the water system assets as collateral on the debt, which means that under the risks identified above, the assets could again become property of private investors under a repossession scenario. This is placing the Mountain employees, assets, and the community into the most uncertain ownership scenario we have ever been in. There is no certainty of the city being the long-term owner under this type of short-term risk-taking.

It should be made very clear to the short-term private debt holders that if the assets were to become private again, the Public Service Commission would once again regulate the utility. Under PSC regulation the debt holders who repossess the system could only set water rates based on the original cost of the assets of $40,000,000 (our current rate base with the PSC), not the fair market value for which they loaned under the condemnation statute. Without disclosing that fact to potential investors, the scenario would place the Mountain employees into an ownership situation that would have extreme financial challenges the new owners were not fully aware of: $76,000,000 to $100,000,000 of stranded investment.

Homeowners are aware of short-term financing risk. We understand the details of all this can get confusing. But zooming out from the details, what is being asked of you to consider is similar to what happened in the housing and financing crisis of 2007 - 2008. People who couldn't afford a traditional long-term mortgage were sold on taking short-term, variable interest rate debt. These homeowners were sold not only on the idea that they could now afford the house, but because their payments were interest only, they could afford a more expensive house. These homeowners committed to risky variable interest rate loans on the hope that in the next few years things would change enough for them to refinance with traditional long-term fixed rate mortgages. That model did not work out well for many homeowners who found themselves "upside down " on their financing and chose to walk away from their homes; and it most likely won't work out for a water utility either. The city could find itself "upside down" on the water utility financing just has homeowners did just a few years ago. If you can't get the financing you need now, it's a dangerous gamble to buy it on a short-term variable interest rate note today on the hope you can refinance it with traditional long-term fixed rate debt in a few years when interest rates are likely to increase.

Bottom line is short-term financing creates numerous concerns and risks. We have significant concerns over being tasked with operating and maintaining this water system with such minimal resources available. Furthermore, we fear that when the revenues fall short of the required debt payment amounts (even over the short-term), the debt covenants will force even deeper expense reductions than those already forecasted in Mr. Bickell's Aug. Projections. And if the city cannot get future financing, the water assets, and employees' careers, will fall into unknown private hands.

We hope as a council you are able to find better financing options that provide a more secure future for the water system and projections more in line with what it actually takes to operate the system and serve the customers. **We highly recommend against acquiring the water system under the short-term adjustable rate option and associated risks.**

If you do opt for short-term adjustable rate financing, we ask that you properly protect the water system employees from having to bear the cost of the short-term risks with appropriate employee contract and debt indenture language. Also, please properly inform the prospective private debt holders of their risks as potential future private utility investors.

We hope you again find our input helpful for the long-term benefit of Missoula's water system. We can only continue to responsibly operate and maintain the system and provide great service and reasonable rates to our customers if we have fiscally responsible owners. As the representative from Springsted stated this is the largest bond debt Missoula has ever taken on. Your decision on how you finance this major acquisition has significant consequences for this community. We wish you the best of luck in your deliberations. Let us know if we can assist you further.

Sincerely,

Michelle Halley

Michelle Halley

Logan McInnis

Ross Miller

John Kappes