



WORKING DRAFT

To: Members of the Utah State Legislature
From: Tom Sanzillo, Director of Finance, Institute for Energy Economics and Financial Analysis (ieefa.org)
Date: March 9, 2016
Re: Fiscal and Implementation Risks Created by SB0246: A bill that appropriates \$53 million for the State of Utah to invest in an export terminal in Oakland, California

Summary

The proposed law, SB 0246, is designed to allow the State of Utah to invest \$53 million of taxpayer dollars in the development and operation of a “throughput facility” – an out-of-state export terminal that ships coal and other commodities. The proposed law is offered as a narrow, technical transfer of state funds to make available sufficient resources so various counties could participate in a transaction which is not named in the legislation.

However, the actual project for which the legislation is intended, a coal export terminal in Oakland, California, is a highly speculative undertaking that raises serious questions of financial and liability risk for Utah taxpayers. This legislation has all the trappings of causing a major loss for the State of Utah. The State risks losing not only \$53 million, but also has potential liabilities that extend beyond this proposed budgeted amount.

The most significant fiscal and implementation risks in this legislation include:

1. The proposed law provides \$53 million for a project that is presumably to lend money to a public private partnership that runs a shipping port in Oakland. Under the statute, the state would provide a loan or grant to local governments, and the state could forgive the loan and interest payments. The statute limits state recourse for repaying the money to revenues it would receive from the port project. This is a high risk transaction, given the structural and dramatic decline affecting international coal markets.
2. Although the proposed law provides \$53 million in state funds, it offers no guidance as to how state and local officials are to protect the interest of Utah taxpayers in the port negotiations. Key here is whether or not the state's \$53 million is subordinated to the \$200 million that the private sector is supposed to invest. The original application by the counties to the impact board stated that a \$200 million private investment from an institutional investor would be available

by June 2015. This benchmark has been missed. The only entity in this transaction with an open checkbook and a deep pocket is the State of Utah. In this sense, the law is asking Utah taxpayers to buy a pig in a poke.

3. The proposed law uses as an investment vehicle an existing state program that is designed to assist local governments in making better use of their resources. However, this transaction flies in the face of that purpose: it is a highly risky, complex entanglement in global coal markets at a time of great uncertainty and decline. The state program identified in the law never contemplated that local governments would be involved in international securities lending. The law sends a plumber to perform a heart transplant.
4. Although the bill tries to make it easier for the State to participate in this deal than it would be allowed to due under existing law, it fails. The legislation actually introduces new types of risk and uncertainty to the transaction, exposes the State to a potential (and in this case likely) loss of \$53 million, and raises a host of liability concerns beyond the allocation.
5. The rush to approve this public/private investment is ill considered. Proponents, opponents and neutral third parties to these type of transactions all counsel deliberation because these transactions carry complex risks.
6. The fiscal analysis of the bill to date is defective. Its conclusion that the appropriation is budget neutral ignores significant risk to the state's budget balance. The material risk stems first from the fact that coal export transactions are losing money in today's markets and often require additional cash outlays, and second because the technical movement of money risks creating a hole in the State of Utah's infrastructure budget.

Background: The project as defined in the legislation

This piece of fiscal legislation provides authority for a Throughput Infrastructure Fund (TIF)¹ to make a loan or grant to an interlocal entity as defined in the Interlocal Cooperation Act, Title 11, Chapter 13² (in this instance a consortium of counties interested in participating in the Oakland export terminal).³ The purpose of the loan or grant is to pay for the cost of acquisition or construction of a throughput infrastructure project. The statute says such costs may include working capital, reserves, transaction costs and other amounts determined by the administrator to be allocable as throughput infrastructure costs.⁴

The TIF will be administered by the board of the Permanent Community Impact Fund ("the impact fund"). The impact fund is charged with the responsibility to establish the

¹ <http://le.utah.gov/~2016/bills/static/SB0246.html#59-12-103>, Section 35A-8-308

² <http://le.utah.gov/~2016/bills/static/SB0246.html#59-12-103>, Section 35A-8-309

³ The statute refers to an unspecified "Throughput Infrastructure facility" that could be either in state or out of state. We correct for the unspecified nature of the port project in the legislation by referring to the Oakland Project that was the subject of an application by four Utah counties to the Permanent Community Impact Fund in April 2015. The bill with this artificial construction now can lead to the conclusion that an instate ocean terminal could be financed. See: <http://le.utah.gov/~2016/bills/static/SB0246.html#59-12-103>, Section 35A-8-312, (8a) and (8ai).

⁴ <http://le.utah.gov/~2016/bills/static/SB0246.html#59-12-103>, Section 35A-8-309.

fund as a revolving fund, determine loan repayments (including the interest rate), establish criteria for awarding loans and grants and establish criteria for eligibility.

The statute provides the following language:

The impact board may restructure or forgive all or part of a local political subdivisions or interlocal entity's obligation to repay loans for extenuating circumstances.⁵

The statute further prescribes that such loans or instruments to secure the state's interest shall be non-recourse and limited to the revenues from the throughput facility project.⁶

Other provisions define⁷ the throughput facility and authorize various potential ownership arrangements or contract terms with a project inside or outside the state. Under the performance impact statement attached to the bill the state does not anticipate creating any new programs or agencies to carry out the infrastructure transaction.

The proposed legislation provides for the TIF to make a loan or grant to an interlocal entity. Presumably the interlocal entity then uses the proceeds of a loan to enter into the transaction for the throughput facility. The impact fund is directed in the legislation accordingly to:

use money transferred to the Throughput Infrastructure Fund in accordance with Subsection [59-12-103](#)(14) to provide a loan or grant to finance the cost of acquisition or construction of a throughput infrastructure project to one or more local political subdivisions, including a Utah interlocal entity created under the Interlocal Cooperation Act, Title 11, Chapter 13;⁸

The statute governing interlocal entities allows for local governments in Utah to form cooperation agreements to improve services to the public and find economies from innovative combinations. The statute anticipates but is not limited to cooperation agreements in the areas of cable television, law enforcement, waste and waste water treatment facilities and energy provision. To form an interlocal entity requires a joint agreement approved by each participating local government. The agreements may allow interlocal entities to provide resources, contract and perform services, enter into joint facility ownership, share taxes and other revenues, control and operate facilities jointly, issue bonds, pledge revenues for those bonds. The statute also requires each interlocal entity to adopt competitive procurement procedures.

The statute contains broad language that does not relieve individual units of local government from of any of their legal or other responsibility as a result of participation in

⁵ <http://le.utah.gov/~2016/bills/static/SB0246.html#59-12-103>. Section 35A-8-309 (3).

⁶ <http://le.utah.gov/~2016/bills/static/SB0246.html#59-12-103>, Section 35A-8-309 (5),(b),(i and ii).

⁷ <http://le.utah.gov/~2016/bills/static/SB0246.html>, Definitions, Section 305-8-302, 8(b)(i-iii).

⁸ <http://le.utah.gov/~2016/bills/static/SB0246.html#59-12-103>, Section 1(b)

the interlocal unit. The statute also grants to the state a right of action to recoup damages should an interlocal entity become engaged in a controversy.⁹

The actual project which this legislation is intended to support is the Port of Oakland, California, coal export terminal.

Several flaws in the bill leave the State of Utah and its counties exposed and will prove impractical

This bill, as recently amended, allows for the state to write off the debt owed to it by the interlocal entity under "extenuating circumstances," limits state recourse to local government assets in the event of default, and restricts the State's right to collect repay to revenues from the throughput facility project.

The underlying transaction – investment in an export terminal in Oakland using coal as the revenue source -- is a highly speculative, perhaps even reckless, use of funds. U.S. coal producers are plagued by bankruptcies, overleverage, low prices domestically and globally with many of the losses stemming from failed coal export deals. We note the following events that have occurred in the last sixty days:

- Cloud Peak Energy, a leading coal producer and exporter of coal from the western shores of North America, has zeroed out its export activity for 2016 and the foreseeable future. Cloud Peak has been paying liquidated damages to coal ports on the west coast for failing to deliver coal according to existing throughput agreements.
- Signal Peak mines in Montana, a leading coal exporter off the west coast, has taken a value impairment (declared a loss of value of the mine) reflecting the weak state of the export market.
- Bowie Resources, an important beneficiary of the proposed transaction from the shipping of coal from its mines in Utah, is showing serious signs of financial weakness. It has failed to close its financial plan to buyout private equity investors and has failed to secure investment interest in a timely way for a purchase of three western mines from Peabody Energy. It has also failed to meet its targets for coal shipping through the Port of Stockton, California, The Port of Stockton has announced it will see reduced activity and revenue for 2016 (and saw reductions from 2015).
- Arch Coal, a coal company with substantial interests in both port and mine projects in Montana, and the west coast has declared bankruptcy.
- Wood Mackenzie, a major global consulting firm which until recently was a major proponent of new coal export terminals, reversed course on the viability of U.S. coal-export expansion in February 2016, calling new U.S. coal ports "risky long term bets."

⁹ http://le.utah.gov/xcode/Title11/Chapter13/11-13-S210.html?v=C11-13-S210_1800010118000101. The structure and function of the administration of Interlocal groups can found in Sections 201 through 225 of the statute.

It is very likely that this proposed investment by the State of Utah will meet a similar fate. The legislation now makes explicit that the State of Utah and not the counties will absorb the loss.

1. In an apparent attempt to provide the State of Utah with financial flexibility to participate in the deal, the legislation provides a blank check for a private development deal. The law implies but is unclear as to whether the administrator and impact board or the interlocal group consisting of a number of the State's political subdivisions is the maker of the loan. Further, there is some guidance¹⁰ offered as to how the State should provide the money to the local government but none as to how the actual transaction with the port and its developers should be made. The Oakland port project, when it was described in the eligibility application to the Permanent Community Impact Fund in April 2015, claimed it would have a \$200 million investment from an unidentified "institutional investor." Will the State of Utah's \$53 million contribution be subordinated to the \$200 million in the event of default?
2. The statute uses the Interlocal Cooperation Act, a tool to improve services to state residents as a trading and loan broker for a highly speculative coal commodity deal in a very weak coal market. This is plainly inappropriate.

The ICA is a state statute designed to foster cooperation between local municipalities – an incentive for local governments to share resources and services, revenues and any savings that may come from various creative combinations.

This law never contemplated local cooperation that creates a state supported fund for the purpose of speculating in the global commodities market, particularly the global coal market.

Several provisions of the ICA law suggest that interlocal entities should not engage in creating loans and loan standards. There is no explicit language in the law granting them the authority to do so. Under the ICA if capital is required the statute allows provides for bond issuances¹¹. The process of bond issuance for either taxable or tax exempt bonds would provide the kind of financial rigor and oversight that is needed for a transaction of this sort. The specifics of lending amounts, terms, relations with other investors and coal markets is not regularly part of the skills found in local or state government. The key here is that the project would still thrive or not based on revenue, but

¹⁰ There is for example no clear guidance as to how the impact board should set an interest rate between it and the counties. Like the questions rose in this note about the propriety of using the interlocal entities as a trading instrument it remains to be seen how the impact fund can establish an interest rate that reflects market realities. We note that under the prior construction of this law that Industrial Assistance Account has some governing standards regarding how it should set interest rates. Here the issue is far more complex as the revenues are being generated by a private transaction, not from local taxes and fees.

¹¹ http://le.utah.gov/xcode/Title11/Chapter13/11-13-S210.html?v=C11-13-S210_1800010118000101, Authority of public agencies or interlocal entities to issue bonds and Pledge of revenues to pay bonds, Section 218 and Section 219, respectively.

instead of the State of Utah advancing the capital and bearing the risks a group of investors with fixed income portfolios could do so. The transaction would also be supported by bond underwriters, counsel and financial advisors with specific professional competency to judge the transaction.

3. The bill allows for several unusual revenue transfers that appear intended to increase the flexibility of state and local representatives to participate in the transaction. The organizational structure for implementation actually creates more risk and uncertainty. For example, the law requires each cooperative unit to adopt competitive bidding standards. The statute also appears to require the impact fund to assess eligibility criteria. The project under consideration is already in place with developers and coal mining companies already identified and public and private budgets at least publicly released. Competitive bidding requirements are used to insure that the public is obtaining a fair price for whatever it is buying or selling. Competitive bidding requirements from the standpoint of Utah's taxpayer I in this instance would be a sham exercise.

In addition to competitive bidding the Interlocal Cooperation Act requires the approval of each local governmental unit of an agreement, and presumably of the loan terms. The ICA also contemplates "controversies involving agreements between Utah public agencies and out-of-state agencies".¹² Utah state law allows under these conditions the state to intervene to recoup or make itself whole for damages. The State of course can be sued under these provisions as well.

This is a high risk deal. The State of Utah will be investing presumably, under the best conditions with an institutional investor that has a global outlook and legal, technical and financial infrastructure that dwarfs anything the State of Utah could create on an adhoc basis for this one deal.

4. The bill inappropriately uses a narrow, technical fiscal bill to address major financial policy issues. State of Utah officials are assuming they can achieve their objectives without creating a new state agency or new organization. This is a mistake. Prudence would require the state to enact a single purpose, special economic development entity that walls off the state and its local government from liability.

The type of transaction under consideration between private developers, institutional investors and the state and local governments of Utah is a complex public private transaction. Opponents'¹³ and proponents'¹⁴ of these public-private partnerships, as well as neutral third party guidance,¹⁵ all agree that sound planning, a skilled public sector negotiating team, good financial

¹² http://le.utah.gov/xcode/Title11/Chapter13/11-13-S210.html?v=C11-13-S210_1800010118000101

¹³ <http://kfos.org/wp-content/uploads/2015/06/4.-KEDS-PRIVATISATION-IN-THE-ENERGY-SECTOR.pdf>

¹⁴ <http://www.ncppp.org/wp-content/uploads/2013/03/WhitePaper2012-FinalWeb.pdf> , See also:

http://www.ifc.org/wps/wcm/connect/e00cbd004e4adc988f0caf7a9dd66321/PPPStories_Kosovo_ElectricityDistribution.pdf?MOD=AJPERES

¹⁵ http://www.cscd.gov.bc.ca/lgd/policy_research/library/public_private_partnerships.pdf

advice and openness are critical elements of success.¹⁶ Many of these agreements result in project specific legislation as a way to articulate planned public benefits and to offer liability protections for the government.

5. This bill addresses a highly unusual use of state funds and operational statutes. The quality of the transaction has unique features that require both extra diligence and oversight. But the proposed legislation does not address the oversight needs for this project. It is advisable that this legislation specifically direct the state auditor to audit the project and address both the fiscal and program compliance issues that are combined in the bill shortly after funds are released,

The fiscal note accompanying the bill is flawed

A fiscal note has been prepared for the recently amended bill.¹⁷ The purpose of the note is to focus only on what the implications of the statutory proposal is for state budget balance over a two year period.

The fiscal note states that the action proposed in the legislation could cause some local governments to receive less money and then concludes that the action would have no impact on budget balance. The note was effectively saying this would be a budget-neutral transaction.

Any future fiscal note needs to take into account the material risks to the State budget inherent in this transaction.

First, the legislation transfers \$53 million over a two year period. The fiscal note ignored a rather significant threat to budget balance created by this transaction. Many coal export projects in the United States are being canceled or the sponsors are taking write downs and impairments and ports and mine projects. There is every reason to believe that this project will suffer from those same market dynamics.

The fiscal note makes no mention of whether the loan amounts will contain provisions to cover cost overruns¹⁸ and if so by what share. Such overruns are likely to occur during the two year period. The statute establishes the TIF as a revolving fund perhaps in anticipation of future allocations to it. So, while the statute only allows for a specified amount of money to be allocated, the combination of impact fund requirements on the local governments and development pressures as a participant in the transaction exposes the State of Utah to demands for further allocations. We take due note of the fact that the original application by the counties to the impact board stated that a

¹⁶ This business model is used all over the world. For example, the World Bank also provides a series of detailed guides to the use of public private partnerships and the various legal, financial and governmental implications.

<http://ppp.worldbank.org/public-private-partnership/overview/ppp-objectives#risks>

¹⁷ <http://le.utah.gov/lfa/fnotes/2016/SB0246S02.fn.pdf>

¹⁸ The example of Ambre Energy is instructive here. The company has been participating in a number of port and mining projects in the western part of the United States. It has experienced considerable financial stress requiring new capital infusions, selling of assets prematurely and restructuring under a new name with new investors after posting losses. http://trib.com/business/energy/ambre-energy-sells-north-american-assets-in-bid-to-save/article_5da88180-3145-5d4c-bbd7-179674c1836b.html

\$200 million private investment from an institutional investor would be available by June 2015. This benchmark has not been disclosed and probably missed. The only entity in this transaction with an open checkbook and a deep pocket is the State of Utah.

Second, the fiscal note does not comment on whether the transfers out of the Permanent Community Impact Fund are within any statutory annual or project limits for disbursements. It is unclear given the recently amended language whether this is an issue. However, failure to maintain appropriate ratios of PCIF expenditures leaves the fund, and hence the state budget susceptible to calls for restoration of funds to it beyond that provided by any federal royalty payments.