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January 30, 2012

Board Members
The Harrisburg Authority
212 Locust Street, Suite 302
Harrisburg, PA 17101

**RE: Resource Recovery Facility Forensic Investigation Report, Dated January 12, 2012**

Dear Board Members:

We have reviewed your Resource Recovery Facility Forensic Investigation Report, dated January 12, 2012 (the "Report"), on behalf of the Dauphin County Commissioners (the "County") and the following is our response.

## A. Introduction

The Report covers an examination of certain financing transactions related to the Resource Recovery Facility (the "Facility") of The Harrisburg Authority (the "Authority"). The 2003 Retrofit financing and the 2007 Retrofit Completion financing involved the guarantees of the City, as primary guarantor, and the County, as secondary guarantor.[1]

Our response is limited to those portions of the Report which directly relate to the County's participation and where we deem the Report inaccurate or containing unsupported assumptions or conclusions.[2]

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[1] The terms used herein with an initial capital letter shall have the meanings indicated in the Report, unless otherwise indicated herein.

[2] Many of these may have been averted had the County been requested to comment on a draft of the Report or had County representatives been interviewed. The County received only limited requests for information to which it responded except where attorney/client privilege was asserted. No interview request was made to any County representative.

**B. Summary**

Between 1995 and 2003, the County reviewed its Act 101 Plan and made two policy decisions: (1) to discontinue reliance upon landfills for County municipal waste disposal; and (2) to support the City's retrofit of the Facility in order to provide a state-of-the-art facility to dispose of County waste and to assist the City in dealing with its $104 million of standard debt. The Report criticizes the County's due diligence in awarding the County Disposal Contract to the City and in providing its guarantees for a portion of the Retrofit Bonds. Twenty/twenty hindsight is always perfect. The Report's conclusion appears to be based on little more then a review of preliminary reports prepared by the County's advisors which simply summarized their conclusions. PFM was the only County advisor interviewed.

The Report reviews only the planning of the Retrofit Project, not its execution. The extent to which the risk factors identified by the Report contributed to the project's catastrophic failure is unknown. A true forensic examination should have reviewed the execution of the project by the Authority, the City and their agents. Presumably the construction fund records are held by the Authority and were available to the investigators.

We believe it was reasonable for the County to anticipate (i) competent execution of the project by the Authority and the City and (ii) performance by the City of its primary full faith and credit guarantees.

We disagree with much of the Report's legal interpretations concerning the 2007 Retrofit Completion financing. The conclusions concerning application of certain working capital limitations under the Debt Act and the Report's interpretation of documents such as the 1998 Indenture and 2003 Retrofit Indenture are misplaced. Indeed, the Report seems to be "reaching" to find some taint or infirmity with respect to the issuance of the 2007 Notes. The Authority's bond counsel approved the validity and enforceability of the 2007 Notes.

To understand the current status of the City's debt obligations with respect to the Facility, it is necessary to review the actions (or inactions) of the parties since 2009, when the Authority and City first defaulted. There were a number of opportunities proposed by the County to resolve or at least mitigate the ongoing exposure. The failures of the Authority and the City to address these issues have resulted in substantial worsening of the burden upon City and County taxpayers in the amount of approximately $20 million from 2009 to January, 2012.

## C. <u>The 2003 Retrofit Financing</u>

### (1) Background of County's Involvement

Under Act 101 of 1988, the County is required to adopt a Municipal Waste Management Plan (the "Plan") and to direct County waste flow to approved disposal facilities. Between 1990 and 1995, the City filed numerous legal challenges to the County Plan, which at that time relied solely upon landfill disposal. The County successfully defended these actions; however, in 1995 the City and County reached a settlement where, *inter alia*, the County agreed to assist the City through the County Plan to obtain a waste stream sufficient to generate revenues to finance a retrofit of the Facility.

In early 2003 the County determined to seek long term waste combustion capacity to address rising landfill costs and to avert the reopening of the Dauphin Meadows Landfill. In September, 2003, following an RFP process, the County entered into a long term disposal agreement with the Authority conditioned upon completion of retrofit of the Facility (the "Disposal Agreement"). Hearings were held throughout the County and subsequently the County Plan was amended to reflect designation of all County municipal waste to the Facility upon completion of the Retrofit Project.

In 2003 the Facility was closed by order of regulatory authorities and had standard debt in the amount of $104 million guaranteed by the City (the "Existing Debt"). The Report erroneously suggests that the County had some involvement or control over the Existing Debt (R. p. 48).[3] It had none.

The Authority and the City could not have begun to finance the Retrofit Project without the County Disposal Agreement. It was the only large volume long term waste flow available to the Facility. City representatives also made it clear that the City was facing extreme financial distress given the Existing Debt without a revenue stream to repay it.

### (2) The County's Guaranty

In early 2003, City representatives advised the County that credit enhancement in the form of a County guaranty would be required to finance the Retrofit; otherwise, the financing costs would be prohibitively expensive. We understand that the bond insurer, FSA, advised the City that a County guaranty would be required for it to proceed. The County ultimately agreed to extend its guaranty (on a portion of the bonds) in order to allow the Retrofit Project to proceed and to assist the City in dealing with the Existing Debt.

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[3] References to the Report will be cited as "R. p. -."

At page 56, the Report suggests that the County could not guaranty debt issued to pay interest costs on the Existing Debt. The County specifically did not guaranty debt issued with respect to such costs. The County's guaranty was limited to the 2003 Series D and Series E Retrofit Bonds. As set forth in the Official Statement, published in connection with the Retrofit Bonds, it was the proceeds of the 2003 Series F Bonds (not guaranteed by the County) which provided for the "Payment of Existing Debt Service."[4]

At page 43, *et seq.*, the Report suggests that the County was aware of the risks associated with the Retrofit Project and for that reason extracted a guaranty fee. That is not accurate. The County initially objected to the City's guaranty fee and was advised that the City required the fee proceeds in order to balance its 2003 budget. The County then requested a guaranty fee simply to maintain some parity with the City.[5]

The County evaluated the risks associated with the project and proceeded based upon the review and advice of its advisors. The County's consulting engineer reviewed Barlow's projects across the country and reported that all were on schedule, or had been completed successfully. The County's consulting engineers and its financial advisor (PFM, a national firm with expertise in Pennsylvania municipal financing) reviewed the project performas and accepted the assumptions as "reasonable." PFM reviewed and approved the financing structure including the Swaps. The County also reviewed the Buchart-Horn evaluation.

Planning and execution of the Retrofit Project was in the hands of the Authority, as owner, and the City, as manager of the Facility. The City devoted extensive effort in planning the Retrofit Project since the late 1990s. The County's opportunity and time for review were limited. In large part the County relied upon the fact that the City was backing the Project with its primary full faith and credit guarantees.

To be critical of the County and its advisors now is no more then second guessing. Indeed, there were risks associated with the project of which the County was aware; typically, revenue bond financing has built in risks associated with construction and operation of a project. Deviations in costs or delays in completion of construction are not uncommon, but typically can be dealt with by restructuring or other adjustments. However, it is a quantum leap to suggest that the County and its advisors could have anticipated the catastrophic failure that occurred with respect to this Project.

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[4] See December 19, 2003 Official Statement regarding Retrofit Bonds, page 6.

[5] The Report cites a statement by a representative of PFM to the effect that Commissioner Haste "wanted a guaranty fee" (R. p. 45). The County guaranty fee was negotiated by the County's special counsel with little involvement by PFM. All Commissioners approved the County guaranty fee.

**D. Why Did The Project Fail?**

In our view, the greatest failing of the forensic investigation and Report is the lack of any examination or conclusion as to why the project failed. The Report reviews only the financing and planning decisions. Other then a brief review of the pay-out of Barlow's retainage (R. pp. 71-73), there is no examination or conclusion as to what happened during the actual construction of the project. Presumably, all of the construction fund records, requisitions, certificates, etc. are available in the Authority's files. Why were the records not reviewed? Where did the money go? The Report has no answer.

Within a period of two years, the Authority, the City and its agents squandered the Construction Fund of $82 million, including the contingency, Barlow's retainage and a reserve fund of $5 million held to construct the steam line[6], plus an additional $25 million borrowed from CIT - yet the project remained uncompleted. The Authority required another $55 million and another two years to complete the project. Most of the construction contracts were GMP (guaranteed maximum price); obviously substantial overruns had to have been authorized. The financial failure of Barlow is only part of the answer.[7] Who was providing construction management? Who authorized expenditures from the Construction Fund and upon whose certification? These are all issues which a proper forensic examination should have addressed and answered. [8]

Whatever the answers, there is no doubt that the project was horribly executed by the Authority, the City and its agents. No "forensic" examination or revisionist history can change the fact that the County had absolutely no participation in execution of the Retrofit Project.[9]

In the final analysis, the County in granting its guarantees relied on two things:

(1) competent execution of the project by the Authority and the City; and

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[6] See § 5.01 of the Retrofit Indenture. The steam line was never repaired and now will require reconstruction at substantially more then the $5 million.

[7] The Authority's "substitute security" for Barlow's performance may have been inadequate; however, as noted by the Report, it also was not properly implemented, since Barlow's retainage was paid out prior to completion of its work (R. pp. 71-73).

[8] Testimony by Daniel Morash in the recently completed CIT trial provides a snapshot of some of the earlier mishaps regarding Barlow's dealings with its boiler fabricator in Tulsa, Oklahoma. If the testimony is to be believed, it is evidence of gross mismanagement.

[9] Authority and City representatives provided very limited status reports to the County during the construction project. The first indication of trouble was when the County was advised in the fall of 2005 that Barlow was financially distressed and was seeking financing from CIT.

(2) satisfaction by the City of its full faith and credit obligations.

Neither was provided.

### D. 2007 Retrofit Completion Project

The Report's examination of this financing transaction contains a number of conclusions and assumptions which we believe to be inaccurate.

#### (1) Background

In December, 2006, representatives of the Authority and the City advised the County that Barlow was again out of money and its contracts would be terminated. The City was also terminated as manager and Covanta was retained to complete the Retrofit Project and to operate the Facility. City and Authority representatives also advised the County that additional funds would be required to complete the project and sought the County's support and participation. Initially, the Authority requested the County to guaranty an "off-market" swap to provide approximately $11 million to complete the project. The County objected to the off-market swap and demanded full disclosure of the Facility's completion status as well as operating and construction budgets. The County's initial review indicated that the costs to complete would far exceed $11 million. The County insisted upon a comprehensive plan approved by both the Authority and the City (including City Council) before it would commit to participate.

Negotiations on the Retrofit Completion financing extended over a year. At one point, in mid-2007, the Authority and the City requested new financing of up to $60 million. The County refused and limited its participation as a guarantor to $30 million.[10] Accordingly, the parties finally agreed to a Retrofit Completion Project in two components, with Covanta funding the construction costs in the amount of approximately $25 million to be guaranteed by the City only and with a working capital component in the amount of $30 million with a primary guaranty by the City and secondary guaranty by the County.

The parties entered into a series of written agreements with respect to proceeding with the Retrofit Completion Project, as follows: (1) The Cooperation Agreement, dated October 12, 2007 among the City, the County, the Authority and Covanta; (2) the Tri-Party Interim Funding Agreement, dated October 5, 2007 among the Authority, the City and the County and; (3) a First Addendum and Supplement to the Tri-Party Interim Funding Agreement, dated November 27, 2007 among the Authority, the City and the County (herein collectively the "2007 Agreements"). Pursuant to the

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[10] Members of City Council, in sessions to discuss the Retrofit Completion Project, repeatedly criticized the County for limiting the amount of its guaranty.

2007 Agreements both the City and the County made certain advances to the Authority for working capital purposes, including payments due to Covanta (to keep it on the job) as well as amounts required to cover interest costs coming due during 2007. Pursuant to the 2007 Agreements, the County's working capital advances were to be repaid from proceeds of the working capital component.[11]

In December, 2007, the Authority issued the Covanta Construction Loan Note and issued the Series C and Series D Notes (the "2007 Notes") pursuant to a Trust Indenture, dated as of December 15, 2007 (the "2007 Indenture"). The City and the County issued their respective guarantees with respect to the 2007 Notes. The Covanta Note and the 2007 Notes represent the issuance of subordinated debt by the Authority as referenced in the 1998 and 2003 Indentures.

**(2) Legal Issues Relating to Retrofit Completion Project**

The Report contains a number of inaccuracies with regard to its discussion of the Retrofit Completion Project.

(a) <u>County Debt Statements</u>

At page 117 the Report claims that it was not until the end of August, 2011 that the County filed debt proceedings which included the "RRF Bonds towards the County's gross outstanding debt." That statement is incorrect. The County did not file a Section 8110(b) report claiming the 2003 RRF debt to be self liquidating in any Debt Act filings after 2008. A review of the County's filings with DCED would reveal this.

(b) <u>Working Capital</u>

At page 118, *et. seq.* of the Report, it is claimed that application of proceeds of the working capital loan for certain purposes, i.e., repayment of County advances under the 2007 Agreements, payment of County system fees, etc. violated working capital limitations as to the "cost of a project" under the Debt Act. This conclusion is based upon a strained interpretation of the 2007 financing. The Report suggests that the 2007 financing was a separate and distinct "project." Clearly it was not. The 2007 financing was to complete the Retrofit Project as originally authorized in 2003 for the purpose of retrofitting the Facility so that it complied with environmental standards and was able to accept municipal waste for processing. That work was not completed in 2007.[12] Thus,

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[11] First Addendum and Supplement to Tri-Party Interim Funding Agreement, section 2.

[12] The Report suggests that since there was a change in contractors (from Barlow to Covanta), it was not the same project (R. p. 118). A change in contractors does not change a project. The Report also makes reference to a change in the Barlow technology (R. p. 118); it is our understanding that the Barlow technology was installed in all 3 units and was not removed until approximately 2009. In any event, the use of a different process does not change the ultimate purpose of a "project."

to pay interest costs on any of the outstanding bonds was a proper "cost of project" under the Debt Act. The Debt Act includes within the cost of a project ". . . interest on money borrowed to finance the project [and] . . . a reasonable initial working capital for operating the project . . . ." 53 Pa. C.S.A. § 8007. The advances made by the County pursuant to the 2007 Agreements were, in large part, payments made to Covanta pursuant to its operating agreements, which clearly represent working capital for "operating the project," under the Debt Act. Finally, the County's system fees, which were due pursuant to the Disposal Agreement, are also project operating costs permitted to be capitalized and included within costs of a project under the Debt Act.

(c) Reimbursements to County

At pages 120 *et seq*, the Report suggests that payments to the County for advances made to the Authority pursuant to the 2007 Agreements and repaid from the proceeds of the 2007 Notes were somehow improper and should have been treated as reimbursements to the County pursuant to the 2003 Reimbursement Agreement. This position is not supported by the documents.

The Authority approved and authorized the 2007 Agreements, which approved the County's advances and contained the Authority's agreement to repay the advances from proceeds of the 2007 Notes. [13] These payments cannot be considered as reimbursements to the County under the 2003 Reimbursement Agreement. First the Reimbursement Agreement applies only to the County's 2003 guarantees of the payment of debt service. The advances to the Authority for payment of operating costs to Covanta clearly are not debt service and are not covered by the guarantees or the Reimbursement Agreement. Furthermore, the advances for interest costs made by the County during 2007 were not then required under its guarantees. The 2003 County Bond Guaranty only requires payment from the County in the event of deficiencies in the Debt Service Reserve Fund. See Section 3.15 of the 2003 County Bond Guaranty. In 2007, there were no deficiencies in the Debt Service Reserve Fund and no demands had been made by the Trustee on the County guarantees. [14]

(d) Fees

The Report suggests that fees payable to the County's professionals covered services provided in the "prior two to three years" (R. p. 121). This is not accurate. The only fees payable to County professionals from the proceeds of the Retrofit Completion Project were payments to its special counsel and financial advisor. In both cases the fees covered services from approximately December, 2006 to December, 2007, all

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[13] See First Addendum and Supplement to Tri-Party Interim Funding Agreement, section 2.

[14] The Report appears to concede that the advances made by the County technically were not payments made pursuant to the County's guarantees (R. p. 123).

related to the negotiation and structuring of the Retrofit Completion Project. Finally, it should be noted that the complaint that these financings were "fee driven" is not applicable to the County. The fees of the County's professionals in the case of both the 2003 financing and the 2007 financing were charged on an hourly rate basis and were payable irrespective of whether the financings closed or not.

(e) Compliance with Indenture Documents

At pages 122 *et seq*., the Report attempts to maintain that the issuance of the Covanta Note and 2007 Notes and application of the proceeds thereof violated the 1998 Indenture and 2003 Indenture. The suggestion is that the loan proceeds were "receipts and revenues" as defined in the Indentures and thus should have been paid into the revenue account and required to flow through the "waterfall" applicable to receipts and revenues (R. p. 124). This is simply wrong.

Loan proceeds for completion of a project are not "receipts and revenues" which typically represent gross income from operation of a project, not the proceeds of debt. The Authority's financial statements do not treat loan proceeds as "revenues".

The Covanta construction loan and the 2007 Notes represent the issuance of subordinated debt by the Authority. Both the 1998 Indenture in Section 3.05 and the 2003 Retrofit Indenture in Section 3.05 permit the Authority to issue subordinated debt, limiting only the priority of repayments if receipts and revenues are pledged. In the case of the 2007 Notes, the 2007 Indenture securing the same does not pledge receipts and revenues.

The Report's contention is also inconsistent with other Indenture provisions. Both the 1998 Indenture and the 2003 Retrofit Indenture authorize the issuance of additional bonds for additional construction or completion of a project. In both cases the proceeds of any additional bonds to complete a project are required to be paid to a "construction fund" as created by a supplemental indenture. See Sections 3.03(8) respectively of both the 1998 Indenture and the 2003 Retrofit Indenture. If, indeed loan proceeds to complete a project were to be treated as receipts and revenues, then the proceeds of the additional bonds would have to be deposited in the revenue account. Obviously that makes no sense and specifically is inconsistent with the provisions of the Indentures.

Finally the Report's position on the treatment of loan proceeds of the 2007 financing is inconsistent with its discussion with respect to the 2003 Retrofit financing. The Retrofit financing was also the issuance of subordinated debt under the 1998 Indenture. Nowhere in the Report's discussions does it suggest that the proceeds of the 2003 Retrofit financing should have flowed into the 1998 revenue account and through the waterfall under the 1998 Indenture. The position cannot be sustained.

### E. Subsequent Failures to Address Facility Debt

We suggest that the Report should have reviewed the ongoing failures of the City and the Authority to address the Facility's debt. Since 2009, the County has made multiple attempts to address issues related to the Facility's debt, proposing solutions, in whole or in part, designed to mitigate the escalating damage to City and County taxpayers. These efforts have elicited little or no response from either the Authority or the City. [15] Examples of these failed efforts follow.

In early 2009 City and County representatives engaged in discussions in an effort to develop a plan for resolution of the Facility's debt. In August 2009, representatives of the County presented a detailed proposal for restructuring the Facility's debt to representatives of the Authority, the Mayor's staff and some Members of City Council. The County's proposal was very similar to the plan presented to the City by Management Partners in early 2010 and to the plan recommended by the Act 47 Coordinator in 2011. Indeed we suspect that the Receiver's plan for dealing with the Facility's debt will contain similar elements. The County never received any response from any of the parties to that proposal.

Had the parties in 2009 engaged in negotiating a plan resolving the Facility's debt, we estimate that approximately $20 million representing debt service to be borne by City and County taxpayers could have been avoided or saved. City and Authority officials are well aware that the failure to engage and resolve these issues results in escalating costs to City and County taxpayers of approximately $1 million per month.

On several occasions during the past two years, the County's financial advisor requested the Authority and its financial advisor to consider a termination of the three Swaps applicable to the Retrofit Bonds which cost the Authority net payments of several hundred thousand dollars each June and December. The County's financial advisor concluded that the three Swaps could be terminated at a net cost of $0 to the Authority. The timing of the termination is critical since market conditions determine the cost of termination at any particular time. At several points in 2011, all three Swaps could have been terminated at no cost. The Authority's financial advisor advised County representatives that there was no support by the Authority Board for termination. Now, it will no longer be possible to terminate the two remaining Swaps at no cost.

During 2010 the County, on several occasions, requested the Authority and the City to join it in refinancing the 2007 Notes which matured on December 15, 2010. The Authority covenanted in the 2007 Indenture "... to use its best efforts to take all action as necessary to issue bonds or other obligations in amounts sufficient to provide funds

[15] One exception was the recent effort by Mayor Thompson to engage representatives of the Authority, City and major creditors prior to the appointment of the City Receiver.

to pay the Maturity Value of or Accreted Value of the Series 2007 Notes on or before the maturity date ...." 2007 Indenture, Section 8.01. These requests also were met with little or no response. At a meeting in the fall of 2010 among Authority, City and County representatives, a member of City Council agreed to take the issue before City Council; the County never received any indication of whether it was considered. The Authority refused to formally place the issue before City Council or to take any action, despite its covenant to the contrary, to proceed with a refinancing of the 2007 Notes.

In late 2011, the City approved a financing, at extremely unfavorable rates and terms, by the Harrisburg Parking Authority for the short term purpose of providing approximately $7 million of funds to balance the City's 2011 budget and to provide approximately $3.5 million of funds for the 2012 budget. This is a continuation of the City's short sighted approach to its financial problems and in this case resulted in depressing the value of the parking system in the event of any sale or lease to assist in resolving the Facility's debt.

The County looks forward to a constructive plan from the City Receiver which hopefully will relieve the City and County taxpayers from these continuing failures.

Very truly yours,

Charles B. Zwally

CBZ:njc
cc via emai:
The Honorable Jeffrey Haste
The Honorable George P. Hartwick, III
The Honorable Michael Pries
David Unkovic, Esquire, Office of the Receiver for the City of Harrisburg
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