K-02b

DETROIT WATER AND SEWER DEPARTMENT (DWSD):
Discussion, Status and Business Issues
Rochester Area Republican Club

April 3, 2014

DWSD OVERVIEW

- A regional water and sewer authority, properly launched and governed supports critical regional goals – clean water, economic development and a vibrant southeastern Michigan to live, work and recreate. Despite the media's assertions to the contrary concerning Oakland's position, a regional authority makes sense.

- Clean water and properly processed sewage operated in a cost-efficient manner and in compliance with EPA standards is critical for regional economic development and vitality – and jobs that arise therefrom.

- With the Great Lakes representing 20% of the fresh water in the entire *world* and covers 40% of the State's population, the State of Michigan has an enhanced obligation to be actively involved in the resolution of the DWSD matter to ensure the Great Lakes remain pristine. Unfortunately, the State has played a very minor role in the discussions to date.

DWSD OVERVIEW (Cont.)

- The Emergency Manager's (EM's) DWSD offer and related discussions for the past 9 months does not support a long-term strategy but one that clearly supports a short-term goal of infusing the maximum amount of DWSD cash into the City's general operations and leaves unresolved the DWSD operating and capital needs.

- Clearly, the EM had the legal authority to address the operating issues facing DWSD under Public Act 436 and / or via the bankruptcy court proceedings. He choose not to do so leaving value that could have been extracted from a more efficiently run operation unaddressed.

- Oakland County Executive Patterson – 'No deal is better than a bad deal.'

OVERVIEW – CRITICAL DATES

- Federal court oversight imposed in 1978 (mismanagement, EPA failures, etc.) - ends spring 2013.

- Late in the Federal Court oversight process, a Root Cause Committee (3 members of DWSD / 3 members of Detroit – no regional members) was created. Root Cause Committee report in March 2013:
  - Cited goal to establish a regional authority.
  - Had a very complicated organization and governance structure.
  - Was not vetted at all by the Wayne, Oakland and Macomb Counties (although the Counties would have continued discussions).
  - Contemplated a $50 million to $70 million annual lease payment from the authority to the City with nominal cost avoidance (e.g. it would have been an *incremental* cost).

- Judge rejects Root Cause Committee report – he had no legal basis that would have permitted him to create a regional entity. Court exits oversight (although a legal challenge still exists).

OVERVIEW – CRITICAL DATES (Cont.)

- Started regional DWSD discussions with EM - June 2013.
- Detroit petitions for bankruptcy – July 18, 2013.
- City proposal (**$9 billion** lease payments over 40 year lease term) – October 2, 2013.
- Discussions on City proposal and development of memorandum of understanding on 'terms and conditions' – October 2013 through February 2014.
- Disclosure Statement / Plan of Adjustment – February 21, 2014.
- General rejection by Counties of lease payment, memorandum of understanding, and discontinuation of Counties / City meetings – mid-March 2014.
- City issues request for information from private companies – late March 2014.

OCT. 2, 2013 CITY PROPOSAL

- Divergence of goals – EM and regional leaders:

  - **EM's representative** – 'Counties are not his clients and his sole purpose is to maximize the value extracted from the DWSD deal for the benefit of the City.' Represents ***combative*** and ***short-term*** objectives to resolve the immediate bankruptcy needs only for the City, not the DWSD. Caveat emptor – buyer beware.

  - **Counties' leadership** - interested in a water / sewer system that provides services in compliance with EPA regulations at a cost-efficient price well into the future. ***Collaborative*** and ***long-term*** goals involving a well-operated water and sewer system sustainable well after the bankruptcy has ended.

OCT. 2, 2013 CITY PROPOSAL (Cont.)

- City proposal of a 'revenue neutral' approach:

  - ***Projected costs avoided*** due to bankruptcy actions taken by the EM, regardless of whether the savings are actually achieved in the future, would be paid to the City in the form of a lease payment essentially forever. The net effect of the cost avoidance, in theory, would be that the new authority would be in no worse financial shape than it is today and would be in the future.

  - 40-year contract that could not be broken even for breaches / defaults and *automatically* renews so long as the new authority had outstanding debt. **A 40-year plus 'no cut' contract requires substantial due diligence - a proper review and complete understanding of the financial, operations, environmental and other business issues as once the region is committed there is no turning back – CAVEAT EMPTOR.**

OCT. 2, 2013 CITY PROPOSAL (Cont.)

- Annual lease payment - $94M in 2015 increasing to $228M in 2023. In 2023, the $228M lease payment becomes a base amount to be increased at not less than 4% per year for the remaining life of the 40-year lease term (or beyond). Over 40-year term, the estimated lease payments would have accumulated to be $9.0 billion.

- Costs that would be avoided in the original proposal:

  - **DWSD pension costs** – DWSD is a part of City's general retirement system to provide City employees not only a defined *benefit* plan, but a supplemental defined *contribution* plan whereby they were ***guaranteed*** a rate of return of ***no less than* 7.9% on amounts invested**. Accrued pension liability for retirements system, as calculated by the EM's actuaries, including DWSD - $1.9 billion for this guaranteed benefit.

  - **Retirees' healthcare** – eliminate 'pay-as-you-go' medical bills for DWSD retirees. Bankruptcy is eliminating an estimated $200,000 in value per retiree and active employee on average ($6B+ / 32,000 active employees and retirees = $200,000). Media is focusing only on pension reductions, not loss to actives and retirees for lost medical benefits. Annual DWSD savings in the near term - $21 million.

OCT. 2, 2013 CITY PROPOSAL (Cont.)

- **Financing savings –** EM assumed lower borrowing costs under an authority separate from the City. *In theory*, a better bond rating (estimated by the City at no less than 'A' without bond insurance) would provide an lower borrowing cost (e.g. interest rate).

  - City wanted credits on the *assumption* that the existing $5.7 billion in debt would be refinanced. EM incorporated it into the lease payment even though most of the bonds were not yet callable. Accelerating the call date, which is now proposed, creates a bond impairment with the result of a bond rating downgrade - actually creating a substantial *increase in borrowing costs*, rather than *assumed benefits* over the 40-year lease term.

  - Recently, Fitch and Standard & Poors rating agencies have lowered the debt rating, in part, because of the proposed impairment.

OCT. 2, 2013 CITY PROPOSAL (Cont.)

- **Pension debt** - elimination of pension certificate of participation debt service (e.g. a special type of long-term debt) alleviates future principal and interest payments.

- **Operations** – EM wanted savings from the restructuring of operations over 10 years even as the City representatives would not be party to achieving the new authority's actual savings.

- The lease payment would have preference over existing debt and operations – to be paid first. Bondholders and bond insurers objected.

OCT. 2, 2013 CITY PROPOSAL (Cont.)

- The proposed investment banking fees paid to the City's advisers for closing a DWSD deal are summarized below under two alternatives (to be paid as part of a 20-year term new bond financing):

  - **County regional authority** - $8 million, with additional services and fees possible. Plus, potentially additional fees for certain other related services.

  - **Privatization** - alternatively, a fee for privatization (e.g. sale to a private entity) of DWSD would be based on a commission on size of the deal – between $35 million and $45 million (based on Oct. 2, 2013 proposal).

CRITICAL BUSINESS ISSUES

- ‘Back-stopping’ of unpaid customer invoices – a deal breaker:
  - Those who have the ability to pay would fund those who *will* not or *cannot* pay for the new authority’s capital and operating needs over the 40-year period.
  - Despite numerous requests by the Counties for the State and City to discuss the ‘back-stopping’ issue, the State decided not to assist in the DWSD back-stopping matter.
  - Order of magnitude - retail (e.g. Detroit residents) delinquent accounts at Feb 28, 2014: amount owed by retail customers - $170M. **Amount 60 days or over delinquent - $140M (represented by 162,000 customer accounts, or say 300K residents). Over 80% delinquent. Annual write-offs of roughly $40 million in unpaid bills.**

CRITICAL BUSINESS ISSUES (Cont.)

- Back-stopping (cont.) - Actions to reduce losses:

  - **Delinquency on property tax bills** – the print media recently reported that only 53% pay their property tax bills on a current basis. After 2 years, the collection percentage rises to 85% of amounts originally levied. Disclosure Statement filed with the court – 85% collection rate in 2014 with NO improvement expected through 2023.

  - **Shut-offs** – assuming that 300K residents have no water, what could happen in July when temperatures hit 90+ degrees (public safety issues for 'shut-off' employees and unrest / health-related issues / creation of further abandonment of homes causing increased blight)?

CRITICAL BUSINESS ISSUES (Cont.)

- Back-stopping issues (cont.):

  - Highland Park (considered a 'wholesale' customer) was delinquent as well - $19.6 million increasing at $600K per month (DWSD has filed a lawsuit in 2014). Other minor amounts delinquent from remainder of wholesale customers (all of which have 'work-out' agreements to pay over a specified period of time).

- Lack of adequate and timely information provided to the Counties to evaluate the City's proposal – financial, actuarial (pension / retirees' healthcare), legal, labor status, insurance, capital needs, environmental compliance, etc.

  - Mid-March 2014 quote from Orr: 'During the coming due diligence we **will** be giving the Counties everything that is **available**.' Been discussing DWSD for 10 months. Example – given millions being spent on accountants / consultants why would the City not hire a few bookkeepers from these firms to close the DWSD books to make the information available to the Counties?

CRITICAL BUSINESS ISSUES (Cont.)

- Capital needs:

  - Range from \$2.5B to \$5.0B over next 10-year period (bonding for the new capital causing increases in the rates) - if bonding can be obtained at all. The \$2.5B amount is based on affordability (e.g. ability to pay), not based on what would be needed to properly maintain / improve the DWSD system (higher amount).

  - New debt service (e.g. principal and interest payments for above) would result in rate increases - can the rate increases be passed onto Detroit customers if the City has 80% delinquency rate and writes-off \$40 million annually in uncollected billings?

  - Standard & Poors has dropped the bond rating to ‘CCC’ with a negative watch (meaning if the underlying business issues are not improved, the raring could be reduced further). Fitch has rated the debt at BB+ with a negative watch. Ratings below BBB are considered to be ‘junk.’   The meaning – future interest rates on debt borrowed for the capital needs above will increase and thereby be included in future water and sewer rates.

CRITICAL BUSINESS ISSUES (Cont.)

- Capital needs (cont.):

  - City's representatives targeting of an 'A' rating for financing savings (see costs avoided) with no bond insurance required - likely not possible in the near term for DWSD as a department and / or as a separate authority.

  - Detroit infrastructure needs - estimated Detroit water loss of 150 million gallons / day (28% of all water produced by the DWSD), with billed usage of 75 MGD – half of the water lost. Old infrastructure (pipes, water mains, etc.) requiring replacement would cost billions. Has yet to be properly quantified.

  - Loss of Detroit's population, businesses and other issues continues to result in constantly smaller water usage. In past 10 years, the billed water usage for Detroit has dropped in half. With a largely fixed-cost operation (operations / debt service) and the basis for rates being water / sewer flow, the continued flow loss is going to contribute to higher future rates for Detroit residents – are they even collectible?

CRITICAL FINANCIAL ISSUES

- Operating losses for the 7-year period ended June 30, 2013: **$1.5 BILLION ($150 million in FY-2013) –** two of the largest components of which are:

  - $514 million in likely bonded projects (cost of which is in the water and sewer rates), launched and vendors paid, and then, abandoned. NO benefit received from abandonments.

  - $547 million in swap termination losses (buy-out of risky financial transactions / agreements that went sour) in 2012. NO benefit received.

- Ending equity of water and sewer operations combined ('net worth') of DWSD at June 30, 2013 – **just $20 MILLION (9 months ago), down from $1.52 BILLION as of June 30, 2006.**

- The accumulated unrestricted deficit of the combined water and sewer operations as of June 30, 2012 was $1.1 billion (FY-2013 balances not yet available); 3.3 times the City's General Fund accumulated deficit that is causing a Chapter 9 bankruptcy. The State's Department of Treasury has never required a deficit elimination plan to be produced for the water and sewer operations.

CRITICAL FINANCIAL ISSUES

- DWSD expects to reduce 700 employees through 2022 through attrition. Said differently, DWSD is currently carrying 700 employees that will not be needed in a more efficient operation (gross cost to carry these employees is estimated at $170 million through 2022 and is currently included in the water and sewer rates).

- Annual rate of return provided to Detroit customers - $29 million:

  - Amount to be paid in 2014 by wholesale (suburban) customers to Detroit retail customers for the risks and rewards of the City's DWSD ownership.

  - Rate of return has been incorporated into the rate calculations for decades. Amounts would be over and above the City's proposed lease payment.

TERMS AND CONDITIONS

- Spent October 2013 to late January 2014 trying to nail down 'terms and conditions': non-financial lease terms (governance; responsibilities for operations; funding; etc.).

- Governance – two representatives from each of the three counties; two from City and one appointed by governor. Affirmative voting for major issues (e.g. would require a single 'yes' vote from each of the four entities for major action to be approved).

- As proposed by the EM the new authority would have to fund capital needs of wholesale and retail (Detroit) regardless of whether any retail / wholesale customer could pay (e.g. part of the 'back-stopping' issue). Funding the capital needs would become an authority issue regardless of source of funds.

TERMS AND CONDITIONS (Cont.)

- Term – 40-plus years (perpetual unless there is no long-term debt at end of 40 years); there would be no exiting the agreement even if one party breaches. **Due diligence becomes critical!**

- Despite Oakland County having provided input for months, at the end of January 2014, there remained over 30 critical issues involving the terms and conditions that had not been addressed at all or had been rejected by the EM representatives. The County's questions, comments and issues still remain unaddressed at this time.

- The terms and conditions efforts were largely abandoned in late January 2014 after a two-week concerted push to resolve them in mid-January.

RECENT DISCUSSIONS - $47 MILLION

- Annual lease payment of $47 million is EM's recent proposal. EM considers $47M to be the minimum necessary for City bankruptcy resolutions and is a ***floor*** (meaning other presently undefined circumstances could result in a higher amount to be paid).

- The $47 million is supposedly comprised of the *cost avoidance* of the pension certificates of participation (debt) payments and retirees' healthcare payments (total - $36 million over the next 10 years or so); yet the lease payment is $47 million ('revenue neutrality' is no longer on the table).

- In addition to the $47 million, the new authority would be expected to assume the $1.0 billion in unfunded pension obligations (caused in large part due to the guaranteed interest rate matter).

- Numerous other problems with the underlying assumptions as well – repairing these problems were rejected by the EM.

RECENT DISCUSSIONS - $47 MILLION (Cont.)

- In early March 2014, the EM representatives would only agree to permit 'confirmatory' due diligence: only the underlying assumptions of the calculation of the $47 million lease payment was to be considered as well as demonstrating that the assumptions used could result in a sustainable system.

- City / State would not fund professional costs unless the Counties agreed in advance to 'good faith' efforts to the creation of an authority even given the egregious issues proffered by the EM representatives from inception through March 2014. Hardly bargaining in 'good faith.'

- EM: 'During the coming due diligence we **will** be giving the Counties everything that is **available**.' Why now when they haven't for past 10 months and if little or no efforts were expended to accumulated known needed materials, of course they won't be available.

- Three counties choose to reject the 'confirmatory' due diligence efforts.

DWSD AS A DEPARTMENT

- The Disclosure Statement / Plan of Adjustment prepared by the EM intends on penalizing the wholesale customers if no authority is formed:
  - 'Affordability program' – the City would initiate a program that lowers the water and sewer rates for Detroit residents / businesses to be funded by the suburban customers in addition to the above business issues imposed on wholesale customers and the $29 million rate of return adjustment.
  - Pension contribution increase - $675 million over 10 years (rather than the normal 30 years). Present pension payment is approximately $15 million, for an annual increase in pension costs of $52.5 million. The additional pension cost would result in an estimated 6.2% increase in the rates alone.

DWSD AS A DEPARTMENT (Cont.)

- The $675 million acceleration of DWSD pension payments would allow the City to *avoid the City General Fund pension payments* and the 'savings' from DWSD pension acceleration would be diverted into City capital needs (police / fire cars; technology; etc.) – even as the DWSD has *significant* capital needs as well.

- The Disclosure Statement has implied that the City would impose a 'payment in lieu of taxes' amount which could be a lease payment (e.g. perhaps $47 million by any other name.

- DWSD could continues to operate as a City department with many of the problems being pushed into the coming years. Whether the City would choose to restructure operations (reduce the 700 employee positions) is presently unknown. The bond ratings, however, would likely continue to be a problem.

RECENTLY – ISSUANCE OF RFI

- Recently, EM issued a request for information (RFI) from various potential water / sewer vendors. To be considered for the request for proposal phase, companies must respond to the RFI no later than April 7, 2014. The EM's review team on the RFI proposals would 'short-list' vendors that could formally propose. A *binding* request for proposal would be due no later than June 1, 2014.

- Proposal should consider either an outright sale of DWSD to a private entity, lease or a vendor operating the water and sewer system. Significant financial and statutory barriers exist in the sale of DWSD to a private entity.

- Private entity would have to fund the $47 million in lease payments or equivalent.

- Private entity must either accept a nearly $1 billion unfunded pension liability or commit to funding the $675 million pension payment over 10 years.

RECENTLY – ISSUANCE OF RFI (Cont.)

- Interestingly, they have required that the new vendor cap the rate increases for 10-years at no greater than 4% (even as this rate has been insufficient to avoid the $1.5 billion in operating losses for the past 7 years).

- Doubtful that this cap in the RFI requirement is realistic given the DWSD financial status. Still need to resolve weak balance sheet accumulated over past 7 years, structural operating losses, finance capital needs and resolve City bankruptcy needs – either through rate increases and / or restructuring of operations.

- Private entity must commit to fund capital needs even as only the estimated needs for the first five years of a ten-year term are provided in the RFI.

- Under the Counties' consideration is the use of the Michigan Public Services Commission as a body used to set water and sewer rates should a private entity be selected to own or operate the DWSD.

OAKLAND'S ALTERNATIVE STUDY

- The Oakland County administration and Water Resources Commissioner are seeking the designation of $3.0 million (of which $500,000 would be immediately appropriated) from the Board of Commissioners for a study of alternative water and sewer services for Oakland residents and for bankruptcy attorneys to protect the County's rate-payers. Board committees have approved the request.

- Matters to be considered as part of the study – expansion of existing sewage treatment plants; collaboration with Macomb and Genesee Counties for water services; and such other approaches that would serve to minimize reliance on the DWSD for water and sewer services.

- No short-term solutions are presently possible given infrastructure needs for transmission of water and sewage flow.

SUMMARY

- The County Executive and Water Resource Commissioner believe that a properly managed and operated regional authority would be the best solution for economic development, job retention and attraction, and the general health of the County's residents and businesses.

- The EM's "revenue neutral" plan is based on the notion that a new lease payment can be funded within existing rate charges because of the 'savings' realized by better management under an authority.

SUMMARY (Cont.)

- The better management 'savings' arises from the end of corruption, the right-sizing of the admittedly bloated labor force, the use of modern best operating practices, and from potential interest savings on bonds after Wall Street sees the improvements.
- The flaw is this: if the 'savings' are required to be returned to the City as a lease payment, isn't the EM simply institutionalizing, for the next 40+ years, the unjust cost (tax of sorts) of the criminal and programmatic victimization of the DWSD rate-payers?
- The EM's plan calls on the rate-payers to continue to pay the cost of mismanagement and corruption, but this time it is called a lease payment. How is that just?

SUMMARY (Cont.)

County Executive Patterson said it best:

‘No deal is better than a bad deal.’

Q&A - Thank you

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OAKLAND COUNTY MICHIGAN