

DATE ISSUED: October 19, 2005

REPORT NO. 05-199

ATTENTION: Honorable Mayor and City Council
Docket of October 24, 2005

SUBJECT: Restructuring of Sewer System Interim Financing – Approval of Documents

SUMMARY

Issue - Should the City Council adopt a resolution approving the restructuring of the presently outstanding, privately placed, \$152 million Non -Transferable Subordinated Sewer Revenue Bonds, Series 2004, for purposes of (1.) Restructuring and extending the amortization period thereof, and (2.) Enabling the City to accept a new State Revolving Fund loan, already approved by the State and by the City Council?

Manager's Recommendation – Adopt the resolution.

Other Recommendations - None

Fiscal Impact – The restructuring of the Non-Transferable Subordinated Sewer Revenue Bonds (Bonds) will result in increased aggregate interest costs to the Metropolitan Wastewater Department (MWWD) if they remain outstanding until maturity, but will allow the department to better manage near to medium term cash flows. Rescheduling and extending the amortization period of the Bonds will result in quarterly interest payments of approximately \$1.1 – 1.4 million until December 15, 2006. On that date, the Bonds, if not previously retired, will begin to amortize over a period of five years, with the first quarterly principal amortization payment, plus interest, due on March 15, 2007. Acceptance of the approved state revolving fund (SRF) loan will reimburse approximately \$10.1 million in prior MWWD pay-as-you-go capital expenditures. The SRF loan will bear interest at an effective rate of 1.795% and be repaid at an approximate annual cost of \$606,000 for a period of 20 years.

The Bonds are currently structured with a two-year amortization period, which begins in December 2005. In addition to interest payments, the current Bond documents require \$38 million in principal payments during Fiscal Year 2006; \$76 million in principal payments during

Fiscal Year 2007; and \$38 million in principal payments during Fiscal Year 2008. The proposed restructuring reduces the principal amortization in those years to \$0 in Fiscal Year 2006; \$15.2 million in Fiscal Year 2007; and \$30.4 million in Fiscal Year 2008.

All related costs, including but not limited to bond counsel, financial advisor, trustee, and preparation of documents will be paid by MWWD, in an amount not expected to exceed \$100,000.

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 the 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 wastewater program financial support.

As part of the on-going wastewater project, in June of 2003, the City Council took a series of actions to approve the issuance of Sewer Revenue Bonds and/or Subordinated Sewer Revenue Bonds in an amount not to exceed \$1.2 billion, for purposes of (1) financing the fifth phase of the approved wastewater system capital improvements program, and (2) refinancing all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Sewer Revenue Bonds to realize interest cost savings.

Pursuant to those actions, staff proceeded to complete the steps necessary to effect the public sale of the bonds on September 9, 2003. As a result of the discovery of certain errors in the City's FY 2002 Consolidated Annual Financial Report and the related MWWD Annual Financial Report (as more fully set forth in a Voluntary Report of Information filed by the City in January of 2004) a decision was made not to complete that transaction.

As indicated above, the City was (and is) under several regulatory obligations which require the construction and renovation of numerous capital facilities on an established schedule. The desire to avoid delays in completion of these critical capital projects resulted in near-term cash flow pressures which were addressed in June, 2004 by means of a privately placed interim, or "bridge" financing in the amount of \$152 million, placed by the Public Facilities Financing Authority of the City of San Diego (the Authority) with Bank of America, N. A. (the Bank), which was intended to be retired by a subsequent public offering of long term debt, which at that time was expected to occur prior to the end of calendar year 2004.

DISCUSSION

Original Structuring of the Bonds

As originally structured, the Bonds were expected to be retired within no more than 18 months, had a nominal maturity of December 15, 2007, and could be redeemed at any time by the Authority, which agreed not to incur any additional MWW – related debt without either paying off the Bonds, or by first seeking and receiving approval from the Bank.

Interest on the Bonds is computed at a variable rate indexed to the London Inter-Bank Offering Rate (LIBOR), which is periodically set for a stated period of time (the LIBOR spread period) at the City's discretion. The current rate, which is set for a six-month LIBOR spread period expiring December 15, 2005, is 3.007%. Interest-only payments on the Bonds are made until December 15, 2005; principal amortization payments of \$19 million per quarter are to commence on March 15, 2006. Interest payments are due at the end of each LIBOR spread period or quarterly, whichever occurs first.

Pursuant to the bond purchase agreement, the Bank agreed to retain the Bonds in its own investment portfolio, and not to resell the Bonds to any third party during the term of the transaction. The Bonds were secured by installment payments to be made by the City exclusively from net system revenues of the Sewer Fund, and are subordinate in right of payment to the Authority's existing parity (senior) sewer revenue bonds.

Proposed Restructuring of the Bonds

The proposed restructuring of the Bonds consists of two elements: (1.) Restructuring and extending the amortization period thereof, and (2.) Authorizing the acceptance of an approved SRF loan.

At the time of their sale in June of 2004, it was anticipated that the Bonds would be retired well before the two-year amortization period was set to commence. As events evolved, it became clear that the onset of the principal amortization period would, in fact, occur before the City regained access to the public capital markets, resulting in an adverse budgetary impact.

City staff and the Bank have agreed on the terms of a restructuring which will permit MWW to better manage departmental cash flows. As proposed, the restructuring will (1.) Defer the principal amortization period for one year, to December 2006, with the first payment of principal due on March 15, 2007; (2.) Extend the term of the Bonds and the amortization period by 4 years to December 15, 2011, thereby reducing the quarterly principal amortization payments from \$19 million to \$7.6 million; and (3.) subject to certain conditions, permit the acceptance by the City of a single, previously approved SRF loan in an amount not to exceed \$13 million.

As is currently the case, interest on the Bonds will be indexed to LIBOR for spread periods chosen at the discretion of the City through December 15, 2011. In response to current conditions, certain changes to the Indenture which provide additional protection to the Bank in

case of a “City Insolvency Event “ as therein defined, as well as interest penalties of as much as 250 basis points (2.5%) under such circumstances, have been added.

Finally, as noted above, the Bank has agreed to authorize the acceptance by the City of a single SRF “zero interest” loan which had previously been approved for funding by the State Water Resources Control Board (SWRCB). While described as a “zero interest loan”, the loan carries an effective interest rate of 1.795% as a result of the City’s prepayment of the SWRCB’s “matching fund amount”. City acceptance of this loan, which was approved for purposes of financing the construction of the San Diego Environmental Lab Project (which has already been completed using pay-as-you-go capital) will reimburse the City for monies already spent, resulting in the generation of approximately \$10.1 million in new capital for additional wastewater projects at low cost.

Financing Documents

City Council approval of two new documents specific to this transaction is required. The documents being submitted for approval at this time will enable the Authority to restructure the Non-Transferable Subordinated Sewer Revenue Bonds, Series 2004, as described above. The Resolution approves the form, execution and delivery of financing documents and certain other actions within the City Manager’s purview and adds limitations which are necessary and in the best interests of the City to restructure the bonds. A brief description of those documents follows:

- **First Supplemental Subordinated Indenture (Subordinated Bonds)**– An agreement between the Authority and Wells Fargo Bank, N. A., as Trustee, the First Supplemental Subordinated Indenture sets forth the amended terms and conditions under which the subordinated bonds will be amortized and the SRF loan authorized, the responsibilities of the Authority and the Trustee, revised and amplified definitions of events of default and remedies of holders, conditions governing defeasance and related matters. [Attachment 1]
- **First Amendment to the 2004 Supplement to the Master Installment Purchase Agreement of 1993** – This document amends and supplements the master installment purchase agreement of 1993, and provides for the restructuring of the amortization schedule of the Non-Transferable Subordinated Sewer Revenue Bonds, Series 2004, including representations by and between the City and the Authority, a description of the installment payments, conditions governing prepayment, and covenants relating to tax exemption and issuance of additional subordinated obligations. [Attachment 2]

CONCLUSION

It is recommended that the City Council authorize the restructuring of the Non-Transferable Subordinated Sewer Revenue Bonds, Series 2004, in the amount of \$152 million for purposes of extending the amortization period, reducing the magnitude of periodic amortization payments due, and authorizing the acceptance of an SRF loan, all as described above and in the attached documents.

ALTERNATIVE

Do not approve the requested actions necessary to restructure the Non-Transferable Subordinated Sewer Revenue Bonds. This is not recommended because of its adverse effect on the Metropolitan Wastewater Department's near- to mid-term cash flow, and because it will preclude the City's acceptance of an already approved SRF loan.

Respectfully submitted,

Charles E. Mueller, Jr.
Acting City Treasurer

Approved: Lisa Irvine
Deputy City Manager

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Attachments: [1. Form of First Supplemental Subordinated Indenture](#)
[2. Form of First Amendment to the 2004 Supplement to the Master Installment Purchase Agreement of 1993](#)

V4