WASHINGTON COUNTY
WATER
CONSERVANCY
DISTRICT

July 22, 2019

Kade Minchey, CIA, CFE
Auditor General
Office of the Legislative Auditor General
W315 State Capitol Complex
Salt Lake City, UT 84114

Dear Mr. Minchey,

We appreciate the legislative auditor's efforts to prepare *A Performance Audit of the Repayment Feasibility of the Lake Powell Pipeline* (audit). The auditors were professional, responsive and thorough. We're grateful for their work as well as the legislators who initiated this analysis.

We are pleased that the audit confirmed that the Washington County Water Conservancy District (district) can generate sufficient revenue to repay the Lake Powell Pipeline (LPP) costs. The district has already initiated several mechanisms to ensure the financial viability of this project. Those efforts include, but are not limited to:

- Saving money for a project down payment, which is not required by statue;
- Enacting a general capital financing strategy that allows for the systematic increase of revenue (i.e., impact fees, water rates and property taxes) to generate additional funding to reduce/repay project costs, without placing undue burdens on those who pay the fees;
- Creating an additional, secure revenue source (i.e., a monthly surcharge on each water connection) that can be used to offset potential revenue deficiencies from other funding sources; and
- Completing an independent third-party analysis on the district's current general financing strategy and resulting revenue capacity, which was shared with the Governor's Executive Water Finance Board in 2018.

As the LPP project continues to progress, additional efforts will be made to reduce cost, such as value engineering the final design and breaking the project into multiple components to allow local contractors the opportunity to competitively bid services. Additional information on the project's costs will become available as the required environmental Records of Decision are issued and the project advances to a final design. We are committed to managing and reducing expenses to minimize borrowing costs and potential financial impacts to taxpayers.

While we appreciate the analysis on various hypothetical repayment scenarios listed on page 10 of the report, it should be noted that the financing terms specified in the 2006 Lake Powell Pipeline Development Act (act) are not based on straight-line payments nor does the act require the capitalization of interest; therefore, payment structure two is the only option that complies with statue.

Furthermore, the capitalization of interest is inconsistent with how the state has historically financed projects and, as noted in the audit, is not contemplated by nor called for in the act.

In addition, we appreciate the risk assessment performed by the auditors in identifying potential scenarios in which the district may not be able to pay for the LPP, such as a reduction in growth that may decrease planned revenue. While that is a potential risk, we consider the greater and more likely risk to be growing faster than projected – as we have done for the past 50 years – and having an inadequate water supply to support our population and economy. Growing at a faster rate would increase planned revenue, which is not stated in the audit. It is unclear why only the downside risk of population growth is included in the audit, but the risk of faster growth and the potential for water resource instability is omitted.

Every project funded by the state of Utah, including funds for education, roads, airports, etc., shares similar financial risks as investments in water infrastructure. That said, unlike investments in education and transportation, water projects are repaid. Suggestions that water projects should be subject to additional conditions and/or repayment terms not typical in other state financing endeavors are counterproductive. Certainly, if law makers had intended to include such "special conditions," they could have written those conditions in the act. They chose not to; and, to add them after the fact, is inappropriate and inconsistent with a plain reading of the statute.

As requested, we have reviewed the audit and are providing our feedback to both the recommendations and report in general. Again, we are grateful for the opportunity to respond and believe the audit and our accompanying response will be an important resource for those considering the district's ability to pay for the LPP. Our feedback is outlined below.

District Response to Recommendations

We agree with the recommendation to prepare a formal repayment plan for the LPP once the financing terms and costs are finalized, considering the financial impact on taxpayers and water users while generating enough revenue in the event of an economic downturn. This plan is already scheduled to be completed in advance of construction when the project cost, interest rates, financing terms and other market factors are known.

We agree with the recommendations to clarify the terms for repayment, how repayment costs can be divided among and within repayment contracts and the final repayment time frame for outstanding pipeline reimbursable costs; however, we default to legislators on if this requires an additional statute or if this falls under the statutory authority given to the Utah Board of Water Resources in the act. This effort should consider the formal correspondence between the district and Utah Division of Water Resources (division), in which some of these terms have already been clarified. The district has relied on these determinations and has progressed with the project based on its reasonable interpretation of the act and subsequent correspondence with the division that confirmed our understanding. In addition, the Bureau of Reclamation's (Reclamation) financing model should be reviewed as it provided sample guidelines that legislators adopted in the act. For example, the division of repayments (referred to as "block notices" by Reclamation) allows for water to be paid in blocks as delivered, and the 50-year repayment timeframe from the date of water delivery is also realized in Reclamation's model.

We agree that it would be beneficial to formalize the repayment process, including any expectation of a down payment, with the Board of Water Resources for items in which they are given statutory authority. We anticipate this will be part of the formal repayment plan previously mentioned and formalized in the contract with the state.

We agree with the recommendation that multiple sources of funding for the LPP should be considered, but options that impose limitations and/or significantly increase project costs should not be pursued as that is not in the best interest of those who will ultimately pay for the project, much less, all those who will ultimately benefit from it.

District Response to Report

Introduction & Chapter 1

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- The audit reads: "The 2006 Lake Powell Pipeline Development Act (act) authorized the state Board of Water Resources to build the Lake Powell Pipeline Project (LPP) subject to funding." The act itself reads "The board [of Water Resources] shall construct the project as funded by Legislature." The language used in the audit questions if the project will be funded, whereas in the act considers how, not if, the funding will occur.

Chapter 1

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- While population growth does drive the need for the LPP, having a second, more reliable water supply is also critical. Most of Washington County's residents are dependent on a single water source of variable quantity and quality – the Virgin River basin.

Chapter 2

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- As previously stated, the financing terms specified in the act are not based on straight-line payments nor does the act require the capitalization of interest; therefore, payment structure two is the only option that complies with statute and the interpretation of that statue provided by the agency in authority. Payment structure three is clearly inconsistent with both the act and interpretations of that statute previously provided by the division.

  The act, which was modeled after the Bureau of Reclamation's financing terms, allows the participating districts to take the water down in multiple blocks and allocates a repayment period for each water block. This model allows for payments to increase with growing revenue, and it equitably enables multiple generations of water users to repay project costs, rather than burdening the current generation with the full project cost. Clearly, the concept of building a water system solely for people who live in a region today is illogical, as the people for whom the system would be constructed would not reside in the area but for the presence of safe, secure and sufficient water resource.

  This interpretation of the payment scenario was confirmed in formal correspondence between the district and the division. We have relied on this interpretation in moving forward with the project.

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- The caption for Figure 2.1 reads that revenue is "sufficient to cover LPP payments after 2039," but does not clarify that is only based on the hypothetical straight-line payment scenario one. The district's ability to make LPP payments based on current law (scenario two) indicates sufficient revenue to cover LPP payments in 2028, as depicted in the figure, to coincide with the project's anticipated completion date. It is unknown why the caption only highlights the conditions under payment scenario one.

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- Project delays may result in a higher cost due to inflation, but it also allows more time to generate revenue for a down payment, which would reduce financing costs.

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- As a not-for-profit public agency, the district will continue managing revenue and expenses to ensure adequate funds are available to secure, treat and deliver water while meeting debt obligations without generating "large excess revenue." The district's current capital financing strategy was developed to demonstrate capacity if all revenue increasing mechanisms were employed to their full extent to cover the costs of all current district project including, but not limited to, the LPP. Adjustments will be made as needed to ensure an appropriate balance.

- The audit reads that Utah code is "unclear as to the actual model of repayment." This is not the case. The act is not unclear relative to the model of repayment; the act is silent as to the model of repayment. This and countless other details are left to the administrative agency, in this case the Utah Division of Water Resources, to provide a reasonable interpretation. They have provided such an interpretation, and the district has relied upon it.

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- Funding for the district's projects that will precede the LPP will not interfere with project repayment or the anticipated down payment. The audit reports "projects planned prior to 2028 totaling over $200 million." Nearly half of the district's $200 million-plus cash on hand at the end of 2018 will be used to fund these projects. When possible, the district pays for projects upfront to minimize financing costs and save taxpayers money.

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- The auditor correctly clarifies that the potential increase in water rates from $1.24 (2019 rate) to up to $3.84 (2045 rate) per 1,000 gallons is exclusive to the district's wholesale water rate. This is an important point because water users pay a blended rate of district and municipal fees. A percent increase to the district's wholesale rate does not equate to an equal percent increase to the water user.

- The auditor included retail water "base rates" in Figure 2.6 which is appropriate given that is a cost to water users. While our municipal water rate tier structure may be lower compared to the other listed desert cities, the base rates of our municipal partners, which range from approximately $15 to $32, are comparable to or higher than the listed cities.

Chapter 3

Pg. 27

- The concept of "full cost to bond" appears to contemplate opportunity cost of state funds and capitalization of state interest costs, even when no interest cost is actually borne by the state. We are unaware of anywhere in Utah's municipal finance history where the "full cost to bond" has been applied nor is this contemplated by the act.

  The Office of the Legislative Fiscal Analyst, who establishes and balances the state's budget as directed by legislators, "[does] not measure a bill's…non-fiscal impacts like opportunity costs."[1]

[1] Utah State Legislature, Office of the Legislative Fiscal Analyst website: https://le.utah.gov/lfa/index.htm#

While opportunity cost is rarely, if ever, considered, what is commonly considered are the economic and fiscal benefits to the state, which include, but are not limited to the following factors:

- Sales tax revenue supported by the LPP is estimated to generate more than $9.4 billion between 2026 and 2060, 78% of which would inure to the state[2]
- Income tax revenue supported by the LPP is estimated to generate more than $11 billion between 2026 and 2060[3]
- Water from the LPP (based on conservative 2016 estimates) would annually support approximately:
  - 102,000 jobs[4]
  - 106,000 businesses[5]
  - More than $9 billion in personal income[6]
  - Nearly $4 billion in wages and salaries[7]
  - More than $9 billion in gross domestic product[8]
- In addition, there are one-time construction impacts to the economy. An estimated $1 billion project in Washington County, UT would generate approximately[9]:
  - 10,000-plus jobs
  - $425 million-plus in wages
  - $1.5 billion-plus in economic output

As previously mentioned, state investments in water infrastructure are repaid. In addition, several water infrastructure projects continue to generate annual state revenue. For example, Quail Creek and Sand Hollow state parks, water storage projects fully paid by water users in Washington County, return millions of dollars in revenue to the state annually.

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- We appreciate the auditor's note that the division has never capitalized interest on state projects they have funded, meaning more than 1,000 water projects in Utah have been funded <u>without</u> capitalized interest. In addition, the state has a tradition of offering loans at a subsidized or low-interest rate. Given these well-established traditions, it's unclear why the LPP would be subject to different conditions that would complicate funding for a project that would benefit the state.

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[2] The Economic and Fiscal Implications of Water Policy in Washington County, UT, June 13, 2018
[3] The Economic and Fiscal Implications of Water Policy in Washington County, UT, June 13, 2018
[4] U.S. Bureau of Labor Statistics
[5] U.S. Bureau of Labor Statistics
[6] U.S. Bureau of Economic Analysis
[7] U.S Bureau of Labor Statistics
[8] U.S. Bureau of Economic Analysis and the St. George Metropolitan Statistical Area, coterminous to Washington County, UT
[9] Water Stability in Washington County, UT: A Review of Economic, Fiscal and Development Impacts, 2013

The audit reads "the federal Bureau of Reclamation does charge and capitalize interest during the construction of water projects for municipalities." To clarify, Reclamation charges two types of interest: interest during construction (IDC) and interest on investment (IOI). IDC is charged on construction costs quarterly and is capitalized. When the construction is "substantially" complete, the costs, including IDC are transferred to a "plant in service" capital account and depreciation begins. At that point, Reclamation starts collecting payment and IOI, which is not capitalized. IDC works like a construction loan when building a house, and IOI works like a mortgage loan.

As indicated in the audit, "depending on payment and capitalization schedules, the amount that would be repaid by the district could increase dramatically," so if the state is going to depart from historical precedent relative to capitalizing interest, it's critically important that the way that will be applied is clearly presented.

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- Based on the Kem C. Gardner's 2017 population projections for Washington County, which are significantly lower than actual historical and current growth rates, and projected water demand, it is anticipated that the full 82,249 acre feet of water from the LPP will be contracted and in use by the mid-2050s. We do not foresee a scenario in which the district does not contract for and repay 100 percent of the water.

Again, we express our appreciation to our legislators and the auditors involved in this analysis. We're grateful for the time and resources dedicated to this important topic and look forward to additional discussions on the LPP financing and repayment as the project continues to progress.

Respectfully,

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General Manager

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Deputy General Manager