

DATE ISSUED: July 17, 2002

REPORT NO. 02-158

ATTENTION: Honorable Mayor and City Council
Docket of July 22, 2002

SUBJECT: Water System Financing Program

REFERENCE: City Manager's Report 02-081

SUMMARY

Issues - Should the City Council adopt an ordinance authorizing (a.) the issuance of Water Revenue Bonds and/or Subordinate Water Revenue Bonds (collectively, "Bonds") by the Public Facilities Financing Authority of the City of San Diego ("Authority") to finance upgrades to and the expansion of the Water System in an amount not to exceed \$350 million; (b.) an Indenture between the Authority and the Trustee; (c.) a Supplement to the Master Installment Purchase Agreement between the City and the San Diego Facilities and Equipment Leasing Corporation ("Corporation"); (d.) an Assignment Agreement between the Corporation and the Authority; (e.) the City Manager or his designees to enter into and execute a Forward Delivery Agreement; (f.) the City Manager or his designees to negotiate with a qualified counter party, one or more interest rate swap agreements; (g) the investment of a portion of the proceeds of the Bonds in instruments with a term of maturity in excess of five years; and (h.) the City Manager or his designees to take such actions, and to execute such documents as may be necessary to complete the sale and issuance of the Bonds and/or the insuring of all or a portion of the Bonds and/or the refinancing of all or a portion of the previously issued 1998 Certificates of Undivided Interest ("1998 Certificates")?

Manager's Recommendations- Approve the above actions, and adopt an ordinance authorizing: (a.) the issuance of Bonds by the Authority to finance upgrades to and the expansion of the Water System in an amount not to exceed \$350 million; (b.) an Indenture between the Authority and the Trustee; (c.) a Supplement to the Master Installment Purchase Agreement between the City and the Corporation; (d.) an Assignment Agreement between the Corporation and the Authority; (e.) the City Manager or his designees to enter into and execute a Forward Delivery Agreement; (f.) the City Manager or his designees to negotiate with a qualified counter party, one or more

interest rate swap agreements; (g) the investment of a portion of the proceeds of the Bonds in instruments with a term of maturity in excess of five years; and, (h.) the City Manager or his designees to take such actions, and to execute such documents as may be necessary to complete the sale and issuance of the Bonds and/or the insuring of all or a portion of the Bonds and/or the refinancing of all or a portion of the 1998 Certificates.

Other Recommendations- None.

Fiscal Impact - Issuance of between \$150 and \$350 million (depending on market conditions, the number of months of construction that are financed, and whether refunding all or a portion of 1998 Certificates is determined to be in the best economic interests of the City) of Bonds of one or more series of parity or subordinate bonds will result in annual debt service payments of approximately \$10- \$28 million over a thirty year period, subject to market rates at the time of sale. All related costs of issuance, including but not limited to underwriters, bond counsel, trustee, and preparation of the Official Statement will be reimbursed from bond proceeds.

BACKGROUND

In August of 1998, following a year-long planning effort culminating in the development and Council adoption of the Strategic Plan for Water Supply (Strategic Plan), \$385 million of the 1998 Certificates were delivered for purposes of funding the first phase of the water system capital improvements called for in the Strategic Plan.

On April 30, 2002, the City Council adopted a series of water rate increases for Fiscal Years 2003 through 2007 to increase water system revenues by 6% per year for five successive years, and authorized the City Manager to proceed with preparation of the documents necessary to finance the second phase of the improvements (the Project).

In accordance with that direction, the following independent consultants were, or are in the process of being, retained to assist with the financing:

Financial Advisors:	Montague DeRose & Associates
Bond/Disclosure Counsel:	Orrick, Herrington & Sutcliffe LLP/ Webster & Anderson
Feasibility Engineers:	O'Brien & Gere Engineers, Inc.

In order to complete the financing, an underwriting team and trustee will also be retained.

DISCUSSION

The issue size of the Bonds is expected to be between \$150 and \$350 million, secured with installment payments to be made by the City exclusively from net system revenues of the Water Utility Fund. The actual dollar amount of the Bonds will be determined by the level of interest rates at the time the bonds are actually priced in the marketplace, the number of months of construction that are financed, and whether it is in the best economic interest of the City to refund (refinance) all or a portion of the 1998 Certificates to achieve lower interest costs. If it is

determined that a 2 year construction period is in the best economic interest of the City, it is anticipated that the issue size will be between \$150 and \$180 million, resulting in annual debt service payments of approximately \$10 to \$13 million. If the construction period is 3 years, it is anticipated that the issue size would be between \$230 and \$255 million, resulting in annual debt service payments of \$17 to \$20 million. It is anticipated that if all or a portion of the 1998 Certificates are refunded that the issue size would increase by approximately \$50 to \$95 million, resulting in additional annual debt service payments of \$3.5 to \$8 million, which would be offset by a reduction in obligations with respect to the 1998 Certificates refunded, and result in an associated present value interest cost reduction of at least 3%.

It is anticipated that the term of the Bonds will be 30 years, structured with serial and term maturities, as dictated by market conditions at the time of pricing. It is expected that the Bonds will be brought to market in early October 2002, with proceeds becoming available later that month.

The Bonds will be used to fund projects including the repair and replacement of aging and deteriorating components of the Water System, upgrades to facilities to meet Safe Drinking Water Act requirements, and the expansion of Water System treatment plants to meet the needs of current and future residents and commercial customers. A schedule of water capital projects, their timing and associated costs that are expected to be financed between FY03 and FY07 is attached. The approval of the Bond documents today will finance the projects either through FY04 or FY05. Future issuances of bonds will be necessary to complete this program. Timely funding of these projects is essential to meeting the project schedule as to be agreed to in an amended compliance order with the California Department of Health Services.

Financing Documents

The documents being submitted for approval at this time will enable the Authority to issue Water Revenue Bonds, Series 2002 and/or Subordinate Water Revenue Bonds, Series 2002 (collectively, "Bonds") in Fall 2002, as described above. The Ordinance approves the form, execution and delivery of financing documents and certain other actions, within the City Manager's purview and limitations, which are necessary and in the best interests of the City, to issue not to exceed \$350 million of Bonds. A brief description of the major financing documents follows:

2002 Supplement to the Master Installment Purchase Agreement- Specifies which components of the Project will be funded and the terms and conditions governing how they'll be paid for.

Indenture - This document outlines the parties' rights, responsibilities, and obligations with respect to the issuance of the 2002 Bonds.

Assignment Agreement– Under the Assignment Agreement, the Corporation assigns to the Authority without recourse all of its rights under the 2002 Supplement, including, without limitation, its rights to receive the 2002 Component Installment Payments payable by the City to the Corporation.

Proposed Financing Structure

The recommended financing vehicle for the Bonds is water revenue bonds. Revenue bonds are issued to fund capital improvements and debt service is paid from and secured by a pledge of the gross or net revenues of the enterprise. It is anticipated that the Bonds will be issued by the Authority. The Authority was created by the City and its Redevelopment Agency to engage in financing activities and is administered by a Commission which is comprised of three members of the public, the City Manager, and the City Auditor and Comptroller.

The first water financing in 1998 utilized certificates of undivided interest (similar to certificates of participation) delivered by the Corporation. The City entered into an installment purchase agreement in which the Corporation agreed to acquire or improve various properties using certificates of undivided interest proceeds and then sell the property to the City. The City made installment payments and paid all other expenses associated with the financing and the property. This type of financing vehicle was utilized in 1998 due to legal uncertainties surrounding the use of joint powers agencies at that time. The term “certificates of undivided interest” was used to differentiate the 1998 water financing (revenue-based) from other certificates of participation that were lease-revenue based. Revenue bonds are a more traditional source of financing than certificates of participation that should provide for improved marketability.

The 1998 Certificates were issued using a senior lien structure under which Certificate holders were promised that they would be first to receive interest and principal payments once operating and maintenance expenses were met, and that rates would be set at levels sufficient to insure that at least 1.2 times the principal and interest amount due would be available (the coverage covenant).

A subordinate lien structure is being contemplated for this financing, and may be employed if market conditions are right. A subordinate lien is “subordinate” primarily because the buyers of these securities receive principal and interest payments only after the City’s senior lien obligations are met. From the City’s standpoint, the use of a subordinate lien structure can increase management flexibility because the coverage and other covenants are typically less stringent than under the senior lien structure. Coverage covenants typically applicable to subordinate lien structures are 1.1 times principal and interest, and sometimes as low as 1 times principal and interest. A lower coverage covenant means funds ordinarily committed to coverage can be put to use in meeting additional capital, operating or reserve fund needs.

CONCLUSION

It is recommended that Council authorize the issuance of Bonds in an amount not to exceed \$350 million and approve the related financing documents so that the second phase of the necessary improvements may proceed.

ALTERNATIVE

Do not approve the requested actions necessary to issue Bonds for the upgrade and expansion plan of the Water System.

Respectfully submitted,

Mary Vattimo
City Treasurer

Approved: Patricia T. Frazier
Deputy City Manager

VATTIMO/KAHLIE/CR

Attachment: Anticipated Expenditures, FY2003 – FY2007