<u>**DES in the 2021 Budget Cycle**</u>

The administration has elected not to rely on the sale of DES to complete the FY21 budget. The following is a summary of its conclusions:

- **Extending the existing agreement with the current operator will reduce the burden DES places on the General Fund by reducing the overall cost to operate; and the responsibility for needed capital replacement at the plant will be retained by the operator.**

- **The administration has concluded that this arrangement, coupled with selling available capacity, positions the City to sell DES in the future for a potentially greater value than the present sale offer (or to retain DES if a path to financial sufficiency can be determined in the interim).**

- **Regardless of future direction, the sale of DES is unlikely to occur in time to meet the current budget cycle or possibly the next one.**

Background:

Construction of the DES Energy Generating Facility began in August of 2002 and was completed and placed in operation on December 16, 2003. The Facility provides steam and chilled water (mostly for heating and air conditioning) to 42 locations in the downtown corridor for 19 private customers, the State of Tennessee, and Metro. **Metro is a major customer,** paying an average of $6.6M each year for service -- approximately 40% of the total revenue. The savings to Metro using the government-run DES system, versus a private operator or conventional Heating Ventilation and Air Conditioning (HVAC) system, are difficult to quantify in a practical manner, but noteworthy.

History of the System Financing

- **Metro Funding Amount (MFA) -** Since the DES began operating, a gap has existed between the total cost to operate and the total revenue it generates. Metro provides funding to cover this gap, which is referred to as the Metro Funding Amount (MFA). Over the last 11 years, the MFA has been as high as $2,605,710 and as low as $1,640,300, with an average of $2,075,183. In its April 21, 2020 letter, Engie states that the General Fund has "lost" almost $25M over the last 11 years by subsidizing DES. In fact, the total MFA over the last 11 years is $22.8M, though this does not account for the full economics of the system for Metro as a customer.

- **Customer Contracts -** Most of the customer contracts date back to when the DES began operating and include terms that extend for roughly 15 more years. Many of the customer contracts only allow Metro to recover for the original capital outlay for the generating plant but not for capital required to keep the distribution system maintained and growing. *In short, the customer payments are not based on the actual cost of services.*

- **Eliminating the MFA -** The only way to eliminate the MFA with the current customer base and contractors would be to (1) renegotiate customer contracts, (2) reduce operating costs by 35% without adding more debt or (3) to add numerous customers, for which the system does not presently have sufficient high-growth capacity.

Administration Conclusion

The administration has not rejected the possibility of selling the system in the long term. Rather, the administration's review supports the conclusion that no sales transaction could be concluded in time to impact the FY2021 Budget or possibly FY2022. However, action must be taken to reduce the subsidy to make a positive near-term budget impact.

Substantive conversations regarding adding customers to the DES system continue. As new contracts come to fruition, the system becomes more marketable. Combined with meaningful replacement of aging capital (see CNE offer below), the System would be in a better position to sell in future years and/or retain if a path to financial sufficiency can be found.

Selling DES to a private entity creates uncertainty and risk for Metro and the other DES customers. Engie has sought regulatory approval to operate as an unregulated utility, which if granted would eliminate any public oversight of rates. Also, because of the high costs and disruption involved in converting the buildings currently served by the DES to conventional heating and cooling systems, Metro and other customers would have limited means beyond those provided in the customer contracts of protecting themselves from the risk of rate increases.

- *Engie Offer*

    - Engie has offered Metro $60M for the system. However, after addressing debt and other items, the actual impact would be a one-time revenue infusion of $11.5M to the City. (Engie's letter of April 21, 2020 omits this actual revenue impact figure.)

    - The offer eliminates the MFA completely.

    - Engie states that it intends to invest millions in the system, though enforcing this commitment would be difficult, and it is not clear that such investments would necessarily benefit Metro.

- *Constellation New Energy offer*

    - Constellation New Energy (CNE) has offered a 19% reduction in Fixed Operating Cost (FOC), which reduces the MFA by $1.1M (relative to FY16-FY19) and reduces the cost of service for Metro-owned buildings by $100,000.

    - As required by the contract, CNE continues to maintain and replace equipment when needed. (Some of the larger, critical units are near the end of projected useful life.) This provides Metro the value of dollars already spent for these eventual capital replacements. Capital replacement of the large equipment in the plant is estimated to total at least $28.3M.

    - Metro retains control and is allowed time to improve the system by addressing pending maintenance issues.

Timing and the Budget Process

The costs associated with extending the DES operating agreement, rather than selling the system, are incorporated into the Mayor's proposed FY2021 budget. Council will review the budget implications of this approach, together with the many other budget recommendations. Consideration of whether to pursue a sale of the DES rather than extend the current operating agreement should take into account the following:

- Engie conditioned its proposal on receiving a ruling from the Tennessee Public Utilities Commission that it would not be a regulated utility after the sale. The Attorney General's office has filed a brief arguing that the Commission should instead rule that Engie would be a regulated utility. Though not binding on the Commission, the Attorney General's argument will carry weight in the decision. There is no certainty that the Commission will rule before the closing of this fiscal year, nor as to the time required to resolve possible appeals of that ruling.

- CNE protested the Metro Purchasing Agent's decision to award the contract to Engie. The hearing of that protest before Metro's Procurement Appeals Board has yet to be conducted nor even scheduled. The hearing and potential litigation arising from it may take a year or more to conclude.

- Engie noted a need to gauge potential changes in its valuation of the system, which may take additional time.

Metro Water Services Involvement

During discussions of future operations, the Administration determined that contract oversight would be better suited for Metro Water Services that regularly manages industrial plants as well as large distribution and collection systems. The proposed budget designates Metro Water Services as contract manager overseeing the Thermal Engineering Group and CNE contracts. The Administration has asked MWS to continue to explore options, whether strengthening the asset for an eventual sale and/or developing a path to financial sufficiency for DES, given the dependence Metro has on this asset.