

**Regular meeting
September 25, 2007**

**APPROVED MINUTES OF REGULAR MEETING OF
THE BOARD OF DIRECTORS
OF
EL PASO WATER COMPANY, INC.**

September 25th, 2007

The regular meeting of the Board of Directors of El Paso Water Company, Inc. convened in the City Council Chamber, 611 Mulberry, Derby, Kansas at 8:32 p.m. following adjournment of the City Council meeting.

The following Directors were present and constituted a quorum:

Dion Avello
Cheryl Bannon
Chuck Warren
Jim Craig
George Arnold
Mark Staats
Jim Meidinger

Others in attendance:

Kathy Sexton, Chief Executive Officer
Phil Alexander, Vice President
Jean Epperson, Secretary-Treasurer

Mr. Avello called the meeting to order.

APPROVAL OF MINUTES

MOTION: Warren moved to approve the minutes of the August 28th 2007 board meeting. Meidinger seconded.

VOTE: Craig yea, Arnold yea, Warren yea, Staats yea, Bannon yea, Meidinger yea, Avello yea, Schwarz absent, 7 yea, 0 nay, 1 absent, motion carried.

DECLARATION OF DIVIDEND

Jean Epperson, Secretary/Treasurer presented the staff report.

MOTION: Warren moved to adopt a resolution declaring and directing payment of a dividend for the month of August in the amount of \$130,825.76 to the City of Derby, Kansas, as the sole stockholder of the Company. Arnold seconded.

Mr. Avello asked if there were any concerns in the ability to cover debt with these dividends.

Ms. Sexton advised there is enough revenue to cover the debt, no concerns at all.

VOTE: Craig yea, Arnold yea, Warren yea, Staats yea, Bannon yea, Meidinger yea, Avello yea Schwarz absent, 7 yea, 0 nay, 1 absent motion carried

REPORT ON APPRAISAL OF EL PASO WATER COMPANY ASSETS

Phil Alexander, Vice President of El Paso Water Company presented the staff report.

Scott McBeth, Hinkle Elkouri stated that Mr. Alexander did a very good job in summarizing what has transpired and the reason for the appraisal. At the time the City purchased the water company in January of 1999 it was structured as a stock sale. The City bought the stock of the water company and stepped into the shoes of the selling stockholders. Prior to that point in time the water company was a private company owned by private stockholders and operated as a corporation. Corporations, under our tax system are generally treated as a separate identifiable tax payer. The corporation pays tax on its net income and if it's a "C" corporation as the water company was, when it makes distributions of dividends to its stockholders those distributions are ordinarily a taxable income to the stockholder as well. The corporation is subject to tax on its own income and the stockholder is subject to taxation on amounts distributed to the stockholder as a dividend. When the city bought the stock two rulings were requested from the Internal Revenue Service. One of those rulings related to whether the purchase of the stock and amendment of the articles of incorporation of the water company to make it a not for profit corporation would cause an effective liquidation of the water company. A response came back from the Internal Revenue Service, that no, provided the water company could operate, its income would be exempt from tax as a public utility. The income of which is accruing to a political subdivision so there would be no income tax consequences from the operation of the water company. What we are talking about here though is not so much income from the operation of the water company since the date the city acquired ownership, we are talking about a liquidation because the water company is a separate tax payer, a liquidation of the water company is deemed to be a disposition of the assets of the company, in other words, a taxable disposition. At the time the city purchased the stock there was accumulated depreciation on the books of the

water company of approximately \$3.6 million. Meaning prior to the point in time when the city acquired the stock \$3.6 million of depreciation on the assets had been taken and recorded on the books, used to offset the income of the water company. There is a case on facts that are very similar to this. A municipality purchased the stock of a water company from private individuals and the issue that came up in that case was after purchasing the stock, the municipality in that case liquidated the water company. The IRS audited that transaction and came to the conclusion that accumulated depreciation, to the extent there was gain on the liquidation of the water company, gain being measured by the difference between the fair market value of the assets, hence the reason for the appraisal and the adjusted basis of those assets, the gain on the liquidation. To the extent of accumulated depreciation, that gain was taxable to the municipality. On our actual facts, if we were to liquidate the water company, the fair market value of the assets owned by the water company back on January 27th (or whatever it was in 1999) there was \$3.6 million of accumulated depreciation associated with those assets. If we were to liquidate the water company today, we would have to recognize income associated with those specific assets if the gain on liquidation as \$3.6 million or whatever portion of gain there was. We've got gain here of over \$4 million and the assets were appraised at \$7,197,000. The adjusted basis of those assets is \$2.9 million, meaning there is gain on liquidation of \$4.2 million. The accumulated depreciation attributable to periods of time before January 27, 1999 is \$3.6 million, so a gain of \$3.6 million would be recognized on the liquidation. When you apply tax rates to the \$3.6 million of income, the tax liability is \$1.2 million. That flows just by determination of value, determining what the gain is, looking back at the books and records on the date the city acquired ownership and there is no way around that, it is a consequence that flows from liquidation. There is case law that is almost directly on point so he can't envision or see a way to argue around the applicable case law so a liquidation will result in a tax liability of \$1.2 million. That's the bad news; the flip side of the coin is you have assets and not all the assets were appraised, they are simply assets that the water company owned on the date the city bought the stock and that it still owns today. The purchase price for the stock was in the neighborhood of \$7 million. On the flip side you bought stock for \$6 million and the assets retained, if not appreciated in value. It gives rise to a tax liability, but that liability, to be honest was locked in to some extent and was inherent in the structure of the transaction. When the city bought that stock that is when the consequences were put into stone with respect to a liquidation. He does not see an argument or a means for liquidating the company without looking at recognizing that income.

Mr. Warren asked about the conclusions on page #3. If we choose the option to maintain the status quo and do nothing, we are not limited in our ability to operate or sell our product, other than the fact we have a little more administrative headache because we have to have a separate set of books, is that correct?

Mr. McBeth advised that is correct. One of the bases for that conclusion is that we have the two rulings that were obtained at the time of purchase. Maintaining the status quo keeps us under those rulings so if the Internal Revenue Service or anyone else wants to discuss, or starts raising issues we can point out that we have maintained our structure and our relationship and it has already been ruled on.

Mr. Warren asked what our additional cost of operation by virtue of having it as a separate corporation versus a department in the city, what does that cost us in terms of time, money, effort to maintain as a separate entity.

Ms. Sexton responded it is really hard to put a number on right now. Partly because it is very different because if it were a city department it would be just like wastewater. That is a separate fund, separate accounting just for wastewater fund and we would do the same thing for water. The difference here to some extent, water takes more of our time now because what we are trying to do is convert things to the city way, so to speak, the policy and procedure manuals, the personnel rules, benefits to the staff. Now that the five year limit has passed we are able to make sure people have similar types of job rules and requirements and things like that. She wouldn't say we are on any kind of a stable normal operating pattern. That's okay because what we are trying to do is get away from a different set of rules for each employee that makes a pretty good argument for consistency.

Mr. Warren asked if the city could hire all the employees and then subcontract them to the water company. That way we have everybody as an employee of the city.

Mr. McBeth pointed out that the key from the tax perspective is that the assets of the water company stay the assets of the water company.

Mr. Warren clarified that the employees of the water company could become employees of the city and we just subcontract them out to the water company for \$1.00 a year, or whatever it may be.

Mr. McBeth explained that the current structure now, as he recalls it, is after the purchase of the stock by the city, any additional assets that were necessary for the system were acquired by the city and are leased to the water company and the water company pays rent back to the city. If the city were to hire the employees and lease them to the water company, for tax purposes he does not see any hurdles there at all. He added that he and Mr. Alexander had discussed what the alternatives would be; liquidation would have a big tax bill associated with it. Status quo doesn't necessarily result in the complete and total assimilation of the water company into the city, which is really, if we had our druthers what we would like to see. The third alternative that was discussed was the possibility that the water company would reverse the current structure; instead of the city leasing its property to the water company, what if we terminated that relationship and the water company leased its assets to the city and the city could pay the water company. The difficulty with that is that it changes the structure that the IRS already blessed and so we fall outside that private letter ruling. His thought would be that we could go down that path but the best course of action in that regard would be to go back to the IRS, submit a second ruling request indicating our current structure and proposed revisions. There are pretty good arguments that we could make to say we are not doing anything here that is unusual, we are not circumventing the government, the federal government is not going to collect any more or any less, we just want to restructure for administrative

purposes but he is uncomfortable doing that without going back to the IRS and asking them to approve it.

Mrs. Bannon advised she has had dealings with the IRS before and once you get one blessing you hate to go back to that same well for another one. We have been looking for a decision, this seems fairly definitive to her and in view of the current depreciation, so that no future council looks at doing this again, how many decades are we out from this ever happening? By the time the depreciation goes off and there wouldn't be a tax?

Mr. McBeth stated that essentially it would be with reference to the assets that were owned by the water company on January 27, 1999. Once those assets are gone then the issue goes away because there would be no depreciation recapture associated with any of the assets of the water company.

Mrs. Bannon asked if we were relying on depreciation only?

Mr. McBeth responded that most of these would be either 15 or 39.5 year. Because some of the more significant ones would be improvements associated with land improvements, pipes, wells, etc., those things are generally 15 year property and they could be deemed to be real estate and go longer than that. It is a good question and we could certainly look at the financials back in 1999 and figure out what that is.

Mrs. Bannon commented that Mr. Warren brought up an idea but the city manager and staff would have to look at what that would give us that we are not on track to already accomplish by bringing up personnel manuals and other things to see if there is any savings to do that. She asked about the 16" piping, she assumes this is what is in the ground, it is not sitting in a warehouse somewhere, correct?

Mr. McBeth advised he believed that was correct.

Mrs. Bannon asked if there are any assets of the water company that we could sell or divest ourselves of or are they all being used.

Ms. Sexton stated that the vast majority are not things you would want to sell, water tower and water pipes currently serving homes are all being used.

Mrs. Bannon stated the only thing we have to sell is the water in the ground. She encouraged moving in that direction and look at possibilities out there, entertain talks with people and think outside the box somehow.

Mr. Alexander explained that the assets that were appraised are essentially all fixed assets. The only exception to that of any consequence, being some vehicles and meters that are routinely changed out. They have a long life but they are changing over time.

Mr. Craig commented that he is sure the appraisal went back to January 27, 1999 and he is sure it was accounted for that there was only a certain part of the infrastructure that was

really owned by the water company at that time because there was a significant part that was not owned by the water company which the city had taken on the burden back in 1972 or something like that.

Mr. McBeth advised that was accounted for.

Mr. Craig stated that it is becoming clear to him that the status quo shall remain for a while because anything else will be somewhat punitive as far as paying taxes. He thinks that this board of directors has the ability to start moving in the direction to align the personnel as our CEO has indicated. How long do we expect that to take because he would like to see the employees of the water company be somewhat of a mirror image of the employees of the city. He asked if there were a timeline for that to happen.

Ms. Sexton explained that some things have been accomplished and next month at this board meeting the new policy and procedure manual should be before the board, similar to what you saw last week for the city employees. They thought they would have it done today but they are still checking with KPERS as far as retirement. She explained that is typical anytime you look at city/county consolidation of a department or anything of the sort the number one thing is the retirement plan. Otherwise, most everything in the policy manual that you adopted last week for the city will be implemented for the water company with the board's approval next month.

Mr. Craig clarified that the retirement deal is pretty much the hard one to get over so it's close.

Ms. Sexton advised it's going to take more work, she doesn't know that it's hard. She added that there are some other personnel matters that won't be completely resolved when you adopt that book; we have to implement a lot of things after adoption. We have job descriptions to write for all the employees just to bring them up to standard levels and implementation of annual performance reviews, merit pay and that kind of thing and that is a whole new policy. What she will be recommending to the board next month is that we not start that until we have our new performance measurement system.

Mr. Craig asked whose task is this that is working this project right now.

Ms. Sexton advised it would be Jean, Phil, herself, Jenny Thrush and Pat Swaney.

Mr. Craig stated that since Jenny is our expert in human resources she must be the focal point of this.

Ms. Sexton responded that is true for the personnel related things, polices and benefits absolutely.

Mr. Warren stated that it is time to stop spending money, this is what it is and let's go forward. Anything we can do to assimilate our employees to make it a little easier to work sounds like the direction we need to go. We are not hindered from doing anything

with the company that we want to do any other way so it seems pretty straightforward to him.

Mr. Avello stated that we have assets in the ground that have been evaluated. It would cost us \$1.2 million. Let's say a pump breaks that was included in those assets way back when and we have to replace that pump and it's non fixable, does that come off the asset role?

Mr. McBeth advised it would come off the list. The adverse tax consequences arise from the acquisition by the city through the liquidation of assets that were owned back on the date of acquisition, January 27, 1999. If an asset was acquired after, placed into service afterward, there is no depreciation or capture associated with that, so we are not concerned with that. If things are replaced and they were on the list, tainted assets we'll call them and they are disposed of they are no longer on the list.

Mr. Craig stated he is encouraged by the marketing of groundwater statement in the staff report (he read the statement allowed) and clarified that it indicates we can advertise our water for sale.

Mr. McBeth advised he believes so. The water company has the water rights and you are operating under the protection of the prior ruling and as long as you are operating it as a public utility.

MOTION: Craig moved to receive and file the report and instruct staff to proceed on the norm of working the personnel issues and the city will remain the sole shareholder. Seconded by Bannon.

Mr. Avello commented that he is sorry Mr. Schwarz is not here because he led the fight on this thing most of the way.

VOTE: Craig yea, Arnold yea, Warren yea, Schwarz absent, Staats yea, Bannon yea, Meidinger yea, Avello yea, 7 yea, 0 nay, 1 absent motion carried.

ADJOURNMENT

MOTION: Warren moved to adjourn at 9:07 p.m. Meidinger seconded.

VOTE: Craig yea, Arnold yea, Warren yea, Schwarz absent, Staats yea, Bannon yea, Meidinger yea, Avello yea, 7 yea, 0 nay, 1 absent motion carried.

Jean Epperson, Secretary

