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TO: City of Menasha Common Council
Menasha Utilities Commission

FROM: Anita Gallucci and Richard Heinemann

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RE: **STEAM TEAM REPORT**

Boardman, Suhr, Curry & Field, LLP ("Boardman") was engaged by the Menasha Utilities Commission ("MU") in November, 2008 to assemble and coordinate a team of financial, legal and rate design consultants to develop a strategic plan regarding the steam utility. The need for such a plan was prompted by the necessity of refinancing the impending September 1, 2009 maturity of \$24.16 million steam utility revenue bond anticipation notes (the "Revenue BANs"), which the City of Menasha ("City" or "Menasha") issued to finance construction of the steam utility. In addition to Boardman attorneys, the Steam Team initially consisted of Gary Price, Price Consulting Services, Inc. (rate design); Carol Ann Wirth, Wisconsin Public Finance Professionals, LLC ("WFPF") (financial advisor); Quarles & Brady, LLP (bond counsel); and Vicki Hellenbrand, Virchow Krause & Company, LLP (financial modeling), together with representatives of the steam utility, the Utilities Commission, and the City.

MU also engaged the law firm of Dewitt, Ross & Stevens, S.C. ("Dewitt") to address certain environmental issues faced by the steam utility, principally a Notice of Violation ("NOV") issued to MU and the City by the Wisconsin Department of Natural Resources ("WDNR") in November, 2008, as well as a number of emissions-related claims that have been raised against the steam utility and the City by the Sierra Club. Dewitt has also assisted MU in responding to an information request made by the U.S. Environmental Protection Agency, which at this point has not taken any enforcement action against the steam utility. MU also engaged the law firm of Davis & Kuelthau ("DK") specifically to handle an arbitration claim filed against MU and the City by George A. Whiting & Company ("Whiting"). The Steam Team has worked closely with Dewitt and DK to coordinate efforts and collaborate on strategy.

On a recommendation of the Steam Team, the City subsequently issued a Request for Proposals in December, 2008 to prospective underwriters for the refinancing of the \$24.16 million Revenue BANs and selected Stern Brothers & Co. ("Stern Brothers") in February, 2009, in large measure

because of Stern Brothers' expertise in working with financially distressed municipalities and municipal utilities. Stern Brothers was asked to analyze the current and prospective financial performance of the steam utility with a view toward determining whether and under what conditions the steam utility would be able to structure a refinancing of its existing obligations. The result of this analysis is Stern Brothers' conclusion that, given the existing steam supply contracts, the steam utility cannot access the financial markets to refinance the Revenue BANS, and furthermore, the steam utility will be unable to generate sufficient revenues to cover operating expenses in 2009 or beyond, and will generate no revenues to provide payment for any of the revenue or general obligation notes issued to finance the steam utility. Consequently, Stern Brothers recommends that the operations of the steam utility cease.

For the past several months, culminating in the issuance of Stern Brothers' recommendation, the Steam Team has engaged in numerous activities, including analysis of debt refinancing and restructuring options, review of existing bond documents and covenants, and filing of continuing disclosure "material events" notices. In addition, in an effort to enhance potential steam utility revenues and minimize losses, these activities have included negotiating with current steam customers to explore the possibility of restructuring the existing steam contracts; undertaking discussions with potential new customers, in particular Svenska Cellulosa Aktiebolaget ("SCA"); and developing ways to increase revenues associated with the electric operations of the steam utility. The Steam Team has also engaged in discussions with state officials to explore the availability of state and federal funding to support steam utility-related operations and/or help alleviate the City's steam utility-related debt obligations. The Steam Team has also initiated discussions with WPPI Energy ("WPPI") to explore what assistance MU's power supplier may be able to offer.

In addition, the City's environmental consultants, led by Dewitt, have submitted an air permit application to the WDNR that applies a best available control technology ("BACT") analysis and proposes a detailed set of cost-effective emissions control measures to address the issues raised by the NOV. If approved by the WDNR and implemented by the steam utility, the capital costs associated with these measures could be as much as \$1.5 million.

All of these efforts have been taken into account by Stern Brothers in formulating their recommendation, which includes a detailed analysis of how the revenue requirements of the steam utility would be impacted under various scenarios.

The following is a more detailed discussion of the activities that have been undertaken by the Steam Team to date and that are anticipated to be undertaken as part of a work out strategy in the event the council decides to follow Stern Brothers' recommendation:

- **Existing Bondholders**

Cessation of operations of the steam utility will violate the covenants the City made in its resolutions authorizing the Revenue BANS and, when combined with the inability to issue revenue bonds, will almost certainly result in default in payment of the Revenue BANS on their September 1, 2009 due date. This will necessitate extensive work-out discussions and negotiations with bondholders, and may result in further rating actions,

have a negative impact on the City's ability to access the credit markets, and expose the City and MU to potential litigation from bondholders resulting from those actions. Stern Brothers and WFPF are expected to take the lead in working with existing bondholders, regulators, rating agencies and others in this regard.

- **Existing Customers**

The steam utility has three steam customers: Whiting, U.S. Mills-Sonoco ("Sonoco"), and Pechiney Plastic Packaging, Inc. ("Alcan"). Since its initial engagement, the Steam Team has focused a great deal of effort on negotiating primarily with Whiting and Sonoco. The purpose of these negotiations has been to resolve existing claims brought against MU by these two customers for alleged overcharges and to restructure the existing steam sales contracts in such a manner as to enable the steam utility to continue operating in an economically viable manner. With the exception of Alcan, which has been willing to work with the steam utility, these efforts have largely been unsuccessful.

Sonoco

Sonoco represents approximately 91% of the steam utility's steam sales. On December 2, 2008, Sonoco issued a "Notice of Claim" to MU under Wis. Stat. § 893.80(1)(b), alleging that MU overcharged Sonoco for steam purchases in 2008 and estimating damages stemming from such alleged overcharges to be approximately \$2.2 million. Prior to issuing the Notice, Sonoco sent several letters to the utility requesting information to verify the basis of the 2008 rate calculations. The Steam Team complied with these information requests and then made an initial settlement offer that included a dollar amount to address Sonoco's overcharge complaint, as well as a proposed interim rate for 2009 in the \$11.00 per klb range and a request to reopen the current contracts so as to allow MU an ability to recover its costs on a going-forward basis. Sonoco's response was to issue a "Notice of Default" on the grounds that MU had failed to provide Sonoco with timely notice of a 2009 rate for steam purchases in accordance with the contract. MU subsequently set a 2009 steam sales charge of \$9.92 per klb and again requested that Sonoco engage in meaningful discussions to reopen the contract. Sonoco has refused, and instead continues to dispute the 2009 rate and to insist that any discussion of future revisions to the steam contract be predicated on the utility's admission that it overcharged Sonoco in 2008.

Stern Brothers' recommendation includes an analysis of the rates that would be required from Sonoco under the framework of a renegotiated contract to meet the steam utility's anticipated revenue requirements. Incorporating the rate analysis developed by Price Consulting, Appendix D shows that a steam contract rate of over \$16.00 per klb in 2010 would be necessary to meet the City's existing debt obligations and operating and maintenance needs. Assuming a best case scenario for the refinancing of the City's outstanding debt and the financing of pollution control requirements needed to address the NOV, Appendix D shows that the steam utility would need to recover a minimum rate of \$12.53 per klb from Sonoco in 2010. Given the current and projected low prices of natural gas, the Steam Team believes that Sonoco will conclude that it is more

economical to self supply rather than to enter into a restructured long term, take-or-pay requirements contract with the steam utility at the rate that would be necessary for the steam utility to refinance its outstanding debt obligations and remain economically viable. However, the Steam Team is prepared to undertake further negotiations if the opportunity arises.

Whiting

Whiting represents approximately 4.5% of the steam utility's sales. On September 26, 2008, Whiting filed a formal arbitration claim against the City alleging that MU overcharged Whiting for 2008 steam sales by approximately \$47,000, which claim subsequently was increased to over \$90,000. An arbitration hearing was held on December 30, 2008. An arbitration decision was handed down on March 16, 2009. The decision supported Whiting's view that it had been overcharged.

Both before and after the hearing, the Steam Team made several settlement offers to Whiting and requested that the company renegotiate the existing contract to allow full cost recovery. Like Sonoco, Whiting has been unwilling to settle for anything less than the full amount of its 2008 claim, or to enter into meaningful discussions over a new long term contract.

Given the relatively small size of Whiting's load, even if Whiting were to agree to a new long term contract at a substantially higher rate, the steam utility's revenues would fall far short of the required threshold.

Alcan

Although Alcan is charged an equivalent rate under its existing contract as Sonoco and Whiting, Alcan has not raised any issues about either its 2008 or its 2009 rates. Moreover, Alcan has indicated a willingness to discuss a restructuring of its contract. However, since Alcan's load is only about 4.5% of the steam utility's sales, agreement with Alcan over a full cost-recovery rate would be insufficient to enable the steam utility to become economically viable.

- **Potential Future Customers**

Members of the Steam Team have undertaken efforts to reinstitute discussions with SCA to determine whether SCA has any interest in exploring ways in which SCA and MU may mutually benefit from SCA taking steam from the steam utility. Discussions with SCA are at a preliminary stage, and it is unknown whether those discussions are likely to bear fruit. In support of these efforts, Steam Team members have been investigating the possibility of obtaining state or federal grant money to cover the multi-million dollar cost of interconnecting SCA's facility with the steam utility.

- **Revenues from Electric Operations of the Steam Utility**

Initially, the Steam Team, primarily through the work of Gary Price, explored two possible means of increasing steam utility revenues through its electric operations. First, the Steam Team examined an arrangement under which the electric utility would take ownership of the electricity being produced by the steam utility plant and pay for the cost to produce that electricity. The Steam Team determined that this arrangement would likely require the approval of the Public Service Commission of Wisconsin ("PSCW") and, on further review, concluded that PSCW approval would be difficult to obtain. Second, the Steam Team examined increasing the "behind-the-meter" use of electricity produced by the steam utility. Currently, under a contract with WPPI, MU is able to use a certain amount of that electricity behind the meter to offset energy purchases from WPPI. Increasing the amount taken behind the meter could be a way to increase steam utility revenues; however, even if WPPI agreed to such an increase, it would likely be a temporary, stop gap measure and would not be sufficient to enable the steam utility to become economically viable.

- **State and Federal Assistance**

The Board of Commissioners of Public Lands has approved the City's application for \$7 million in loans from the State Trust Fund Loan Program. This money is available to be used to refinance some of the City's outstanding steam-utility related debt. The Steam Team has recommended that the City seek additional funds from the program.

In addition, the steam utility has already received a \$24,000 grant from the Wisconsin Department of Administration to fund a preliminary study of whether sufficient biomass sources are available for a possible fuel conversion of the steam production facilities.

Steam Team members have separately met with local state representatives and a senior advisor to Governor Doyle to discuss the issues faced by the City related to the steam utility and with representatives in the Commerce Department to determine what additional assistance the state may be able to offer. Those efforts will continue.

- **Possible Next Steps If Notice to Shut Down Plant Is Issued**

If a decision is made to follow Stern Brothers' recommendation and cease steam utility operations, Stern Brothers will lead the Steam Team's efforts to develop and implement an appropriate work out strategy that will, among other things, involve negotiating with existing bondholders, continuing to explore governmental funding sources, and, if warranted, undertaking discussions with existing and potential future customers, and/or potential third party purchasers of steam utility assets. Such a work out strategy will be targeted at minimizing impacts on the City and its taxpayers, while preserving the health of the City's electric and water utilities, which remain among the City's most important assets.

The Steam Team will respond to any interest from current and/or potential steam customers to keep the plant open under an arrangement that would support the economic

viability of the steam utility. This could include a public-private partnership with the customers and/or third parties.

The Steam Team will also assist MU in evaluating the value of the plant under various scenarios: i.e., as a coal plant needing to be upgraded with BACT to address environmental issues; as a converted plant using a combination of biomass and other fuels (coal or gas); or as a dismantled plant, where parts are sold separately.

Finally, the Steam Team is developing a comprehensive list of issues to address in the event the plant is closed and steam production ceases. These include employment and financial issues, as well as potential liability MU and the City may have under the existing steam supply contracts and other steam utility-related contracts

The Commission and Common Council should be aware that closing down the steam utility and ceasing the provision of steam to its customers under the steam supply contracts will violate covenants made by the City in the bond documents and may expose MU and the City to further rating downgrades, negative market access impacts and potential litigation associated with defaulting on bond covenants and non-payment of the Revenue BANs, as well as to fixed termination fees.