South Dakota Municipal Facilities Authority
330 South Poplar
Pierre, South Dakota 57501

RECEIVED
AUG 07 2003
MAYOR'S OFFICE

August 5, 2003

Mayor Jim Shaw
City of Rapid City
300 South Sixth Street
Rapid City, SD 57701

Allco Finance Corporation
South Dakota Municipal Lease-Leaseback Transaction

Dear Mayor Shaw:

The captioned lease-leaseback transaction (referred to for convenience as the "Transaction") proposed by Allco Finance Corporation ("Allco") has reached the stage where legal documentation has begun and governing body approval by participating cities will very soon be required. We thought it important to contact you to introduce ourselves and the Municipal Facilities Authority (the "Authority"). We also wanted to explain what the Authority's role in the Transaction has been to date, and what we believe it will be as the Transaction progresses.

The Authority was authorized by SDCL 5-28, adopted by the State Legislature during its 2001 session for the sole purpose of enabling the Transaction. Governor Rounds has appointed all of the Authority board members, and the first meeting of the Authority is scheduled for August 13, 2003, in Pierre.

The role of the Authority in the Transaction has been, and will continue to be, that of facilitator. Accordingly, the Authority (and the State) have retained legal counsel and a financial advisor to help understand the Transaction and advise the Authority on its benefits and risks from the State's perspective. It is important for you to understand that the Authority does not represent the cities considering participating in the Transaction. For this reason, the Authority should not be thought of as counseling either in favor of or against Rapid City's participation in the Transaction. It is therefore very important that your staff become familiar enough with the Transaction to form their own conclusions about what it offers the city.

At the same time, we recognize that we have most likely had more exposure to the details of the Transaction than you and your staff, and we certainly want to be available as a resource to you. Toward that end, we participated (together with our legal counsel and financial advisor) in an informational conference call on Monday, August 4.

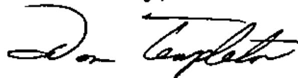
Also, we are including with this letter a copy of the explanatory materials being provided to the Authority's board members for their August 13 organizational meeting. The materials contain what we believe is an updated description of the Transaction, together with a flowchart-style diagram. Attached to the materials is also a memorandum prepared this spring for the Governor's Office and the Commissioner of Management and Budget. The memo discusses the risks associated with the Transaction and the features of the Transaction designed to help mitigate them. While the memo discusses the risks from the State's perspective, the risks will be borne primarily by the cities, and we believe it is important for you to understand them.

We will continue to monitor the progress of the Transaction through the city approval and documentation process. Our legal counsel and financial advisor will be participating in the documentation process to ensure that the documents properly reflect our understanding of the substance of the Transaction.

The final form of the Transaction will, of course, be subject to approval by the participating cities, the Authority, and the State. Following the closing of the Transaction, the Authority will have annual administrative responsibilities related to the Transaction and expects to contract with the South Dakota Building Authority to staff these needs. A budget for these and other operating costs of the Authority is being prepared and will be shared with participating cities shortly. Since the Authority was formed solely to permit the Transaction to occur, the annual operating costs of the Authority will be billed to participating cities pro rata based on the value of their assets involved in the Transaction.

We look forward to working with you as the Transaction progresses.

Sincerely,



Don Templeton

Executive Summary

The South Dakota Municipal Facilities Authority (the "Authority") was created by SDCL 5-28, adopted by the 2002 South Dakota Legislature. The legislation was drafted to permit the Authority to contract with the South Dakota Building Authority for staffing in to order reduce costs and avoid duplication of staff. The annual operating costs of the Authority associated with the transaction described below will be paid out of transaction cash flows.

The Authority has been requested to participate with a group of South Dakota cities in a lease-leaseback transaction arranged by Allco Finance Corporation ("Allco"). The transaction calls for the cities to lease wastewater system assets, through the Authority, to one or more investor trusts. The trusts will pay the cities (again through the Authority) an amount equal to the fair value of the leased assets, and will lease the assets back to the cities, again via the Authority, and, in this latter case, the State DENR. The funds paid by the trusts will ultimately be used in part to purchase special investment agreements which will fund all rental payments of the cities (and the Authority and the DENR) under the leaseback.

It is expected that after payment of the cost of these investment agreements, there will be funds remaining in an amount equal to approximately 3.6% of the value of the lease-leaseback assets. These funds will be retained by the cities, who are free to apply them as they deem fit. The investor trusts will realize a return on their equity investment composed of annual rental payments under the leases as well as federal income tax benefits.

Transaction Description

Introduction. The lease-leaseback transaction is perhaps most easily explained and understood in steps, although all of the steps described below will take place essentially simultaneously. It may be helpful for readers to refer to the attached transaction diagram as they read through the steps below.

Step One: The Lease. The participating cities will lease wastewater system assets to the Authority for a term of approximately 99 years. The Authority, in turn, will sublease the assets to one or more investor trusts, also for a term of approximately 99 years. During the term of these leases, legal title to the assets will remain in the cities.

Step Two: Prepayment of the Lease and Sublease. The investor trusts will prepay their rental obligations under the subleases from the Authority by making a single, one-time payment to the Authority; and the Authority will similarly prepay its lease obligations to the cities. In each case, the amount of this payment will be equal to the fair value of all the underlying wastewater system assets eligible for lease.

Step Three: The Leaseback. The investor trusts will lease back the wastewater assets to the Authority for a term of approximately 30 years. The Authority will sublease the assets to the State DENR, who will sublease the assets back to the cities, also for an approximately 30

year term. The annual rental payments under the two subleases will be identical to the payments under the Authority's lease from the investor trusts. That is, the payment of rent by a city under its sublease will fully cover the DENR's rent obligations to the Authority, and the Authority's rent obligations under its lease from the investor trusts. Although each of the leases involved in the leaseback will contain stated annual rental payments, all of these payments will be prepaid as described in Step Four, below. Following the lease back, the cities will continue to operate the wastewater assets as before, including rate setting and payment collection.

It is important to note that the obligations of the cities under their respective subleases will constitute "general obligations" of the cities, for which all of the cities' financial resources will be available. The city subleases will not, however, be cross-collateralized – that is, if one city fails to pay, the Authority cannot expect another city to cure the problem.

Step Four: Prepayment of the Leaseback. The cities will use a portion of their prepayment receipts under Step Two, above, to prepay their sublease-back from the State DENR. The DENR will use the funds to make an identical prepayment of its sublease from the Authority. The Authority will apply these funds to purchase several specially structured investment agreements from highly rated financial institutions and/or insurance companies. The investment earnings on these agreements will be structured to cover all of the rental payments required of the cities under their subleases (and thereby, all of the rental obligations of the State and the Authority under their respective leases). As a result, and assuming that the investment agreements pay as scheduled, it is not expected that either the cities, the State or the Authority will ever be making an "out-of-pocket" lease or sublease rental payment. There are certain risks to the cities and potentially to the Authority and the State associated with the investment agreements. A memo (prepared this spring for the Governor's office and the Commissioner of Management and Budget) which discusses these risks is attached.

Step Five: Payment of Transaction Costs. All transaction costs will be paid by the equity investors.

Step Six: Funds Retained by the Cities. The amount of the cash benefit retained by the cities is expected to equal approximately 3.6% of the value of the assets under the lease-leaseback program. For example, a city which leased and leased back $100 million of wastewater assets eligible to the transaction would receive a distribution of approximately $3.6 million. There is no restriction of any kind on the cities' use of these funds; however, as part of the EPA approval process, the cities will be required to inform their ratepayers as to how the funds will be used.

Participants and Transaction Costs

The table below shows the professional participants in the lease-leaseback transaction. Precise fee/expense information will be available for the Authority's review prior to completion of the transaction.

Name	Firm	Role
Jim Wavle Scott Scofield	Allco Finance Corporation, New York	Transaction design and coordination, equity and debt placement
Bruce Bonjour	Perkins Coie LLC, Chicago	Special legal counsel to the Authority and DENR, and bond counsel to the South Dakota Conservancy District
Jack Arnold	Dougherty & Company, Minneapolis	Financial advisor to the Authority
Dave Williams	Chapman and Cutler, Chicago	Co-counsel to the participating cities
Lynn Endorf	Dorsey & Whitney, Minneapolis	Co-counsel to the participating cities
Don Templeton Jerry Fischer	South Dakota Building Authority/Municipal Facilities Authority	Authority staff
Todd Meierhenry	Danforth, Meierhenry & Meierhenry, LLP, Sioux Falls	Counsel to the Authority
Jason Dilges	State Bureau of Finance and Management	Commissioner

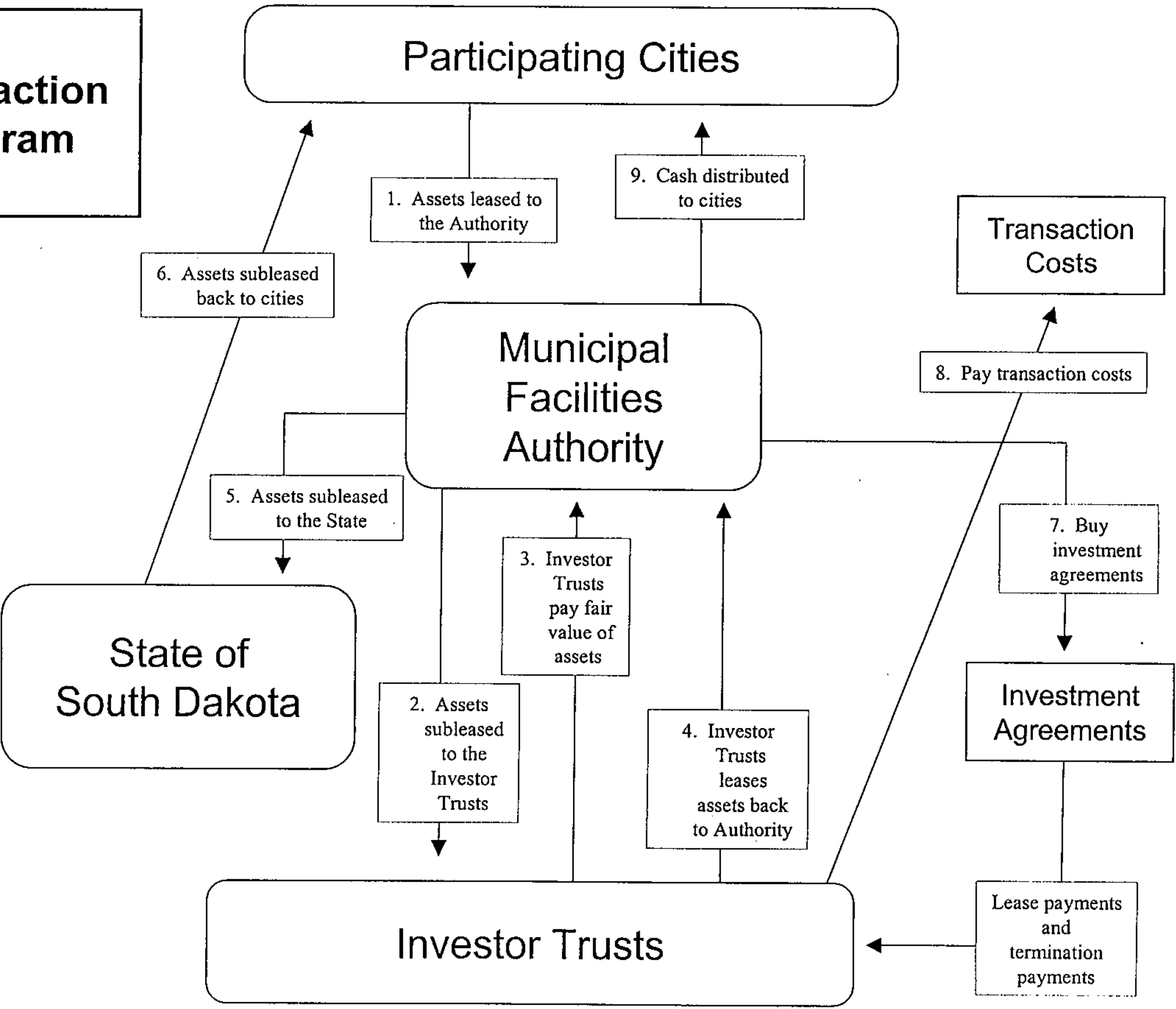
The Investors

Allco has identified three potential equity investors for the lease-leaseback transaction. They include Bank of America (San Francisco), Fifth Third Bank and KBC Bank (Brussels). The investors will fund the investor trusts partly with borrowed funds (approximately 85%) and partly with a cash equity contribution (approximately 15%). The Authority and the cities have no liability with respect to any borrowing by investors.

Potential City Participants

It has not yet been determined which South Dakota cities will participate in the lease-leaseback transaction. The table below shows which cities are considering participation.

Potential Participant	Eligible Assets	Potential Cash Benefit
Aberdeen	$65,000,000	$2,353,000
Brandon	$14,000,000	$509,696
Brookings	$59,000,000	$2,135,800
Huron	$19,000,000	$687,800
Madison	$19,000,000	$687,800
Mitchell	$44,000,000	$1,592,800
Pierre	$24,000,000	$868,800
Rapid City	$239,534,720	$8194,128
Sioux Falls	$485,000,000	$17,557,000
Spearfish	$21,000,000	$760,200
Sturgis	$18,000,000	$651,600
Vermillion	$27,000,000	$977,400
Watertown	$41,000,000	1,484,200
Yankton	$45,000,000	$1,629,000


Transaction Diagram
Participating Cities
1. Assets leased to the Authority
9. Cash distributed to cities
Transaction Costs
6. Assets subleased back to cities
Municipal Facilities Authority
8. Pay transaction costs
5. Assets subleased to the State
3. Investor Trusts pay fair value of assets
7. Buy investment agreements
State of South Dakota
2. Assets subleased to the Investor Trusts
4. Investor Trusts leases assets back to Authority
Investment Agreements
Investor Trusts
Lease payments and termination payments

MEMORANDUM

TO: Jerry Fischer and Don Templeton

FROM: Jack A. Arnold, Dougherty & Company
Bruce A. Bonjour, Altheimer & Gray

DATE: April 10, 2003

RE: Allco Long-Term Lease/Leaseback Transaction

Introduction

We understand that following our Wednesday, April 2, conference call, the Governor's Chief of Staff raised concerns over possible risks to the State associated with the proposed Long-Term Lease/Leaseback Transaction. You have asked us to address the following items from the perspective of the State:

1. The nature of the possible risks to the State;
2. The potential costs associated with these risks;
3. The features of the Lease Transaction designed to mitigate these risks;
4. The feasibility of accomplishing the Lease Transaction without participation by the State;
5. The statutory authority for the State to enter into the Lease Transaction;
6. Information previously furnished to Legislators or the Governor regarding possible risks to the State; and
7. Allco fees associated with the Lease Transaction.

We will address each of these items in this memorandum. However we also suggest that a face-to-face meeting in Pierre would greatly facilitate a better understanding of this transaction by those who are new to it. We think the meeting should include, at a minimum, Jason Dilges, Rob Skjonsberg, the two of us, you and Don Templeton, and Scott Scofield and Jim Wavle of Allco.

Transaction Outline

We believe the first three items on the list above are best understood by beginning with a brief outline of the key components of the Lease Transaction itself.

- The participating cities will lease water/sewer system assets to the South Dakota Municipal Facilities Authority for a term of 99 years. The Authority will sublease the same facilities to an investor trust, also for a term of 99 years.

- The investor trust will prepay its rental obligation under the sublease by making a single payment to the Authority in an amount equal to 100% of the appraised fair market value of the water/sewer system assets. The Authority will pay these funds to the cities to prepay the rental obligation under its lease of the water/sewer assets from the cities. This completes the "lease" side of the lease/leaseback transaction.

- The "leaseback" side of the transaction begins with the investor trust leasing back to the Authority the water/sewer assets for a term of approximately 30 years. This lease will call for specified annual lease payments from the Authority to the investor trust during the lease term. The Authority will then sublease the water/sewer assets to the State, and the State will sublease them back to the participating cities. The term and payment requirements of these subleases will mirror the Authority lease.

- Using approximately 96% to 97% of the funds they received from the Authority, the cities will make a single payment to prepay their subleases from the State, and the State will use these funds to prepay its sublease from the Authority. The Authority will apply these funds as described below. The 3% to 4% of the funds received by the cities and not used to prepay their subleases can be used by the cities for such purposes as they deem fit.

- The Authority will use the remaining 96% to 97% of the funds it received from the State to purchase three specially structured investment agreements. (These were referred to as PUA's in the materials for the April 2 conference call.) The investment agreements will be written by highly-rated financial institutions referred to as "providers." The agreements will obligate the providers to make a series of payments which, when aggregated, will precisely match the payments required to be made by the Authority under its lease from the investor trust. It is thus intended that none of the Authority, the State or the cities will be required to make any lease payments from their own funds. This completes the "leaseback" side of the transaction.

- The cities will also have the option to repurchase their water/sewer assets from the investor trust at the conclusion of the 30 year lease for a specified amount. This amount is also covered by payments to be received under the Authority's investment contracts.

- From the State's perspective, it is important to note that if any participating city is ever required to make a payment from its own funds (as described in the Risk Factors, below), any such payment is a general fund obligation of the city. That is, the obligation to pay is not limited solely to the city's water/sewer system revenues.

Risk Factors

Provider Downgrade

Nature of Risk. During the course of the Lease Transaction it is possible that one or more of the providers of the three investment agreements may be downgraded by rating agencies. The Authority may wish to replace the downgraded provider with a higher-rated provider. To do so would likely require the Authority to sell or terminate the affected investment agreement at a market price and purchase a new one to replace it. There would be a cost to the Authority (passed along to the cities), since the sale of an investment agreement from a downgraded provider would yield a smaller amount than would be required to purchase a similar agreement from a higher-rated provider.

Cost. The costs associated with a downgrade of one or more providers will be affected primarily by structuring options chosen by the participating cities and the State. In general, more protection from risk means lower returns to cities from the Lease Transaction. We are advised by Allco that the cost associated with replacing all three providers is estimated to be in the range of $1-$5 million, depending upon structuring alternatives ultimately chosen, as described in more detail below. At the point when the Authority has chosen the providers and structures to be used, it will be possible to develop a much more refined estimate of these switching costs.

Mitigating Factors. There are a number of options available to mitigate, albeit probably never fully eliminate, these risks. (1) Providers can be required to collateralize their obligations in the event of a downgrade below a specified credit rating. (2) The Authority can fund a reserve from Lease Transaction proceeds to mitigate or eliminate such costs. (3) In the case of Provider A (whose investment agreement is by far the largest of the three), it is likely that the replacement risk can be eliminated entirely after approximately the

first five years of the transaction. (4) The level of outstanding investment with the providers declines dramatically after the first five to seven years of the transaction, and thus both the risk associated with those parties and the costs of replacing them would also decline substantially.

State Exposure. If (1) a provider downgrade occurs, and (2) the Authority desires to or is required to replace such provider(s), and (3) any reserve fund held by the Authority proves to be insufficient, and (4) one or more participating cities is unable to pay its pro rata share of the shortfall; then the unpaid amounts would become an obligation of the State, subject to appropriation by the legislature. Note that the State would have recourse to the cities for reimbursement.

Provider Insolvency

Nature of Risk. A provider becomes insolvent and unable to make any payments under its investment agreement.

Cost. The cities would be required to make the required lease payments from their own funds.

Mitigating Factors. As described above, the Authority will monitor the providers' credit standing and have the ability to sell or terminate an investment agreement at any time. It would be extraordinarily unlikely for a provider to move from a top category rating to insolvency without a series of downgrades over time.

State Exposure. If the cities were unable to make the required lease payments from their own funds, the State would be obligated to do so, subject to appropriation by the legislature. Note that the State would have recourse to the cities for reimbursement.

Indemnity Payments

Nature of Risk. Once the assets have been leased to the investor trust and then leased-back to the cities, all of the financing parties (the investor trust, the lenders, etc.) will require that the cities, State and Authority indemnify and hold harmless each of them for most all claims which may occur. Examples of such claims are violations of NPDES discharge restrictions, various changes in state law deleterious to the investors (property taxes assessed on the wastewater facilities) or injuries to a worker or customer as a result of a dangerous condition associated with the wastewater plant. Some, but not all of these claims can be insured against. In the leases, the cities, State and Authority will be unconditionally obligated to indemnify all other parties for such claims.

Cost. Impossible to determine in advance.

Mitigating Factors. Most of the circumstances under which the cities would have an obligation to indemnify are within the control of the cities and/or the legislature and most of such claims (injuries to customers/employees, improper discharges in violation of NPDES permits) would be the obligation of the cities whether or not they entered into the lease transaction.

State Exposure. If the cities were unable to make the required indemnity payments, the State would be required to do so, subject to appropriation by the legislature. Note that the State would have recourse to the cities for reimbursement.

Casualty Losses

Nature of Risk. Uninsured casualty loss of water/sewer system assets.

Cost. Impossible to determine in advance.

Mitigating Factors. The cities will be required under the leases to insure and properly maintain their facilities. Further, given the nature of the asset, the possibility of a total casualty is highly unlikely, and in the event of a partial casualty the affected city would almost certainly repair or rebuild as necessary, just as it would absent the transaction. In such case, no additional cost is imposed by the transaction.

State Exposure. Lease payments would continue to be made by the Authority's investment agreements regardless of casualty losses, meaning that such losses alone do not create any State exposure. However, if water/sewer assets were totally destroyed and if for some reason the affected city chose not to reconstruct them, the city's lease agreement would terminate and the city would be required to make a termination payment. While it seems extremely unlikely that a city would not rebuild water/sewer assets, the failure of the city to make the termination payment would potentially require the State to do so, subject to appropriation by the legislature. Note that the State would have recourse to the city for reimbursement.

Eliminating the State From the Lease Transaction

In order for the Lease Transaction to be feasible, Allco advises that a minimum of approximately $250 million worth of water/sewer system assets must be included. This is considerably more than any single South Dakota city other than Sioux Falls and possibly Rapid City possesses, making it critical that a number of cities participate. However, every city has different credit characteristics and being required to evaluate them individually would likely make the transaction unmarketable to potential investors.

At best, a potential investor would only be willing to evaluate the credit of the two or three largest cities, thereby resulting in most of the South Dakota cities being unable to realize any benefits from the transaction. Even if investors were willing to evaluate all participating cities, the result would most likely be a "weakest link" approach, resulting in less favorable pricing to all the cities. By interposing the State into the chain of leases, the credit characteristics of the individual cities are effectively homogenized, and many more cities will be able to participate in the transaction.

Statutory Authority for the State's Participation

Section 5-28-8 of SDCL provides in relevant part:

> 5-28-8 The state, the authority or any corporation formed by the authority may take title to or enter into any conveyance, lease or contract necessary or desirable in furtherance of the purposes set forth in this chapter, including, without limitation, to acquire, own, lease, sell, transfer or otherwise use, operate or obtain services from or dispose of land or municipal facilities and any other improvements made upon or under such land and capital equipment necessary or useful for the operation of the municipal facilities to be acquired by it pursuant to this chapter,
>
> Section 5-28-1(8) defines the term "state" as follows:
>
> (8) "State," the State of South Dakota acting by and through the Department of Environment and Natural Resources or any other department, agency or authority of the state designated by the Governor.

Information Previously Furnished to the Legislature or the Governor

During the legislative consideration of what is now Chapter 5-28, SDCL a number of discussions were had with Governor Janklow and in various combinations, one or both of us, Authority staff, and others regarding the risk analysis from the State's perspective . Attached is one memo from January of 2002 from Jim Wavle of Allco to Governor Janklow as a result of those discussions.

We are advised by Scott Scofield of Allco that prior to each hearing (State Affairs in Houser and Senate), meetings were held with all or nearly all of the Committee members, at which time the transaction and related characteristics including risks were discussed in detail. Thus, the committee hearings alone do not reflect the full extent of discussions with legislators.

Also, Governor Janklow gathered legislative leaders from both the House and the Senate as well as members of the State Affairs Committee to discuss the risks and benefits of the proposed transaction. Both of us were connected by speaker phone, but we recall that the Governor, you and various legislative leaders met in a conference room to discuss a 1-23-02 Memorandum and risk analysis prepared by Scott Scofield of Allco. We have attached a copy of that Memorandum and a spreadsheet for your convenient reference.

Allco Fees Associated With the Lease Transaction

The fees to be received by Allco for its role in the Lease Transaction have not been negotiated, nor do we believe it would be appropriate to do so at this time. However Jack Arnold has made it clear to Allco representatives that (1) all Allco fees will have to be disclosed in full to the Authority, and (2) Allco will be required to demonstrate to the satisfaction of the Authority that its fees are reasonable in view of the facts and circumstances of the Lease Transaction. We believe this approach is consistent with historical practice of the South Dakota Building Authority in connection with unique financing transactions.