CONFIDENTIAL MEMORANDUM

NAMED RECIPIENTS: E-470 Public Highway Authority Board of Directors

AUTHOR: George Allen

SUBJECT: REQUEST TO FREEZE TOLL RATES AND REDUCE TAXES

DATE: June 8, 2017

BACKGROUND

Exactly six months ago, on December 8 2016, I appeared at the board meeting of the E-470 Public Highway Authority ("E-470") and announced I would be providing oversight of the two E-470 directors from Douglas County. I have been providing oversight of the Douglas County Board of County Commissioners for several years. Douglas County over-taxes the citizens and under-manages County business. For 26 years, Douglas County kept its mill levy setting at the TABOR maximum and has extracted excessive taxes from Douglas County citizens.

The Town of Parker similarly over-reaches on taxes. Despite the Town being amply funded, the Parker Town Council proposed a 16% increase in the sales tax rate (from 3.0% to 3.5%) in 2015 with no sunset. The Parker Town Council placed this tax increase question on the November 2015 ballot. The voters in Parker, being heavily taxed by all levels of government (federal, state, county, city, special district), delivered a crushing defeat to the tax increase question by a vote of 70% to 30%. The size of the defeat of this sales tax increase is a measure how much the Parker Town Council is out of touch with Parker voters on sales taxes.

Naturally, making these observations, I considered it necessary to add E-470 to my oversight of local government in Douglas County. I have low confidence that the two E-470 directors from Douglas County are able protect the citizens from over-reaching local government and over-taxation. The E-470 Board of Directors (the "Board") may recall from my December presentation that I would provide oversight during 2017, then prepare a PowerPoint slide presentation on "E-470 Issues and Problems" which I would then present to the community. This memorandum is an interim step toward that goal.

INTEREST RATE SWAP

In June 2007, E-470 hedged its interest rate risk on variable rate debt by swapping variable LIBOR rates for a synthetic fixed interest rate. Had LIBOR rates increased from 2007, E-470's swap would have protected it from higher interest costs on the variable rate debt. Unfortunately, June 2007 was near the 15-year peak in variable LIBOR rates. The timing of E-470's swap could not have been much worse. At the end of May 2007, one-month LIBOR was 5.32%. By May 2014, one-month LIBOR was 0.15%, which is a decline of 97% in the rate (see chart attached). Had E-470 not entered into the swap agreement, it would have enjoyed a handsome economic gain from the 97% decline in LIBOR interest rates. Instead, E-470 has incurred significant losses on the swap contract. By December 2016, E-470 has paid swap losses of $17.4 million and accrued additional swap losses of $44.6 million.

At the February 9 Board meeting, the E-470 finance team presented the interest rate swap strategy for 2017 (slide attached). The E-470 presentation slide says "Total swap fair value (net) $(44,595,208)". Actually that $44.6 million is an accrued swap loss and a balance sheet liability. During the presentation, E-470 stated the strategy for 2017 was to "let it ride" because the swap is starting to work in a rising interest rate environment. When the presenter solicited questions from the Board, the Board was completely silent. The Board did not ask a single question. I thought the Board missed an opportunity. If I were the Board, I would have asked "What is your 2017 interest rate forecast?" And I would have asked "What is the correlation between an increase in the underlying interest rate and the movement in the fair value of the interest rate swap?" The combination of the $44 million accrued loss, the "let it ride" strategy and no questions from the Board creates the impression that the Board is not sufficiently knowledgeable on this issue or is not sufficiently engaged to protect the toll-paying highway drivers from losses.

The next question is the performance of the swap contract in Q1 2017. Ostensibly, the swap contract is a hedge against rising interest rates. And the one-month LIBOR rate actually increased in Q1 from 0.77% on Dec 31 2016 to 0.98% on March 31 2017. LIBOR increased but, regrettably, E-470 lost an additional $1.6 million on the swap in Q1 2017. Quite obviously, the Q1 swap loss combined with rising interest rates and the "let it ride" because the swap is working strategy is doubtful. Therefore, the Board can expect more questions and more scrutiny from me on this topic.

FATALITY RATE ERROR

At the February 9 2017 Board meeting, the Board viewed the 2016 Accident Analysis Review slide presentation. Slide 7 (attached) presented the Fatality Rate Per Million Miles Driven. When I attended the February 9 Board meeting, I watched this Accident Analysis presentation with the Board. The Board was completely silent and did not ask any questions about the Fatality Rate. But I saw three errors on this slide that the Board did not seem to notice. First the standardized measure of highway fatality rates is per 100 million miles not per 1 million miles as shown on the E-470 slide. Second, the calculation of the 2015 E-470 fatality rate of 0.08 is erroneous. Third, comparing the E-470 fatality rate of 0.08 to the USDOT NHTSA national rate of 1.12 is inappropriate because E-470 is a controlled access highway and the USDOT NHTSA national rate is for all types of roads. My observation is that an E-470 fatality rate at $1/14^{th}$ (0.08 ÷ 1.12) of the USDOT NHTSA national fatality rate is just not plausible. Even from my high-level, outsider perspective, it appears that the E-470 Board either does not understand its business very well or is not paying attention at the Board meetings or both.

E-470 PROJECTED ENDING CASH BALANCE OF $3.2 BILLION

E-470 uses the consulting firm CDM Smith Inc. ("Wilbur Smith") to estimate future traffic volumes and toll revenues. Wilbur Smith's October 2014 projections for E-470 are included in E-470's Official Statement for the 2017 bond offering as an appendix. The Board has been basing its toll rate increases for many years on the Wilbur Smith projections. Upon my request, E-470 provided me with the Wilbur Smith projections converted to enterprise cash flow (attached) for 2017 through 2042. Here is a summary of the enterprise cash flow provided by E-470, in billions of US Dollars:

Gross Revenue	$10.7
Less: Operating Expenses	($2.7)
Less: Senior Debt Service and Swaps Due	($2.9)
Less: Capital Expenditures	($1.9)
Accumulated Cash Balance	**$3.2**

Notice also that the $3.2 billion accumulated cash is after paying $2.9 billion of debt service, including interest, principal, capital appreciation on the bonds, and the swap loss. The Board can see from the enterprise cash flow attached that the $1.8 billion of future capital expenditures is comprised of a flat $75 million each year from 2021 through 2042. E-470 has some lane widening and interchange projects planned. But the highway is largely built. And the total depreciable transportation infrastructure on the E-470 balance sheet is $919 million. For the eight-year period from 2008 through 2015, the total capital expenditures of depreciable assets were only $63 million, which includes not only transportation infrastructure, but also E-470 buildings, equipment and software. Yet for the projection period, E-470 estimates capital expenditures of $75 million per year. As a result, I am skeptical that E-470 needs an additional $1.8 billion to fund capital construction projects through 2042.

The Board is approving toll rate increases that track the Wilbur Smith projections and following a revenue growth curve to accumulate $3.2 billion more than operating costs, capital expenditures and payments of debt principal and interest. The revenue growth curve in the Wilbur Smith projections is too high. The Board's toll increase policy is over-charging customers on a prospective basis if not a historical basis. When I explained my objection to E-470's senior management team, I was informed that E-470 would prepare a new long-term master plan that would be the foundation for a revised capital expenditure plan and cash flow projection. The Board should have questioned E-470's cash flow projection and the accumulation of an ending cash balance of $3.2 billion years ago when it was approving all the annual toll increases. Again, from my high-level, outsider perspective, I am questioning whether the Board understands its business and is sufficiently engaged to protect the highway users and taxpayers from government over-reach and excessive toll increases.

SUMMARY

As I have stated in the past, E-470 has been a successful project, and a driver of economic growth for the community. But I think the Board has gone too far with its toll rate increases. The Board has allowed E-470 to increase tolls annually on a revenue growth curve to an accumulated cash balance of $3.2 billion.

I am able to catch errors that the Board appears to miss. I am able to see business problems that the Board appears to address with silence and inaction. One of the duties of the Board is to protect the citizens, voters, taxpayers and toll road users from government over-reach. Significant and immediate improvement is needed in this area. The E-470 toll increases are similar to the over-reach by the Parker Town Council and their 2015 sales tax rate increase ballot question. I have seen similar government over-reach and over-taxation in by Douglas County. Until the 0.5 mill levy decrease in 2017, Douglas County has kept its mill levy at the TABOR maximum despite accumulating $254 million of cash and investments on its balance sheet, among other problems. Douglas County was unaware of the Colorado statute that allowed them to temporarily reduce the mill levy without losing their TABOR authorization until I brought it to their attention. It should be clear why it has been necessary for me to provide oversight of E-470 and the two Douglas County directors on the E-470 Board. The Board should be aware that I see numerous other business problems and issues that I have not yet brought up due to the limited time I can devote to this oversight project. However, I am rather appalled that the first time the Board finds out about these business problems is from me. Finally, by presenting my policy changes, as shown below, I am not at the end of the E-470 oversight project. I am at the beginning.

And this is how our American system of self-government works. When government over-reaches and becomes a self-centered, bossy master rather than a faithful, capable servant, then unknown, private citizens such as myself step forward as agents of change.

E-470 POLICY CHANGES

If I were the E-470 Board, I would make the following financial policy changes:

1. <u>Eliminate the Highway Expansion Fee ("HEF")</u> – The building permit charge is not a fee. It is a tax. In 2016 the HEF raised only $427,000, which is 0.2% of E-470's operating revenue of $206 million. The HEF is administratively burdensome on the local governments. E-470 has extracted enough tax revenue from local building permits.
2. <u>Eliminate the Vehicle Registration Fee ("VFR")</u> – The $10 fee is also a tax on citizen vehicle registration. The VRF has been in place since 1988 for citizens of Arapahoe, Douglas and Adams counties. The VFR also served as the start-up capital for E-470. The VFR sunsets in 2018 and should not be renewed. Again, E-470 has extracted enough tax revenue from local citizens.
3. <u>Freeze Highway Tolls</u> – Freeze the tolls at the current amounts until E-470 completes the appropriate master plan, capital expenditure plan, cash flow projections, and highway maintenance funding plan. I would develop a new toll policy and revenue growth curve below the Wilber Smith revenue growth curve that does not result in projected ending cash balance of $3.2 billion. The Board's current plans, data, documents and projections are not sufficient to ask the honest, hard-working, law-abiding E-470 drivers to pay higher tolls.

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