

Testimony of David Dornbirer

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CoBank

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Committee on Transportation and Infrastructure

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On

A Review of Innovative Financing Approaches for

Community Water Projects – Part 11

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Chairman Gibbs, Ranking Member Bishop and Members of the Subcommittee - good morning, and thank you for the opportunity to be with you this morning. I am Dave Dornbirer, Sector Vice President, Energy and Water Services Division of CoBank and manage a \$1.1 Billion portfolio of water, wastewater and solid waste loans. CoBank is a national cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. Many rural Americans depend on CoBank's water customers every time they turn on the tap. Not only are many of our customers in the business of providing clean, safe drinking water to rural areas, but others also process wastewater and deliver other services.

It is an honor to have been asked to testify this morning to provide an overview of Project Finance in the water sector. CoBank is the largest U.S. bank lender to the water industry and has over 23 years experience in providing a variety of different financing structures for water and wastewater utilities, including use of federal guarantees from the United States Department of Agriculture. CoBank provides a wide variety of financing ranging from long-term fixed rate loans, working capital revolving loans, project financing for both construction and term loans,

leasing and interest rate hedging products. We have a history of lending along side of State and Federal agencies, which has provided us an informed viewpoint of the pros and cons of various government financing programs.

As others have already mentioned, the need to upgrade our nation's water infrastructure is critical. The ability to leverage all resources – public and private – to provide the financing necessary for our nation's water systems is an admirable goal. There are different approaches to financing water infrastructure and various conduits through which to do so. While CoBank has extensive experience throughout the water sector, I will focus today's testimony on a proven public-private partnership structure whereby private capital is invested to meet the needs of a municipal system, either water or wastewater, and spreading the risks of such an undertaking among the different interest groups.

In a recent press release, the American Council of Engineering Companies California remarked that the state's policy makers need new ideas for solutions on how to improve California's infrastructure and better leverage the state's extremely limited capital. It went on to say "Public-private partnerships are (a) particularly useful tool for delivering new water supply projects." This same concept can be expanded to include other water and wastewater infrastructure.

“Project Finance 101”

I was asked to provide a “Project Finance 101” presentation for the committee. (Refer to the Attachment to this testimony for amplifying information.) To begin with, “project-finance” is not the same thing as “financing projects.” When I talk about project finance, I am referring to the long-term financing of discrete assets of water and wastewater infrastructure owned by a single purpose company. It can be used to finance a treatment plant, water storage facility or pipeline, though it can be expanded to include an entire water system. The financing of that entity is dependent upon its projected cash flows. Though there are innumerable variations, each has the same basic characteristics. And, the overriding factors are the identification of the risks of the project and the proper allocation of those risks among the project parties. You want each party assuming risks that it is best suited to manage.

I'll start by providing an example of a project-finance deal, and then explain the various financing considerations of a typical deal and refer to my example for context. Project finance has been utilized for decades in this country to develop infrastructure in the power, oil and gas, solid waste and transportation sectors. This structure is widely used for water and wastewater projects around the world, but it has not gain much acceptance in the United States to meet our mounting needs.

The City of Santa Paula (the City) sits in a citrus-growing valley 65 miles north of Los Angeles. In 2007, the City's almost 70 year-old wastewater treatment facility faced severe compliance fines and needed to be replaced quickly. However, the City was uncertain as to a dependable source of funding, cost and schedule to achieve its compliance mandate. Realizing traditional delivery methods of financing would not provide adequate certainty; they chose to utilize a public-private partnership.

In 2008, the city contracted with one entity, Santa Paula Water (the project company), which was an alliance of PERC Water Corporation and Alinda Capital Partners, to design, build, operate and finance the new facility. The speed of Alinda Capital's investment enabled construction to begin immediately and PERC's expert management delivered the plant on budget seven months ahead of the compliance schedule. The City did not begin paying its service fee to Santa Paula Water until the plant was in full operation and in compliance with its waste discharge permit. It is likely this would not have been possible under a traditional method of project procurement.

The City Council understood that this structure would provide long-term rate and regulatory certainty for the citizens of Santa Paula. For the next 30 years, the City would have certainty of compliance, certainty of capacity and certainty of cost.

If the City had taken a more traditional finance route of grant funding, government loan programs and/or the municipal bond market, they would have had difficulty in trying to raise money when funds were needed to complete construction within the regulatory timeframe. The facility was 100 percent privately funded and the City did not pay anything toward the facility until after it was in full operation. The City now pays a monthly service fee that covers 30 years of capital replacements, debt service, operations and maintenance and the option to expand capacity of the plant. The City maintains responsibility for the wastewater collection, customer contact and billing, certain permits and user rates. In 30 years, the facility will be returned to the City at no cost in good working condition. In addition, the City has the right to purchase the plant from the Santa Paula Water at a predetermined price. This approach freed up valuable municipal financing capacity for the City to pursue important planned improvements, in addition to minimizing the construction and operating risks associated with the project.

This project was the first of its kind of financing. CoBank and DZ Bank arranged the debt financing package for the project in the height of the credit crunch during the recession.

The facility is considered one of the more energy-efficient and most cost-effective of its kind in the world. Energy costs are now 38% lower than what was originally bid. The \$20,000 a month savings is split evenly between the City and Santa Paula Water. The plant is a water recycling facility because the effluent produced by it is treated to such a degree that it can not only recharge the local aquifer but it is safe enough to irrigate community parks and golf courses. The project not only exceeds its requirements but produces a commodity that is expected to have financial value in the future.

This type of project takes a long-term approach. Often times there can be a disconnect between engineering a plant design, construction of the plant and operation of the plant. But PERC Water's innovative approach incorporated all three elements from the start, enabling it to accurately determine the construction budget and the certainty of the cost to operate the plant for the life of the contract. They understood that their job is not done for 30 years. This holistic approach provides flexibility and incentives to invest in infrastructure over time.

The Santa Paula project finance deal was successful due to a variety of factors. The City faced time constraints, compliance deficiency, technical complexity, financial uncertainty, debt limitations, and importantly – political will. Part of the political will was to realize that consumer

rates needed to be raised. Raising rates is never an easy task, but the rates had not been raised for over 20 years and the aging infrastructure had suffered neglect as a result. The average increase per household is about \$20 per month to support needed upgrades to the wastewater system.

It is important to note that government financing - state revolving funds, federal direct loans or grants most often have lower stated interest rates, but much of the risk falls to local, state and/or federal taxpayers. Loan guarantee programs do a better job of risk sharing as the lenders utilizing the guarantee are liable for a portion of the losses should they occur. Under a project finance structure, risks that were once only held by the user or the taxpayer are mitigated by other parties. The flexibility that project finance provided for the City of Santa Paula allowed it to accomplish its goals in record time and with appropriate safeguards in place because Alinda Capital and PERC Water assumed risks they could control and, in turn, were able to determine the appropriate underwriting of the project.

Onto Project Finance 101: A single purpose entity is formed to develop, build and own the project. At the beginning stages of the deal, the parties – the municipality, the private equity sponsor, and the management team decide how the project will be structured. This entity can be wholly owned by the private equity sponsor of the project or it could form a partnership with the municipality and jointly own the project. By forming a standalone special purpose entity, all the contract parties can look only to that project company for the enforcement of contracts. This limits the liability of the project sponsor as well as the municipality if it is a joint owner. From the point of formation of the project company all the work begins with negotiating and executing the contracts that give the project life.

Lenders to the project company are relying solely on the contracts executed by the project company and the cash flows generated by it. Legal due diligence is key to understanding the rights and obligations of each contract party and the enforceability of each contract. The lenders are basically loaning against the contracts because those contracts govern the construction budget, the expected revenues, the operation and maintenance of the plant and the financing. The lenders will size their loan amount based on the expected cash flows generated by the project company, not the balance sheet of the project company.

The heart of a water project finance deal is the DBOF agreement, which stands for Design, Build, Operate and Finance, between the project company and the municipality. In the case of Santa Paula, this is a 30-year contract. The DBOF lays out who is responsible for what—the specifications of the plant, the delivery schedule, damages for failure to uphold contract provisions, the revenue from the rate payers to the project company, permits, dispute process, design changes, future expansion, and transfer of ownership. Because the project company is exclusively dependent on user fees, the municipality will be required to segregate those payments from other departments. In addition to rate setting, the municipality may also agree to be responsible for those operating costs of the plant that it can control. The City of Santa Paula agreed to a pass-through of electricity and sludge disposal costs, however, the DBOF spelled out maximum power usage limits, which mitigate the City's liability. As water and wastewater facilities are strictly regulated by environmental agencies, it is vital that the proper party, the municipality or the project company, be responsible for meeting permit requirements over which it has the greatest control.

If the DBOF is the heart of a project, rate-setting is the lifeblood. Considerations include rate-setting authority, the essential service nature of the project, the rate-setting and rate dispute process, public utility commission involvement, potential for rate shock, inflation adjustments, mix of ratepayers (residential, commercial, industrial, municipal), creditworthiness of the sponsoring municipal agency, and community demographics. The source of project revenue should be transparent and easily modeled in order to obtain the most attractive financing terms benefiting the project and subsequently the ratepayers. Simplicity is also important. The 30-year rate schedule for Santa Paula is on one sheet of paper.

Aside from the financing documents, which I will touch on later, the next most critical contract is the construction contract. This can have various names, such as EPC, which stands for engineering, procurement and construction. While these contracts can take on many different forms and include more than one contract party, it is simpler to highlight the best case scenario where a firm provides a fixed-priced, turnkey contract. Here, it is the EPC contractor's sole responsibility to design and deliver the plant per the specifications (mutually determined by the project company and the municipality) on a contractual schedule and for a fixed price. Key considerations for an EPC contract and the contractor include experience in this field, realistic budget and construction schedule assumptions, quality of subcontractors, financial wherewithal to meet its obligations, contingencies, liquidated damages, dispute process, technology risk, permitting, and equipment delivery and warranties.

Next is the operations and maintenance, or O&M, agreement. This should be a fairly straightforward contract. The project company wants to ensure the operator has sufficient experience running this type of plant and the process being used. It is important the operator has the financial wherewithal to stand behind its contractual obligations. Often times there will be incentives for the operator to manage the costs of operating the project within a lower and upper bound. Having confidence in the O&M costs adds to the stability of cash flows, which improves the credit quality of the project. Water and wastewater plants typically use proven technology and processes, and, therefore, operational risks are normally considered low. However, the risks should be mitigated with O&M reserve funds (in case it is more expensive to run than originally projected), major maintenance reserves for schedule overhauls and equipment replacements along with warranties that match expected performance.

At Santa Paula, the EPC and the O&M contracts were melded into a DBO agreement between PERC Water and the project company. PERC took responsibility for the design, building and operation of the entire project. I believe this to be an ideal model because PERC knew it had to operate the plant it designed and therefore was in the best position to model the whole lifecycle cost of the plant, including major maintenance and future expansion. Under more common procurement and delivery methods where a "project is financed" rather than "project financed" it isn't always clear if the entire lifecycle costs are properly modeled leading to potentially more risk for a municipality down the road. The DBO arrangement also gave the City a single point of contact during and after construction, which facilitates better coordination between the City and the project company.

Having laid out a typical project structure, I will now address the finance part of project finance. The provisions of the various contracts that I mentioned earlier are the very considerations

lenders analyze when structuring the financing, with a few additions. A crucial element is the financial and business profile of the main project sponsor(s). The firm providing the equity into the project should demonstrate commitment to the water sector. These projects are complicated to develop and involve a lot of patience and time. Secondly, the equity sponsor needs to be deep-pocketed in relation to the size of the project. Even though contracts may state the required amount of hard dollars to be invested in the project company, one can sense if the sponsor is committed and can ensure the project crosses the finish line. At Santa Paula Water, Alinda Capital was such a sponsor. They not only have adequate capital to invest and experience in the water sector, but there are a number of project finance professionals in the partnership group and on the deal team.

The project sponsors develop a comprehensive base-case financial model that captures in great detail the expected costs and cash flows of the project from construction through the term of the DBOF. Lenders vet that model analyzing all the variables, including the ability to pay principal and interest, before determining the appropriate level of debt the project company can support. The leverage, or the percentage of debt, can be as high as 80% for projects that prove to have very stable and predictable cash flow generation. The amount of debt financing and the cost of that debt depend on proper risk allocation through the contractual structure, solid sponsorship, equitable contracts, sufficient rates, solid demographics, operational cost certainty, adequate reserves, community acceptance, comfort with the contractors and the essential service nature of the facility.

Additional components of the lenders' due diligence process are hiring an independent engineer, an insurance consultant and legal counsel. The independent engineer is the lenders' proxy in the evaluation of the plant design, construction contract and budget, project financial model, and permitting, along with periodic monitoring of construction and operations. The insurance consultant analyzes the policies procured by the various project parties to determine adequate coverage for loss, business interruption, liability, etc. Lenders' counsel analyzes all the project contracts and regulatory issues and drafts and assists in negotiating the loan agreement. All of these costs are borne by the project company.

The resulting loan is to the project company. The loan amount plus the sponsor's equity will cover all the costs of building the plant. The lenders will not have recourse to the project sponsor, other than enforcing the sponsor's equity injection, or to the municipality. This is the crux of risk sharing. The lenders are willing to shield the municipality and share in the risk through proper due diligence of the project structure. Ultimately, the goal of the contractual structure in a project financing is to leave only operating risk and counterparty risk with the project company and its lenders and owners. As long as the municipality does not cause a default under the DBOF for not producing the agreed upon revenue, which, in turn, could cause a default under the loan agreement for inadequate debt service, it is protected from problems caused by the project company. The public-private partnership using a project finance structure delivers certainty to and boxes the risk for the municipality that a more conventional financing of a project does not.

Again, assuming it is a well structured project, there is quite a bit of flexibility in the debt's terms and conditions. Banks can fund construction and provide term financing out to 20 years. The

loan agreement can be amended to allow the debt to remain in place if the municipality exercises its right to purchase the plant prior to the expiration of the DBOF. Once construction is complete, the plant has passed acceptance testing and begun full scale operation, other long term providers of debt capital like insurance companies would be interested to refinance the bank debt and extend the financing further towards the end of the DBOF term. Bank lenders will require that the debt be fully repaid prior to termination of the DBOF so that there is no debt assumed by the municipality.

Lenders will be secured by mortgaging the plant and filing liens on all the assets of the project company. Non property, plant and equipment assets include future cash flows, bank accounts, contracts, and intellectual property. If the project company defaults under the terms of the loan, the lenders reserve the right to step in and replace the operator or seek other remedies in order to return the project to sound operation.

Major advantages of a project finance vehicle are the flexibility of the loan terms discussed previously and the flexibility of debt sources. The structure can incorporate government grants and co-lending by either state and/or federal loan programs. Commercial lenders lending alongside government programs require an inter-creditor agreement that outlines the rights of each class of lender. Another advantage is project financing saves the bonding capacity of the municipality because it is not the party incurring the debt. Also, lenders will typically not require a rating from a credit rating agency, which eliminates a significant cost. As the tax-exempt municipal bond market functions on credit ratings, project finance opens an avenue for smaller systems to pursue relatively large projects assuming the financing considerations explained above are adequately addressed. Projects funded through government programs sometimes incur onerous requirements that commercial lenders do not require. These programs carry administrative and subsidy fees comparable to the financing fees charged by financial institutions to arrange debt financing. In the country's current low interest rate environment, commercial rates can be competitive with tax-advantaged rates, particularly for municipalities that are unable, or do not wish, to secure a credit rating. A potential disadvantage of project finance, but similar to conventional financing, is the transaction costs are about the same regardless of the size of the project. For example, assume there is \$300,000 in lender due diligence costs, which sum the expenses of the consultants and legal counsel outlined earlier. If the project plant has a capacity of 10 million gallons per day (MGD), the project's due diligence costs \$3,000 per MGD. But, if the project is only 1 MGD, then those costs work out to \$30,000 per MGD. As a result, Project finance may not be the appropriate approach for these very small water systems.

Impediments

I was asked to comment on some of the barriers to innovative financing similar to the Santa Paula example. First of all, the Santa Paula public-private partnership is just a different way of doing business and it will take time for other water systems to become accustomed to alternative structures of financing. Many water systems are comfortable with the traditional approach of issuing tax-exempt bonds and applying for funding through federal and state programs. Most public water systems have carried all the risk for project improvements and lack experience in sharing risk with private entities. Historically the financial risk of the water infrastructure has

been carried largely by the federal and state funding programs, not by the private sector. Additionally, projects are delayed while municipalities hold out hope that they will be eligible for grant funds and/or government program loans. There is a lost opportunity to waiting as it decreases project certainty, particularly in an inflationary environment, and delays the needed improvements in water quality or wastewater service. Exploring public-private partnerships requires a paradigm change for tens of thousands of publicly-owned water systems and may take time to be widely adopted.

Direct and Guarantee Loan Programs

As the Committee explores developing a new direct and guarantee loan program, please keep in mind that CoBank is committed to being a dependable provider of credit and other financial services to water systems across rural America. We would welcome an opportunity to participate in a new guarantee loan program or a direct loan program that includes a private sector match to meet the financing needs of our nation's water infrastructure. With over 52,000 different water systems across the country, having access to a multitude of financing options is beneficial.

CoBank has experience working with the Rural Water and Waste Water Guarantee Loan Program administered by the Rural Utility Service of the United States Department of Agriculture (RUS). In the past year CoBank has received a surge in inquiries from small rural water companies seeking financing, which has led to an increased interest in the Water and Waste Water Guaranteed Loan Program. This guarantee loan program enables CoBank to extend credit to small rural water companies with loan tenures of up to 30 years. Loans with tenures of up to 30 years greatly assist small water systems that lack the financial wherewithal to use our in-house 20-year loan products. Without the guaranteed loan program, CoBank would not be able to offer 30-year loans to these systems. We are discussing the use of guarantee loans with some prospective customers and hope to close a handful of deals this year.

Conclusion

Thank you for the opportunity to appear before the Subcommittee today. It has been an honor to be here and provide an overview of Project Finance and highlight how CoBank uses innovative financing to meet the challenge of upgrading our nation's water infrastructure. Thank you and I would be happy to respond to any questions you might have.

COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE
Truth in Testimony Disclosure

Pursuant to clause 2(p)(5) of House Rule XI, in the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include: (1) a curriculum vitae; and (2) a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by an entity represented by the witness. Such statements, with appropriate redaction to protect the privacy of the witness, shall be made publicly available in electronic form not later than one day after the witness appears.

(1) Name: David Dornbirer

(2) Other than yourself, name of entity you are representing: CoBank, ACB

(3) Are you testifying on behalf of an entity other than a Government (federal, state, local) entity?

YES

If yes, please provide the information requested below and attach your curriculum vitae.

(4) Please list the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by you or by the entity you are representing: NONE



Signature

3/16/12
Date

DAVID DORNBIRER

Sector Vice President

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CoBank, ACB**

David Dornbirer leads the Water Services lending team in CoBank's Rural Infrastructure Banking Group. He is responsible for a portfolio in excess of \$1 billion of loans to more than 80 not-for profit, investor owned, and public-private partnership water, wastewater and solid waste companies across the United States. He has more than 13 years of experience advising and lending to companies in the water and energy sectors.

Mr. Dornbirer joined CoBank in 2004. Prior to joining CoBank, Mr. Dornbirer served as the Director of International Operations for Blackbird Holdings, where he was responsible for budgeting, finance, human resources and legal functions for the provider of derivative trading services. Mr. Dornbirer has also held positions in the international and project finance groups at Bank of America after having served nine years in the U.S. Navy.

Mr. Dornbirer earned a bachelor's degree in finance from Miami University, and a master's degree in business administration from Thunderbird School of Global Management.

ABOUT COBANK

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