

DATE ISSUED: June 11, 2003 **REPORT NO.** 03-120

ATTENTION: Honorable Mayor and City Council
Docket of June 17, 2003

SUBJECT: Wastewater System Financing Program

REFERENCE: City Manager's Report 01-209, issued October 10, 2001
City Manager's Report 03-037, issued February 26, 2003

SUMMARY

Issue - Should the City Council adopt an ordinance (a.) approving the form of and authorizing the issuance of Sewer Revenue Bonds and/or Subordinated Sewer Revenue Bonds (collectively, "Bonds") by the Public Facilities Financing Authority of the City of San Diego ("Authority") to finance upgrades to and expansion of, and to refund certain outstanding obligations of, the Sewer System in an amount not to exceed \$1.2 billion; (b.) approving the form of an Indenture (Subordinated Bonds) between the Authority and the Trustee; (c.) approving the form of and authorizing the execution and delivery of a First Amendatory Supplement and a 2003 Supplement to the Master Installment Purchase Agreement between the City and the Authority; (d.) authorizing the City Manager or his designees to enter into and execute a Forward Delivery Agreement; (e.) authorizing the City Manager or his designees to negotiate with a qualified counter party, one or more interest rate swap agreements; (f) authorizing the investment of a portion of the proceeds of the Bonds in instruments with a term of maturity in excess of five years; and (g.) authorizing 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 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds?

Manager's Recommendation- Approve the above actions, and adopt an ordinance (a.) authorizing the issuance of Bonds by the Authority to finance upgrades to and expansion of, and to refund certain outstanding obligations of, the Sewer System in an amount not to exceed \$1.2 billion; (b.) approving the form of an Indenture (Subordinated Bonds)

between the Authority and the Trustee; (c.) approving the form of and authorizing the execution and delivery of a First Amendatory Supplement and a 2003 Supplement to the Master Installment Purchase Agreement between the City and the Authority; (e.) authorizing the City Manager or his designees to enter into and execute a Forward Delivery Agreement; (f.) authorizing the City Manager or his designees to negotiate with a qualified counter party, one or more interest rate swap agreements; (g) authorizing 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.) authorizing 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 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds.

Other Recommendations- None.

Fiscal Impact - Issuance of between \$375 million and \$1.2 billion (depending on market conditions, the number of months of construction that are financed, and whether all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds are refunded to achieve interest cost savings) of one or more series of parity and/or subordinated bonds will result in annual debt service payments of approximately \$23.7 million - \$85.9 million over a thirty year period, subject to market rates at the time of sale. It is anticipated that if all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds are refunded with new Bonds paying lower interest, annual debt service cost savings of as much as \$2.3 million per year could be realized. 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 October of 2001, the City Council approved increasing all sewer service charges by 7.5% on March 1, 2002, 2003, 2004 and 2005 to ensure continued compliance with the requirements of the Clean Water Act, the Ocean Pollution Reduction Act (OPRA), the State Ocean Plan, the National Pollutant Discharge Elimination System (NPDES) permit, and the federal Stipulated Final Order for Injunctive Relief (Stipulated Order). In connection with approval of the aforementioned service charge increases, the City Council was advised that it would be necessary to issue additional sewer revenue bonds on a periodic basis which, in combination with additional pay-as-you-go funding derived from rates, would provide the required project financial support. Consistent with that advice, the following independent consultants were subsequently retained to assist with the anticipated financing:

Financial Advisors:	Montague DeRose & Associates LLC
Bond/Disclosure Counsel:	Orrick, Herrington & Sutcliffe LLP
Trustee:	Wells Fargo Bank, National Association
Underwriters:	UBS Paine Webber, Inc., Merrill Lynch, Inc., and Redwood Securities Group, Inc.

DISCUSSION

The issue size of the Bonds is expected to be between \$375 million and \$1.2 billion, secured by installment payments to be made by the City exclusively from net system revenues of the Sewer Fund. The actual principal 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 previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds to achieve lower interest costs. Assuming 24 months of construction are funded, it is anticipated that the issue size will be approximately \$375 million, resulting in annual debt service payments of approximately \$23.7 million. It is anticipated that if all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds are refunded, the issue size and annual debt service payments could increase by as much as \$825 million and \$62.2 million respectively. But, by refinancing outstanding Bonds with new Bonds paying lower interest, annual debt service cost savings of as much as \$2.3 million per year could be realized.

As was the case with the previous issuances, the 2003 Bonds will be used to fund a part of the Council-approved wastewater capital improvement program consisting of numerous projects, including the repair and replacement of aging and deteriorating components of the Sewer System, upgrades to facilities to meet requirements of the Clean Water Act, OPRA, the State Ocean Plan, the NPDES permit and the Stipulated Order, as well as to meet the needs of current and future residents and commercial customers. Approval of the Bond documents today will facilitate the financing of projects through FY05. A schedule of sewer capital projects, their timing and associated costs that are expected to be financed between FY04 and FY05 is attached. Future rate increases and bond issuances will be necessary to complete this program.

Financing Documents

The documents being submitted for approval at this time will enable the Authority to issue Sewer Revenue Bonds, Series 2003 and/or Subordinated Sewer Revenue Bonds, Series 2003 (collectively, "Bonds") in Summer, 2003, 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 no more than \$1.2 billion in bonds. A brief description of the major financing documents follows:

Indenture - This document outlines the Authority's and Trustee's rights, responsibilities, and obligations with respect to the issuance of the 2003 Bonds.

First Amendatory Supplement to the Master Installment Purchase Agreement of 1993 – Amends certain sections of the Master Installment Purchase Agreement of 1993 to facilitate the issuance of subordinated debt.

2003 Supplement to the Master Installment Purchase Agreement of 1993- Specifies which components of the overall capital program will be funded and the terms and

conditions governing repayment of the Series 2003 Bonds.

Proposed Financing Structure

The proposed financing vehicle for the FY04-05 sewer capital program is sewer 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 Treasurer, and the City's Community and Economic Development Director.

The four previous sewer financings in 1993, 1995, 1997 and 1999 utilized revenue bonds delivered by the Authority. The City entered into an installment purchase agreement in which the Authority agreed to acquire or improve various properties using revenue bond proceeds and then sell the properties to the City. The City makes installment payments and pays all other expenses associated with the financing and the properties.

The 1993, 1995, 1997 and 1999 bonds were issued using a senior lien structure under which bondholders 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 ensure that at least 1.2 times the principal and interest amount due would be available to make those payments (the coverage covenant).

A subordinate lien structure is being contemplated for this financing, and will be employed if dictated by market conditions. A subordinate lien is "subordinate" primarily because the buyers of these securities receive principal and interest payments only after operating and maintenance expenses are paid, and 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 a senior lien structure. Coverage covenants typically applicable to subordinate lien structures are 1.1 times principal and interest, and sometimes as low as 1.0 times principal and interest. A lower coverage covenant means less pressure to raise rates simply to meet coverage requirements.

CONCLUSION

It is recommended that the Council authorize the issuance of Bonds in an amount not to exceed \$1.2 billion and approve the related financing documents so that the next phase of improvements to the wastewater system and the refinancing of all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds to achieve interest cost savings may proceed.

ALTERNATIVE

Do not approve the requested actions necessary to issue Bonds for the upgrade and expansion of the Sewer System and the refunding of all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds. This is not recommended because of its adverse effect on the Metropolitan Wastewater Department's ability to execute its ongoing capital improvement program and the City's ability to reduce its wastewater-related debt service costs by as much as \$2.3 million per year by refinancing certain of the Sewer System's preexisting obligations.

Respectfully submitted,

Mary Vattimo
City Treasurer

Approved: Patricia T. Frazier
Deputy City Manager

KAHLIE

Attachments: [1. Project Schedule](#)
[2. Form of Indenture](#)
[3. Form of First Amendatory Supplement to Master Installment Purchase Agreement of 1993](#)
[4. Form of 2003 Supplement to Master Installment Purchase Agreement of 1993](#)