CITY COUNCIL INFORMATION MEETING
Wednesday, August 20, 2003

PRESENT:
Council President Ron Kroeger
Council Vice President Bill Waugh
Mayor Jim Shaw
Alan Hanks
Sam Kooiker
Tom Murphy
Jeff Partridge
Martha Rodriguez

(NOTE: For sake of continuity, the following minutes are not necessarily in chronological order. All referenced documents are on file with the Master Minutes.

Also, Historic Preservation was scheduled to present information today, but did not attend this meeting.)

TOPIC: Wastewater Lease/Leaseback Proposal

Council President Ron Kroeger began the Information Committee at 3:05 PM in the Council Chambers at CSAC. City staff present included Finance Officer Jim Preston, Assistant Finance Officer Coleen Schmidt, Acting City Attorney Jason Green, Tracy Davis and Sandy Malone.

Doyle Estes began the presentation by introducing Scott Scofield from Allco Finance Corporation. Estes said he had the opportunity to meet Scott about 2 months ago when he was contacted by a friend of his from Sioux Falls, who introduced him and Pat Tlustos to a concept, which Scofield and others will introduce to Council today.

Scofield opened by saying he would give an overview of the transaction, talk about the terms, conditions and economic benefits, give a history on the transaction and specifically address the timing of the transaction.

He handed out a concept overview of the long-term lease/leaseback transaction. He identified what the concept is not. The concept of the transaction is not the traditional old-sale leaseback that many political subdivisions have used in the past, whereby they take an existing asset and sell the asset to generate a large chunk of cash that they would then go to buy a new capital asset and use revenues off the system to pay for the leaseback of the original asset. That was more in lieu of traditional debt, another way to create additional funding.

It is <u>not</u> a privatization of the system. You are not going to take the asset of the wastewater treatment plant and sell it or lease it out and have some private company operate it.

The concept <u>is</u> where the City of Rapid City would lease their wastewater treatment plant and collector system to a for-profit corporation, traditionally large banks or large insurance companies who have long-term sustainable, predictable, long-term income. They use these types of transactions as part of their overall tax strategy that comes out of their treasury department. So the asset is leased to them for 100 percent of fair market value. The most recent appraisal of the wastewater treatment facility is $255,000,000. A large bank, in this case, KBC, a Belgium-based bank with a large presence in the United States, would give Rapid City $255,000,000. However, KBC doesn't want to operate the wastewater facility, so in turn, the asset is leased back to Rapid City, who does want to operate the system.

By leasing it to them for 98-99 years, and because they pay you 100 percent of fair market value, Congress has passed a code that says that constitutes tax title and therefore they get to claim tax ownership for the asset and can depreciate it even though legal title remains with the City. They get amortization of transaction costs, interest expense and depreciation, which has a significant value to them (on average of 7-9 percent return), plus a nominal cash return to them. Consequently, they say, we don't need you to give us 100 percent of fair market value, so Rapid City would get to keep 3.62 percent of the asset value. In this case, in Rapid City, that would be $9,229,102. The balance of the funds are used to pay for the lease for the next 25-30 years, not determined yet but predicated on the depreciation schedule of the asset that will be determined before the transaction is closed by the equity investor.

In summary, KBC will give $255 million, $9.2 million goes in the City's pocket and the balance is put into an escrow account to be used to pay for the leaseback period over 25-30 years.

Scofield then introduced his colleague, Lynn Endorf, a partner with Dorsey and Whitney, Minneapolis. Endorf, along with Dave Williams, from Chapman and Cutler, Chicago, are two well-respected and recently renowned bond counsel in South Dakota. They will be co-counsel to the participating cities.

He also introduced Jack Arnold, Dougherty & Company, Minneapolis, who is the financial advisor to the State of South Dakota and the Authority;

Don Templeton, South Dakota Building Authority and Health and Education Authority, and presumed to be appointed director or lead of the Municipal Facilities Authority (MFA); and

Jim Wavle, Allco, Scofield's colleague, who is the technical expert on the transaction from the equity investor's perspective.

After a question from Alderman Bill Waugh about any adverse effects on the bonds, Mr. Scofield responded that there are none. Alderman Partridge asked what the difference was between the head-lease and the leaseback. Scofield responded by saying the head-lease is when you lease it out for 98-99 years to the MFA, then the state will aggregate the assets and then lease them on to the equity investor. The equity investors want to do deals that are about $250-300 million in size. They are then leased back through the state and that is called the lease back for 25-30 years. The reason it is only 25 years, is the first lease had to be well beyond the remaining useful life of the asset, but the 25-30 year lease is actually more typical of what the depreciable life of the asset is. After that, the depreciation value is basically zero. The last payment buys out the lease hold interest in the remaining 75 years and the deal collapses and goes away. The last payment, balloon payment, is an option to make, not an obligation.

There are no out-of-pocket expenses incurred by the City in entering into the transaction. The equity investors pay for all of the transaction and closing costs. During the lease period, title to the asset remains with the City. The lease is not regarded as debt, and current or future tax-exempt bonds are not adversely affected. The City continues to operate the facility, deliver services, set the rates, collect the fees as they typically would as if the transaction had never occurred.

Alderman Alan Hanks asked about assets removed from the plant, and Scofield answered, from an operational perspective, the City retains full control to operate and maintain the system, and to make all upgrade and expansion decisions. He went on to say that if there were any modifications within the footprint specifically identified with the assets included in the transaction that would be part of the ordinary course of business and contemplated in the transaction. If, on the other hand, another part of the community is annexed and added on to the collector system, that new asset is completely outside of the scope of this transaction and is not contemplated in the asset value or in the proceeds. If there is an asset and a whole new functionality is added that wasn't there before, a) this doesn't prevent you from doing that, and b) you can still do that with the source of funds today.

Allco stands for the Australian Land Lease Corporation. Origins are in Sydney, Australia, with a New York-based firm on Park Avenue. They also have offices in Western Europe. Scofield is a Sioux Falls native with an office in Madison. Allco's role is an arranger. They create relationships with lessees and lessors and bring the two together for a transaction.

Alderman Jeff Partridge noticed most of the cities represented were German. Scofield answered that major metropolitan areas (Chicago, Boston, New York, Washington, Houston, Denver, etc.) have done these deals for over 20 years. Most of them are subway systems or rolling stock assets. About 10 years ago, these assets started to get exhausted and the equity investors turned to Allco and asked if they could find transactions in Europe. Five to six years ago, they started looking for infrastructure opportunities in Europe, and about two or three years ago, (9/11 had some bearing on it), they decided to do fewer deals cross boarder and do more deals domestically.

There are no out-of-pocket expenses incurred by the City in entering into the transaction. All transaction costs are paid by the equity investors. All of the City's financial obligations under the lease and the sub-lease are pre-funded from the funds they receive when they lease the assets to the equity investor; therefore again, no on-going out-of-pocket expense to the City. The City continues to keep all system revenues, and the revenues are not pledged as collateral. The equity investors are subordinate to current and future tax-exempt debt and SRF loans. The City is free to pledge any on-going revenues to bondholders for future additions or improvements to the system. At the end of the lease, the final payment from the defeasance accounts (at the option of the City) collapses the head-lease, and terminates the transaction. The equity investors assume all the risks associated the investor's tax benefits of the transaction.

Alderman Sam Kookier asked if other assets qualify. Scofield answered that it has to be an asset with commercial viability, such as rolling stock, subway systems, wastewater, drinking water systems, natural gas distribution, power generation and qualified technological equipment (QTE).

This is not a deal that is done in the cloak of darkness—this is not an Enron deal. This transaction is registered with the IRS and Congress passed particular laws and IRS codes to support the transaction. Shifting depreciation from one entity to another is what leasing is all about. A question from Alderman Alan Hanks concerning the balloon payment was answered that the balloon payment is included in the appraised value of the $255,000,000 that the City gets. At the end of the lease period, when the balloon payment comes up, it is sitting in the escrow account. The City then has the option to spend it and collapse the head lease, or keep it. (The equity investor wants you to spend it.) The City would make annual payments.

Scofield went on to say that the role of the state is to 1) act as the aggregator, 2) provide credit enhancement and 3) create the MFA. Proportionate share of the costs for the MFA might be around $15,000-20,000/year for the term of the lease.

The way Allco approached cities in South Dakota was through the SD Municipal League for help to get the word out and test the interest of the cities. In South Dakota, they worked with the Finance Officer and City Engineer to set the stage for the transaction, explore the benefits, talk about the terms and conditions, examine the economics and complete the appraisal process. They thought there would be plenty of time to do this, but unfortunately, KBC has a 60/40 rule. They can only do 40 percent of these types of transactions in the 4th quarter of the year. Therefore, the timeline is September 30 to close this. Madison, Yankton, Aberdeen and Vermillion are taking this proposal to their councils for approval Monday night. (There are 14 South Dakota cities considering participation.) This would not be a decision to do the deal, but rather authorization to have the Mayor and Finance Officer work with Council to determine the conditions, terms, and economics. Until there are final documents and word from legal counsel that you like what you see, you're still not committing yourself.

The downside is there are funds that need to be managed. The state will help manage them with their financial advisor, but if those funds aren't there to make the lease payment, the City is still obligated to do so.

Jack Arnold then presented a diagram on how the lease payments will be made and answered questions from the Council.

Mr. Arnold, Mr. Endorf and Mr. Templeton gave overviews of their companies and what they do.

Alderman Partridge asked about the 3.62 percent cash benefit and why it couldn't be more. Scofield answered that it is not a negotiable number. It is predicated on the asset value and the remaining municipal life of the asset. Everyone is at 3.62%. The asset value may be different.

The process needs to be approved by four entities.

1) City makes ultimate decision and passes draft resolution that authorizes the Mayor and Finance Officer to enter into a transaction, but only if they like the terms and conditions.
2) DENR approval. They have a vested interest because they make the SRF loans.
3) MFA approval.
4) EPA approval. Because of the grants and loans, they feel they have an equity interest in the transaction.

Indications are the EPA fully supports the transaction. They have concurrence from Region VIII. One of the things EPA wants to know is how the City will intend to use the money. They would like you to put it back into the wastewater system. They also ask for a bill insert that explains to the citizens that the transaction was made, funds were received and what the intentions for funds are.

Keep in mind that there is a 20-day waiting period within the timeline for the resolution to be adopted. Closings will vary. They would like the Council to come back with the level of interest to proceed.

Alderman Kooiker asked for the risk to be explained. Over time, if it is decided the investment contractor is having trouble, (for example, they get downgraded to an AA or A rating), they can get a new lender. The risk would be the City's cost to replace the AIG lender. The likelihood to find another partner would be easy.

A response to Finance Officer Jim Preston's question was that once the balloon payment is made, the payment to the MFA stops. As far as setting aside $200,000 to make the $15,000-25,000 payment, it is a legitimate use to tell taxpayers. Assistant Finance Officer Coleen Schmidt stated she commended the group for closing the problem areas that they saw initially. Her question on the escrow account was answered by saying the reserve fund will cover the cost of getting a new lender and a new investment contractor, if need be.

Council members requested Acting Attorney Jason Green to draft a resolution for the lease/leaseback proposal and ask Mayor Shaw to add it to the Special Council agenda prior to Public Works Committee on Tuesday, August 26.

Mayor Shaw stated that when he first heard this, it was almost too good to be true. The City is going to get $9.2 million and the simplest definition is we are allowing someone to use something we can't use and that is the depreciation. In exchange for someone able to do that, we will benefit $9.2 million for projects in the community. That makes it interesting and agrees it is something they should do. He feels it is fortuitous and beneficial to the citizens of Rapid City. The risks are small and potential benefits of having the money to invest in various infrastructures to move the City forward far outweigh the risk. He thanked the good work of the group.

Green answered a question from Council President Ron Kroeger that Legal and Finance approval is not required for resolutions--only ordinances and this did not need to go before Legal and Finance. It could go on the agenda for the Special Council meeting.

Kroeger suggested putting copies of the materials in the mailboxes of Council members not here today so they could look at the proposal before the meeting on Tuesday.

The Information Committee ended at 4:57 PM. The next meeting is scheduled for September 17. Tentative topic is the Fire Department.