

Terre Haute Competes

September 27, 2017

Dear City of Terre Haute and Vigo County Residents:

Terre Haute Competes, a working group of public officials from the City of Terre Haute, public officials from Vigo County, and local business leaders from the private sector, are today issuing a recently completed report that analyzes the City of Terre Haute's Wastewater Utility, one of five areas of local government operations the group reviewed.

The Terre Haute Wastewater Utility manages the collection and treatment of wastewater both inside and outside of the City limits. The Utility is also responsible for implementing the Long Term Control Plan for Terre Haute, a federally mandated strategy designed to eliminate combined sewer overflows into local rivers and streams. Finally, the City of Terre Haute has a number of additional obligations under federal and state law related to managing local stormwater issues. In recent years, the Utility has also made a payment in lieu of taxes (a "PILOT") to the City of Terre Haute to help fund City operations.

Following a year of data gathering, research, meetings, and discussions with stakeholders, including community leaders, we have arrived at the following conclusions:

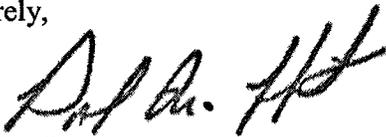
1. As the City's Wastewater Utility deals with modernizing its treatment facility, aging in ground infrastructure, a costly Long Term Control Plan and un-funded stormwater responsibilities, ratepayers have been tapped to pay the bill. At 16 percent rate increase in 2016 and a scheduled 5 percent increase next year will likely not be the end of the rate hikes required to deal with wastewater issues in Terre Haute.
2. Other communities across the United States and Indiana that were struggling with these same issues have used public private partnerships ("P3s") to mitigate rate hikes and reduce stormwater management costs. P3s can include operations and management (O&M) agreements, long-term concession-lease agreements, or asset sales.
3. The Wastewater Utility manages a significant community asset and is perceived by many as being well run; however, P3s are frequently more cost effective because large-scale private partners have operating advantages that even the most committed public manager cannot duplicate. Those advantages include massive economies of scale, robust research and development capabilities, abundant capital, long-term investment horizons, and access to advanced technology.
4. Struggling communities are increasingly soliciting competitive proposals from private operating partners to determine whether it is possible to mitigate future rate hikes while simultaneously improving services and enhancing environmental protections. The market for these transactions is robust and highly competitive.
5. Past experience demonstrates that these transactions can generate meaningful benefits for cities while also protecting incumbent staff. Staff protections include no layoff policies and contract guarantees for comparable wages, benefits, and union recognition.
6. Given the significant financial and operational challenges facing Terre Haute, the burden of raising user fees, and the strong likelihood that a P3 could generate meaningful value,

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we recommend that the City administration and the City Council solicit competitive P3 proposals from the marketplace to determine whether this strategy can help mitigate future rate hikes or otherwise benefit the City and the rate payers.

The full report is attached.

Sincerely,



Paul Thrift
Steering Committee Chair
Terre Haute Competes



O. Earl Elliott, CPA
Wastewater Utility Study Team Chair
Terre Haute Competes

Terre Haute Competes Project Recommendation Form

The purpose of this Project Recommendation Form is to summarize our research regarding a specific cost savings or service improvement project and to recommend next steps, if any.

1. Cost Savings or Service Improvement Project Name

Sewer System Optimization

2. Study Team Members

Leader

Earl Elliott

Other Team Members

Steve Witt, Andy Hendricks, Norm Lowery, Beth Tevlin, Dottie King, Mark Fuson, and Bryan Duncan

Project Support Leads

Skip Stitt and Nick Weber

3. Brief Description of the Project

Sewer rate payers in Terre Haute have seen meaningful rate hikes in recent years. These rate hikes were needed to address the City's aging sewer infrastructure, rebuild and expand its wastewater treatment facility, and comply with its federally mandated Combined Sewer Overflow (CSO) obligations embodied in the City's Long Term Control Plan (LTCP). More recently, the City has explored a stormwater fee to help pay for its LTCP. Unsurprisingly, many residents have expressed concern over the creation of a new fee to pay for the LTCP. The Terre Haute City Council instead recently adopted an increase to the sewer rate to fund the LTCP.¹ These concerns have been magnified as the City has recently implemented a new trash service fee and there continues to be discussion of a County Option Income Tax (COIT) to fund needed public safety infrastructure.

These challenges are not unique, especially for older cities facing deteriorating infrastructure, increasing costs, and federal environmental mandates. For example, the Scranton Sewer Authority (the Authority) in Scranton, Pennsylvania (city population of 76,000) adopted three sewer rate hikes of over 44% each since 2003 to fund the city's \$139M Long Term Control Plan. City financial advisors projected that the costs to fulfill the terms of the Consent Decree would require annual sewer rate hikes of 4.57 % per year for the next 28 years. Closer to home,

¹ To date, the City has not implemented a Stormwater fee.

Hammond, Indiana (city population of 80,830) has proposed an across-the-board rate hike of 49% for customers in Hammond and nearby Munster, where it provides service, to address long-delayed sewer maintenance issues. These rate hikes come on the heels of nearly \$500,000 in penalties related to alleged violations of the Clean Water Act.²

In order to control and mitigate future rate hikes and stormwater fees, many cities have turned to public private partnerships (P3s) to deliver water and wastewater services. P3s take many forms and, in the water and wastewater arena, they include operations and maintenance (O&M) contracts, concession-lease agreements, and asset sales. While each structure has advantages and disadvantages, our recent experience indicates that the asset sale model is highly effective at maximizing value, controlling user rates, protecting incumbent employees, preserving assets, transferring risk, and ensuring long-term environmental compliance.

4. Key Research Findings

Cities across the United States have implemented water and wastewater P3s for many years as a way to improve service, protect the environment, control costs, fund new infrastructure, and transfer risk. There are a number of regional, national, and global providers of water and wastewater services and the market is highly competitive, mature, and generally well-developed.

Over the last decade, U.S. cities and authorities have renewed over 2,500 competitively procured service contracts to deliver water and wastewater services. In fact, over 47 million Americans currently receive water service from a private provider, including in Terre Haute. Smaller, but still meaningful, numbers of residents are served by private sewer services, including nearby Indianapolis and several smaller local systems in Central Indiana.

While results vary from project to project, recent utility P3 transactions in Pennsylvania and Indiana indicate that there is the potential to create meaningful value through the P3 process.

In 2016, after a competitive solicitation, the Scranton Sewer Authority agreed to sell its sewer system to Pennsylvania American Water for \$195 million. The Authority used the transaction proceeds to pay off approximately \$75M in existing utility debt. In addition, the project committed approximately \$350 million to customer rate mitigation over the next 28 years, and provided the system's owners, the City of Scranton and the Borough of Dunmore, with net proceeds of about \$90 million to spend on other priorities. In that project, the acquirer hired all of the incumbent staff at comparable wages and benefits and negotiated a new, multi-year agreement with the employees' union.

Similarly, in 2012 the City of Westfield, Indiana, a 32,066 person community near Indianapolis, sold its water and wastewater assets to the Citizens Energy Group (Citizens), a local non-profit public charitable trust that serves as the regional gas utility. The \$91 million transaction allowed the City to pay off the utilities' \$45 million debt, reduce user rates from projected levels, and produce a \$46 million payment that the City invested in local infrastructure improvements. The acquirer retained the employees of Westfield Utilities and offered them new positions, which

² See http://www.nwtimes.com/news/local/lake/hammond/sewer-rate-hikes-for-hammond-munster-possible/article_0cdbc6d6-0612-551f-ba4e-74811d1a259d.html.

enhanced the overall efficiency and customer service provided by Citizens. Along with lower utility rates, ratepayers also benefitted from an additional revenue stream of about \$2 million per year in property taxes paid by Citizens.

Finally, on a smaller scale, a private partner has offered Lake Station, Indiana (city population of 12,572) approximately \$20.7 million for the municipality's water plant. This transaction is not complete, but we continue to monitor its progress.

5. Potential Concerns

There are a number of transactional barriers and concerns that can arise when cities explore utility-related public-private partnerships (P3s). These barriers and concerns can be addressed as part of a well-run P3 process. Barriers and concerns typically include:

- Potential job losses for existing utility employees – Private partners will view the city's existing employees as valuable assets that are needed to run the utility in the future. In addition, depending upon the utility's goals, transactions can require that private partners hire all of the incumbent employees at comparable wages and benefits.
- Unions – Private partners usually have workforces that are already unionized. In fact, private partners will likely have more union employees and more extensive union relationships than most of the cities they serve. In addition, transactions can require that private partners recognize existing unions and negotiate with them in good faith. In Scranton, the existing union, Teamsters Local 229, negotiated a new, multi-year contract with the private partner before the sale transaction closed.
- Rate increases – In an environment of rising costs (wages, healthcare, and pensions), aging infrastructure, consent decrees, and long-term control plan obligations, many utilities are already raising user rates. National experience suggests that because of political pressure to keep rates low, city fiscal bodies or boards are often reluctant to raise rates until it is absolutely unavoidable. This reluctance can result in the need for very significant increases to address delayed maintenance or capital projects. Therefore, as part of a P3 transaction, it is often difficult to reduce rates from existing levels. However, it is common for P3 transactions to include future rate mitigation for rate payers. That is, even if rates rise, they do so at a lower and slower level than they would have without the P3.

For a P3 to be viable in the first place, it has to save money by lowering operations and maintenance (O&M) expenses and capital costs below projected levels. Asset owners (cities) must determine how to allocate that future stream of savings. Some asset owners prefer a large up-front payment, some prefer lower user rates in the future, and some prefer a mix of both an up-front payment and lower future rates. Private partners are typically agnostic on this issue and, subject to regulatory reviews and approvals, are generally willing to do whatever asset owners want. In the Scranton transaction, the asset owners received both a large up-front payment (\$195M) as well as meaningful future rate mitigation (about \$350M in rate savings spread over 28 years or \$7,650 per residential customer). In the Westfield project, the city received a \$90 million up-front payment for the utilities and a commitment from the purchaser to mitigate rate increases that the city had previously approved.

- A Private Partner will make a profit – A private partner will want to earn a profit, but that need not result in higher costs to the city or the utility customers. Private partners typically bring deep subject matter expertise, leading-edge technology, lower costs for purchased goods and services, and significant economies of scale that are generally not available to smaller utilities. In addition, a private partner and its management team are focused on one thing: operating utilities. Their tight focus and very long-term planning horizons are important advantages that can result in lower costs and higher quality. The resulting cost advantages can provide for both a fair profit margin as well as lower costs for rate payers.
- “Loss of control” – This is often a generic objection to P3 projects. Our experience, however, suggests that well-managed projects with strong contracts and rigorous contract oversight can actually increase control and transparency. Some utilities may not have strong financial and operational performance measures in place for their existing internal operations. In some cases, the request for proposals process represents the first time that key operational and performance standards (other than environmental standards) have been identified and fully documented. Contractual performance guarantees and financial penalties can also enhance control. For asset transactions involving regulated entities, Public Utility Commission and Utility Consumer Counselor oversight may be as effective as—or even more effective than—traditional legislative oversight. The discipline imposed by a regulatory body is intended to benefit the utility and its customers. In addition, contracts can require periodic reports to the council, regular updates to community associations, and/or the adoption of a service advisory board comprising representatives of the community and the private partner.
- Subsequent sale of the utility assets to another party – It is typical for contracts to constrain the purchaser’s ability to re-sell the assets, to provide for the city’s approval of any sale, and/or to provide the city with a right of first refusal should the assets be offered for sale.
- Loss of an existing PILOT or similar subsidy – In many cities, the utilities make a payment in lieu of taxes (a PILOT) to the city or otherwise financially support local government activities. Because these costs are already included in the existing operation and rate structure, it may be possible to include these payments as an ongoing feature of a transaction. Similar to the up-front payment versus rate mitigation discussion, above, asset owners can, subject to regulatory approvals, determine how they want the future stream of savings to be allocated (e.g., PILOT versus up-front payment versus rate mitigation or some combination). In the Westfield project, the sale transaction included a property tax payment to replace an existing \$1.7M per year subsidy that the City received from the utility. In Scranton, Pennsylvania, the private partner began paying property taxes of approximately \$405,000 per year. In Indianapolis, the private partner committed to pay an annual PILOT over a 30-year period pursuant to a schedule agreed upon by the asset owner and private partner and which was approved by the local regulatory body upon closing of the sale transaction.
- Existing debt loads – It is typical for the asset owner (the city) to pay off existing bonded indebtedness with a portion of the sale proceeds. In Westfield, the city used a portion of the sale proceeds to pay off 100% of the utility’s debt (about \$40M) and in Scranton, the Authority use a portion of the sale proceeds to pay off all of the utility’s debt (about \$75M) as part of the transaction. In the Indianapolis transaction, the private partner assumed the obligations related to about \$1.4B in debt at the water and wastewater utilities.

- Consent Decrees and Long-Term Control Plan obligations – It is typical for the private partner to assume responsibility for consent decree obligations as well as the long-term control plan obligations. In Scranton, the private partner assumed responsibility for the utility’s \$139M long term control plan obligations. In Indianapolis, the parties negotiated with the EPA to reduce certain consent decree obligations, resulting in savings for both the private partner and the utility customers prior to the private partner assuming responsibility for the asset.
- Ongoing environmental compliance – It is typical for the private partner to assume responsibility for ongoing environmental compliance, including compliance with the National Pollutant Discharge Elimination System (NPDES) permits. This typically includes taking responsibility for any fines or penalties that might be levied in connection with a future permit violation.
- Asset management and preservation – Cities have typically made large investments in their water and wastewater infrastructure and, as a result, they are keen to ensure that their assets are well-managed on a going-forward basis. Private partners, especially acquirers, have strong incentives to maintain infrastructure assets because they are responsible for replacing them should they wear out or fail. Even in a transaction where the city engages an O&M manager but retains ownership of the utility, the manager will commit to defined maintenance obligations and will be responsible for any damage to or failure of the assets resulting from poor maintenance practices or failure to comply with its maintenance obligations.

In addition to contractual requirements related to asset maintenance and management, all high-quality private partners will have comprehensive maintenance programs that include the use of predictive maintenance, preventive maintenance, scheduled maintenance, corrective maintenance, supervisory control and data acquisition (SCADA) systems for remote monitoring and control, and computerized maintenance management systems (CMMS) to track work orders, inventory, equipment lists, and meter readings. Any project would include regular and robust reporting on system performance issues and maintenance activities.

- Stormwater issues – Given economies of scale and the interrelationship among water, wastewater, and stormwater infrastructure and issues, it may make sense for cities to address stormwater challenges in conjunction with a sewer P3 transaction. Moreover, coordinating stormwater and wastewater issues facilitates a holistic approach to planning for infrastructure replacement and improvements and enables cities to use the EPA’s *Integrated Planning Approach Framework (2012)*. Stormwater and sewer issues are inextricably linked in older cities due to the prevalence of combined sewers (e.g., underground infrastructure that commingles sewer discharge and rain/snow melt).

While the City or a stormwater authority will, as a matter of law, likely need to hold any municipal separate storm sewer system (MS4) permit, a private partner may be able to cost-effectively assist with operation and maintenance of the stormwater infrastructure, billing/collection activities, capital project management, and compliance issues. In an ideal world, some of the proceeds from an asset sale coupled with the efficiencies of private

management of the stormwater system could help offset a meaningful portion of any future stormwater-related obligations.

- Water and wastewater services are inherently governmental activities and should only be provided by public employees – The private sector already provides a wide range of services to residents. From medical care to food production to air travel services to housing to electric power, the private sector is deeply immersed in residents’ lives in meaningful ways. As noted above, the private water market already serves over 47 million U.S. residents. Many millions more are served by private wastewater providers, including the residents of Indianapolis, Indiana and other central Indiana communities.

6. Recommendation

Well-managed P3s are a powerful strategy that cities can use to improve service, preserve the environment, control costs, fund new infrastructure, protect incumbent staff, and transfer risk. Given our recent experience with asset sales in cities similar to Terre Haute and the presence of a mature and highly competitive market for such transactions, we recommend:

- Determine the most effective and appropriate ways to engage the City Council and Board of Sanitary Commissioners in this process.
- As a key strategy to analyze the merits of the asset sale approach, the City of Terre Haute should use a competitive Request for Proposals (RFP) process consistent with Indiana procurement and disposition laws to determine whether private partners are interested in acquiring the City’s sewer utility and, if so, at what price and under what terms.
- If the City moves forward with an RFP process, we recommend the City includes the following as objectives:
 - Protect the System’s customers by mitigating future rate increases;
 - Ensure the use of industry best practices;
 - Provide consistently high-quality services to the System’s customers;
 - Meet all applicable environmental requirements;
 - As appropriate, transfer operational and environmental risks from the City to the private partner;
 - Pay off the existing debt;
 - Ensure that the System’s assets (both existing and new) are properly maintained;
 - Treat the System’s employees fairly and equitably and enhance their career opportunities – this includes providing job offers for all incumbent staff at comparable pay and benefits as well as union recognition;
 - Minimize future capital costs using value engineering and other strategies while achieving equal or better environmental results;
 - Develop a strategy to continue to pay a PILOT;
 - As permitted, ensure that the acquirer pays property taxes in the future;
- Conduct a public discussion on how to allocate the value created by this transaction, with the potential uses including an up-front payment, an ongoing PILOT, future sewer rate mitigation, and/or offsetting future stormwater obligations. Further, conduct a public discussion about where to allocate any funds received as part of an up-front payment.

7. Next Steps

- Develop a proposal for the Steering Committee that outlines the Study Team's recommendation to move forward, beginning with the tasks below:
 - Engage with the Mayor, the City Council and the Board of Sanitary Commissioners to determine the composition and the duties of a Terre Haute Sewer Optimization Task Force (SOTF);
 - Staff and manage leaders and members of the SOTF through all phases of the P3 process;
 - Identify any legal, procurement, contractual, human resources, or collective bargaining limitations or barriers to the recommendation;
 - Develop a strategy to address or mitigate any identified limitations or barriers;
 - Agree on the most appropriate and effective procurement process to engage a third-party provider (e.g., RFI, RFP, other);
 - Draft and circulate a competitive solicitation document;
- Evaluate the responses and advise the SOTF whether proposals adequately address the City's needs,
- If the SOTF determines that a transaction is warranted, develop corresponding recommendation to the Board of Sanitary Commissioners.
- If approved, facilitate entering into a transaction with the preferred respondent; and
- Track and report cost savings and related progress.

8. Timeline

If an RFP was issued in Q4 2017, the process would likely take about two years, including the required Indiana Utility Regulatory Commission (IURC) approvals.

9. Other Issues

- N/A