

MILLCREEK TOWNSHIP WATER AUTHORITY

POSITION PAPER

I. INTRODUCTION

With the intent to resume discussions between Millcreek Township Water Authority and Erie Water Works, the Millcreek Board of Supervisors sent a letter dated Dec. 17, 2007 to Erie Water Works. On July 21, 2008 Erie Water Works sent a request to the Millcreek Board of Supervisors for financial and operating information. On April 22, 2009 Erie Water Works authored a “conceptual outline of a proposal to lease, operate and manage” the Millcreek Township Water Authority and began meeting with the Millcreek Board of Supervisors. On July 15, 2009 the Millcreek Township Water Authority was officially brought into the negotiations. This Position Paper has been prepared to provide the Millcreek Board of Supervisors with information Millcreek Township Water Authority considers to be relevant with regard to the proposed association of Millcreek Township Water Authority and Erie Water Works.

The Millcreek Township Water Authority has focused their study on whether or not such a merger or lease should be considered in accordance with the very conceptual outline presented by Erie Water Works. **The Millcreek Township Water Authority believes that as a minimum, a “due diligence” study needs to be performed.** The stakes are significant since the Millcreek Township Water Authority system has an estimated value between 25 and 30 million dollars¹.

It should be noted, that Erie Water Works has submitted previous cash offers for all or a portion of the Millcreek Township Water Authority water system. Additionally, there was a regionalization study published in 2002 sponsored by the Regional Government Opportunities Task Force and the Millcreek Board of Supervisors commissioned an independent study for equality of water rates conducted by Alan R. Kugler who issued his report dated June 5, 2008. **Neither report favored regionalism by lease.**

The Millcreek Township Water Authority and Administration strongly recommend, that should the process to merge or lease proceed, that independent financial and legal experts be engaged to conduct an exhaustive study of the proposed association to protect the interest of Millcreek and its citizens.

¹ See 2008 M.T.W.A. Audit by Buseck, Barger and Bleil, pg 8.

II. ERIE WATER WORKS FINANCES

The accounting firm of Schaffner, Knight, Minnaugh & Company P.C. (SKM) has been engaged to review Erie Water Works' audited financial statements for the year ended December 31, 2008. They were engaged for the purpose of rendering a preliminary opinion, subject to further investigation and review of Erie Water Works financial matters, relating to the future financial viability of Erie Water Works. SKM has indicated to us that there is cause for concern. Their opinion is similar to ours in that the equity of Erie Water Works has decreased to \$5,000,000 and it therefore is a possibility that its' liabilities could exceed its assets at the end of this year.

It should be noted that Erie Water Works current Cost of Service Study concludes at December 31, 2009. The Cost of Service Study effective on January 1, 2010 could be telling if the finances are as bad as we believe, the future cost projections for water for all customers may be significantly increased.

The 2009 Cost of Service Study should be proceeding as this is being written. In the past Erie Water Works has developed a five year financial plan from the Study and strictly adhered to it. Adoption of studies and financial plans have historically been done at Erie Water Works' December meetings. The Studies require advance publication to allow for comments prior to adoption. In anticipation of receiving the study within the next 60 days, it would make sense to have and review the Erie Water Works Cost of Service Study prior to any final decisions.

Items from the 2008 Erie Water Works Audit that are cause for concern and require further investigation include:

- A.) Erie Water Works added over \$50 million in new borrowing in 2008 so their long term debt and projected interest is close to \$400 million² as compared to Millcreek Township Water Authority at \$4.6 million;
- B.) Erie Water Works has recorded losses of \$2 million or greater in 2003 and for every year since, with 2008 showing a \$5 million loss³;
- C.) Erie Water Works has raised residential rates over 58% since 2000 yet their operating revenues have flat-lined⁴;
- D.) Erie Water Works average daily sales volumes have decreased by about 10 million gallons since 1999; (See Exhibit "A")
- E.) Erie Water Works latest lease extension of 10 years has obligated in excess of \$46 million of payments to the City of Erie for that same time period⁵;

² 2008 E.W.W. Audit, Sean Sullivan, pg 31.

³ 2008 E.W.W. Audit, Sean Sullivan, pg 47.

⁴ 2008 E.W.W. Audit, Sean Sullivan, pg 49.

⁵ 2008 E.W.W. Audit, Sean Sullivan, pg 20.

- F.) Erie Water Works borrowed the \$2.5 million “up front” payment⁶ to pay the City of Erie for the lease extension in addition to the 2008 lease payment of \$2,641,721⁷;
- G.) Erie Water Works, despite being an Authority, is still paying for Erie’s unfunded pension liability 17 years after its’ formation and several years ago this line item took a 78% budgetary jump from \$400,000 to \$715,000⁸ annually;
- H.) Erie Water Works debt service, lease payment, and unfunded pension liability takes 50% of the Erie Water Works annual operating revenues as compared to Millcreek Township Water Authority at 27.5% and is almost zero in five years; and
- I.) Erie Water Works is currently participating in interest rate swap (swaptions) which require three and one-half pages of description and associated risks in the audit⁹. Swaptions have recently been the subject of newspaper articles for the inability to determine the fees charged by the brokers for arranging these swaps.

It is very important that you seriously consider a study of Erie Water Works’ finances going forward before any decision is made regarding a merger or lease. *Millcreek Township Water Authority is seriously concerned to the point of being scared for all ratepayers of Erie Water Works.*

III. REPRESENTATION

The Millcreek Township Water Authority is concerned that the proposal does not provide for Millcreek representation on the Erie Water Works Board. The Township currently appoints all members to the Millcreek Township Water Authority, controls their borrowing, and service extensions by assessments. The Millcreek Township Water Authority Boards have managed the operational and financial aspects of the water system admirably for a considerable period of time. Without adequate representation and input from members of our community there is no system of checks and balances that would assure us that appropriate business decisions are being made as required, including Millcreek Township Water Authority system maintenance and depreciation (renewal) projects.

⁶ 2008 E.W.W. Audit, Sean Sullivan, pg 6 & pg 9.

⁷ 2008 E.W.W. Audit, Sean Sullivan, pg 12.

⁸ 2008 E.W.W. Audit, Sean Sullivan, pg 13.

⁹ 2008 E.W.W. Audit, Sean Sullivan, pg 32.

Sufficient representation is also important because, in the past, there have been extreme philosophical differences between the Township and the City and now Millcreek Township Water Authority and Erie Water Works in matters of borrowing, project priorities, system extensions, development promotion, community services, etc. Millcreek Township has used the Millcreek Township Water Authority as an economic development tool and many of its 7,000 customers, both residential and commercial and additional customers in Fairview and Summit would not be located or even exist in Millcreek, Summit or Fairview were it not for Millcreek Township Water Authority.

There are still areas in Millcreek that have potential for development, there are still areas that are on individual wells, and there are still areas that are hard to service with public water and public fire protection. The Millcreek Township Water Authority had originally been charged with this responsibility when the City of Erie and Erie Water Works could not and would not do it. Little seems to have changed in this regard.

As a reminder, the Millcreek Township Water Authority Mission Statement is noted:

MISSION STATEMENT

The purpose of the Millcreek Township Water Authority is to acquire, hold, construct, alter, improve, refurbish, enlarge, furnish water works, water supplies, water distribution systems and acquire necessary land for such purposes in the County of Erie, Pennsylvania. It is also the purpose of the Millcreek Township Water Authority to provide for the fire safety and security of Millcreek Township.

The Millcreek Township Water Authority is dedicated to the advancement of the water system within Millcreek Township, as to facilitate the Millcreek Township Supervisors 10 year master plan. The Authority's goal is also to provide quality service and to establish positive customer and development policies and procedures that meet the goals as defined by the Millcreek Township Supervisors.

Finally, the best example of the benefits the Supervisors presently enjoy is the ability to walk to the other end of the hallway, present an issue, and expect a reasonable resolution from Millcreek Township Water Authority administration. The Millcreek Water Authority administration often finds itself answering questions or helping on problems not within the Authority's service area.

IV. LEASE OR PURCHASE

Prior to the most recent Erie Water Works conceptual outline, Millcreek Township Water Authority assumed the question of should a merger take place was open to whether the form of the merger would be a lease or a purchase. The current offer only proposes a lease option. The proposed lease does not include any lease payment to Millcreek Township Water Authority or Millcreek Township and requires cash reserves to be given to Erie Water Works, effectively paying Erie Water Works to take Millcreek Township Water Authority.

However, a review of the Erie Water Works' audited December 31, 2008 financial statements discloses that the City of Erie will be receiving approximately \$170,000,000 of lease payments from Erie Water Works through December 31, 2050¹⁰. In fact, the City of Erie has been advanced in excess of \$10,000,000¹¹ specifically related to future lease payments and has already received around \$30,000,000 in past lease payments for a current total in the neighborhood of \$210,000,000.

It also appears that during the course of 2008, that Erie Water Works secured new financing of which \$2,500,000 was paid to the City of Erie in exchange for an extension of its' lease through December 31, 2050.

The Millcreek Township Water Authority and the Citizens of Millcreek Township have no guarantee that transfers of this nature will not continue after a merger or lease. Furthermore, there is little doubt that rates charged to the citizens of Millcreek will increase to cover this subsidy to the City of Erie. Essentially, the City has used Erie Water Works to extract taxes not only from City water rate payers, but water rate payers from the surrounding communities as well.

Curiously, when the City and Erie Water Works began the current lease, the Erie water system was valued at \$25 million, or about the same as the Millcreek Township Water Authority system is valued now. If Erie Water Works is able to stop the payments at \$210 million, they will have paid Erie 800 percent of the original system value and may still not own anything. The City is not obligated to share any of this lease money with anyone else, despite the fact that Millcreek and possibly Harborcreek, Lawrence Park and Wesleyville gave over their water system assets to the City.

The Millcreek Township Water Authority believes a long term lease of 30 years or more without benefit of initial or continuing payment will reduce the future market value of the Millcreek system to zero and will leave Millcreek without the equity or cash reserves to restore the system. At the end of 30 years or more, there is no more Millcreek Township Water Authority "corporate memory", no licensed operators, and no staff if the system were to be taken back by Millcreek. There is no guarantee that system value would be maintained by depreciation projects and the record of Erie Water Works, especially in Millcreek, is poor.

¹⁰ 2008 E.W.W. Audit, Sean Sullivan, pg 35.

¹¹ 2008 E.W.W. Audit, Sean Sullivan, pg 18.

Millcreek rapidly loses the ability to provide oversight to Erie Water Works, the current proposal has no representation for Millcreek on the Erie Water Works Board, and Millcreek has no power or authority to do anything under the current proposal.

The Kugler Report noted that true rate equality was not achievable until the City of Erie surrendered its lease payments and that Erie Water Works became independent from the City of Erie. The 2002 Regionalization Report recommended the restructuring of the Erie Water Works Board to coincide with the new service area. Ending the abusive Erie lease payments will lower everyone's bills and should help in using water as an economic development tool for all Erie County. The proposal from Erie Water Works does not reflect any of these recommendations.

V. OPERATIONAL MATTERS OF CONCERN

The Erie Water Works proposal is to manage, maintain and operate the Millcreek Township Water Authority system. We are aware of the following operating issues that concern us. This is not meant to be an all-inclusive list since we are not aware of many of the details of Erie Water Works operations.

- A.) Erie Water Works water leakage and loss is an average 7.7 million gallons per day or 29% of the daily water produced (See Exhibit B). This equates to residential revenues of \$8,700,000 lost on an annual basis. Industry recommendation is no more than 10% water loss and Millcreek Township Water Authority water losses have been less than 4% for the last three consecutive years. Erie Water Works water loss in a single day is almost 3 times the daily water purchase of Millcreek, Fairview and Summit combined.

- B.) Erie Water Works averages 250 breaks a year (See Exhibit B) and their expenses increased by \$1.1 million for water main break repairs in 2008¹². On August 7, 2009 the Erie Times reported 3 breaks had occurred within 2 months affecting the Presque Isle/Peninsula area, which is a high traffic tourist area. Erie Water Works response was less than stellar, indicating their funds for 2009 projects have been allocated (See Exhibit C). This despite the fact they have borrowed about \$100 million within the last 3 years. In fact, the Erie County Department of Health recently called the Millcreek Township Water Authority for help on this situation as Erie Water Works had not responded to its calls.

¹² 2008 E.W.W. Audit, Sean Sullivan, pg 7.

- C.) Fires in Millcreek and the response of the Erie Water Works water system are a significant concern to Millcreek Township Water Authority. The Granada Apartments are served by a 6” diameter main, 6” diameter piping network, and a general lack of public fire hydrant in that network. This would appear undersized for service to high-density housing units. Fuhrman’s Cider Mill appeared to suffer from multiple non-functional hydrants. Fires at LOC Inc. located in the EBCO Industrial Park were hampered by service from a dead end 6” diameter main, which again appears to be undersized and inappropriate for the land usage it serves.
- D.) The Millcreek Mall is currently negotiating with Millcreek Township Water Authority to explore the possibility of changing service providers. They are trying to get out of the water distribution system ownership and desire a higher level of service than Erie Water Works is willing to provide (See Exhibit D). It is our understanding that the Mall’s efforts to discuss these issues with Erie Water Works have been ignored.

VI. RATES

Millcreek Township Water Authority is concerned that there appears to be no guarantee that all rates will be equal to all customers. A number of the proposed provisions would give Erie Water Works control over pricing and the Supervisors would have no input or control (See Exhibit E).

We had inquired of Erie Water Works regarding a clarification of the rate-making procedure, but the response continues to be ambiguous (See Exhibit F). The lease premise appears to add to the complexity of future rate making. Future rates are also dependent upon cost of service studies that are totally controlled by Erie Water Works, who have accepted little or no outside input to their past historical creation. The Millcreek Township Water Authority is concerned that this becomes an area where control is lost and another reason for Erie Water Works to request Millcreek Township Water Authority cash reserves and future cash (tapping fees).

At our meeting in July, we believe we heard that if the Supervisors wanted any services that are now unique to the Millcreek Township Water Authority/Supervisors relationship, they would be debited from the separate “project” and if no funds were remaining, ***the level of service would be adjusted downward. This is unacceptable and not in the spirit of what the Supervisors desire in a proposed merger.***

Millcreek Township Water Authority has continuously disputed the Erie Water Works Cost of Service Studies especially those of 1999 and 2004. Asking the Supervisors to trust the future Erie Water Works Cost of Service Studies does not give the Millcreek Township Water Authority any confidence. The following are serious issues that Millcreek Township Water Authority and its’ partners, Fairview and Summit, share joint concern:

- A.) Cash payments to Erie Water Works for capital projects in which the Bulk customer base shared were not properly credited. The cash payments exceeded \$1.2 million.
- B.) The Bulk rate class is being charged for capital projects that are not associated with the bulk take points, for projects that do not benefit the bulk rate class, and for projects that have been subsidized by grants to Erie Water Works. Examples are meters within the City of Erie and expansion of Erie Water Works system into Harborcreek and McKean.
- C.) Erie Water Works has been charging the bulk rate class for fire protection services within the City, even though the bulk rate class has to maintain their own fire protection services (tanks, pumping stations, hydrants) and all water used in the Millcreek, Fairview and Summit systems for fire protection and training is metered.
- D.) Erie Water Works has been charging the bulk rate class for breaks in their system no matter where they occur and for water losses in the City, despite the fact the bulk customers are all master metered themselves and responsible for their own repairs.

The matter of the bulk service customers being overcharged is a long standing issue that needs to be resolved prior to a merger. It not only impacts the potential cash reserves but the correctness of costs of service studies into the future.

VII. THE DISPUTED USE OF M.T.W.A. CASH RESERVES

Erie Water Works has attempted to legitimize the use of Millcreek Township Water Authority cash reserves by maintaining certain capital projects need to be completed (no legitimate list has been presented for Millcreek Township Water Authority comment), that Millcreek will be considered a “special project” for accounting purposes, that their attorney says it has to be that way, and their proposal (Item No. 8, the transfer of all assets) provides for it. **This is simply ludicrous and an attempt to have Millcreek pay Erie Water Works for taking the system.** It is also ludicrous to have current Millcreek Township Water Authority customers pay capital cost surcharges. **It is another way to justify future unequal rates for current Millcreek Township Water Authority customers should a merger occur.**

The true value of the cash reserves changes daily. No one has discussed the value of future assessment or tapping fee payments currently on the Millcreek Township Water Authority books that has been bought and paid for. The converted cash value of these future payments could approach another \$1 million in value and should not automatically be given to Erie Water Works.

There is also the potential “sale” of shared transportation systems (pumping stations, mains, tanks) to Fairview and Summit. Millcreek Township Water Authority should attempt to sell these to Fairview and Summit to accumulate cash reserves that would equalize rates under the Erie Water Works plan for an additional period of time. Fairview and Summit have both contributed to the purchase, construction and maintenance of the joint transportation systems, and are concerned over the potential loss of the positive working relationship should Millcreek Township Water Authority disappear.

Additionally, there is potentially a legal matter to be considered regarding Bulk Rate Class historical overcharges. The rebate to Millcreek Township Water Authority could approximate \$1,200,000. Outstanding issues were noted previously in Section VI.

The disposition of millions of dollars is too important to just hand over to Erie Water Works.

VIII. FINANCIAL IMPACT TO MILLCREEK TOWNSHIP

In 2008 Millcreek Township Water Authority made \$630,306.61 in payments for various services to Millcreek’s Sewer Revenue Department, the Township Supervisors and to the Sewer Authority (See Exhibit G). There has been no real discussion on how to make up for this shortfall.

Millcreek Sewer ratepayers enjoy a number of efficiencies achieved by having the Sewer Authority share expenses with the Water Authority in their combined operations. These include:

- A.) Rent, utilities, and cleaning services;
- B.) Equipment (computers, printers, vehicles & repair costs, copiers, postage machines, etc.);
- C.) Employee salaries and fringe benefits; and
- D.) Special systems such as utility billing, PA One Call, and the SCADA system (which is actually owned by the Water System).

The sharing of Authority employees between Sewer and Water is extremely efficient for both Authorities and the potential dissolution of Water will disrupt this. Certain full-time positions will still be required because of the Sewer Authority size and activity. These include the Executive Director, Chief Financial Officer, Technical Manager, and Billing Supervisor. **The Sewer Authority will become responsible for their entire salaries and fringe benefit package. The final disposition of the Authority staff is of concern to both the Water and Sewer Authority Boards and none of these details have been discussed.**

It should also be noted that Millcreek Township Water Authority currently contracts and pays for two (2) full time employees from the Township field staff. This includes overtime charges and all fringe benefits. The disposition of these two (2) full time positions is unknown and also has not been discussed.

IX. LOSS OF COMMUNITY SERVICE

There is little doubt that the Millcreek Board of Supervisors have benefited from Millcreek Township Water Authority as a local and sometimes regional economic development tool. Millcreek Township Water Authority was used to promote the residential development that has occurred in the southwest portion of Millcreek, and the commercial on West 26th Street, and the upper Peach Street area. This was done at a time when City of Erie and Erie Water Works were unable and/or unwilling to provide water service to these areas.

In its early history, Millcreek Township Water Authority was also used to provide public water service to large areas having polluted or failed private wells. This continues today, but on a smaller scale.

There are still both developed and undeveloped areas of Millcreek that could benefit from water extensions and retrofits to public water. The Millcreek Township Water Authority's willingness to cover upsizing costs, provide developer reimbursements, and underwrite costs in hard to reach service areas is normal policy procedure, and does not require capital surcharges or debits to cash reserves as proposed by Erie Water Works.

Millcreek Township Water Authority has also made contributions to the McDowell Flood Detention basin (\$44,000), Cassidy Park (\$11,900 with matching grant potential), Belle Valley Pool, Brown's Farm Barn, and MYAA service connections. On several occasions, Millcreek Township Water Authority has absorbed the cost of leaks on Millcreek Township Parks & Recreation properties. Millcreek Township Water Authority has performed water main break clean-up on private property, laundered clothes, and in times past replaced dishware and clothes. In one water quality emergency in a commercial area Millcreek Township Water Authority even reimbursed restaurants for their expense in obtaining bottled water.

The Millcreek Township Water Authority has spent about \$70,000 equipping its' hydrants with Storz adaptors. The ratio of fire hydrants to customers on the Millcreek Township Water Authority system is one (1) hydrant for 10 customers. The Erie Water Works ratio for its customers is one hydrant for 20 customers, with large areas left totally unprotected (See Exhibit H). Millcreek Township Water Authority has installed hydrants and buys hydrant markers for Township use, whereas Erie Water Works charges the Township for the installation of these and does not financially participate in their purchase.

X. LACK OF TRUST IN ERIE WATER WORKS

There has been almost continuous litigation and animosity regarding water between the City of Erie and Millcreek Township for over 30 years. It has transcended numerous administrations on both sides and continues to be present in Erie Water Works and Millcreek Township Water Authority relations. In this 30 year time period, there have been settlement agreements and service agreements, none of which resulted in a final resolution. As a result, Millcreek Township Water Authority has become extremely cautious and any discussion of merger or lease requires very serious study.

XI. SUMMARY

The potential transfer of Millcreek Township Sewer Authority's assets to Erie Water Works is a business decision that will impact the citizens of our community. As such, we recommend that outside financial consultants and attorneys be engaged to ensure that any future association with Erie Water Works is in the best long-term interest of our constituents. There is no need so important that a \$25,000,000 asset, including untold millions in cash, should be given away without the proper due diligence. There are numerous serious issues that must be resolved prior to a merger including:

- 1. Erie Water Works finances are very troubling and unsustainable.** With the 2008 borrowing and lease extension alone, Erie Water Works long-term liabilities grew by \$125,000,000 in new debt, interest and lease obligations. These long-term liabilities now total \$560,000,000 and there is no guarantee that Erie Water Works will stop this uncontrolled growth of debt. This, coupled with the 10-year downward spiral of total sales, portends serious future problems.
- 2. Millcreek's lack of effective representation on the Erie Water Works Board is not proposed to change.** With a merger, 30% of the customer base will be Millcreek customers, but there is no plan proposed to alter current appointment methodology, which has failed to protect the interests of Millcreek Township residents. To make matters worse, the lease proposal provides no oversight mechanisms or controls retained by Millcreek once the transfer is made. *Lack of representation should be a deal breaker.*
- 3. Equal rates are not guaranteed by the lease proposal.** Establishing a "special project", capital surcharges, and using cash reserves to debit for now common services is not in the spirit of the original intention of equal rates. Erie Water Works proposal is vague and appears based on cost of service studies that Millcreek Township Water Authority contends have been historically flawed. Combined with lack of representation and oversight retained by Millcreek make this potentially disastrous. *Potentially unequal rates should be a deal breaker.*

4. **Unequal lease treatment.** The City of Erie will be receiving over \$210,000,000 for the lease of a system originally valued at \$25,000,000; while Millcreek has to pay Erie Water Works to lease a financially stable system currently valued at \$25,000,000. The lease and the lack of payment to Millcreek is in direct opposition to the findings of previously commissioned studies. ***A requirement to pay Erie Water Works to take the lease should be a deal breaker.***
5. **Lack of understanding of impact to Township finances.** There has been no discussion regarding the impact of the loss of \$630,000 annually into the economy of the Township, Sewer Revenue or Sewer Authority, and the effect on all of the residents of Millcreek Township.
6. **Change in the level of service.** Current differences in levels of development, community service, fire protection and responsiveness are significant and Erie Water Works levels can not be expected to improve or even remain at the high level currently enjoyed.. Erie Water Works has significant problems and other priorities, which have and always will govern over needs in Millcreek, especially with lack of effective representation on the Erie Water Works Board.