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March 1, 2018

Mr. Richard Abbott, Finance Director
City of Waukesha
201 Delafield Street
Waukesha, WI 53188

Mr. Joseph Ciurro, Administrative Services Director
Waukesha Water Utility
P.O. Box 1648
Waukesha, Wisconsin 53187

Re: Water Utility Bond Anticipation Note (BAN) Financing Recommendation

A handwritten signature in blue ink, appearing to read "Rich Joe".

Dear Mr. Abbott and Mr. Ciurro,

The action before you is to act upon two companion resolutions, one relating to the Sanitary Sewer Utility and the other the Water Utility, to authorize the issuance of a note anticipation note in the case of the Sanitary Sewer Utility and a bond anticipation note (BAN) in the case of the Water Utility.

The Waukesha Water Supply/Great Lakes Diversion project is one of the City's and Water Utility's largest-ever public infrastructure and financing initiative. After many years of analysis, planning, and approvals, the project is now moving closer towards the construction phase and the related growing expenditure funding needs. The construction process is currently scheduled to occur between 2018 - 2023, which causes variables to exist now as to the actual amounts and timing of funding expenditures, and the form of the final long-term financing.

More intensively over the last 18 months, work has focused on the most advantageous financing approach given the profile of the project and the financial standing of the two utilities. In the latter part of 2017, the City and the Water Utility decided to move forward with a draw bond approach. A draw bond is a financing tool with two primary elements. First, it provides ongoing access to funds to pay project costs at a minimal fee. Second, the interest cost 'clock' doesn't start until funds are drawn upon, and then only on the number of funds withdrawn. In combination, it provides a minimal cost to have funds available and once 'draws' are made the interest is based only on those amounts and not the entire bond amount. Draw bonds are used for short-term periods of time, often matching the construction period, and as such are a 'staging' tool, until such time a long-term bond is issued. Draw bonds facilitate a more precise definition of the actual long-term financing amount while providing flexibility of accessing the long-term bond market or obtaining state/federal low-interest loan/grant programs.

A draw bond's potential downside is that once a draw is made interest begins, the rate is variable and changes monthly. Therefore, interest rate movement exists after the initial drawdowns of funds throughout the term of the bond; three-years for the Sanitary Sewer Utility and five-years for the Water Utility. We have provided a risk mitigation tool to assist the City and Water Utility in managing this risk through the ability to pre-pay the draw bonds at any time after one year without a penalty. If this is exercised, the bonds could be funded with other non-variable rate short-term obligations or potentially right to long-term bonds.

Since the City's decision to proceed in mid-December 2017, the municipal bond market has experienced an upward trend both in short and long-term bonds given the federal Tax Reform Act and the improving economy. During this time the financing team has studied the changing interest rate costs of the draw bond approach versus more traditional approaches developing projections over the next few years. Based on assumptions and estimates, the staff members of the City and Water Utility, and its advisors now believe the primary benefit is in the first 24 – 30 months during which the funds are available but not completely drawn upon during the period of mostly paying the minimal availability fee. Therefore, it is very important to monitor the actual construction funding draws and the interest rate movement throughout this program.

Finally, since the mid-December action, the City and Water Utility completed a competitive selection of banks to place the draw bond. This process resulted in the selection of BMO Harris Bank.

Water Utility Testing Impact of Interest Rate Movement

Recently in conjunction with City and Water Utility staff given the interest rate market situation, we estimated the change from December in the financial benefit of using draw bonds from the traditional fixed-rate note. This testing assumed a rapid increase in the short-term borrowing rates, those charged upon draws of funds, in the first year and then a more gradual increase after that. For traditional fixed-rate notes, those interest rates have also moved upward since December. For this analysis, therefore, the draw bond option has upward interest rate movement over time; the traditional notes have rates from the early February market. Interest rates from early February have moved upward. That analysis estimated the net present value benefit from draw bonds is approximately \$550,000.

As stated above most of this benefit, approximately 90%, occurs within the first 24 months after issuance according to the construction expenditure estimates. If the construction is protracted then the benefit would increase as the borrowing rate would apply to a reduced amount of drawn principal.

Water Utility Transaction: Primary Business Points

Title: Bond Anticipation Note (BAN)

Bond Amount: \$32,800,000. The Water Utility decided on this amount to meet three objectives.

1. To refund its outstanding 2008 Bonds in order to gain more financial flexibility moving forward.

2. To fund the first two years of its five-year construction cost calendar, as in year three the Water Utility forecasts then current revenues will meet that year's construction. In the final two years of construction the Water Utility is forecasting the need to finance between \$75-\$100M of additional costs for a final maturity in 2023.
3. Rather than financing the entire project now, by dividing the financing into the two pieces, more information will be actually known about the total costs, the timing, the then appropriate financing options, and the availability of low interest loans or grants from state and federal agencies.

Term: 5 years, matures on April 1, 2023. The Water Utility decided on a five-year term because of the probability that state and federal low interest loans or grants would not be available until near the end of the project's construction. Therefore, a scheduled final maturity before such time would only cause an unnecessary re-issuance. The one-year optional prepayment permits the Water Utility as its sole discretion to terminate the BAN prior to five years. With access to such programs the total interest costs, hence user rates, could be reduced as compared to traditional municipal bonds.

Security: Not a general obligation of the City. Payable from the net revenues of the Water Utility and the proceeds from the issuance of long-term water revenue bonds or state/federal low interest loan funds or grants.

Optional Prepayment Provision: Prepayment at Par after one-year from issuance (same as Sewer).

Draw Availability fee: 10 basis points or 1/10th of 1% on undrawn amounts (same as Sewer).

Interest Rate on Draw Amounts: a formula based a broad market 'taxable' index, LIBOR, multiplied by a conversion factor to a tax-exempt rate, plus a factor relating to each Utility's credit quality and bond term – 'Tax Exempt Credit Spread' or the "Applicable Spread".

- a. For Water, One-Month LIBOR rate X 81% (tax exempt factor) + 74 basis points currently with LIBOR at 1.65%: Water Rate would be 2.07%.
- b. The Authorizing Resolution states the Applicable Spread component, here 74 basis points, is a maximum which will be defined and locked-in prior to closing on April 2, 2018. As this spread relates to market conditions it can be fine-tuned to the market changes as we approach closing. The City can only benefit by this condition.

Utility Change in Credit Rating: If the Water Utility's credit rating is downgraded while the draw bond is outstanding then the interest rate will adjust upward by approximately 10 basis points per rating notch.

Conclusion

In consultation with City and Water Utility staff, the estimates of the net benefit from using a draw bond approach still exist and therefore the City should proceed with the issuance of the BAN. Given the potential changes in the project as to construction expenditures and their timing, and in the interest rate markets, the financing program should be actively monitored to evaluate the actual benefits particularly over the first 12 to 24 months. The ability to prepay the BAN after 12 months provides a risk management tool for the City to adapt the project as it actually unfolds.

Respectfully,

A handwritten signature in black ink, appearing to read "David MacGillivray", is enclosed within a hand-drawn oval.

David MacGillivray
Chairman

cc Brian Lanser, Partner Quarles & Brady LLC