THE CITY OF SAN DIEGO

REPORT TO THE CITY COUNCIL

DATE ISSUED: December 21, 2006 REPORT NO. 06-194

ATTENTION: Council President and City Council
Docket of January 16, 2007

SUBJECT: Water System Financing

REFERENCE: Companion Report - Water System Improvements Report

REQUESTED ACTIONS:

Authorize the issuance of Non-Transferable Subordinated Water Revenue Notes, Series 2007A (Payable Solely From Subordinated Installment Payments Secured By Net System Revenues of the Water Utility Fund) ("the Notes") in the principal amount not to exceed $57 million by the Public Facilities Financing Authority of the City of San Diego ("Authority") and related financing documents to finance upgrades to the Water System including reimbursement for eligible CIP expenses for past projects and costs of issuance. The related financing documents would include an indenture between the Authority and Wells Fargo Bank, National Association ("Trustee"), a supplement to the Master Installment Purchase Agreement between the City and the San Diego Facilities and Equipment Leasing Corporation ("Corporation"), a Note Purchase Agreement between Morgan Stanley & Co. Incorporated (the "Purchaser") and the Authority, and an Assignment Agreement between the Corporation and the Authority.

Authorize the City Attorney to appoint Hawkins Delafield & Wood LLP and Robinson & Pearman LLP as Co-Bond Counsel for the City in connection with the issuance of the Series 2007A Subordinated Notes, and pay in amounts not to exceed $75,000 and $50,000 respectively, plus expenses in each case not to exceed $5,000.

STAFF RECOMMENDATIONS: Approve the requested actions.

SUMMARY:

I. BACKGROUND

As described in the companion Water Department Water Systems Improvement Report, the City Council adopted the Strategic Plan for Water Supply (Strategic Plan) in August 1998 and approved financing for the first phase of the improvements described in the plan.

On April 30, 2002, the City Council adopted a series of water rate increases for FY 2003 through 2007 to increase water system revenues by 6% per year for five successive years, and authorized the issuance of Water Revenue Bonds, Series 2002 to finance the second phase of the improvements. Funds from the 2002 issuance were drawn down completely as of March 2006. The Department had anticipated returning to the bond market by 2005 but was unable to do so because of the City's financial situation.

II. DISCUSSION

This financing is intended to fund the Water Department's capital improvement needs until early FY 2008, as detailed in the companion Water System Improvements Report. All projects being funded with 2007A Note proceeds are included in the Strategic Plan. Financing for these projects is not dependent on water rate increases in FY 2008 and FY 2009, as debt service for this financing in those years will be covered under the existing rate structure. Under the proposed rate case and CIP Plan, the Water Department is expected to require another bond issuance in early FY 2008.

The Debt Management Department and the financial advisor for the transaction identified the short term direct purchase financing option as the best method to secure sufficient funding for the State Department of Health Services mandated and other time critical CIP projects scheduled for early 2007.

In May of 2006, the Debt Management Department issued a Request for Proposals to solicit proposals from financial institutions to execute a direct purchase, private placement or a public offering. Twenty-one responses were received on June 7, 2006. A short list of four prospective purchasers was selected to compete for the transaction. Each of the four short-listed purchasers conducted a comprehensive credit process and participated in due diligence meetings with the City, including Water Department, Debt Management Department, City Attorney's Office, co-bond counsels, and the financial advisor. The due diligence process included a review of materials, approved by the DPWG, pertaining to the City and Water Utility.

Competitive bids for the direct purchase were submitted by the short-listed firms on December 1, 2006. The winning bidder, Morgan Stanley, was selected for submitting the lowest bid which conformed to the City's terms of the purchase. See bid summary sheet - Attachment 1. The bid will remain valid until February 1, 2007.

Transaction Time Line

December 14, 2006	DPWG Meeting for disclosure assessment and certification
January 16, 2007	City Council approval of the financing documents
Week of January 16, 2007	FELC and PFFA meetings to approve legal documents Note Purchase Agreement ("NPA") signing
Week of January 22, 2007	Note closing and receipt of Note proceeds

Financing Team

Montague DeRose and Associates, LLC was selected to provide financial advisory services in support of water financing from an as-needed list of financial advisory firms generated by a request for proposal process. Montague DeRose's fee for this issuance will not exceed $77,500. The City Attorney's Office has identified Hawkins Delafield & Wood LLP and Robinson & Pearman LLP to serve as co-bond counsels through a competitive selection process. Hawkins Delafield & Wood has proposed to provide such service for a fee in an amount not to exceed ~~$65,000~~ $75,000. Robinson & Pearman LLP has proposed to provide such service for a fee in an amount not to exceed $50,000. Expenses in each case are not to exceed $5,000. The fees of both bond counsels are contingent upon the successful closing of the Note issue.

Financing Documents

The documents being submitted for approval will enable the Authority to issue the Notes in the aggregate principal amount of not to exceed $57 million. The City Resolution approves the form, execution and delivery of the financing documents and certain other actions, within the Mayor's purview and limitations, which might be necessary and in the best interests of the City. A brief description of the major financing documents follows:

The **2007A Supplement** to the Master Installment Purchase Agreement between the City of San Diego and the San Diego Facilities and Equipment Leasing Corporation provides for installment payments by the City to pay the debt service on the Notes. This is a supplement to the 1998 Master Installment Purchase Agreement, dated as of August 1, 1998, as amended by a First Amendatory Supplement, dated as of September 19, 2002, and supplemented by a 1998 Supplement to Master Installment Purchase Agreement, dated as of August 1, 1998, and a 2002 Supplement to Master Installment Purchase Agreement, dated as of October 1, 2002, each by and between the City and the Corporation. In addition, the **Master Installment Purchase Agreement** is being amended by the **Second Amendatory Supplement**, dated as of January 1, 2007, by and between the City and the Corporation in accordance with its terms to clarify certain of its provisions.

The **Indenture** between the Authority and the Trustee provides for the issuance of the Notes and sets forth its terms, including the specific rights, responsibilities, and obligations of each party with respect to the issuance of the Notes.

The **Note Purchase Agreement** between the City, Authority and Purchaser defines the terms of the Note. Specifically, the Purchaser will affirm the following:

- the Purchaser has acknowledged that it has sufficient experience to evaluate the risks associated with the Series 2007 Subordinated Notes

- the City has supplied sufficient information to enable the Purchaser to make an informed investment decision regarding the Notes

- the Purchaser has undertaken its own analysis regarding the security of the Notes

- the City has not filed audited financial statements for FY 2003 through 2006
- the Purchaser has received draft unaudited financial statements of the City and Water Utility fund
- the Purchaser will not resell the Notes (but may transfer them to a parent, affiliate or subsidiary)

The **Assignment Agreement** between the Authority and the Corporation assigns to the Authority the Corporation's right to receive installment payments made by the City.

Legal Structure

In order to meet the legal requirements for issuing this debt obligation, two agencies have been involved:

PFFA: The San Diego Public Facilities Financing Authority was established pursuant to a Joint Exercise of Powers Agreement, dated May 14, 1991, between the City and the Redevelopment Agency of the City. The Authority is a financing vehicle for City issuance of obligations to finance certain of its facilities and projects. The Authority was also the issuance vehicle for the 2002 Water Revenue Bonds and the 1998 Water Certificates.

FELC: The San Diego Facilities and Equipment Leasing Corporation was established on February 3, 1986 to acquire and lease to the City real and personal property to be used in the municipal operations of the City. The City is the sole member of the Corporation. The FELC was also the issuance vehicle for the 2002 Water Revenue Bonds and the 1998 Certificates.

III. FISCAL IMPACT

The interest rate on the Notes will be a 45 basis point spread above the two-year natural, AAA-rated Municipal Market Data (MMD) index and will be set upon the signing of the Note Purchase Agreement, January 18, 2007, after the Council approval of the document. The MMD is an industry standard bond index associated with long term municipal debt. For reference, the indicative interest rate would be 3.90% on the proposed note based on the MMD index of 3.45% on December 1, 2006.

The Note issue of $57 million is estimated to result in semi-annual interest payments of approximately $1.1 million over the two-year Note term, with the principal to be repaid by the end of the term. Depending on the final interest rate established in January 2007, the Water Department could pay an estimated total of $4.4 million in interest payments over the full term of the Note. Interest is payable semi-annually, on February 1 and August 1 of each year until the Note is paid off. Staff expects to repay the principal by issuing long-term bonds in FY 2008 that is anticipated to include additional borrowing for CIP needs in FY 2008 and 2009.

Sources and Uses of Funds

Proceeds of the borrowing will be used as follows:

Par Amount of Subordinated Water Revenue Notes Series 2007A	$57.0 million

Estimated Uses of Funds

Reimbursement of advance funding	$23.3 million
New money for capital projects	$33.4 million
COI*	$ 0.3 million
Total	$57.0 million

*Costs of Issuance include fees of co-bond counsel, purchaser's counsel, financial advisor, trustee, and other related expenses.

Proposed Financing Structure

The Notes will be secured with installment payments made by the City exclusively from net system revenues of the Water Utility Fund. The City will have the right to prepay the Notes without premium or penalty, in whole or in part, at any time after the six-month anniversary of the closing of the notes.

It is anticipated that the transaction will close the week of January 22, 2007.

The Notes are not rated by a credit rating agency. The Note Purchase Agreement stipulates that the Note may only be transferred to the parent, subsidiary or affiliate of the purchaser, and will not be syndicated or resold. The intent of this restriction is to limit the sale of the Notes to only sophisticated investors whose intent is to own and hold the Notes through maturity because no disclosure document is being prepared in connection with the sale and issuance of the Notes.

Payment of the principal of the Notes is structured to be paid with proceeds from an anticipated long term bond issuance in FY 2008. The total amount of this future financing is projected to be approximately $300 million to fund additional CIP projects in FY2008 and 2009. The FY 2008 financing is contingent upon approval of planned water rate increases. In the event that the City is unable to issue debt to repay the principal on the Notes prior to the expiration of their payment term, staff will take necessary actions to seek Council authorization to restructure or convert the Note to a long term bond.

Other Outstanding Long Term Debt of the Water Department

As of December 1, 2006, the Water Department's outstanding debt obligations include $263 million in parity obligations from the 1998 Certificates of Undivided Interest, $282 million in subordinate obligations from the 2002 Water Revenue Bonds, and $21 million on a State Revolving Fund loan. Debt service payments are made from the net system revenues of the Water Department.

IV. ALTERNATIVES

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

V. COMMUNITY PARTICIPATION AND OUTREACH EFFORTS

There were no community participation or outreach efforts.

VI. KEY STAKEHOLDERS & PROJECTED IMPACTS

Business entities involved in this transaction are: Morgan Stanley & Co. Incorporated (note purchaser); Hawkins Delafield & Wood LLP and Robinson & Pearman LLP (co-bond counsel); Wells Fargo Bank, National Association (Note trustee); and Montague DeRose and Associates (financial advisor).

Respectfully submitted,

Lakshmi Kommi
Director of Debt Management

Jay M. Goldstone
Chief Financial Officer

Attachments: 1. Bid Summary Sheet

Attachment 1

City of San Diego
Non-Transferable Subordinated Water Revenue Notes, Series 2007A
Summary of Bids

1. The City distributed the Term Sheet and Bid Response Sheet to 4 firms
   a. Bank of America
   b. Citigroup
   c. Lehman Brothers
   d. Morgan Stanley

2. All 4 firms submitted bids based on the two-year natural MMD index ; several of those firms submitted multiple bids (using different assumptions)
   a. One firm submitted bids that conformed to the Term Sheet
   b. One firm submitted one bid that conformed to the Term Sheet and one bid that did not conform to the Term Sheet ((i.e. included conditions contrary to those in the Term Sheet)
   c. Two firms submitted bids that did not conform to the Term Sheet
3. Summary of the bids is as follows:

   a. Conforming Bids

Firm Name	Spread to MMD	Estimated Yield*
Morgan Stanley	+ 45 basis points	3.90%
Lehman Brothers	+ 190 basis points	5.35%

   b. Non-Conforming Bids

Firm Name	Spread to MMD	Estimated Yield*	Key Bid Condition(s)
Bank of America	+ 145 basis points	4.9208%	Required transferability to QIBS, after 6-month lock-out
Bank of America	+ 95 basis points	4.4207%	Required transferability to QIBS, after 6-month lock-out, plus no call feature
Citigroup	+ 34 basis points	3.79%	Required transferability to QIBS
Citigroup	n/a - firm bid	3.90%	Required transferability to QIBS
Lehman Brothers	+ 50 basis points	3.95%	Required transferability to special purpose entity

** Estimated for bid purposes only; actual rate will be set based on the spread to MMD as of the date the Note Purchase Agreement is signed*