EHLERS
LEADERS IN PUBLIC FINANCE

Memo

To: Recycling and Energy Center Board

From: Brian Reilly & Bruce Kimmel – Ehlers

Cc: Joint Leadership Team

Date: March 21, 2019

Subject: Financing of Recycling and Energy Center Improvements

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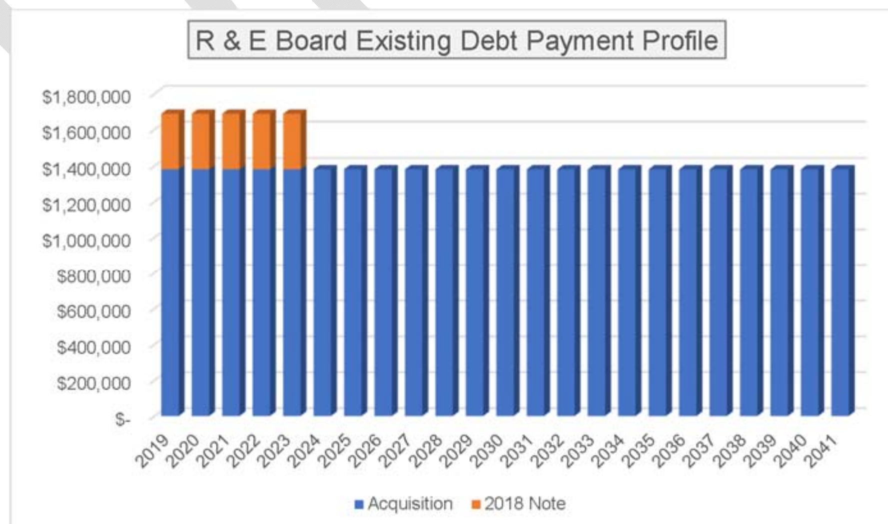
Ehlers has been asked to review and comment on financing options related to the Recycling and Energy Board's (REB) consideration of improvements to the Recycling and Energy Center (REC). This memorandum relies on the data and estimates provided by Foth in its "Preliminary Design for Processing Enhancements at the Recycling & Energy Center" draft report, dated January 2019, as well as other REB source documents and discussions with various REB administrative staff. Our analysis and recommendations also incorporates contemplated improvements to the REB administrative facility and load-out areas.

<u>Background</u>

The REC and related assets were acquired in 2015 through $24,488,000 of capital contributions by REB partners Ramsey County (73%) and Washington County (27%) (collectively referred to as the "Counties"). The REB has entered into fully amortizing loan agreements with the Counties, which loans are payable through 2041 with annual repayment requirements of approximately $1,380,000. Additional capital contributions to fund facility improvements were made by each respective county in 2018, totaling $1,535,000. The 2018 capital contributions took the form of zero interest, five-year loans evidenced by a Promissory Note (the "2018 Note), with an aggregate annual payment requirement of $307,010 in the years 2019 – 2023.



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The REC has been under ownership of and operated by the REB for approximately three fiscal years (some of which time the REB contracted with Great River Energy Newport Services for operations). Audited financial statements are available for the periods ending December 31 in the years 2016 and 2017. The financial operations of the REC are classified as an Enterprise Fund in the REB's financial statements. Administrative activities and corresponding revenues and expenses are classified under the REB's General Fund and are not included in our analysis.

The REC has shown operating losses of $1.131 million and $1.168 million in fiscal years 2016 and 2017, respectively. Enterprise Funds are best reviewed through the lens of Debt Service Coverage in relation to Net Revenues. Net Revenues is an approximation of cash flow generated by operating activities, as it adds back depreciation, a non-cash expense (interest expense is considered a non-operating cost, so is not added back to operating income). Table I depicts Ehlers' estimate of Net Revenues Available for Debt Service and Debt Service Coverage for the fiscal periods ending December 31 in the years 2016 and 2017.

TABLE I

	2017	2016
Total Operating Revenues	$ 34,462,856	$ 32,702,600
Total Operating Expenses	$ 35,631,092	$ 33,833,683
Operating Income (Loss)	$ (1,168,236)	$ (1,131,083)
Plus:		
Depreciation	$ 2,361,581	$ 2,708,826
Investment Earnings	$ 62,287	$ 17,146
Net Revenues Available for Debt Service	$ 1,255,632	$ 1,594,889
Total Debt Service	$ 1,380,000	$ 1,380,000
Debt Service Coverage (x)	0.91	1.16

Total Debt Service is an approximation of the actual, annual repayment requirements related to the REB's loan agreements with the Counties for REC acquisition.

There are presently no minimum Debt Service Coverage requirements or covenants in place under any of the REB's loan agreements with the Counties. Prevailing underwriting standards for debt secured by net revenues of a facility, such as the REC, typically contain covenants that provide for a minimum level of debt service coverage of 1.10x – 1.25x. Debt service coverage that is at, or near, sufficiency (1.00) is generally demonstrative of an enterprise that is depleting cash resources and/or at risk of unanticipated cash outlays to remedy deferred replacement or maintenance. Based on conversations with REB finance staff, we understand that tipping fees were consciously maintained at lower levels during these prior periods.

Fiscal year 2018 operating results are not yet available for review in either draft or audited form. However, we have discussed preliminary estimates with finance staff and have compiled a reasonable approximation of operating results and Net Revenues based on tipping fee increases implemented for both fiscal years 2018 ($7, or 10%) and 2019 ($2, or approximately 2.50%). Table II below presents Ehlers pro-forma compilation of operating performance and

Debt Service Coverage. Only operating revenues have been adjusted, along with the addition of the 2018 Note payment for 2019 Total Debt Service. Operating Expenses are held constant from FY 2017.

TABLE II

*Pro Forma Estimates**	2019	2018
Total Operating Revenues	*$ 38,604,427*	*$ 37,662,856*
Total Operating Expenses	$ 35,631,092	$ 35,631,092
Operating Income (Loss)	$ 2,973,335	$ 2,031,764
Plus (Add Back):		
Depreciation	$ 2,361,581	$ 2,361,581
Investment Earnings	$ 62,287	$ 62,287
Net Revenues Available for Debt Service	$ 5,397,203	$ 4,455,632
Total Debt Service**	$ 1,687,010	$ 1,380,000
Debt Service Coverage (x)	3.20	3.23

Note(s)

** Tipping fee increases of $7.00 (10%) for FY 2018 and $2 (2.50%) for FY 2019 are included in the pro forma operating revenue estimates. All other line items held constant from FY 2017 audited operating results, other than Total Debt Service.*

*** Includes repayment requirements of 2018 Note*

As can be seen, the prior periods insufficiency should be remedied with the increases to tipping fees in the two most recent budget years. Provided the above Table is a reasonable estimate of operating results for fiscal 2018 & 2019, the REC can support meaningful additional debt capacity. These calculations should be updated when draft FY 2018 financials are available for review.

REC Improvements – Assumptions

Estimated total capital costs and associated operating impacts for the REC Administrative Building (comprised of administrative building and load out enclosure improvements), Durable Compostable Bags (DCB) processing, and enhanced recyclables recovery have been prepared by Foth. Our analysis of estimated financing impacts takes into consideration each project, respectively, and combined. The Foth report offers estimated cost ranges for each respective project (low, mid and high), inclusive of soft costs. Our analysis uses the high end of the range as we prefer conservative assumptions when estimating financing costs and impacts.

We incorporate the assumptions embedded in the Foth report by reference. It should be noted that the Foth report does not take into consideration some of the transportation expense related to hauling/transfer of DCBs and organics, and there are other assumptions with respect to future values of organics and recyclables that may, or may not, hold true in the context of future net operating impact.

Table III, set forth below, shows the assumptions for both total estimated capital costs and net operating revenue/(cost) impacts that are used to construct financing impact estimates and our

recommendation(s) (numbers in parentheses represent negatives/net cost). For ease of presentation, the Table only includes the low and high end of the cost estimate and operating impact ranges.

TABLE III

Project(s)	Range of Total Estimated Capital Costs		Estimated Net Operating Impact	
Admin & RLO	$ 4,150,000	$ 6,300,000	N/A	N/A
DCB Processing	$13,400,000	$19,300,000	$ (3,800,000)	$ (3,950,000)
Recyclables Recovery	$17,400,000	$23,600,000	$ 1,986,000	$ 2,780,000
TOTALS	**$30,800,000**	**$42,900,000**	**$ (1,814,000)**	**$ (1,170,000)**
High End Project Estimates				
Admin & RLO		$ 6,930,000		N/A
DCB Processing		$19,300,000		$ (3,950,000)
Recyclables Recovery		$23,600,000		$ 2,780,000
COMBINED		**$42,900,000**		**$ (1,170,000)**

We have prepared financing cost impact estimates for each project on both a discrete and combined basis. The Net Operating Impact is anecdotally considered in the context of our analysis (see Table V).

Understanding that the projects can be financed directly by either the REB itself as a joint powers authority and under its bylaws or one/both of the Counties, we have built two sets of conservative financing assumptions. We estimate that financing sourced directly by the REB would come at a cost of approximately 50 – 75 basis points (0.50% - 0.75%) greater than if one or both Counties sourced the capital directly. The REB does not have general taxing authority, and would not, therefore, be able to secure debt with a general obligation pledge similar to the Counties. The REB would be required to issue debt secured by a pledge of facility revenues, which debt may be further secured by a collateral security interest in assets of the REC, as well as the potential for an appropriation pledge by the Counties (often referred to as a “moral obligation”).

Table IV depicts the estimated annual debt service required to finance the Mid Point total cost estimates for the DCB Processing enhancements and Recyclables Recovery improvements. The table also includes our conservative interest rate assumptions, which carry a reasonable margin over current interest rates. Financing impacts have not been prepared for each term interval for which interest costs have been provided. We assume that the Counties could individually finance the project(s) at similar costs of capital, given their respective credit profiles.

TABLE IV

Interest Rate Assumptions (Years)

	County	REB
5	2.00%	2.75%
10	2.50%	3.25%
15	3.00%	3.75%
20	3.50%	4.25%
25	4.00%	4.75%

Annual Payments by Term (Years)

	County				REB			
	Admin & RLO	DCB	Recyclabes	**Combined**	Admin & RLO	DCB	Recyclabes	**Combined**
10	$771,493	$2,148,602	$2,627,306	**$4,775,908**	$822,806	$2,291,510	$2,802,053	**$5,093,563**
20	$487,602	$1,357,969	$1,660,521	**$3,018,490**	$521,273	$1,451,743	$1,775,188	**$3,226,931**
25	$443,603	$1,235,431	$1,510,682	**$2,746,113**	$479,453	$1,335,273	$1,632,769	**$2,968,042**

Estimated annual payments above assume level total payments over the respective terms and fully amortizing debt structures. We have not attempted to structure debt payments to better match anticipated available net revenues. The REB will obtain additional debt capacity of a little more than $300,000 in fiscal year 2024 once the 2018 Note is retired in 2023 (see prior chart). The Foth report does not specifically indicate the useful lives of the assets financed, so we have not crafted financing scenarios that take asset life into consideration. Generally speaking, assets should not be financed over a period that exceeds useful life. IRS regulations limit the maximum term of tax-exempt financing to no greater than 120% of the useful life of the financed asset.

As previously mentioned, Net Revenues of the REC during prior fiscal periods for which audited financial statements are available do not demonstrate a level of cash flow sufficient to service debt associated with the estimated new capital costs. The ability to issue revenue-secured obligations is generally pre-conditioned by either: 1) a history of reasonable debt service coverage and expectations of the same in relation to additional financing requirements; or, 2) an independent forecast of operations through the point of stabilization that demonstrates feasibility of expected net revenues that meet projected debt service coverage requirements. General obligation debt payable from enterprise revenues need not demonstrate a requisite level of debt service coverage; however, best practices would call for similar levels of debt service coverage to provide for feasibility and reasonable operating performance. As such, we have prepared a simple debt capacity analysis in Table V based on 2019 estimated Net Revenues to be compared against the financing impacts in Table IV. Two scenarios have been set forth that show unadjusted 2019 pro-forma results, as well as results that are adjusted for Foth's estimate of net operating impact upon completion of the facility and processing improvements.

TABLE V

Estimated Debt Capacity and Impact(s)

SCENARIO 1		
2019 Estimated Net Revenues for Debt Service:	$ 5,397,203	[A]
Max Annual Debt Service @ 1.25x Coverage:	$ 4,317,763	[B] (= A / 1.25)
Max Annual Debt Service @ 1.10x Coverage:	$ 4,906,549	[C] (= A / 1.10)
Existing Debt Service:	$ 1,687,010	[D]
Additional Debt Capacity		
1.25x Debt Service Coverage	$ 2,630,753	[E] (= B - D)
1.10x Debt Service Coverage	$ 3,219,539	[F] (= C - D)

SCENARIO 2		
2019 Estimated Net Revenues for Debt Service:	$ 5,397,203	[A]
Less:		
Estimated Net Operating Impact of REC Improvements	$ (1,170,000)	[B]
Adjusted Net Revenues for Debt Service	$ 4,227,203	[C] (= A + B)
Max Annual Debt Service @ 1.25x Coverage:	$ 3,381,763	[D] (= C / 1.25)
Max Annual Debt Service @ 1.10x Coverage:	$ 3,842,912	[E] (= C / 1.10)
Existing Debt Service:	$ 1,687,010	[F]
Additional Debt Capacity		
1.25x Debt Service Coverage	$ 1,694,753	[G] (= D - F)
1.10x Debt Service Coverage	$ 2,155,902	[H] (= E - F)

Note(s)
Additional debt capacity of approximately $300,000 becomes available in 2024 after retirement of 2018 Note

It should be noted that approximately $300,000 in additional debt capacity becomes available in fiscal year 2024 upon retirement of the 2018 Note in 2023. Neither scenario above have been adjusted to incorporate a projection of this additional anticipated debt capacity.

In our experience a debt service coverage level of 1.10x on a sustained basis results in deteriorating operating performance for capital-intensive operations that require frequent and regular maintenance and replacement. Insufficient free cash flow eventually leads to deferred capital investment, which manifests in larger future borrowing, which burdens the enterprise with undue interest expense.

As a gauge of operational sensitivity, we will note that REB staff have communicated that a $1 increase in the tipping fee results in an approximate gross revenue increase of $450,000 per year. This back-of-hand calculation can be used to assess the required revenue stream to service debt, as well impacts to residents/users within the service area.

Recommendations

The REB has reviewed various sources of capital for the contemplated improvement project(s), which are considered within the framework of our analysis and recommendation. Other than traditional debt financing, the REB has reviewed:

- Grant funding (DEED)
- State funding through allocation of bond funds or direct appropriation(s)
- Loan sourced from the Closed Loop Fund

Other than a loan sourced from the Closed Loop Fund (CLF), the timing related to the other sources of funding would currently be indeterminable. Additionally, grant and state funding would most likely be in the form of reimbursement of prior costs, assuming the project(s) proceed in the near future.

Ehlers has spoken directly with a representative of the CLF. CLF provides no (zero) interest loans with a term up to ten (10) years to municipally-owned projects in amounts up to $2.5 million per governmental jurisdiction ($5 million total for REB based on dual-County ownership). Based on CLF's published eligibility standards, the recyclables sorting enhancements to increase diversion would be considered an eligible project type for the program. However, the CLF representative indicated that the output in the form of refuse-derived fuel (RDF) is a negative consideration under their review process. Furthermore, the timeline for CLF's application review, underwriting, and due diligence process would likely take 4 – 6 months, at which time a term sheet would be offered, and legal proceedings between the borrower and lender would formally begin. The CLF requires a collateral security interest in the assets financed but does not seem to require a specific pledge of system revenues for its loans. The CLF representative could not provide a definitive response as to whether the organization would refinance an interim/construction financing, as that would only be determined by their finance staff during review. He did indicate there was no express prohibition against such a refinancing.

Our review and analysis has directed us to the conclusion that the primary risk to financial feasibility is most tightly correlated to the total financing amount for the contemplated projects, rather than execution, timing, or interest cost. The REB should exhaustively seek out all sources of funding that would reduce the amount of debt financing needed to fully construct the authorized project(s). Additionally, project finance principles generally dictate that the authorized project(s) should have full funding at the time construction and acquisition contracts are executed. Insufficient funding can lead to project delays, which correspondingly delay the in-service date of the project and can disrupt or increase the cost of existing operations. Furthermore, sound decision-making can be jeopardized during periods when unfunded costs materialize and follow-on financing is required.

Our recommendation is to seek interim/construction financing for the authorized project(s) based on the following quantitative and qualitative factors:

- An innovative project concept with the potential for large variance(s) in actual costs.
- A currently undefined procurement/contracting method. The construction manager as agent approach has been contemplated. The contracting and procurement approach will determine which party takes on construction risk, the resulting cost of the project(s) and the likely time from design to completion.

- Estimates of financial operating impacts that are subject to assumptions that do not carry a high level of confidence.
- The possibility of future funding that can be used to reduce permanent financing needs but won't be available at the time of contracting/project commencement.
- Current financial results that show inadequate debt service coverage for both existing and prospective debt. In addition, audited financial statements for the 2018 fiscal year are not likely to be available for a number of months (draft financials will likely be available sooner).
- The inability to begin meeting substantial new debt service requirements, perhaps as soon as the 2020 fiscal year.

Interim/construction financing could be secured by either the Counties or REB as issuer. While there are methods by which interim financing could be sourced in the public debt markets (most likely by way of the Counties as issuer), a private/direct bank placement in the form of a loan is recommended. A bank loan is likely the most expedient, cost-effective and flexible interim financing solution. In the event a lender may require a collateral security interest in the assets financed, the REB as issuer might present most efficient approach. The REB is owner of the facility and real property, and would, therefore, be the legal entity through which the security interest would be perfected. The REB as issuer may also bring an appropriation pledge (moral obligation) on the part of the Counties into play. Given the essential public purpose of the facility, the PCA waste designation, the acquisition and operating history, and the commitment of the joint powers partners, we do not foresee the need for a general obligation pledge of the Counties for such a financing structure.

Bank financing would come in the form of a term credit facility that would function much like a line of credit. The authorized/maximum principal amount would be defined at the outset and can be established at a dollar amount that would comfortably fund the project(s). The rate for such an instrument would likely float (resetting periodically) and be pegged to a market index, such as LIBOR or SIFMA (LIBOR-based pricing is generally a percentage of LIBOR for tax-exempt debt, such as 70% - 75% of LIBOR). There are some instances where a rate can be fixed for the term of the loan. However, short-term rates are stable, and the interest rate curve is very flat through about five years in term. Periodic advances on the facility would correspond to payment requisitions. Interest would only accrue on amounts advanced, although there may be a facility fee charged against the undrawn balance (5 – 15 basis points). Interest would be payable at regular intervals (say, semi-annually) and could be paid from revenues or "capitalized" by advancing additional funds to pay interest due. The facility would have a term-out date, at which time it would need to be fully redeemed or terms renegotiated (re-issuance). We suggest a term that extends beyond the anticipated substantial completion date to mitigate the risk the project timeline is delayed. The credit facility would be subject to optional pre-payment at any time. The intent would be to permanently finance the project(s) with a defined, fully amortizing debt structure and/or other sources of capital prior to term-out. There are many national and regional commercial lenders that would be interested in providing this type of financing at reasonable terms. The Counties themselves could also effectively act as "the lender" during the construction financing period. This solution should be properly vetted with legal counsel to ensure the desired permanent financing outcome remains achievable.

Ehlers would assist with crafting a set of documentation to solicit construction financing proposals and assist with evaluation of said proposals to arrive at selection of a financing partner. We estimate the solicitation process, including evaluation and selection, to take approximately 4 – 6 weeks from the start of drafting to selection. A succinct project description will be necessary to craft a requisite solicitation document. Legal document drafting, negotiation

and lender due diligence will likely take another four weeks, with closing/funding to occur, shortly thereafter. The timeline may be extended in the event real property/assets are encumbered as collateral for the financing. We recommend the REB consider representation by qualified and recognized bond counsel prior to embarking on financing. Ehlers can assist with this effort. The REB could limit its consideration of bond counsel to the firm currently engaged by the Counties, which would likely provide continuity of thought and offer time and cost efficiencies. Should circumstances materially change from present assumptions, we will amend our formal recommendation(s), accordingly.