THE CITY OF SAN DIEGO

# REPORT TO THE CITY COUNCIL

| | | |
|---|---|---|
| DATE ISSUED: | May 18, 2006 | REPORT NO. 06-059 |
| ATTENTION: | Council President and City Council | |
| SUBJECT: | Update on Issuance of Community Facilities District No. 3 (Liberty Station) Special Tax Bonds | |
| REFERENCE: | Memorandum to Mayor and City Council, dated June 27, 2005, "Status Update on Proposed Issuance of Community Facilities District No. 3 (Liberty Station) Special Tax Bonds, Series A"<br>Manager's Report No. 05-112, dated May 11, 2005<br>Manager's Report No. 02-096 dated April 29, 2002 | |


SUMMARY:

THIS IS AN INFORMATION ITEM ONLY. NO ACTION IS REQUIRED ON THE PART OF THE CITY COUNCIL.


## BACKGROUND

On May 24, 2005, the City Council, acting as the legislative body of Community Facilities District No. 3 (Liberty Station) ("CFD No. 3" or the "District") adopted a resolution authorizing and approving: the issuance of Community Facilities District No. 3 (Liberty Station) Special Tax Bonds (the "CFD Bonds") in a principal amount not to exceed $16.0 million, and the execution and delivery of certain documents pertaining to the issuance of the CFD Bonds, including the Bond Indenture and the Private Placement Agreement (the "Private Placement Financing"). Manager's Report 05-112, dated May 11, 2005 (the "Report," included as Attachment 1) provides background information on the Private Placement Financing. As more fully described in the Report, CFD No. 3 was formed in 2002 in connection with the Naval Training Center Redevelopment Project. Specifically, the Disposition and Development Agreement ("DDA") between the Redevelopment Agency of the City (the "Agency") and McMillin-NTC, LLC ("McMillin"), which was approved by the City Council and the Agency in June 2000, gave McMillin the right to pursue formation of a community facilities district for the purpose of financing a portion of the public improvements that McMillin is responsible for under the DDA. These improvements include certain road improvements and the regional park improvement (the "Public Facilities").

In June 2005, approximately two weeks prior to the private placement of the CFD Bonds, City staff became aware that mold had been detected within several units of the Anchor

Cove condominium project located within CFD No. 3. At that time, and as described in a memorandum to City Council, dated June 27, 2005 (Attachment 2), it was determined that the Private Placement Financing should be suspended until the Financing Team (comprised of staff of Financing Services, the City Attorney's Office, and the City Auditor's Office, as well as the City's Bond Counsel [Stradling, Yocca, Carlson, & Rauth], the City's Financial Advisor [Fieldman, Rolapp & Associates], and the City's Placement Agent [Stone & Youngberg and E.J. De La Rosa]) had additional facts about the mold issue and the required remedial measures.

**DISCUSSION**

Based on information provided in a report entitled "Review of Water Damage Assessment and Mitigation Report, Anchor Cove at Liberty Station, San Diego, California," dated April 21, 2006, (the "Mold Report") (Attachment 3) issued by Ninyo & Moore, an independent consultant familiar with mold and moisture assessment and abatement, the Financing Team believes the City can proceed with the issuance of the CFD Bonds. Ninyo and Moore was hired by the Agency and asked to provide an opinion on the adequacy of the mold investigation and remediation performed by McMillin's consultant, Environmental Resources Management ("ERM"), with respect to certain residential units located within CFD No. 3. According to reports issued by Ninyo & Moore and ERM, it was concluded that the mold found within certain units at Anchor Cove was caused by "green" insulation blown into common walls between units, which did not properly dry. The mold was generally found behind finished features (i.e., mirrors, vanities, and cabinets). It is understood that there are 140 units at Anchor Cove and that, as of the date of the Mold Report, all but six units (whose owners, according to McMillin, have not yet granted access to ERM) were tested. Of the 134 units inspected in Anchor Cove, 54 were found to be impacted by the mold and remediation activities were performed on such units. ERM also conducted an initial assessment of approximately 10% of the homes in the other two residential projects located within CFD No. 3 (Beacon Point and Admiralty Row, which total 209 units), and, according to a report issued by ERM, "adverse impacts from the use of the natural fiber insulation in the homes comprising Beacon Point and Admiralty Row were not observed in the homes inspected." In the Mold Report, Ninyo & Moore stated its opinion that "…the source of water was accurately represented in [a] report [issued by ERM], and that this source has been mitigated, along with affected building materials encountered during the investigation, and no further investigation or remedial action should be necessary." Ninyo & Moore did recommend that the six inaccessible units in Anchor Cove be assessed in the future, when access is granted. However, Ninyo & Moore also advised the Financing Team that, if left untreated, any related mold issues in those six units should not impact other units. The special taxes levied upon the six units would represent approximately 1.01% of the estimated total CFD No. 3 special tax levy for Fiscal Year 2007.

Because Ninyo & Moore concluded testing and remediation activities conducted by ERM were in conformance with industry protocol and no further investigation or remedial action should be necessary, the Financing Team believes it is reasonable to proceed with the issuance of the CFD Bonds. Appropriate language regarding the mold issue will be included in the Investor Letter that each investor in the CFD Bonds would be required to sign. The discussion provided below is intended to update the City Council on information regarding the CFD Bonds, which was previously provided in the Report.

UPDATE OF INFORMATION PROVIDED IN MANAGER'S REPORT 05-112

**1. Private Placement Structure**

The basis for the Private Placement Financing that was approved by City Council in May 2005 is still valid. At that time, the City's bond and disclosure counsel for the CFD Bonds and the City's general disclosure counsel had each advised the Financing Team that although the CFD Bonds are not obligations of the City, any material adverse information regarding the City's financial condition or any material adverse developments regarding the pending investigations being conducted by the Securities and Exchange Commission, the U.S. Attorney's Office, the FBI, the District Attorney's Office, and the City Attorney (the "Investigations") could have a negative impact on the value of the CFD Bonds in the secondary market. Counsel further advised that until the City is in a position to provide current financial information to the marketplace, the CFD Bonds should not be publicly offered. Accordingly, an alternative method of sale (the Private Placement Financing), involving placement of the bonds with a limited group of qualified institutional buyers sophisticated with the risks associated with the purchase of municipal bonds was developed and ultimately approved by the City Council. This approach addresses the issue of potential secondary market impacts relating to any new developments pertaining to the City's financial condition or the Investigations and is appropriate since the City still has not issued audited Comprehensive Annual Financial Reports for the fiscal years ended June 30, 2003, June 30, 2004, and June 30, 2005 (the "CAFRs").

In May of 2005, the Placement Agent had estimated, based on market conditions that existed at that time and forecasted market conditions, that execution of the Private Placement Financing could result in a lower interest rate than waiting to execute a public offering. The Placement Agent currently estimates that it could place the CFD Bonds under the approved private placement structure at a rate that is approximately 0.30% higher than if a public offering could be executed today. Due to the fact that long term rates did not rise as generally expected by the market over the past nine to ten months and that there continues to be a general market expectation that rates will rise, it is still expected that issuing the Private Placement Financing in the near term is preferable from an economic standpoint than waiting to issue the bonds via a public offering.

When the Private Placement Financing was approved, City Council also approved a companion item involving an amendment to the NTC Park Improvement Agreement contained within the DDA (the "Park Amendment"). This amendment addressed McMillin's commitment to accelerate the schedule set forth in the NTC Park Improvement Agreement for commencement and completion of a first park phase ("Phase 1"). In substance, McMillin agreed to commence Phase 1 within 30 days of the CFD Bond sale, and to complete the phase within 16 months. It is understood that, notwithstanding the delay in the issuance of the CFD Bonds due to the mold issue, McMillin proceeded with the accelerated Phase 1 completion schedule and broke ground on the park in August 2005. The original commencement date set forth in the NTC Park Improvement Agreement was December 2005. Under the Park Amendment, Phase 1 was also expanded to 18 acres (rather than the original 14 acres). The Agency understands that McMillin expects to complete Phase 1 by December 2006, in accordance with the schedule set forth in the Park Amendment, which is two years ahead of the original Phase 1 completion date of December 2008.

**2. Issuance Size**

As described in the Report and authorized by the City Council in May of 2005, the issuance of this first series of bonds would be in a principal amount not to exceed $16.0 million. The bond proceeds would be used to establish an Acquisition Fund to reimburse McMillin for eligible Public Facilities upon completion of the facilities and a review of the costs for such facilities by the City's accounting consultant and the City Auditor,[1] as well as to fund a required debt service reserve fund (a "DSRF") and costs to establish the District and issue the bonds.

The following table provides an update of the estimated sources and uses of bond proceeds:

Sources and Uses of Bond Proceeds

| | |
|---|---|
| Estimated Sources: | |
| Bond Proceeds: | $ 16,000,000 |
| Estimated Uses: | |
| Public Facilities (Acquisition Proceeds) | $13,295,509 |
| Debt Service Reserve Fund | 1,117,412 |
| Costs of Formation and Issuance[2] | 1,587,079 |
| TOTAL: | $16,000,000 |

As also described in the Report, special taxes ("Special Taxes") are levied upon taxable property interests within CFD No. 3 according to the rate and method of apportionments (the "RMAs"), which were approved in connection with the District formation proceedings in 2002. In accordance with the RMAs, the City has levied Special Taxes on developed property within CFD No. 3, beginning with the Fiscal Year 2004 tax year. Under the RMAs, the Special Taxes can be used to pay debt service on the CFD Bonds and to directly fund the Public Facilities. The following table provides updated information on the anticipated facilities to be acquired with Special Tax receipts collected in Fiscal Years 2004, 2005, and 2006 and with the acquisition proceeds of the CFD

[1] Rosecrans/Lytton Street Improvements and Harbor Drive Improvements totaling $5,990,181 have already been completed and the costs reviewed by the City's accounting consultant, David Taussig & Associates, Inc. and the City Auditor's Office.

[2] Includes the Placement Agent Fee ($304,000); remaining costs of formation and issuance ($1,283,079) include, among other items, bond counsel and disclosure fees, financial advisor fees, special tax consultants fees, City staff costs, and trustee fees.

Bonds:

Sources and Uses of Acquisition Funds

| | **FY 2004-2006 Acquisition Levy Receipts** | **Acquisition Bond Proceeds** | **Total** |
|---|---|---|---|
| Estimated Sources of Acquisition Funds | | | |
| FY 2004 Levy - Acquisition Receipts | $381,024 | -- | $381,024 |
| FY 2005 Levy - Acquisition Receipts | 951,207 | -- | 951,207 |
| FY 2006 Levy – Acquisition Receipts | 1,339,732 | | 1,339,732 |
| Bond Proceeds (Acquisition Fund) | -- | 13,295,509 | 13,295,509 |
| *TOTAL* | *$2,671,963* | *$13,295,509* | *$15,967,472* |
| Estimated Uses of Acquisition Funds | | | |
| Rosecrans/Lytton St. Improvements[1] | $2,671,963 | $2,429,807 | $5,101,770 |
| Harbor Drive Improvements[1] | -- | 888,411 | 888,411 |
| *Sub-total Road Improvements* | *$2,671,963* | *$3,318,218* | *$5,990,181* |
| Park – Phase 1 | -- | 7,958,866 | 7,958,866 |
| Park – Phase 2 (portion)* | | 2,018,425 | 2,018,425 |
| *Sub-total Park Improvements* | -- | *$9,977,291* | *$9,977,291* |
| *TOTAL* | *$2,671,963* | *$13,295,509* | *$15,967,472* |

* Phase 2 cost is estimated to total $6,820,934, which includes a $466,729 contribution to the aquatic center. Combined with the Phase 1 cost ($7,958,866), the park costs total $14,779,800.

As shown in the table above, approximately 25% ($3,318,218) of the bond acquisition proceeds are anticipated to be used to acquire road improvements, with the remaining 75% ($9,977,291) expected to acquire park improvements.

### 3. Financing Documents

[1] Rosecrans/Lytton Street Improvements and Harbor Drive Improvements totaling $5,990,181 have already been completed and the costs reviewed by the City's accounting consultant, David Taussig & Associates, Inc. and the City Auditor's Office. To date, $2,032,231 has been released from the Fiscal Year 2004, 2005, and 2006 levies shown in the table to reimburse McMillin for these road improvements.

The financing documents that the City Council approved in May 2005 include the forms of the Indenture and the Private Placement Agreement.

> The Indenture – The Indenture is an agreement between the District and the Trustee for the CFD Bonds, Wells Fargo Bank, National Association. Generally, it outlines the District's and the Trustee's responsibilities and obligations, and the rights of the CFD Bondholders. It also creates the pledge of a portion of the Special Taxes levied within the District to the repayment of the CFD Bonds, and provides a form of the Investor letter. Prior to the purchase of any CFD Bonds, each investor would be required to sign an Investor Letter acknowledging, among other things, that: it is a Qualified Institutional Buyer as defined under Rule 144A of the Securities Act of 1933; it understands the nature of CFD Bonds (i.e., that the bonds are not financial obligations of the City, and are limited obligations of the District); it does not have a view to resell the bonds; and understands that any significant development regarding the Investigations or the CAFRs could have an impact on the bonds in the secondary market. As described above, appropriate language regarding the mold issue will also be included in the Investor Letter.
>
> The Private Placement Agreement – The Private Placement Agreement is an agreement between CFD No. 3 and the Placement Agent involving placement of the CFD Bonds by the Placement Agent with a limited group of Qualified Institutional Buyers.

Shortly following the completion of the financing, a CD-ROM containing the executed financing documents ("Transaction Closing Binder") will be forwarded to each City Councilmember and the City Clerk's Office.

**4. Schedule**

On May 10, 2006, the Disclosure Practices Working Group reviewed the financing structure and the current form of the Investor Letter (there is no City disclosure document relating to the transaction). It is currently anticipated that the CFD Bonds will be placed/priced the week of June 12, 2006. The bond closing (receipt of bond proceeds) is expected to occur two weeks after the placement of the CFD Bonds, or the week of June 26, 2006.

## FISCAL CONSIDERATIONS:

There is no fiscal impact to the City. In accordance with Council Policy 800-03, all costs related to CFD No. 3 have been funded by McMillin. The costs related to establishing and administering CFD No. 3 and acquiring the Public Facilities will ultimately be borne by property owners within CFD No. 3, via the collection of the Special Taxes.

## PREVIOUS COUNCIL ACTIONS REGARDING CFD NO. 3:

During the May 7, 2002 City Council Meeting, City staff presented City Manager's Report No. 02-096, entitled "Naval Training Center – Proposed Formation of Community Facilities District No. 3 (Liberty Station)." At this meeting, the City Council adopted a resolution that: (1) declared its intent to form CFD No. 3; (2) designated the boundaries of the District; (3) declared its intent to levy special taxes; (4) approved the Rate and Method of Apportionment of Special Taxes for the District; (5) approved the Purchase and Finance Agreement between the City and McMillin; and, (6) set the time and place for a public hearing on the establishment of the District. Subsequently, on June 25, 2002, following a public hearing and a special election, each conducted in accordance with the Mello-Roos Act, the City Council adopted the necessary resolutions to form CFD No. 3, certified the results of the Special Tax and bond authorization election for the District, and authorized the levy of a Special Tax within CFD No. 3.

At the April 5, 2005 City Council Meeting, City staff presented a memorandum to the Mayor and City Council, dated March 29, 2005 on "Status Update on Proposed Issuance of Community Facilities District No. 3 (Liberty Station) Special Tax Bonds, Series A." At that meeting, City Council adopted a resolution in which the City Manager, City Attorney, and the remainder of the Financing Team were directed to "bring back the financing documents…to the City Council by May 17, 2005; and to codify [the commitment] by McMillin to start and finish the park [sooner than required under the DDA]." On May 24, 2006, following the deferral of the item from the May 17, 2005 City Council Meeting agenda, City staff presented City Manager's Report No. 05-112 on "Naval Training Center – Proposed Issuance of Community Facilities District No. 3 (Liberty Station) Special Tax Bonds Series A of 2005 in an Amount Not To Exceed $16.0 Million." At that meeting, the City Council adopted a resolution authorizing and approving the Private Placement Financing.

## COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:

As described above, and in accordance with the Mello-Roos Act, a public hearing was held on the CFD Bonds in June 2002. Prior to the hearing, a Notice of Public Hearing was provided to each property owner of record and was published on the City's web-site and in the San Diego Daily Transcript.

## KEY STAKEHOLDERS AND POTENTIAL IMPACTS:

Key stakeholders include McMillin and the Agency; it is understood that placement of the CFD Bonds would implement an element of the DDA between these two parties. Other stakeholders include the special taxpayers within CFD No. 3. If forecasted rates rise as the market expects, the issuance of the CFD Bonds in the near term could ultimately be advantageous to the special taxpayers in the District.

Jay M. Goldstone
Chief Financial Officer

Attachments:
1. Manager's Report No. 05-112, dated May 11, 2005
2. Memorandum to Mayor and City Council, dated June 27, 2005, "Status Update on Proposed Issuance of Community Facilities District No. 3 (Liberty Station) Special Tax Bonds, Series A"
3. Report Issued by Ninyo & Moore, dated April 21, 2006, "Review of Water Damage Assessment and Mitigation Report, Anchor Cove at Liberty Station, San Diego, California"