The Vista Ridge Project: Financial Questions Answered

Save Our Springs Alliance
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November 18, 2015

Last November the City of San Antonio, acting through its water utility San Antonio Water System ("SAWS"), inked a "take-*and*-pay" contract that, if financed, would commit the city to purchasing up to 50,000 acre-feet of water per year for 30 years at an estimated total cost of $3.4 billion for the water alone. The project, with Abengoa Vista Ridge LLC ("Abengoa Vista Ridge"), a subsidiary of Spain-based Abengoa, S.A. ("Abengoa, S.A."), and Austin-based BlueWater Systems ("BlueWater"), calls for pumping groundwater from Simsboro and Carrizo aquifer wells in Burleson County, northeast of Austin, through a new 142-mile long pipeline to a delivery point on the north side of San Antonio.

The Vista Ridge project is "high risk," which is SAWS' justification for approaching a private party to carry the risk to finance, construct and operate the pipeline. The additional cost ("risk premium") to SAWS' ratepayers for this will be around $700-800 million versus if SAWS executed the project itself. That amount is equivalent to almost double the estimated cost for all three phases of SAWS' (now under construction) brackish water desalination project ($410 million) which, at no risk, provides two-thirds as much water as the $3.4 billion Vista Ridge project. Is Vista Ridge really a good investment?

How will San Antonio pay for the Vista Ridge project?

- Abengoa Vista Ridge is responsible for the capital costs, or the up-front costs, of building the pipeline and infrastructure of the Vista Ridge project, which will total approximately $885 million.
- SAWS estimates water will start arriving in 2020, in which case the 30-year "Operating Period" for the delivery of water and SAWS' obligation to pay for it, will last until 2050.[1]
- Once water begins arriving, SAWS will begin paying Abengoa for as much water as it delivers, up to 50,000 acre-feet of water per year, regardless of whether San Antonio needs the water or not.
- The price of the "raw" groundwater is set in the Water Transmission and Purchase Agreement ("WTPA" or "Contract") at $1,852 and may be adjusted as high as $1,959 per acre-foot, depending on changes in interest rates between the Contract Date and the Financial Closing Date. [2] The price of raw groundwater will be fixed at the financial closing date for the 30-year contract term.[3]
- On top of the cost of raw groundwater are the costs of operation and maintenance ("O&M") and pumping (energy needed to move the water), which according to SAWS estimates, will increase the price by another $175 and $173 per acre-foot, respectively.[4] With these costs, which will be paid by SAWS to

[1] Vista Ridge Regional Supply Project Water Transmission and Purchase Agreement (hereinafter "WTPA"), Art. 1, 6, 17, 29, *available at* http://www.saws.org/Your_Water/WaterResources/projects/VistaRidge/docs/201502_SAWS_VistaRidge_WaterTransmissionAndPurchaseAgreement_FINAL.pdf. (The "Operating Period" is the period identified in the Contract as that time between the "Commercial Operation Date" when water delivery begins, and the "Termination Date", which is either when the Contract expires in 30 years [up to 50 years] after the Commercial Operation Date, or when the Contract is canceled for some other reason before then. The 30-year Operating Period is what's usually referred to as the Contract.)
[2] WTPA at 140-141.
[3] WTPA at 51 ("Upon the satisfaction or waiver by SAWS of the Financial Closing Date Conditions," the parties will acknowledge satisfaction and declare that the Financial Closing Date has occurred. The Contract Date is Nov. 4, 2014. The Financial Close is estimated to occur between 18 and 30 months from the Contract Date, but no later than 910 days after the Contract Date [May 2, 2017].)
[4] Robert R. Puente, President-CEO, SAWS, Presentation to SAWS Board of Trustees about Vista Ridge Water Supply Contract (Sept. 22, 2014), *available at* www.saws.org/your_water/waterresources/projects/vistaridge/docs/20140922_SAWSBoardBriefing_VistaRidgeContract.pdf (O&M budgets to be developed annually and paid by SAWS estimate at $175 per ac-ft in 2014, escalating with inflation; Electrical Costs, paid directly by SAWS estimated at $173 per ac-ft in 2014, escalating with inflation.).

Abengoa Vista Ridge, the total cost of the groundwater will be about $2,200 - 2,300 per acre-foot, or $3.4 - 3.45 billion total.

- The price of $2,300 per acre-foot is approximately four to seven times higher than Edwards Aquifer water and almost twice the cost of the most expensive Carrizo water from Gonzales County.[5]
- There will still be additional costs to SAWS for (1) integrating the water into the SAWS distribution system;[6] (2) a reserve fund for major maintenance on the 142-mile pipeline facilities to be established by SAWS;[7] and (3) operations and maintenance costs for the new integration infrastructure. Together, these costs could increase the $2,200 – 2,300/ac-ft price tag of groundwater by more than 15%.[8]
- After 30 years, ownership of the pipeline and infrastructure will transfer from Abengoa Vista Ridge to SAWS, control of the water leases will revert to BlueWater, and SAWS will have an agreement in place with BlueWater for groundwater for another 30 years.[9]

Where will the $885 million in capital come from? What are private activity bonds?

- Abengoa reportedly will put some $82 million of its own funds into the project. While Abengoa Vista Ridge's primary intent is to seek long-term tax-exempt "private activity bonds" in the public market, it also acknowledges that it may have to seek alternative initial financing in either the public or private capital markets.[10]
- Public utilities that generate a revenue stream have traditionally financed projects with tax-exempt revenue bonds, which in the case of water supply projects, are bonds that are paid back with the income generated by selling the water. Tax-exempt financing reduces the cost of capital to a public utility, since the investors who buy the bonds, do not pay income taxes on the interest they earn (in other words, the utility makes lower interest payments).
- Private activity bonds are also tax-exempt bonds issued by a governmental entity and secured by the project's revenues, but they are to finance a project for a *private* company that can demonstrate a public purpose.
- The Texas Attorney General's office must approve the issuance of private activity bonds. San Antonio's rate increases (scheduled for a City Council vote on Nov. 19) are to show the AG's office that Abengoa Vista Ridge will have sufficient revenues to pay its private activity bonds, and that San Antonio will have sufficient revenues to pay all of its obligation, including Vista Ridge. Satisfaction of both "bond allowable tests" are required for AG approval.
- In the case of Vista Ridge, Abengoa Vista Ridge has applied to the Mission Economic Development Corporation to issue its private activity bonds and loan proceeds of the bonds to Abengoa.[11] Repayment of the loan, and the bonds, are secured by Abengoa's revenues from selling water to SAWS.

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5 CALVIN FINCH, ET AL., DRAFT CITIES OF SAN ANTONIO AND FAIR OAKS RANCH WATER POLICY ANALYSES 100-01 (July 2015) *available at* https://www.sanantonio.gov/Portals/0/Files/Mayor/COSA-FairOaksRanchWaterPolicyAnalyses.pdf.

6 Quintin Pollok, P.E. Project Engineer & Andrea Beymer, P.E., Interim Director, SAWS, Presentation to SAWS Board of Trustees about Water Infrastructure Plan & Vista Ridge Integration (Aug. 4, 2015) (Integration is estimated at $125.3 million in Phase I and another $115.2 million in Phase II).

7 WTPA at 141-42; WTPA Appendix 19, A19-2. (The reserve fund for major maintenance is stipulated in the contract, but no estimate of size is listed.)

8 This 15% estimate was based on the following: Depending on interest rate assumptions and duration (25-30 years) of bonds, integration would add between $268 to $335 per acre-foot. Assuming SAWS puts the equivalent of 1% of total capital costs per year into the reserve fund, this adds $176 per acre-foot. Therefore, the costs of integration and the reserve fund could add about $444 ac-ft to the $2,200 ac-ft estimate—a 20% increase in the cost of the water. This calculation did not include O&M for additional infrastructure. Therefore, the 15% estimate is conservative.

9 TEXAS A&M INSTITUTE OF RENEWABLE NATURAL RESOURCES, ET AL., CITIES OF SAN ANTONIO AND FAIR OAKS WATER POLICY ANALYSIS 35 (Nov. 2015) *available at* http://irnr.tamu.edu/media/605219/cosa-for-final-water-report.pdf.

10 WTPA, Appendix 16, A16-2 – A16-3 (Nov. 4, 2014), *available at* http://www.saws.org/your_water/waterresources/projects/vistaridge/docs/201502_SAWS_VistaRidge_WaterTransmissionAndPurchaseAgreement_FINAL.pdf.

11 Under the Development Corporation Act, Economic Development Corporations may issue bonds, and those bonds are payable from the sales tax proceeds collected by the EDC or lease revenues that EDC receives from the user of the financed project. *See* TEX. LOC. GOV'T CODE §§ 501.006, 505.104, 505.302.

If revenue bonds are secured by SAWS paying for water, why is Abengoa's financial situation important?

- Abengoa Vista Ridge, LLC, a subsidiary incorporated in Delaware and based in Austin for the purpose of financing and building the Vista Ridge pipeline, will be the primary obligor (the one who must pay) on the bonds. Since the bonds are revenue bonds, buyers (investors) will primarily be looking at the revenue stream, which comes from SAWS, not Abengoa.
- However, investors who will buy the revenue bonds still want confidence that Abengoa will perform in constructing and operating the project. Abengoa's current financial status and history hardly inspire confidence.
- Abengoa S.A., the parent company, has a financial rating three levels below investment grade (junk) and its rating is under review by Moody's for a downgrade.
- Abengoa S.A., has: (1) a junk bond credit rating; and (2) in the last months, been seeking to divest itself of (get rid of) a significant portion of its shares in its own holding company (Abengoa Yield, PLC) in an attempt to improve its credit rating. The holding company contains a portfolio of Abengoa S.A.'s assets (projects). In other words, because of Abengoa S.A.'s dubious prior business decisions, it is trying to distance itself from its own projects. Additionally, Abengoa Yield, PLC shares have lost 53% of their value in the four months between the end of May and the end of October 2015.

What if the water is not available, or Abengoa is unable to perform? Who bears those risks?

- It is unclear if the water needed to pay the revenue bonds will actually come down the pipeline, either before or after the contract expires in 30 years. Even if SAWS has successfully transferred this risk to Abengoa during the contract term, it could still impact investor or lender confidence and ultimate willingness to finance the project.
- The local groundwater conservation district publicly said that if necessary to protect the aquifer, it will cut back pumping, and it does not guarantee additional pumping permits would be issued to Abengoa to make up for such reductions.[12] If a supply deficiency occurs during the 30-year contract term, then SAWS will not have to pay for water it does not receive, and Abengoa would lose revenue it would need to pay back bonds. This is uncertainty that investors don't like.
- Although SAWS has said that it could take over the project should Abengoa be unable to operate it, if the cause is a limited water supply, SAWS would have to increase the cost of the water (the water rates) in order to service the revenue bonds. This is a risk investors would like to avoid – and an outcome ratepayers would certainly dislike.
- Another regulatory risk that impacts whether the water is available is the terms of the permits issued by the groundwater district. Currently, the terms of Abengoa's "Production Permit" (authority to pump) and "Export Permit" (authority to export water out of the district) do not match the contract term, also a problem for investors.[13]
- No matter the reason, severe supply problems ultimately may result in the pipeline, and the project, becoming a form of "stranded asset", which typically refers to an asset that has suffered from an unanticipated or premature write-down, devaluations, or conversion to a liability. Research estimates that at least 60% of institutional investors have concerns about stranded assets, leading to reductions of this exposure in their portfolios.

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[12] Nathan Ausley, President of POSGCD Board of Directors, addressing a group of landowners in Burleson County (Aug. 8, 2015).

[13] BlueWater's 40-year production permit will expire on September 11, 2044, while its 30-year transport permit will expire on September 15, 2034. If the pipeline starts producing water in 2020, the Contract will expire in 2050.

SAWS keeps saying that all the risk is on Abengoa? What risk does San Antonio assume?

- SAWS admits that Vista Ridge was too risky for SAWS to take on themselves. SAWS sought out a P3 (Public Private Partnership) for the project to transfer the risk to a private entity; however, the risk that was transferred to Abengoa Vista Ridge is strictly financial.
- Just because Abengoa Vista Ridge assumes the financial risk, does not mean that San Antonio is risk free. San Antonio's biggest risk is that the water will be unavailable when it needs it most – after the initial 30-year term of the contract, and after paying Abengoa Vista Ridge $3.4 billion to build the pipeline and infrastructure.
- Abengoa did not assume the supply shortage risk out of a sense of generosity – it agreed to take the risk in return for a premium price from SAWS for water. If all 50,000 acre-feet are delivered and SAWS cannot sell any of it, then SAWS must pay this premium for water that it can't use. Knowing that ASR cannot accept 50,000 acre-feet per year every year,[14] SAWS assumes the risk of over-paying substantially for water that will not benefit the city.
- The estimated break-even point for Abengoa is selling somewhere between 35,000 and 40,000 acre-feet per year to SAWS, depending on the interest rate they have to pay on the bonds. Plus, they need more than that depending on their opportunity cost of capital to make it worth their while to stay in the deal. In other words, Abengoa needs to deliver the 50,000 ac-ft/year or dang close or the deal could implode. This equals the Texas Water Development Board's total approved withdrawals for the groundwater management district involved.
- Vista Ridge water is not secure, firm yield water; it comes with a high risk of being "interruptible, unreliable water". City Council should take note and demand that SAWS demonstrate how Vista Ridge is compatible with the primary and established water planning principle that -- municipal water providers provide secure, "firm yield" water.

Where will the money that SAWS would pay for the water go? Who gets paid?

- BlueWater has negotiated to get $460 per acre-foot of water sold to SAWS. That's $23 million per year or $690 million over thirty years.
- Of their $460 per acre-foot, BlueWater will pay approximately 10% in royalties – or about $46 per acre-foot to the landowners who leased their water rights.[15]
- Post Oak Savannah Groundwater Conservation District will collect up to $2.77 million per year for a combined production and transport fee.[16]
- The remainder of SAWS' payment will be used by Abengoa Vista Ridge to pay back the bonds with interest and as a return on Abengoa's initial investment, that is, their profit for undertaking the project. According to former SAWS Board of Trustees member Reed Williams, "The provider [Abengoa] will be putting in $82 million, for which they will get a $17.2 million/yr return or about a 21% annual return on equity."[17] If all 50,000 acre-feet per year are delivered, Abengoa will get a gross return of about $516 million on an $82 million investment.

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[14] The Twin Oaks ASR facility is projected to hold up to 120,000 acre feet of storage. At the beginning of 2015, it was over 60% full. *available at* http://www.edwardsaquifer.net/asr.html.
[15] WTPA, Reference Document 3, Groundwater Lease Conveyance Agreement, 9 (Nov. 4, 2014) *available at* http://www.saws.org/your_water/waterresources/projects/vistaridge/docs/201502_SAWS_VistaRidge_WaterTransmissionAndPurchaseAgreement_FINAL.pdf.
[16] Post Oak Savannah Groundwater Conservation District, District Rule § 9.1(6)(b) *available at* http://www.posgcd.org/district-information/district-rules/ ("A combined production and transport fee not to exceed $0.17 per thousand gallons of groundwater transported outside the boundaries of the District.").
[17] Reed Williams, Former Board of Trustees member, SAWS, Presentation to SAWS Rate Advisory Committee (Sept. 16, 2014).