In reviewing the Point / Counterpoint offered by the Lehigh County Commissioners in this morning’s newspaper, several thoughts have come to mind that Lehigh County Authority (LCA) feels it is important to share with you.

First, there were a couple of common themes running through both Commissioner Osborne’s and Commissioner Scheller’s statements. For example, both statements reference LCA’s strong financial performance, as evidenced by our AA bond rating, and both Commissioners referenced our low-cost financing capabilities.

In addition, and most significantly, both Commissioners discuss the variety of “unknowns” that could affect success of the Allentown water and sewer lease deal, and especially the impacts to the suburban communities that LCA already serves. Where the points of view differ relate primarily to the preferred approach to either A) allow LCA to discover the answers to these questions by participating in the bid process, or B) assume the unknowns are too weighty for LCA to handle, suggesting LCA should not participate at all.

LCA appreciates the care and attention all of the Commissioners have given to this important issue. To assist in this important decision, I would like to address a few key issues that were reflected in today’s paper.

**How LCA Would Fund the Allentown Concession Deal**

It is clear that LCA would need to borrow the cash to pay the upfront bid price, and the size of that bid would be significant. However, the debt incurred by the concession should not be viewed as additive to LCA’s existing debt and capital program.
For the past 42 years, LCA has planned its capital program carefully, based on projected needs of our system and the growth that is occurring in the service area. LCA’s current capital program, which shows $150 million in capital improvements over the next 10 years, is fully justified through our existing rate structure to our current and future customers. That is, no additional rate increase is projected to impact our existing customers to fully fund our capital program. We also need to clarify that the wastewater capacity expansion project, estimated at $80 million, is included within the total cost of the capital program, not an added cost on top of it.

The full financial justification of LCA’s capital program is included in our 10-year capital plan document, which is a public document that we typically present to the County Commissioners each fall. This did not occur in October 2012 as the Commissioners declined our request for time on the agenda to do so.

Keeping in mind that our existing capital program is already financially justified through our existing rates and charges, therefore, we are primarily concerned with the ability to fund a concession deal with Allentown. LCA’s approach to formulating a bid will be based on the revenue stream available through the contract, so the bid price we would offer would automatically account for the annual concession debt payment. The revenue stream that would be included in the bid formulation is based on the revenues generated by in-City customers, and the added concession financing cost would be fully funded by Allentown’s ratepayers.

**How the Concession Debt Would be Paid**

As we have explained above, the City customers will pay for the new debt through the concession. This is the same for a private bidder or LCA. However, one of the risks a private bidder brings is related to how rates are calculated for both in-City customers and suburban communities.

With the rate caps in place, we can be sure the private bidders will use every inch of those caps and capital recovery fees to maximize profit. LCA, on the other hand, only needs to set rates to recover the cost of service. We will need to raise rates to cover the debt for sure, but we can contain those rates to actual system costs.

Under LCA, the existing customers in the suburban communities are protected through our administration of the municipal contracts. The risk to suburban communities grows substantially under a private bidder as the contracts are likely to be renegotiated in
the future. There is a significant incentive for the private companies to pass capital costs and concession costs through to the suburban communities to maximize profit. This motivation does not exist with LCA, as we would be accountable to all customers (City and suburban) to ensure rates reflect the true cost of service.

The risk of LCA carrying the concession debt is not a risk to suburban communities. LCA believes the concession costs are a City cost, and we would plan to keep the cost recovery mechanism limited to the City users to the full extent possible.

**Can Private Bidders Do the Job?**

If the lease is administered “as is” then yes, the rate caps would apply equally to LCA and a private bidder, and customers would be protected to a certain extent. However, this would change dramatically if a private bidder were to push the Public Utility Commission for an official ruling that concession agreement, including rate-making, should fall under PUC jurisdiction – at that point, all bets are off and the rate impact will be enormous to all customers in both the City and suburban communities.

Even in the scenario where the rate caps are in place as stated in the contract, there is still a significant risk of higher rates due to strategies related to managing capital expenditures, as we discussed last week.

The rate issue is fundamentally different under the LCA scenario because whether we fund programs through operating costs, which are passed on through the rates and subject to the rate caps, or through capital recovery fees, the limit to LCA’s rate will be the actual cost of service. The value of this municipal authority feature cannot be stressed enough to LCA’s customers, who currently enjoy some of the lowest water rates across the Commonwealth.

In terms of finding efficiencies and economies of scale, the private bidders will certainly look for those, but that does not mean that LCA will be ineffective in doing the same. For example, LCA’s unaccounted-for water benchmark shows that LCA does not fit the typical government mold for system performance. While some systems might report losses in the 25-40% range, LCA’s rate is under 10%, which is an industry best practice, and we would seek to bring the City’s system up to the same standard.
Risks Related to LCA’s Bid

The risk of LCA carrying the debt itself is something that can be managed through careful risk management.

LCA agrees that there are still unknowns in the current concession deal, but that is not a reason to stop looking at the problem to determine if LCA can help be part of the solution. We have the professional capability to analyze the unknowns, such as capital improvements that are needed, how to address water loss, and how to account for delinquencies within our revenue projections, and much more. LCA has successfully illustrated these capabilities as we have assimilated many smaller systems into our full operation over the years, resulting in low rates to the customer as well as improved system performance.

To help us with evaluation of the Allentown systems, we have assembled a very capable team including McNees Wallace & Nurick LLC (legal), Goldman Sachs (financial), CH2M Hill (technical) and Flamm Walton PC (labor). The professional strength of this team will be important to help LCA’s capable staff assess the risk associated with the concession, and to develop strategies to manage the risk.

Bondholders always have some level of risk, which will be identified, evaluated and factored into the bid and credit rating provided for this transaction. Since most risks will be known prior to a bid being made and a bond being issued, the transaction will be rated and the interest rate set accordingly.

It is important for all parties to understand that LCA has no incentive to bid more than can be justified, and that includes an assessment of risk. The rating agencies will provide an independent review and will provide LCA with a harsh and costly rating if LCA takes a high-risk approach. Therefore, LCA would seek to formulate a bid that minimizes risk and increases bondholder confidence.

Our Philosophy

LCA believes that providing safe drinking water and responsible sewer treatment are essential services to meet the most basic needs of residents throughout Lehigh County. We have a proven track record of managing this responsibility in a professional manner than exceeds most industry standards for financial performance, technical capability, environmental protection and customer satisfaction. We shared many of these details with the Commissioners last week. In short, it is clear that LCA’s staff and Board
of Directors have the capability to evaluate the lease and make the right decision about whether to bid, and, if so, how much to bid.

Today, the City of Allentown and LCA are already acting in partnership for the provision of water and sewer services to our respective communities. Our systems are physically interconnected; we rely on each other to work together on improving our wastewater systems; and LCA’s financial performance is interwoven with Allentown’s. The impact of a lease will be felt by LCA, and it is only a matter of the degree to which our existing customers will be affected. What affects Allentown, also affects LCA, and that sums up our position on this situation – we are passionate about remaining involved in the process because no matter what, LCA will be affected.

A closing comment is necessary about LCA accountability, which was raised several times by the Commissioners. Our philosophy is that we are truly accountable to all parties involved in our operation. This includes bondholders, customers, regulators, citizens, our Board of Directors, the County Commissioners and the community at large. Our meetings are open to the public, our decisions are made in public, and our performance clearly illustrates that we take our responsibility to the community very seriously.

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