M-S-R Public Power Agency

SPECIAL MEETING
OF THE FINANCIAL MANAGEMENT COMMITTEE

Wednesday, February 17, 2016 3:30 PM

TELEPHONIC MEETING LOCATIONS:

Modesto Irrigation District
1231 Eleventh Street
Modesto, CA 95354

City of Santa Clara – Electric Department
1500 Warburton Avenue
Santa Clara, CA 95050

City of Redding – Electric Utility
777 Cypress Street
Redding, CA 96001

Dial-in: 877-402-9757
Access Code: 3325500

AGENDA

Any member of the public who desires to address the Committee on any item considered by the Committee at this meeting before or during the Committee's consideration of that item shall so advise the Chair and shall thereupon be given an opportunity to do so.

1. Call to Order
2. Roll Call
3. ***Roundtable Discussion and Possible Action Regarding Recommendations for Use of SWTP Sales Proceeds*** (attached, Martin Hopper)
4. Public Comment
5. ***Confirm date and time of next meeting***
6. Adjourn

ALTERNATE FORMATS OF THIS AGENDA WILL BE MADE AVAILABLE UPON REQUEST TO QUALIFIED INDIVIDUALS WITH DISABILITIES.

M-S-R Public Power Agency
Staff Report

Date: February 16, 2016

From: Martin R. Hopper, General Manager

To: M-S-R PPA Commission

Subject: Roundtable Discussion Regarding Recommendations for Use of SWTP Sales Proceeds

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The Agency's proposed sale of Southwest Transmission Project assets to the Southern California Power Authority is now expected to close late in the second quarter of 2016. The General Manager has been working with the Agency's Financial Advisor and Bond Counsel to develop parameters for the use of such sales proceeds in conformance with the Agency's Bond Indentures and Tax Law. An updated copy of my prior memo which eliminated prior redlines and the first draft of the Financial Advisor's report is attached. This Committee will be charged with developing recommendations to the M-S-R PPA Commission for the highest and best use of such proceeds as may best serve the individual needs of each Member.

CONFIDENTIAL DRAFT

M-S-R Public Power Agency
Staff Report

Date: February 16, 2016

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From: Martin R. Hopper, General Manager

To: M-S-R PPA Commission

Subject: Possible Uses For SWTP Sales Proceeds

The sale of the SWTP assets to LADWP/SCPPA will result in cash proceeds to the Agency of $60 million. Closing of the transaction is expected to occur in the second quarter of 2016. At the time of closing the outstanding balance of the Series 2011 O Bonds (which are the only bonds with an explicit tie to the SWTP) will be about $12 million with a final maturity of July 1, 2018.

Bond Counsel has advised that if LADWP/SCPPA uses Tax-Exempt Financing for its SWTP purchase, the customary assurances required for that issue would suffice to document M-S-R's bonds will not incur private use and will not need to be remediated from the sales proceeds. If LADWP/SCPPA issues taxable debt or a mixture of taxable and tax-exempt debt, because less than three-years of outstanding bonds will remain, Bond Counsel indicates M-S-R will likely be able to demonstrate compliance with a spot-sale or other short-term safe-harbor and again, Bond Remediation may not be required. However, a specific review or determination will need to be made by Bond Counsel.

If remediation of the remaining Series 2011 O Bonds is required or desired by the Agency, Bond Counsel has advised that as no calls are available on the Bonds, the Agency could remediate through the use of a defeasance escrow. The Agency's Financial Advisor estimated that if a defeasance escrow had been established on or before January 1, 2016 (I.e. after the originally expected Closing) and the January 1, 2016, scheduled Debt Service payment is made from funds

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previously deposited with the Trustee, the required deposit into the defeasance escrow would be $12.8 million with assumed earnings at 0.67%. At the time the defeasance escrow is fully funded, the balance of $1.5 million in the Series 2011 O Bond Reserve Fund could be released to the Agency, reflecting a net cost to remediate bonds of $11.3 million. It should also be noted that the balance of the July through December 2015 debt service payments of $1.8 million (6 payments of $0.34 million less the January 1, 2016 interest payment of $0.28 million) could also be used to fund the escrow, leading to a net net cost of $9.5 million. [Needs update for Q2 2016 closing]

Dependent on whether the Agency is required or chooses to remediate the Series 2011 O Bonds, the Agency will have between $50 million and $60 million cash available for beneficial use, provided it makes findings that such funds are surplus to the needs of the San Juan Project (which as a whole includes the SWTP as defined in the Indenture.)

The Financial Management Committee has identified the following possible uses for the available funds:

1. Pre-fund San Juan Mine Reclamation Trust Fund
2. Pre-Fund San Juan Decommissioning Trust Fund
3. Voluntarily redeem 2011 O Bonds if redemption not mandatory
4. Defease or redeem additional San Juan Debt (Not high priority)
    a. Redeem highest cost debt
    b. Rate stabilization – avoid “hockey-stick”
    c. 2008 L Bonds callable in 2018, but are not advance refundable
5. Create debt service coverage revolving fund
    a. May be preferable to fund from Big Horn I Escrows
6. Rebate to members
    a. Part of equation but no amount defined yet
    b. Not before SJGS Restructuring Closes

7. Prepay Big Horn I Wind Energy
    a. Must not endanger Bucket 0 Status
8. Prepay Big Horn II Wind Energy
    a. Must not endanger Bucket 0 Status
9. Buy Big Horn I Assets (Maybe – Consider further analysis)
    a. Must not endanger Bucket 0 Status
10. Buy Big Horn II Assets(Maybe – Consider further analysis)
    a. Must not endanger Bucket 0 Status
11. Purchase/Construct NGCC generation
    a. LEC II
    b. LIbertad
12. New natural gas prepay (Set aside until M-S-R EA Series 2009 C IRS Audit complete)

The Financial Management Committee recommends the Commission prioritize closer examination of the following alternatives:

Purpose of Memo

The purpose of this memo is to summarize Montague DeRose and Associates' ("MDA") preliminary analysis of certain potential uses of the proceeds generated by the sale by the M-S-R Public Power Agency (the "Agency") of the Southwest Transmission Assets (the "Transmission Assets") to the Los Angeles Department of Water and Power ("LADWP" and the "Sale Proceeds").

Background

The Agency expects to receive approximately $60 million from LADWP pursuant to the sale of the Transmission Assets in mid calendar year 2016. MDA understands that the proceeds will be treated as Revenues under the Indenture of Trust dated June 1, 1994 (the "Indenture") and that, absent unexpected costs or expenses, the full amount will ultimately be deposited in the Surplus Fund and may be used and withdrawn by the Agency for "any lawful purpose related to the Improvements or the production of Revenues." Further, MDA understands that pursuant to the sale agreement, LADWP will represent and covenant (a) that it will not sell the Transmission Assets to any private entity and (b) it will not utilize the Transmission Assets in a manner that will constitute "private use" under relevant Federal tax laws. Last, MDA understands that prior to applying the sale proceeds to any specific use, the Agency will need to determine that such use is a "lawful purpose related to the Improvements or the production of Revenues." Given that the Transmission Assets will not be put to "private use" and that there are certain applicable potential safe harbor provisions, it is MDA's understanding that a portion of the Sale Proceeds does not need to be used to retire the outstanding $11,970,000 2011O Senior Lien Bonds associated with the Transmission Assets.

Options for Use of the Sale Proceeds

MDA has preliminarily identified five general uses to which the Sale Proceeds could be applied. It has also estimated internal rates of return ("IRRs"), or ranges of IRRs, that each of these uses could generate. The uses and their associated IRRs are summarized in the table below. The estimated IRRs are calculated based on either the return on invested cash or on the debt cost avoided through the use of cash and are highly dependent on certain assumptions that are discussed in the sections below. In addition, each section briefly identifies qualitative considerations associated with each option.

Use of Proceeds	Estimated IRR	Term	Comment
Long-term investment	2.15% - 2.65%	20 – 30 years	Current long-term UST yield used as proxy for potential long-term investment rate
Transfer to Ratepayers	9.00%	Perpetual	IRR used by CPUC in 2009 direct access proceedings (estimated average credit card borrowing rate)
Defease/Retire Bonds	0.56% - 2.57%	0 – 6 years	Results vary depending on bond series and other assumptions. Economic savings only available if bonds can be called prior to maturity.
Unwind Swaps	0.80% - 0.99%	4-6 years	Assumes future Libor rates match current market expectations. Lower-than-expected rates would increase IRR; higher-than-expected rates would decrease IRR.
Use for Capital Expenditures	3.50% - 5.00%	20 – 30 years	Expected range of avoided borrowing cost over next 1 – 3 years
Fund Plant Reserve or Mine Reclamation Fund	1.00% - 2.00%	5- 10 years	Current 5yr to 10yr UST yield used as proxy for potential short-to-medium term investment rate

It is important to note that since the Sale Proceeds are in effect an "exogenous" source of funds, the Agency can invest and reinvest the funds in perpetuity if reductions in costs attributable to the use of the Sale Proceeds are not passed on to ratepayers through rate reductions. For example, if the Sale Proceeds were initially used to defease debt, the Agency would accumulate cash in future years because it would not have to fund those debt service payments from revenue and the accumulated cash could be applied to new purposes. Alternatively, if rates are lowered to reflect such cost reductions, such a reduction in rates would effectively permanently transfer the Sale Proceeds to consumers.

Option 1 – Long-term Investment of the Sale Proceeds

The Agency could retain and invest the Sale Proceeds over the long term (e.g., 20 – 30 years). For the purposes of this memo, MDA assumes the Agency would invest in U.S. Treasury or Federal agency securities. The Indenture does not restrict the amount or term of Agency investments in such securities. For the estimated IRR, MDA assumes that the Agency would earn the current 20- to 30-year U.S. Treasury yield of approximately 2.15% to 2.65%. Of course, this assumption would change based on the Agency's actual expected investment strategy. If the Agency wishes to explore this option in greater depth, MDA can analyze a wider range of investment options and perform Monte Carlo analyses to provide a more complete framework for decision-making.

Qualitative aspects associated with this option that the Agency may wish to consider include:

- Significantly enhanced liquidity may have a positive impact on credit ratings and credit perceptions
- The Agency should consider how the choice between shorter-term and longer-term investment could impact its net interest rate risk profile
- Earnings would reduce revenues required from other sources (e.g., the Power Purchase Agreements ("PPAs") between the Agency and its members).
- Maintaining significant, long-term investment balances may not be feasible if it creates pressure for rate reductions or to use the funds to meet capital funding needs.

Option 2 – Transfer Sale Proceeds to Rate Payers

The Agency, in concert with its Members, could effectively transfer the sale proceeds to the Members' rate payers, via rate reductions or rebates. Although it is impossible to precisely determine the IRR earned by ratepayers from reduced electricity costs, the California Public Utilities Commission (the "CPUC") considers a consumer discount rate that theoretically reflects customers' marginal borrowing costs and investment opportunities when evaluating returning funds to rate payers either through reduced electric rates or rebates. However, it is difficult to determine which rates to use, for which groups of consumers, and under what circumstances. Typically the cost benefit analysis uses a consumer discount rate that ranges from mortgage rates to credit card rates. Typically, reduced electricity rates are viewed as producing a benefit for consumers in excess of the long-term borrowing rate of a utility. For this reason, the California regulators – when excess cash is available – reduce customer rates rather than repaying debt. In the direct access proceeding in 2009, the avoided consumer debt cost used was 9 percent, which was roughly determined to be the average credit card interest rate for ratepayers in California. For the purposes of this memo, MDA has used this 9 percent estimate as the IRR of using the Sale Proceeds to reduce consumer electricity rates via rate reductions or rebates. Note that a transfer of funds from the Agency to rate payers enables consumers to permanently reduce borrowings or increase investments. Of course, the rates associated with the borrowings or investments can change over time.

Additional investigation is required to determine exactly how a rate reduction or rebate strategy could be implemented, but it should be feasible. For example, the Agency could credit the Sale Proceeds against payments owed by the Members under their respective PPAs. In turn, the Members would be able to reduce the rates charged to their consumers.

Qualitative aspects associated with this option that the Agency may wish to consider include:

- This option may enable the Members to provide some direct, visible economic benefit to their ratepayers
- The Agency would need to carefully communicate the strategy to the rating agencies and demonstrate that the funds are not needed to sustain strong security for bondholders

Option 3 – Use Sale Proceeds to Fund Capital Expenditures

The Sale Proceeds could be used to fund capital expenditures over the next several years, providing a natural hedge for future borrowing costs. This would reduce the need to use internally generated cash flow or to issue debt to pay for capital needs. To the extent that using Sale Proceeds for this purpose would replace internally generated cash, it may allow for rate reductions or rebates as described under Option 2, above. In this case, the IRR would be 9 percent. If used to replace debt funding, the IRR would be the avoided cost of debt, assuming rates are not subsequently reduced to reflect the reduced debt burden. Although the exact avoided cost of debt is unknown, it is reasonable to expect that the Agency's cost of 20 – 30 year fixed rate debt over the next 1 to 3 years would be within the range of 3.50% to 5.00%. One specific potential use of funds would be to finance the purchase of Big Horn 1 from Iberdrola. MDA does not have enough specific information about Iberdrola's cost of capital and monetization of tax and productions credits to assess the IRR potential of this option,

Qualitative aspects associated with this option that the Agency may wish to consider include:

- Funding capital needs with accumulated cash is a common capital planning strategy and would likely be acceptable to the rating agencies, as well as other stakeholders
- Using the Sale Proceeds to fund capital expenditures would reduce future debt service costs, potentially reducing rate pressures
- If rates are not reduced, lower-than-expected future debt service may enable the Agency to accumulate additional cash over time

Option 4 – Use Sale Proceeds to Defease or Retire Outstanding Debt

The Agency could use the Sale Proceeds to defease or retire outstanding debt. The table below summarizes the IRRs that can be achieved under current market conditions by defeasing or retiring the various bond series as well as the estimated debt service reserve funds that are available for release:

Bond Series	Estimated IRR	Term	Estimated DSRF Available
2008L (no current refunding)	2.57%	0 - 6 years	6,468,990
2008L (current refunding in 2018 at today's rates)	1.09%	0 - 6 years	6,468,990

2008M	1.13%	4 – 6 years	3,080,000
2008N	1.41%	4 years	1,116,390
2011O (Non-callable)	0.66%	0 - 2 years	1,505,020
2014Q (Non-callable)	0.56%	0 – 2 years	N/A

Currently, the Agency could achieve economic savings by defeasing the Series 2008L Bonds which are callable in 2018. If used for this purpose, the IRR can be calculated based on the amount of Sale Proceeds required to defease the debt (i.e., the escrow deposit) and either (a) avoiding the existing 2008L debt service through maturity or (b) avoiding the existing 2008L debt service through the call date and avoiding potentially lower current refunding bond debt service after the call date, if market conditions permit an economic current refunding of the 2008L Bonds in 2018. Note that the 2008L Bonds are not advance refundable. Under these two scenarios, the IRR's range from about 1.04% (assuming a current refunding is executed in 2018 at rates approximately equal to today's rates) to 2.22% (assuming the 2008L Bonds cannot be economically current refunded in 2018).

Defeasing the 2011O or 2014Q Bonds would not generate any economic savings because those bonds are not callable prior to their final maturities and therefore no debt service can actually be eliminated. The IRR achieved by defeasing these bonds is simply the yield on the escrows established to defease the bonds. Under current market conditions, these yields are about 0.56% (2014Q) and 0.66% (2011O).

The Agency could also consider using the Sale Proceeds to retire some portion of the Series 2008M and/or 2008N Bonds and terminate a proportional amount of the related swaps. Under current market conditions, $60 million of Sale Proceeds would enable the Agency to retire up to about $49.8 million of the 2008M Bonds and terminate an equal notional amount of the related swap. Alternatively, the Agency could retire all of the 2008N Bonds plus about $32.6 million of the 2008M Bonds and terminate matching notional amounts of the swaps. The economic benefits of this strategy are limited, because although the swaps can be terminated, the Agency must pay the counterparties termination payments roughly equal to the present value of the difference between the existing fixed coupon on the swaps and the lower current market rates on equivalent swaps. In other words, the Agency cannot really benefit from the decline in market rates that has occurred since the swaps were first entered into. The IRRs generated by this strategy are about 1.13% (Series M) to 1.41% (Series N).

Note that we have not analyzed using the Sale Proceeds to defease or retire the 2009ABC Gas Bonds, given that those were issued under a separate Joint Powers Authority and that any such transaction would entail significant legal/structural complexities, including termination of the swap hedge.

Qualitative aspects associated with this option that the Agency may wish to consider include:

- Defeasing and/or retiring debt will improve reported financial ratios and reduce future debt service costs, potentially reducing rate pressures
- If rates are not reduced, lower-than-expected future debt service may enable the Agency to accumulate additional cash over time, especially in 2020 – 2022 when the principal would otherwise have been due
- Terminating a portion of the swaps and retiring the related variable rate bonds will reduce certain minor risks (e.g., swap counterparty risk) and the administrative burden of managing the synthetic fixed rate debt (e.g., renewing or replacing the direct purchase funding facilities).

- To retain greater flexibility, the Agency could earmark funds to retire the 2008L Bonds rather than depositing the funds in a legal defeasance escrow

Option 5 – Use Sale Proceeds to Fund Termination Payments and Terminate Swaps

The Agency could use up to approximately $16.5 million of the Sale Proceeds to terminate the swaps and leave the variable rate 2008M and 2008N Bonds outstanding. In this case, the ultimate economics are unknown and will depend on future floating rates through 2022. The table below shows the IRRs for different average levels of 70% Libor (2008M) and 100% of Libor (2008N).

	2008M		2008N	
Rate Scenario	**Avg 70% Lib**	**IRR**	**Avg 100% Lib**	**IRR**
"Low"	0.35%	4.41%	0.50%	4.07%
"Expected"	0.75%	0.99%	0.91%	0.80%
"High"	4.00%	-46.70%	5.00%	-49.40%

Qualitative aspects associated with this option that the Agency may wish to consider include:

- Terminating the swaps would create unhedged variable rate exposure (to the extent it does not have or retain short-term investments in sufficient amount to hedge that exposure)
- Paying "large" swap unwind payments may not be perceived favorably by certain stakeholders

Option 6 – Use Sale Proceeds to Fund Plant Reserve and/or Mine Reclamation Funds

The Agency could use all or a portion of the Sale Proceeds to meet its obligations to fund its Plant Reserve or Mine Reclamation Funds. In this case, the IRR would be the yield on the investments held in these funds, estimated at this time to be 1.00% to 1.75%, or the yield on 5-year to 10-year UST securities, or a standard 10-year Forward Delivery Agreement. These rough estimates can be refined once details of the relevant investment parameters are determined.