Ascension Parish regional sewer project

Addendum to financial & commercial analysis dated 6 November 2019

27 November 2019

Building a better working world

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Disclaimer

Ascension Parish Government (the Parish) has retained Breazeale, Sachse and Wilson, L.L.P. (BSW) to provide legal representation regarding the participation of Ascension Consolidated Utilities District #2 (the District) in a proposed public-private partnership (PPP) with Ascension Sewer, L.L.C (Ascension Sewer). In furtherance of the BSW rendering legal services to the Parish, BSW, at the Parish's request, engaged Ernst & Young Infrastructure Advisors, LLC (EYIA) and its subcontractor, HNTB Corporation (HNTB), to provide financial, commercial and technical advisory services in relation to the proposed PPP, which BSW will use in rendering legal advice to the Parish.

This Report Addendum, dated 27 November 2019 represents a deliverable required under the terms of the subcontract agreement between BSW & EYIA dated 7 October 2019 ("Agreement").

In preparing the Report, EYIA relied upon certain data and information provided by BSW, the Parish, the District, Ascension Sewer and Ascension Wastewater Treatment (AWT) as an associated party to the potential transaction. No procedures were performed by EYIA to evaluate the accuracy or completeness of data and information provided by these entities, and no such procedures were included in the agreed upon scope of work in the Agreement between BSW and EYIA. Accordingly, EYIA expresses no opinion and issues no other form of assurance regarding the data and information provided by any of these entities. The procedures EYIA performed do not constitute an audit of historical financial statements or an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants.

The services performed by EYIA were advisory in nature. EYIA's scope of work was determined by BSW and agreed to by EYIA pursuant to the terms of the Agreement. Certain analyses and findings in the Report are based on estimates and/or assumptions about future events which were provided by BSW and the entities noted above. There will usually be differences between estimated and actual results because future events and circumstances frequently do not occur as expected, and those differences may be material. We make no representation of, nor do we take any responsibility over, the achievement of estimated or projected results. The findings and analyses contained in the Report are based on data and information made available to EYIA through the date hereof. Should additional relevant data or information become available subsequent to the date of the Report, such data or information may have a material impact on the findings in the Report. EYIA has no future obligation to update the Report.

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The Report is intended solely for use by BSW. While EYIA believe the work performed is responsive to BSW's request pursuant to the scope of work in the Agreement, we make no representation as to the sufficiency of the Report and our work for any other purposes. Any third parties reading the Report should be aware that the Report is subject to limitations, and the scope of the Report was not designed for use or reliance by third parties for investment purposes, or any other purpose. We assume no duty, obligation or responsibility whatsoever to any third parties that may obtain access to the Report.

Glossary

Ascension Sewer	Ascension Sewer, L.L.C
AWT	Ascension Wastewater Treatment
BAU	Business as usual
BSW	Breazeale, Sachse and Wilson, L.L.P.
Capex	Capital expenditures
C&O Agreement	Construction & Operating Agreement
DEQ	Louisiana Department of Environmental Quality
District	Ascension Consolidated Utilities District #2
EYIA	Ernst & Young Infrastructure Advisors LLC
HNTB	HNTB Corporation
IRR	Internal rate of return
O&M	Operations and maintenance
Parish	Ascension Parish
PPP	Public-private partnership
SRF	Clean Water State Revolving Fund
US	United States

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Addendum — updated status of key financial and commercial analysis outcomes

Introduction and purpose

This addendum provides an update to the executive summary of the EYIA report dated 6 November 2019 and addresses the status, as at 27 November 2019, of those financial and commercial risks to the District identified in the 6 November report. In doing so, this addendum draws on the draft Construction, Operating and Cooperative endeavor Agreement (the C&O Agreement) entitled "*BSW – Redline Changes – C&O Agreement 11.26.19".* This addendum follows the same structure as the executive summary of the 6 November 2019 report and provides a synthesis of the executive summary, and commentary on key changes relevant to the financial and commercial analysis previously undertaken. This addendum seeks to address those issues most material to the Parish, but does not seek to identify or comment on every change to the C&O Agreement subsequent to the 6 November report, nor set out an exhaustive list of financial and commercial matters associated with the C&O Agreement. .

Synthesis of 6 November report

Introduction and context

- The proposed project, as embodied in the C&O Agreement, is a utility concession arrangement that combines elements of a rate case-based investor-owned utility model in terms of balance of risk transfer (albeit in this case without the obligation for ongoing financial transparency and disclosure of financial performance or fixed rate of return) and a public-private partnership (PPP or P3).
- This will involve combining the District's existing utility assets and customers with that of local private utility, Ascension Wastewater Treatment (AWT), and construction of a new regional wastewater plant.
- Ascension Sewer is responsible for the design, build, finance, operate and maintenance of the utility assets, with legal ownership of the assets retained by the District at all times, and operational responsibility reverting to the District at the end of the finite contract term. Ascension Sewer bears revenue risk within certain bounds under this arrangement.
- The key value proposition for the project, as set out by Ascension Sewer, is that project capital and operating costs can be spread over a larger consolidated customer base.

26 November addendum commentary

Introduction and context

- The C&O Agreement now includes the requirement for disclosure of financial performance and rate of return on a periodic basis. An enhanced level of financial transparency and disclosure is also now required as a precursor to any rate adjustment event. Overall, this creates a more appropriate level of financial transparency, consistent with our understanding of good market practice.

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Ascension Sewer rate proposal ▸ Ascension Sewer has set out an initial rate of $57.90 per month for residential customers, starting 2020 and subject to 4% indexation thereafter for 10-years, predicated upon a 3% growth in underlying rate base each year. The C&O Agreement allows that the District will then reevaluate rates for future years and will adjust the rates as necessary to meet the cost of service delivery and associated financing costs. Five years into the contract, Ascension Sewer will present a plan to the District for the second phase of construction of the East Bank Regional System and any adjustment to the rates to accommodate agreed future phases will be determined at that point. ▸ The Ascension Sewer rate proposal should be understood in the context of mechanisms within the C&O Agreement relevant to the ability of Ascension Sewer to request adjustments to the rate after the contract effective date to protect its solvency and financial return should a range of supervening events occur, as discussed further in the following sections.	**Ascension Sewer rate proposal** ▸ There has been no change to the initial rate or 10-year indexation factor. ▸ There have been a number of adjustments to the events or conditions triggering a potential rate adjustment. These are to the benefit of the District and are discussed further in the relevant sections below.
Overview of the Ascension Sewer commercial structure ▸ Ascension Sewer will be the contracting counterparty to the District under the C&O Agreement, and will subcontract key functions including (1) Construction (no construction contractor yet selected); (2) Operations (Ascension Sewer); and (3) Financing (combination of (i) Department of Environmental Quality State Revolving Fund (SRF) program loan; (ii) commercial debt; (iii) equity from the project sponsors, primarily Bernhard Capital Partners).	**Overview of the Ascension Sewer commercial structure** ▸ There has been no change to the commercial structure, and no new information forthcoming as to the identify of the construction contractor or final form of the financing structure.
Ascension Sewer financial standing assessment ▸ A financial standing assessment was undertaken on the two core entities identified in the commercial structure: ▸ Bernhard Capital — an equity commitment letter was sought and provided, though the lack of specificity means that the evidence to support the commitment is less than is typically available to conclude on the financial standing.	**Ascension Sewer financial standing assessment** ▸ No additional information has been received and no additional analysis has been undertaken

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Financial standing (cont'd)

- AWT — as lead utility operator, an assessment of recent historic financial operating performance and metrics was undertaken, revealing no material financial standing concerns. However, it was noted that AWT financial standing is significantly dependent on the performance of Ascension Sewer project. This necessarily limits (without further credit support) its ability to manage cost and performance risks under the C&O Agreement to the extent that these deviate from its traditional regulated utility business model.
- A financial standing assessment would also typically be undertaken on the selected construction / EPC contractor. The EPC contractor has not yet been selected by Ascension Sewer and the inability to analyze the financial standing of the lead contractor at this time presents some risk.

Financial model analysis

- The Ascension Sewer financial model appears to be logically constructed, though it has not been developed as a rate-setting project finance model or for modelling the operational dynamics of the project on a basis consistent with the C&O agreement. There is limited functionality or linking of outputs to determine how the rate would be impacted by certain changes in other variables.
- There is currently no detailed mechanic (though there are principle-based provisions) in the C&O Agreement for determining how rates are set or adjusted. In lieu of a common understanding of cost and revenue interdependencies in either the contract or via a dynamic financial model, there is a high degree of uncertainty now as to how rate changes will be determined and proposed in the future, and how the District will be able to assess the reasonableness these on a consistent basis with those assumptions made at the time of contract signature. Any rate setting adjustments in the future will largely be on the basis of bilateral negotiation (and potential dispute resolution process) between the Parish and Ascension Sewer.

26 November addendum commentary

Financial standing *(cont'd)*

- No additional information has been received and no additional analysis has been undertaken

Financial model analysis

- The C&O Agreement now requires a rate-determining model to be agreed as satisfactory by the Parties for the purpose of making potential future rate adjustments in accordance with Section 6 (Rate Setting), and an agreed protocol for rate adjustments, both as a conditions precedent to achieving the Transfer Date.
- Changes to Ascension Sewer's investment model have been made and will continue to be made by Ascension Sewer with oversight from EYIA prior to the Transfer Date to meet this condition precedent.
- A Financial Model Rate Adjustment Protocol has been developed to set out in greater detail the principles and processes underpinning the use of the financial model to determine future permitted rate adjustments. There may still be a requirement for some bilateral agreement of certain elements at the time, but the onus of evidence is on the Operator.
- Together, the (continuing) model revisions and adjustment protocol create a more defined framework of common understanding and visibility over the mechanic for future rate revisions. The enhanced level of financial transparency and disclosure by Ascension Sewer as part of any rate adjustment process will also better allow the District to understand and challenge the drivers of any proposed rate adjustment.

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Financial and commercial assumptions: Equity return

- Ascension Sewer's stated and modelled pre-tax equity IRR of around 8% is broadly consistent with published and calculated return on equity metrics for regulated US water and electric utilities, acknowledging that gearing levels and tax burdens vary by company and region.
- Equally, in terms of experience and visibility of a relatively small dataset of relevant concession / P3 market precedent transactions, base case return levels on water and wastewater concessions with relatively little demand risk (as is the case in this transaction) are either at or above this level, albeit at often higher levels of gearing, using long term debt and supported by large utility operators.
- While the balance of risk allocation in the C&O agreement would seem supportive of a more efficient financing structure, utilizing longer term debt at a higher level of gearing, Ascension Sewer has not advanced financing discussions to a point where confidence can be gained as to this outcome. While AWT's role in the project is critical to the transaction value proposition of Ascension Sewer, its financial standing relative to larger operators more normally involved in wastewater P3 / concessions may be a contributing factor to Ascension Sewer's debt structuring approach.
- However, should a longer time financing structure be attained, after the C&O agreement is signed and rates are set, Ascension Sewer's equity return would be higher than disclosed in its base case financial model. There is currently no mechanism in the C&O agreement to share refinancing gain with the Parish

26 November addendum commentary

Financial and commercial assumptions: Equity return

- Ascension Sewer has updated the financial model to reflect (i) a five-year construction schedule; (ii) a more conservative starting assumption for the District's current rate paying customer base – now consistent with the District's original business as usual case. In combination, the pre-tax equity IRR has increased to 8.9%. Though higher, this is still within a range that is broadly consistent with regulated US utilities.
- Should a more efficient financing structure be achieved after the signature of the C&O Agreement, this creates the potential for enhanced equity return, which is not in itself a rate adjustment trigger (as per Section 6.2 of the C&O Agreement) and would not therefore be recoverable by the District through amended rates, or through separate refinancing provisions.
- However, in the event that a rate adjustment event did occur the District is now able to mitigate any rate increase to the extent Ascension Sewer equity return is above market benchmarks.

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Financial and commercial assumptions: Commercial Debt ► Commercial debt service payments are made over 11 years, assuming repayment of debt service based on cash available (a cash sweep) and a relatively low gearing of 60%-65%. ► It is more typical with P3 based financing structures to see either a long term debt structure, or a refinancing assumed during the term to preserve leverage in a project, preserve financial efficiency and allow for earlier equity releases. ► While the approach adopted in the financial model is consistent with the understanding that there is not a mechanism in the C&O agreement to increase user rates should financing costs or structure (beyond the DEQ SRF loan) change, this potentially comes at the cost of financing efficiency.	**Financial and commercial assumptions: Commercial Debt** ► There has been no change to the commercial debt structure in the financial model.
Technical assumptions: Operations and maintenance cost: ► O&M projections are based largely on historic values or margin targets and are unlikely to be sufficiently reflective of the reconfigured system comprising a new treatment plant, with the risk that such costs are higher that those included in the financial model.	**Technical assumptions: Operations and maintenance cost:** ► There has been no change to the O&M assumptions in the financial model. However, Ascension Sewer is now assuming the risk and reward of any variance in O&M costs relative to the base case model. Unexpected variances in O&M costs are no longer a rate adjustment event within the first 10 years.
Technical assumptions: Construction costs and schedule: ► The project estimates a 4.5 to 5-year development and construction window completing in mid 2024, although the financial model assumes a simplified 3-year construction period 2020 to 2022. ► Ascension Sewer has stated that it is at around 30% design, however, based on data provided and observation, this seems closer to 5-10%, reinforcing that costings are therefore preliminary and subject to potential significant change. ► Analysis by HNTB suggests that the design, development and construction schedule assumed in the technical proposal Gannt chart has very little room to absorb critical path delays.	**Technical assumptions: Construction costs and schedule:** ► The parameters around the ability for higher than estimated costs to result in future rate increases have been narrowed, and this is discussed in greater detail below. Further, additional provisions have been incorporated into the C&O Agreement to create a structured process from the Transfer Date onwards by which Ascension Sewer is required to develop and provide detailed plans and updates on design and construction, providing both parties with greater visibility and foresight over evolving cost profiles and creating the ability to course correct or adjust the project scope as necessary to maintain control over costs.

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Technical assumptions: Construction costs and schedule (cont'd)	*Technical assumptions: Construction costs and schedule (cont'd)* ► While concerns about the ability of the schedule to absorb critical path delays remain, the enhanced planning and reporting structure does potentially help to mitigate some concerns regarding design, development and construction schedule. Equally, while there is no regime for liquidated damages in the event of material construction delay, the District may see a downward rate adjustment if this occurs.
Financial deliverability at the starting rate of $57.90 per month ► The design development, cost estimation, financing structure resolution and construction contractor selection are all at relatively early stages of development. This relative lack of visibility or certainty over final technical parameters and costs can be indicative of potentially material risk over project deliverability at the current proposed rate of $57.90. Ascension Sewer is largely insulated from material commercial risk through the terms of the C&O agreement, and section 6.2 in particular, which sets out the conditions under which a rate increase request can be made. ► The commercial interpretation of these provisions could be such that Ascension Sewer can reasonably request rate increases where capital and operating costs are different from those set out in the financial model, which would largely insulate the operator and investors from risks associated with under-estimated costs as well as to changes in law, lower than expected customer growth and access to anticipated preferential rate DEQ financing.	**Financial deliverability at the starting rate of $57.90 per month** ► As set out below and on the following page, there has been some narrowing of the conditions under which Ascension Sewer can request a rate adjustment in Section 6.2 of the Agreement, and the introduction of greater symmetry to allow rates to reduce as well as increase. The C&O Agreement also now sets out more clearly the processes and procedures associated with potential rate adjustments, which creates opportunity for greater scrutiny and transparency through more structured protocols and review processes, albeit there may still be a requirement for some bilateral agreement of certain elements at the time. ► Specific updates on rate adjustment triggers in Section 6.2 are set out on the following page.
► Third party lenders are made whole in any early termination scenario (i.e., outstanding debt is fully repaid), which is the ultimate end point in the contract for failure to agree rates, reasonably proposed by Ascension Sewer, or default by the operator.	► The operator termination fee provisions have changed in favor of the District compared to the version of the C&O Agreement considered in the 6 November report. Third party lenders remain fully protected in all events of default, though protections for equity are reduced. In the event of Operator default, equity principal is returned to BCP, though equity return may be reduced or eliminated. Equally, for other events of default, compensation to equity is less punitive to the District, and more aligned with market norms.

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Key opportunities for future rate increase requests:

- **DEQ SRF Loan**: Unavailability of this loan would result in an increase in rates being requested to offset higher interest costs from commercial financing. This is explicitly recognized in the C&O agreement.
- **Parish capital contribution**: The initial rate structure relies in the receipt of a capital contribution of $15.8m. To the extent that this cash balance is unavailable or reduced from the level shown in the model, Ascension Sewer has indicated that it will request an increase in rates.
- **Phase 1 construction costs**:. Analysis suggests that currently assumed capital costs are subject to potential significant change given the relatively early stage of design, and it would be prudent for the Parish to assume that Ascension Sewer will seek to recover any increase in such costs above the estimated $215m through the rate setting provisions of the agreement.
- **O&M expenses**: In the context of the provisions of section 6.2 of the C&O agreement it would be prudent for the Parish to assume that Ascension Sewer will seek to recover all such costs through the rate setting provisions of the agreement.
- **Variance in volume growth**: The Agreement assumes that a rate adjustment will be permitted where annual growth in the volume of billings is less than 3%.

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Key opportunities for future rate increase requests:

- **DEQ SRF Loan**: As per 6 November report
- **Parish capital contribution**: As per 6 November report
- **Phase 1 construction costs**: The Agreement now specifies that a rate adjustment will only occur should construction costs be greater than $225.75m, and that no rate adjustment may be made for costs in excess of $240.8m i.e., Ascension Sewer will seek rate adjustments to recover a maximum of $15m ($240.8m less $225.7m) but otherwise takes the risk of costs being between $215m, and $225.75m and costs being in excess of $240.8m. The Agreement now also allows that rates may reduce if actual capital costs are below $215m, or else the District may elect to direct Ascension Sewer to use the savings to make additional capital improvements to the System. This means that the District is still accepting the risk of a rate adjustment to cover some potential cost increase, but this has been significantly reduced and is subject to a limit of $15m compared to the previously uncapped liability.
- **O&M expenses**: Ascension Sewer is now taking the risk and reward of variances in actual O&M costs relative to the estimate in the financial model and so this no longer a risk to the District.
- **Variance in volume growth**: The Agreement now applies a three-year average in determining variance from the currently assumed 3% growth, which creates some additional flexibility for annual fluctuations and a more sustained growth trend before triggering a potential rate increase. It also now includes a provision to allow for a rate reduction where the three-year average growth rate exceeds 5%.

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Key opportunities for equity return upside: ► **Project schedule**: Delays in the commencement of construction from that shown in the financial model (which itself assumes a construction duration materially shorter than Ascension Sewer's own engineering estimates) would result in the reserving of cash generated by the initial rate uplift, which in turn could reduce the financing requirement of the project and increase out-turn equity return. ► **Financing structure:** Should a longer time financing structure be attained after the C&O agreement is signed and rates are set, Ascension Sewer's equity return would be higher than disclosed in its base case financial model. There is currently no mechanism in the C&O agreement to share refinancing gain with the Parish. ► **C&O Agreement**: The C&O agreement does not currently require Ascension Sewer to share audited financial statements or out-turn financial performance, and that rates increase by 3% (growth) +4% (indexation) irrespective of out-turn equity IRR during the first 10 years of the agreement. As discussed elsewhere in this report, the basis of rate adjustment for capital and operating cost changes is not clearly specified in the C&O agreement.	**Key opportunities for equity return upside:** ► **Project schedule**: Ascension Sewer has amended its financial model to reflect the construction schedule consistent with its preliminary engineering plans, which has increased the rate of return (though the net effect is substantially mitigated by the revision down of the initial rate paying customer base to align with the District's business as usual scenario). Section 6.2 of the Agreement also now enables the District to seek a rate reduction if there are delays in construction cost spend beyond the currently estimated five years from the Transfer Date which may help to reduce the potential for return enhancement from delay. ► **Financing structure**: Largely as per 6 November report, though now partially mitigated in the event that a rate adjustment event did occur insofar as that the District is now able to mitigate any rate increase to the extent Ascension Sewer equity return is above market benchmarks. ► **C&O Agreement:** The Agreement now includes requirements for Ascension Sewer to provide audited financial statements and other relevant financial information to provide greater visibility on actual performance.
Rate sensitivity summary ► The analysis performed a number of sensitivities to indicate the order of magnitude impact on rates of certain situations crystalizing, notably relating to potential rate adjustment triggers.	**Rate sensitivity summary** ► No additional sensitivity analysis has been undertaken, however (i) operating cost; (ii) construction costs; (iii) construction timeline sensitivities would be materially mitigated by the changes made subsequent to 6 November and described above.

Addendum — updated status of key financial and commercial analysis outcomes

Synthesis of 6 November report

Analysis of District business-as-usual (BAU) scenario

- Based on the District's BAU scenario analysis — which assumes no regional system and a "mend and make-do" approach to infrastructure upgrades and reactive expansion assuming 2% customer growth — the District estimates an operating deficit of around $27m over a 20-year period based on a starting point of 2,192 billed customers or (based on EYIA analysis) $13.1m based on 3,058 customers. This deficit largely occurs in the first few years when capex requirements are anticipated to be most significant. The BAU case is based on a monthly rate of $60 comparable to that proposed by Ascension Sewer (and up from the current $42.50 payable by the District's customers).
- Although increasing the overall 20-year deficit in terms of total costs, a financing approach that spreads the capital cost more evenly (e.g., assuming the same 0.95% DEQ SRF loan) would help to reduce the near-term deficit spike resulting from significant capex requirements.
- There is also potential for the deficit to be higher if the estimated capital and/or operating costs for the BAU outlook are understated, which the analysis indicated may be the case in some areas.

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Analysis of District business-as-usual scenario

No additional analysis has been undertaken on the District's BAU scenario, although it should be noted that:

- Ascension Sewer has revised down its initial customer rate base assumptions to match those contained in the District's original BAU scenario (2,192 billed customers in the Parish, as compared to 3,058 assumed by Ascension Sewer at 6 November).
- To enable a like for like comparison (albeit recognizing that the District BAU scenario assumes 2% billed customer growth and 3% indexation as compared to 3% and 4%, respectively, for Ascension Sewer), this would correspond to the BAU scenario returning a $27m cashflow deficit over the 20 year analysis period in the 6 November report.
- Further acknowledging that the District could contribute the same $15.8m to the District in the BAU case as it is contributing to Ascension Sewer, the incremental cashflow burden on the Parish of this BAU case would be $11.2m ($27m less $15.8m).
- As in the case of the 6 November report, should the District be able to secure billed customer growth and indexation equivalent to Ascension Sewer and contribute the $15.8m, this could materially close the financial gap between the BAU case and the Ascension Sewer proposal.
- However, its is important to consider the cost and deliverability risks associated with the BAU case. These are (i) a continuation of the unsatisfactory operational configuration of the system with limited future proofing against future performance risk or regulatory tightening; (ii) potentially significant cost risks associated with the Capex and Opex estimates in the BAU case (where all risk is retained, and design has not commenced to any appreciable level); and (iii) uncertain ability on the part of the District to deliver a complex program of works.

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