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White Paper on Franchise Agreement Negotiations

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NewGen Strategies and Solutions, LLC (NewGen) prepared this White Paper at the request of the Lafayette Consolidated Government's (LCG) Mayor-President. It is intended to identify negotiation points that will inform the City of Lafayette, Louisiana (City) and the Lafayette Parish (the Parish), collectively the City-Parish, officials with respect to developing a franchise agreement for operating an electric utility within the City limits. The assumption underlying the franchise agreement negotiation is that a third-party utility would purchase the City-owned Lafayette Electric Utility (Electric Utility or System), and operate that Electric Utility within the City under authority, and provisions of, a franchise agreement granted by the City. Typically, in such franchise agreements, privately owned utilities own and operate the electric utility within the city.

This White Paper is organized into five areas:

1. Basic Franchise Agreement Provisions
2. Strategic Issues
3. Employee Matters
4. Business Locations and Practices
5. Other Items

Certain of the items discussed in this White Paper may more appropriately belong in a Buy-Sell Agreement rather than a Franchise Agreement. They are included here, so that items to be negotiated in a sale are comprehensively presented in a single document.

Basic Franchise Agreement Provisions

An Electric Utility franchise agreement grants the franchisee the rights to operate and maintain electric service to customers residing within the City. These rights generally include the right to occupy and maintain electric utility facilities in public rights-of-way. The City grants the use of City-owned rights-of-way, and imposes conditions upon the franchisee for such use. Typically, these conditions include the following:

- Franchise agreement fee payment to the City
- Specification of the term of the franchise agreement
- Specification as to whether the franchise agreement is "exclusive" or "non-exclusive"
- Recognition that the utility properties will be subject to property tax treatment consistent with other taxable entities within the City.
- Agreement as to reimbursement of any separation costs, or other transaction costs of the sale of utility assets or incurred in establishing and granting a franchise agreement

Franchise Agreement Fee

The Louisiana Municipal Association (LMA) is a state-wide organization promoting and advocating for its members, Louisiana cites, and parishes. The LMA conducted a survey of its members regarding franchise agreement information in 2010. That survey indicated franchise agreement fees ranged from a low of 2% of utility revenues to a high of 5% of utility revenues. Based upon this information, it would be prudent for LCG to negotiate a franchise agreement fee at the high-end of percentages, perhaps starting at around 6%, with the expectation of agreeing on 5%. This fee is the single most important component of the franchise agreement.

Terms

The LMA's franchise agreement fee survey also contains information regarding the term of the utility franchise agreement. The terms ranged from a low of 3 to 5 years (mostly communications franchises) to a high of 60 years (for energy service provider, such as Entergy). Electric utility franchise agreement terms were typically in the 25-year range. When negotiating franchise agreement term lengths, the utility will generally want a longer-term in order to increase the certainty of the future business. The franchise agreement grantor may want a shorter-term, perhaps 10 to 15 years, so that the franchise agreement can be renegotiated with more contemporary terms as conditions in the electric utility industry and/or municipality evolve. Starting negotiations at the lower end, say 15 years, may be a good strategy for the City, with an expectation that a longer-term agreement may result. Terms longer than 25-years should be accompanied with other attractive features of the franchise agreement such as a trade-off, e.g. a higher franchise agreement fee or other City benefit.

Exclusivity

Typically, communications franchises are non-exclusive, recognizing that several communications providers may operate within a municipality. In the case of an Electric Utility, an exclusive franchise agreement is more common, recognizing that a monopoly provider is more efficient than attempting to accommodate competing electric utility providers. Indeed, the Louisiana Public Utility Commission prohibits dually certified utility service territories, so the issue of exclusivity is likely not a negotiation point.

Property Tax

The issue of property taxes is most likely governed by State of Louisiana (State) statute; however, it is worth acknowledging that there is no special treatment of utility assets sold to a third-party in this regard. Therefore, while property taxes on utility assets may provide revenue for a local municipality, they are typically not included as a negotiated item within a franchise agreement.

Separation Costs

Separation costs refer to the investment costs required to isolate service either through metering or in electric equipment when an existing system is divested or joined with another. Depending upon the buyer of the Electric Utility and the physical location of its current utility assets that will be used to serve the City, there may be some costs incurred to accommodate the provision of a new utility provider. The City should be held harmless for any such costs.

Strategic Considerations

There are several strategic considerations that need to be reviewed regarding the potential sale of Electric Utility assets and the development of a franchise agreement. These include the issues related to the existing Communications System, potential repurchase of the Electric Utility assets, and other considerations.

Communications System

LUS's Communications System is a separate business entity from the Utilities System, and its revenues and expenses are generally not comingled with those of the Electric, Water, and Wastewater Systems. However, to finance the building of the Communications System, the Utilities System provided two forms of financial support. One was a provision for the Utilities System to provide direct loans to the Communications System in the amount of $6 million (M). The other form of support is a credit guarantee by the Utilities System that provides a financial "backstop" to the Communications System revenue bonds of which approximately $105M are outstanding.

A review of the Utilities System Bond Ordinance and the Communications System Bond Ordinance does not appear to prohibit the sale of a portion of the Utilities System, so long as the rate covenant is not violated, among other issues. That covenant requires the City to maintain rates for services at a level allowing 100% of debt service to be maintained. The practical effect of this provision is that, without the Electric System, should the Communications System fail, or operate at a loss, Water and Wastewater rates would have to be set high enough to cover the Communications System losses, and pay the Communications System debt service. Under a "shut down the business" scenario for the Communications System, the Water and Wastewater Systems would have to assume, or defease, $105M of Communications System bonds.

While the Utilities System, consisting of all three utilities, provides the financial backstop, as a practical matter, it is the size and strength of the Electric Utility that provides the bulk of the financial support. Should the Electric System be sold, the continued financial backing of the Communications System bonds would not be prudent or practical as the combined Water and Wastewater Systems do not have the financial strength to offer such support. This may jeopardize the financial integrity of LUS.

Because such a result would represent a severe financial challenge to the Water and Wastewater Systems, it may be prudent to combine the sale of the Electric Utility with a corresponding sale of the Communications System. A simple approach to this problem could be to negotiate the sale price for the Electric Utility, and then add a premium cash payment of $105M for the outstanding debt. The City could defease the Communications System bonds, and continue to operate the communications business as it desires. This approach may result in a joint bid between electric utility and communications providers, which may be a challenge; however, from LCG's perspective it would offer a viable solution to the Communications System issue.

Finally, there are many aspects of LCG and the Water and Wastewater Systems that rely on the existing configuration of the Communications System to operate. A future franchise agreement will need to specify the details of how the remaining systems will utilize the Communications System, and if such use would be subject to compensation and certain operational metrics.

Re-Purchase of Electric Utility Assets

It is not uncommon for utility franchises to contain a clause specifying franchise agreement renewal provisions or rights of the grantor at the end of the franchise agreement term. The City should consider including a provision that gives the City the right to re-acquire the electric utility at the end of the franchise agreement term. This right should also specify the price (or the methodology to determine the price) that would be paid to re-acquire the utility assets. Such a price would typically be based upon net book value of the utility assets, but could be negotiated higher if required. The more detailed the methodology included in the franchise agreement, the easier it will be to evaluate such re-acquisition years later at the end of the franchise agreement term.

Other Strategic Issues

There are other strategic issues that LCG should consider before entering into an electric utility franchise agreement. These include items specific to the industry such as pursuit of a renewable portion of power supply, conditions regarding Automated Metering Infrastructure (smart meters), or smart grid accommodations, as well as access to the data provided by such systems. A more thorough review of energy franchise agreements in Louisiana and across the country should be conducted prior to initiation of a franchise agreement with a third-party purchaser of the Electric Utility.

Employee Matters

A sale of the Electric System necessarily requires negotiations, in detail, of how current Utility System employees will be treated. Retention, salaries, benefits, jobs eliminated, and severance payments are just a few important matters to be resolved before a sale can be consummated. Of particular importance is how current and past employees' retirements will be affected. Assuming LUS is largely operating on a "pay as you go" basis for retired electric utility employee benefits, how will those payments be managed going forward? Many publicly -owned utilities have Other Post-Employment Benefits (OPEB liabilities), of which pension obligations are typically the largest and are a continuing financial obligation of the utility. We have not researched how the Louisiana Association of Public Employees Retirement System (LAPERS) works in this regard; however, this will need to be included as a consideration.

While sale of the electric utility may result in some employees being retained, (e.g. line crews and other crafts positions), it is expected that sale would result in a direct reduction of some current electric utility employees. We have not studied how likely, or how many positions, may be eliminated, but it is reasonable to assume the reductions would be significant. These reductions would, at a minimum, require severance payments consistent with current LCG termination policies. These severance payments would also apply to Communications System personnel as well, assuming sale of that system. We have not performed a detailed study of these severance costs; however, our knowledge of LUS suggests that severance on the order of $5M is not an unreasonable expectation.

Business Locations and Practices

The franchise agreement negotiations should include a requirement for the maintenance of business operations within the City. In particular, negotiations should ensure that the City's citizens have similar convenience and access to their utility provider as they currently have with the LUS Electric System. Arrangements for bill payments are likely straightforward; however, the matter of access to utility officials for complaints, service outages, service requests, meter changes, and other day-to-day utility matters should be specified in the franchise agreement.

Other Items

The primary purpose for the City to grant a franchise agreement for utility service is to recognize, and permit, the use of City-owned public rights-of-way to the franchisee. This allows the utility to construct, operate, and maintain facilities in the City's rights-of-way. The franchise agreement should specify any requirements the City wants to impose on the utility for conditions to occupy the rights-of-way. Considerations such as overhead and underground street crossings, street cutting and repair requirements, permits and license requirements, and accommodation of new street alignments are all items that should be documented.

The Communications System uses space on Electric Utility poles for its communications facilities, and the franchise agreement should specify that such use is anticipated, and how it will be accommodated. A pole attachment fee may apply, or be subject of a separate pole attachment agreement. Even under sale of the Communications System to a third-party, the franchise agreement should anticipate, and provide for, the City's use of utility poles for internal communications facilities. LCG may also require communications facilities on utility poles.

LCG has a contract with the Southwestern Power Administration to purchase 23 megawatts (MW) of federal hydropower. This contract cannot be assigned to a third-party buyer, and that should be clearly noted in any franchise agreement negotiations. The contract is set to terminate in 2018; however, a contract extension is likely.

Conclusion

This report is intended to address the key features needed for the City to offer a franchise agreement to a third party, electric utility provider. In the course of negotiating a franchise agreement, other items may arise that have not been considered here. Because utility franchises are long-term commitments, the City should take the time to carefully consider each franchise agreement provision, and the associated benefits and commitments. Should the City embark on such an effort, it should enlist the expertise of LUS management, as well as outside expertise as needed so that a favorable, long-term, and beneficial franchise agreement results.