

# *Memorandum*

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TO: Mayor and City Council

FROM: Grayson Path, City Manager  
Doug Harris, Director of Utilities  
Gene Anderson, Finance Director

SUBJECT: Wastewater Treatment Plant Renovation Project  
Long Term Financing  
Wastewater Utility Rate Adjustment

DATE: January 25, 2021

## **BACKGROUND:**

For several years, the City has been working towards constructing a new Waste Water Treatment Plant (WWTP). The existing WWTP has exceeded its life expectancy and is in desperate need of replacement. The new plant will be a combination of new construction while utilizing portions of the existing plant in order to manage costs.

At the June 10, 2019 City Council Meeting, the City Council approved a Professional Engineering Services Agreement with Garver to conduct preliminary and conceptual work towards this project. That work was substantially completed by the Summer of 2020, which led to a presentation to the City Council regarding next steps.

At the July 27, 2020 City Council Meeting, the City Council heard a comprehensive presentation by Garver and City Staff of the condition and problems of the existing WWTP, the expected consequences we will see if the WWTP is not replaced (operational and TCEQ regulatory), as well as a solution to address this issue. Leading up to this meeting, tours were given to City Council Members to assist in seeing and understanding the condition of the facility and the work that must occur to keep the facility in operation. The City Council then approved Amendment #1 to the Professional Engineering Services Agreement with Garver to proceed with Phase II of design, authorizing the City Manager to sign the Agreement once a plan of action for long term financing was established.

At the time of the July 27<sup>th</sup> City Council meeting, the City was pursuing a low interest loan with the Texas Water Development Board (TWDB). The goal was for this low interest loan to be secured and then the City Manager could sign the Agreement Amendment with Garver to proceed with design. The concern was making sure the City could cash flow the expenses associated with designing the WWTP Project in preparation for bid. The backup option was to pursue traditional long term financing via Certificates of Obligation (COs). Both of these options were favorable given the very low interest rates we were seeing.

#### **STATUS OF ISSUE:**

TDWB: The TWDB continues to experience long delays with their process, which they state is due in combination because of CoVid-19, having received a large number of requests, and concerns about their ability to meet future obligations. We finally received word in September that the City's WWTP scored 90<sup>th</sup> out of 99 projects. At the time, there still appeared to be more available funding than total request, so we were hopeful that a low interest loan was still available. Nevertheless, the process continued to be delayed as we attempted to work with the TWDB.

In late November, the TWDB came out with some drastic changes to their program. In short, timelines were extended well into 2021, the total available funding for all projects was slashed, the cap per project was dropped, and they stated their intention to no longer fund projects over multiple years. Given our ranking, the size of our project, and our needed timeline, every change they made fatally impacted our proposal. On top of this, while these months continued to pass by, the TWDB's interest rates continued to creep upwards, slowly eliminating the advantage of the loan over traditional bonding.

Next Steps: Throughout all of this time, City Staff worked very closely with representatives of Garver, SAMCO Capital (financial advisers), McCall, Parkhurst & Horton LLP (bond counsel), and NewGen Strategies & Solutions, LLC (rate consultants) to carefully examine all possible options we have. This group heavily vetted several options for phasing the WWTP, phasing CO options, possibly pursuing TWDB loans as part of future phases, and phasing in rate increases. At the conclusion of this, we have developed a new plan of action to present to the City Council tonight. This is not an action item as there are no actions to be taken, but rather if the City Council is agreeable with this plan, City Staff will bring back to the Council several action items at the February 8, 2021 City Council meeting.

With every option the City Staff examined, we kept two focuses in mind: 1) Completing the WWTP Renovation Project and 2) Financial impact to the rate payers. Significant rate increases cannot be avoided as part of this project. Garver was tasked with finding alternative funding options, but none have turned up, particularly given the size and scope

of our project. It cannot be understated that the City's ultimate scoring on the TWDB list is a reflection of our need and ability to pay for a project vs. our competition in the State.

Certificates of Obligation (COs): First, given the TWDB Loan is no longer an option at this time, we worked on alternative long term financing, that being Certificates of Obligation (COs) (i.e. bonding). The market has remained favorable in recent months. We learned that IRS regulations for tax-exempt debt limit the amount of COs we can issue to a certain amount that can reasonably be spent within three years. In short, the City must have 5% spent within the first six months and 85% spent within the first three years, otherwise IRS penalties could be incurred. Our project is expected to last 5-7 years. Working with Garver, we have estimated an ability to issue \$46 million as part of a Phase I in bonding, followed by approximately \$18 million as part of a Phase II in bonding. Please remember that these are all still engineering estimates. But in order to take advantage of good rates now and to insure that this project can move from design to construction fluidly, issuing COs for Phase I of construction is recommended. When bids are received, there may be a need to "true up" the bond via a much smaller bond, but that will be addressed at that time. Other options were considered that included only bonding out for the engineering portion at this time, but we run the risk of seeing interest rates go up by the time our significant share of bonding is issued. Likewise, there may still yet be future hope for a TWDB low interest loan in a couple of years when we are ready to pursue the \$18 million share, but that option does not appear likely by the time we are ready for Phase I of construction. By splitting the CO up in to two issues as required by IRS regulations, it has the natural impact of helping to soften the needed rate adjustments over time.

Garver Agreement Amendment: Second, proceeding from the same regulations that impacts our bonding ability, the City can only bid out a portion of the project equivalent to the CO notes we can issue. In other words, Garver cannot bid out the entire project when we only have financing secured for \$46 million of it. Therefore, Garver has developed a strategy that led to the \$46 million / \$18 million divide that will allow us a reasonable transition to proceed through the project, continue to operate, and get us ready for a second phase in bidding. More information will be provided by Garver tonight on how this preliminarily will look. This will though require an amendment to the Professional Engineering Services Agreement that the City Council tentatively authorized on July 27<sup>th</sup> (which has not been signed pursuant to the Council's instructions to secure long term financing first). We intend to bring that to the City Council on February 8<sup>th</sup>. The amendment will be to split the project in two in order to effectively bid out a Phase I and then later a Phase II. It is critical to know though that we will need both Phase I and Phase II to have a completed project.

Debt Payments: Third, with any CO, there are options for easing in to debt payments to help soften the increase in cost – i.e. rate adjustments. Working with SAMCO Capital, they have

developed a strategy to shift the highest proportion of principal payments to later in the bond amortization schedule, thus our first few payments are more interest and less principal, making them more affordable to help us as we move towards increasing our rates. Looking at the estimated scenarios, the two options are only a few million in grand total expense over the life of the COs from one another. And given the size of these COs, both just over \$100 million (principal and interest), this is a very minor increase spread out over nearly 30 years. The result being we have the softest transition possible in to the rate adjustments while still getting this project done.

Adjustment of Rates: Fourth, the most important factor we have worked on is the needed rate increase to cover this expense. The debt will be issued in the form of COs, thus they are backed by the good faith credit of the City, i.e. our ability to raise Property Tax if ever needed, but we will be paying for these using the Waste Water Utility Rates. To begin, the City has a Rate Maintenance Policy that, in short, is designed to maintain a healthy and stable utility for the citizens. Deviation from this policy runs the risk of affecting our credit score, ability to take out debt from creditors, and ultimately our ability to operate and provide this much needed service to the community. We therefore attempt to design our rates to be 1.1:1 revenue to expense. What this means is for every \$1.00 of expense, we set the rate to – in theory – raise \$1.10 because we know utility revenues are very volatile (they depend on usage which is impacted by the economy, number of customers, failures in the lines resulting in water loss, wet/dry seasons, and ultimately whether people pay their bills or not). To have a 1:1 revenue to expense means we are setting the rate to hopefully break even. Anything less than a 1:1 is to knowingly deplete any reserves we have. While we set the rates at 1.1:1, there is always the possibility that we will end up needing to use some of the reserve based on the unknowns described above. And while it is okay and normal to use the reserves once in a while, to knowingly deplete the reserves year after year will have dire consequences long term. Working with our rate consultant, keeping in mind the Rate Maintenance Policy, but also recognizing the need to soften the impact to the rate payers, we have developed three options for the Council to consider tonight and provide direction on what to be brought back in February. These options are all designed to get us ultimately to the 1.1:1 ratio; but over the next 5 years, in order to help soften the impact, maintain at a minimum a 1:1 ratio. The only way to maintain 1.1:1 upfront is to drastically increase the rates now. That is certainly an option, but we wanted to provide the City Council with some options that get us to 1.1:1 long term, but set the rates to at least maintain 1:1 over the next several years, knowing that due to the volatility of rate payments, we might dip below 1:1 from time to time, thus using our reserves, but ultimately getting to the 1.1:1 in time. Please understand that adjustments in time to the proposed rates may have to take place because ultimately the cost of the project will depend on the bids that we receive and the interest rates determined when the COs are sold in the market. In addition, the City must continue to operate which might positively or negatively impact rates from time to time. City Staff though will do everything possible to

manage operations to stay as tight as we have been in Waste Water Treatment these past years. The following table shows the three rate options:

	Two Increase Option	Three Increase Option	Semi-Annual Increase Option
Date of Increase	%	%	%
Apr-21	33.5%	23.0%	8.5%
Oct-21	0.0%	0.0%	8.5%
Apr-22	0.0%	0.0%	8.5%
Oct-22	0.0%	18.0%	3.75%
Apr-23	0.0%	0.0%	3.75%
Oct-23	23.0%	0.0%	3.75%
Apr-24	0.0%	0.0%	3.75%
Oct-24	0.0%	13.5%	4.25%
Apr-25	0.0%	0.0%	4.25%
Oct-25	0.0%	0.0%	4.25%
Apr-26	0.0%	0.0%	4.25%

Option #1 is a Two Rate Increase; this provides the most stability for the WWTP operations and paying back our debt with Waste Water Utility revenues. Option #2 is a Three Rate Increase; while not offering as much stability for the WWTP operations, it helps soften the increases over time. Option #3 is a semi-annual increase; this provides the least stability of the three options for the WWTP operations, but it is our best route of phasing in the increases over time, allowing rate payers to acclimate over the course of six years. Please remember that all three options are set to try and maintain a minimum of 1:1. Option #1 gets us to 1.1:1 faster and Option #3 takes longer to get to this point. And again, please remember that the above is based on engineering estimates for needed bonding. So some adjustments might need to take place over time. And the totals at the bottom of each column are not exact with one another because of the round figures needed and how each scenario uniquely impacts the overall operation. With this said, we are looking at an approximate 65-75% total rate increase for the needed COs.

The following table shows the monthly increase a residential user might see in their bills.

Monthly Increase	Two Increase Option			Three Increase Option			Semi-Annual Increase Option		
Date of Increase	2,000	5,000	8,000	2,000	5,000	8,000	2,000	5,000	8,000
Apr-21	\$ 6.24	\$ 15.50	\$ 30.93	\$ 4.29	\$ 10.66	\$ 21.28	\$ 1.59	\$ 3.95	\$ 7.89
Oct-21	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1.72	\$ 4.29	\$ 8.56
Apr-22	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1.86	\$ 4.63	\$ 9.24
Oct-22	\$ -	\$ -	\$ -	\$ 4.13	\$ 10.26	\$ 20.48	\$ 0.89	\$ 2.21	\$ 4.42
Apr-23	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 0.93	\$ 2.29	\$ 4.56
Oct-23	\$ 5.72	\$ 14.22	\$ 28.38	\$ -	\$ -	\$ -	\$ 0.96	\$ 2.40	\$ 4.81
Apr-24	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1.00	\$ 2.48	\$ 4.95
Oct-24	\$ -	\$ -	\$ -	\$ 3.64	\$ 9.06	\$ 18.08	\$ 1.17	\$ 2.89	\$ 5.76
Apr-25	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1.22	\$ 3.03	\$ 6.03
Oct-25	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1.27	\$ 3.16	\$ 6.30
Apr-26	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1.33	\$ 3.29	\$ 6.57
	\$ 11.96	\$ 29.72	\$ 59.31	\$ 12.06	\$ 29.98	\$ 59.84	\$ 13.94	\$ 34.62	\$ 69.09

Conclusion: The City Staff, working closely with our experts in engineering, financing, bonding and rates, have developed our best recommendations for proceeding with long term financing of the WWTP Project. This is a critical project that needs to be addressed immediately. The TWDB is unfortunately no longer an option at this time, although it might be in a few years. CO rates have been quite favorable in recent months, thus we recommend pursuing bonding in two phases, adjusting the payment schedule to soften the first few payments, adjust the Garver Professional Engineering Services Agreement to account for dividing the project up in to Phase I and Phase II, and one of the three rate adjustment options – while we would recommend the option that provides the most security to the operation, we are comfortable with the option that acclimates the increases over a much softer and extended time.

**BUDGET:**

Please see the Status of Issue section above. There are no immediate budget items at this time.

**OPTIONS:**

Tonight is not an action item, but rather the City Staff are seeking direction on what to do next. If the City Council is favorable with the Conclusion described above, then City Staff will proceed with developing appropriate CO documents, amendment to the Garver Agreement, and rate ordinance. Otherwise, if the City Council wishes to have more information, we will continue to work hard to bring you whatever information you need.

**RECOMMENDATION:**

It is City Staff’s recommendation that direction be given to develop:

1. Certificate of Obligation documents in line with a Phase I of \$46 million, to start this timeline at the February 8, 2021 City Council meeting.
2. Amendment to the proposed Professional Engineering Services Agreement with Garver to split the WWTP Project in to Phase I and Phase II to match the CO, to be brought back at the February 8, 2021 City Council meeting.
3. Rate Ordinance to match one of the three options the council indicates tonight, to be brought back for consideration and approval at the February 8, 2021 City Council meeting.