



THE CITY OF SAN DIEGO  
**REPORT TO THE CITY COUNCIL**

DATE ISSUED: February 13, 2008 REPORT NO. 08-013  
ATTENTION: Council President and City Council  
Docket of February 19, 2008  
SUBJECT: Fiscal Year 2008 Water System Financing  
REFERENCE: Companion Report - Water System Improvements Report

**REQUESTED ACTIONS:**

1. Authorize the issuance of the short-term Water Revenue Notes, Series 2008A (the "2008A Notes"), payable solely from subordinated installment payments secured by net system revenues of the Water Utility Fund, in the principal amount not to exceed \$150 million by the Public Facilities Financing Authority of the City of San Diego (the "Authority") and the execution of related financing documents, to finance 80% of the approved Capital Improvement Program (CIP) encumbrances and expenditures of the Water System, projected through December 2008, and costs of issuance associated with said financing transaction. The related financing documents include:
  - a. An Indenture by and between the Authority and Wells Fargo Bank, National Association (the "Trustee");
  - b. A Supplement to the Master Installment Purchase Agreement between the City and the San Diego Facilities and Equipment Leasing Corporation (the "Corporation");
  - c. An Assignment Agreement between the Corporation and the Authority; and,
  - d. A Note Purchase Agreement (the "NPA") between J.P. Morgan Securities Inc. (the "Purchaser"), the City and the Authority.
2. Authorize the City Attorney to appoint Fulbright & Jaworski L.L.P. as Bond Counsel for the City in connection with the issuance of 2008A Notes, and pay an amount not to exceed \$90,000 , plus reasonable out-of-pocket expenses not to exceed \$3,500, provided however the fees payable to Bond Counsel shall be contingent upon the closing of the 2008A Notes transaction and paid out of the proceeds from the 2008A Notes.
3. Authorize the City Attorney to appoint Hawkins Delafield & Wood LLP as Disclosure Counsel for the City in connection with the issuance of the 2008A Notes and pay in amounts not to exceed \$25,000, plus reasonable out-of-pocket expenses not to exceed \$3,500, provided however the fees payable to Bond Counsel shall be contingent upon the closing of the 2008A Notes transaction and paid out of the proceeds from the 2008A Notes.

**STAFF RECOMMENDATIONS:** Approve the requested actions.

**SUMMARY:**

**I. BACKGROUND**

**A. Previous Water System Financing Transactions**

In 1994, the City entered into a compliance agreement with the State of California Department of Health Services (“DHS”). This agreement required the City to correct operational deficiencies and begin critical capital improvements to its aging infrastructure and established the timeline for implementing such improvements. The City was notified in 1997 that it was not in compliance with the agreement and a DHS Compliance Order was issued in January 1997. Failure to adhere to the Compliance Order could result in penalties for violating a primary drinking water standard under Health and Safety Code, Section 116725.

As a result, the City Council approved, in that same year, the Water Strategic Plan which included an eight-year plan of capital improvements. In August 1998, the City Council approved financing for the first phase of the improvements described in the plan a series of three 6% annual increases in the water rates to support the issuance of \$385 million Certificates of Undivided Interest, Series 1998 (the “1998 Certificates”), which funded the City Council approved Capital Improvement Program (the “CIP”).

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 \$287 million Subordinated Water Revenue Bonds, Series 2002 (the “2002 Bonds”) to finance the second phase of the improvements. Subsequently, the City had anticipated returning to the bond market by 2005 but was unable to do so because of the City’s financial reporting challenges.

In order to fund ongoing DHS related CIP projects through mid FY 2008, on January 16, 2007, the City Council authorized the issuance of the 2-year \$57 million Non-Transferable Subordinated Water Revenue Notes, Series 2007A (“2007A Notes”). Interest payments for the notes were supported by the then existing rate structure. The 2007A Notes will mature in January, 2009 and are expected to be paid from the proceeds of a long term public offering in late, 2008. The proceeds of the 2007A Notes are projected to be expended by March, 2008.

Additionally, following the execution of the agreement in FY 2004, in July 2005 (FY 2006), the Water Department received \$21.5 million in a State Revolving Fund Loan (the “SRF Loan”). As of January 1, 2008, the remaining balance is \$19.4M. The annual principal and interest payments on the 20-year loan are \$1.37M, equivalent to an effective annual interest rate of approximately 2.5%.

**B. Summary of Water System Outstanding Debt Obligations**

As of January 1, 2008, the Water System’s outstanding debt obligations and remaining debt service payments include:

- 1998 Certificates - \$254 million in principal and \$189 million in interest payments.

- 2002 Bonds - \$278 million in principal and \$171 million in interest payments.
- 2007A Notes - \$57 million in principal and \$3.5 million in interest payments.
- SRF Loan - \$19.4 million in principal and \$4.7 million in interest payments.

*Attachment 1* provides a summary of the Water System's outstanding debt obligations. Debt service payments on all outstanding debt obligations are made from the net system revenues of the Water System.

### **C. Revenue Sources for Additional Water System Financing**

The Water Department plans to expend approximately \$450 million on CIP projects from FY 2008 through FY 2010. The CIP expenditures during this period will be used to continue projects that have been delayed, such as upgrading and expanding the Alvarado, Miramar, and Otay Water Treatment Plants, the replacement of the Otay 2<sup>nd</sup> Transmission Pipeline, and the replacement of approximately 75 miles of cast iron water mains. (Also see the Companion Report).

On February 26, 2007, the City Council approved a series of four 6.5% annual water rate increases for FY 2008 through FY 2011. Additional increases, averaging 3-3.5%, in pass-through charges from the County Water Authority were approved by City Council on October 8, 2007 and became effective on January 1, 2008. These increases provide sufficient revenue sources to support additional financing transactions to fund the Water System CIP for the next several years. The proposed 2008A Notes is the first of such transactions which will be discussed and presented below.

## **II. DISCUSSION**

### **A. Water System Plan of Finance – Fiscal Year 2008 Financing**

Assessing the near term CIP needs of the Water Department, staff from the Debt Management and the Water Departments, has developed a plan of finance to secure additional financing to sustain the CIP for FY 2008 and FY 2009. The plan includes 1) a short-term privately placed note issuance in FY 2008 (the 2008A Notes, and 2) a long-term bond issuance in the public markets to meet continuing capital improvement needs beyond those funded with proceeds from the proposed 2008A Notes and to refund the privately placed 2007A and 2008A Notes.

The proposed 2008A Notes, in the amount of \$150 million, are critical to meet the timeline in the Compliance Order and also to meet mandates imposed under the Federal Safe Drinking Water Act. As stated previously, the proceeds of the 2007A Notes will be expended or encumbered in early 2008. Because the City does not yet have the requisite financial information critical to permit entry to the public bond market, the Debt Management Department and the financial advisor for the transaction have identified a short term direct purchase financing option as the best method to secure sufficient funding for the State Department of Health Services mandates and other time critical CIP projects. The long-term public offering (the "2008B Bonds") proposal which is expected to meet continuing capital improvement needs beyond December, 2008, is currently scheduled to be brought to the City Council sometime in late 2008.

The anticipated future issuance of the 2008B Bonds requires a significant undertaking in the preparation of the Preliminary Official Statement (the “POS”). The specific terms and conditions of the 2008B Bonds will be later developed and delineated in a Bond Purchase Agreement (the “BPA”). The POS, BPA, Feasibility Study and other financing documents will be reviewed and approved by DPWG and presented to City Council for approval when completed. The approval of the bond financing documents will require an introduction of an ordinance and a second reading. It is anticipated that this process will occur in September/October 2008.

Pursuant to Council Policy 900-09, J.P. Morgan Securities Inc. has submitted Community Reinvestment Activities (“CRA”) of its community banking operations in the San Diego region. Specific information related to CRA is provided to the City Council under separate cover.

**B. 2008A Notes Water System Financing Key Milestones**

January 30, 2008	DPWG review and approval of the 2008A Notes financing documents
February 19, 2008	City Council approval of the 2008A Notes financing documents
Week of Feb 25, 2008	Corporation meeting to approve the 2008A Notes financing documents
Week of Feb 25, 2008	Authority meeting to approve the 2008A Notes financing documents
February 25-27, 2008	Pricing of the 2008A Notes
February 28, 2008	Closing of the 2008A Notes and receipt of proceeds

**C. Summary of Key Terms and Conditions of 2008A Notes**

Legal Structure

Issuer	The Public Facilities Financing Authority (the “Authority”)
Purchaser	J.P. Morgan Securities Inc.
Transferability	2008A Notes may only be held by the Purchaser or transferred to a parent, subsidiary, or affiliate of the Purchaser or held in a tender option bond trust of which the Purchaser is the sponsor and the trustor provided that the shares of the said trust are held by twelve or fewer Qualified Institutional Buyers
Lien Structure	Subordinated, same as that of the 2002 Bonds and the 2007A Notes

Financing and Pricing Structure

Market	Private
Principal	\$150 million (to fund projected Water System financing needs from 3/08 to 12/08 – 80% of \$188 million projected total CIP)
Maturity	18 months from the date of closing(anticipated in August, 2009)
Interest Rate	Fixed Rate for the term of the 2008A Notes. Rates will be fixed on the pricing date at 98 basis points (0.98%) above the two-year, natural AAA Municipal Market Data (“MMD”) index
Call Provision	A call provision will allow the City to refund 2008A Notes, without premium or penalty, in whole or in part at any time after 12 months following the closing of the 2008A Notes

The 2008A Notes will be secured with subordinate installment payments made by the City exclusively from net system revenues of the Water Utility Fund.

The Water System financing documents establish legally binding senior lien and subordinate lien debt coverage ratios. The current legal requirements are 120% coverage ratio for the senior lien obligations (the 1998 Certificates) and 100% coverage ratio for subordinate obligations (2002 Bonds and 2007A Notes). Further, City Council approved a Debt Policy on November 6, 2007, which requires that a debt coverage ratio of at least 110% be maintained when issuing additional debt obligations supported by Enterprise System revenues.

Debt coverage ratios are calculated by dividing annual debt service payments into net enterprise system revenues. Net system revenues are calculated by subtracting operating expenses from the sum of total operating revenues and other income. For example, Net System Revenues of \$30M divided by annual debt service payments of \$30M would provide a debt coverage ratio of 100%. *Attachment 2* shows the projected debt coverage ratios of the Water System. The projections include estimated debt service requirements of the planned 2008A Notes, 2008B Bonds and other future transactions that can be supported by the approved rate structure. The projected senior lien debt coverage ratios range from 250% to 414% from FY 2007 through FY 2012, while the subordinate lien debt coverage ratios range from 160% to 205%. These projected ratios exceed both the legally required and the debt policy recommended ratios.

The Note Purchase Agreement stipulates that the 2008A Notes 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 2008A Notes to maturity. No disclosure document is being prepared in connection with the sale and issuance of the 2008A Notes.

The interest rate will be fixed at 98 basis points above the 2-year natural AAA Municipal Market Data (“MMD”) index when the Note Purchase Agreement is executed. Based on the January 28, 2008 rate, the indicative interest rate on the Notes is estimated to be 3.30%, which results in \$7.43 million in total interest payments over the 18 month term. Semi-annual interest only payments will be made on August 1 and February 1 of each year until the 2008A Notes mature. For comparison purposes, a California Water Utility with an A rating recently issued a 2-year note in the public markets with an interest rate of 2.88%.

Principal payment of the 2008A Notes in the amount of \$150M will be made with proceeds from the Water Revenue Bonds, Series 2008B which are anticipated to be issued in late 2008.

#### **D. Financing Team**

The City’s Financing Team for the 2008A Notes consists of staff of the Department of Finance, including the Chief Financial Officer, the Debt Management Department, the Comptroller’s Office, the Water Department, the City Attorney’s Office, and consultants, including Montague DeRose and Associates LLC as financial advisor, Fulbright & Jaworski L.L.P. as Bond Counsel, Hawkins Delafield & Wood LLP as Disclosure Counsel, Nixon Peabody LLP as Purchaser’s Counsel, and Wells Fargo Bank as Trustee.

J.P. Morgan Securities Inc. is the proposed purchaser of the 2008A Notes. J.P. Morgan replaces another lender previously identified to provide the funding for the 2008A Notes. Morgan Stanley, the purchaser of the \$57M Non-Transferable Subordinated Water Revenue Notes, Series 2007A issued on January 16, 2007, was initially expected to be the purchaser of the proposed Notes. However, during the initial stages of the financing process, the City and Morgan Stanley were unable to come to an agreement on the financing terms that were preferred by the City, including interest rates and repayment terms. As a result, in December 2007, the City requested the top three proposers who responded to the City's Request for Proposal on the proposed deferred maintenance financing (Short-Term General Fund Backed Lease Revenue Note Obligation), and also conformed to the City's terms of the purchase which were similar to the proposed 2008A Notes, to bid on the Water System 2008A Notes. Through this process, J.P. Morgan was selected to purchase the 2008A Notes. A due diligence meeting was conducted for J.P. Morgan on January 10, 2008, with City representatives, including staff from the Water Department, the Debt Management Department, and the City Attorney's Office, the bond counsel, the financial advisor, and the City's disclosure counsel.

Montague DeRose and Associates, LLC (Montague) was identified to provide financial advisory services for the 2008A Notes from an as-needed list of financial advisory firms generated through an RFP process. Montague entered into a three-year contract with the City starting on July 24, 2006. Montague's fee for the issuance of the 2008A Notes is a not to exceed \$50,000 and \$3,500 in out of pocket expenses. The City Attorney's Office has identified Fulbright & Jaworski L.L.P. to serve as bond counsel through an RFP process conducted in September, 2007. Fulbright & Jaworski L.L.P. will be paid a fee in an amount not to exceed \$90,000 with out of pocket expenses not to exceed \$3,500. Hawkins Delafield and Wood LLP, acting as Disclosure Counsel, will be paid a fee not to exceed \$25,000 with out of pocket expenses not to exceed \$3,500. The bond counsel fee is contingent upon the successful closing of the 2008A Notes.

#### **E. Legal Structure**

In order to meet the legal requirements for issuing 2008A Notes by the Authority, two other City entities, upon the City Council authorization, will be required to conduct the transaction.

The San Diego Facilities and Equipment Leasing Corporation (the "Corporation"), established on February 3, 1986 to acquire and lease to the City real and personal properties to be used in the municipal operations of the City, was the issuing entity for the 1998 Certificates. The City is the sole member of the Corporation. The 1998 Master Installment Purchase Agreement between the City and the Corporation provided for installment payments by the City to the Corporation to pay the debt service on the 1998 Certificates.

The San Diego Public Facilities Financing Authority (the "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 was established to serve as a financing vehicle for certain of the City's facilities and projects. The Authority served as the issuing entity for the 2002 Bonds and the 2007A Notes. Assignment agreements were established between the Authority and Corporation which enabled the Authority to receive the installment payments by the City and to pay debt services on the 2002 Bonds and 2007A Notes.

Another Assignment Agreement by and between the Authority and the Corporation will assign to the Authority the Corporation's right to receive installment payments made by the City, facilitating the Authority to again serve as the financing vehicle for the proposed 2008A Notes.

## **F. Financing Documents**

The documents submitted for approval will enable the Authority to issue the 2008A Notes in the aggregate principal amount not to exceed \$150 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:

- 1) The **2008A Indenture** between the Authority and the Trustee ("Wells Fargo") provides for the issuance of the 2008A Notes and sets forth terms, including the specific rights, responsibilities, and obligations of each party with respect to the issuance of the 2008A Notes.
- 2) The **2008A 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 2008A 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, a 2002 Supplement to Master Installment Purchase Agreement, dated as of October 1, 2002, and a 2007A Supplement to the Master Installment Purchase Agreement, dated January 1, 2007, each by and between the City and the Corporation. In addition, the **Master Installment Purchase Agreement** was 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.
- 3) 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. This assignment agreement will be entered into between the Authority and the Corporation and enables the Authority to make debt service payments on the proposed 2008A Notes. Previous assignments agreements established between the Authority and Corporation enabled the Authority to make debt service payments on the 2002 Bonds and 2007A Notes.
- 4) The **Note Purchase Agreement** between the City, the Authority and the Purchaser defines the terms of the 2008A Notes, Purpose of Financing, Form of Security, Transfer Restrictions, Interest Rate, and Maturity.

Additionally, the Note Purchase Agreement affirms the following:

- the Purchaser has acknowledged that it has sufficient experience to evaluate the risks associated with the 2008A Notes
- the City has supplied sufficient information to enable the Purchaser to make an informed investment decision regarding the 2008A Notes

- the Purchaser has undertaken its own analysis regarding the security of the 2008A Notes
- the City has not completed financial audits for FY 2005 – FY 2007
- the Purchaser will not resell the 2008A Notes but may transfer them after 12 months to twelve or fewer Qualified Institutional Buyers (QIBs)

## **G. FISCAL IMPACT**

### **1) Interest Rate**

Pursuant to City Council direction and as established by the City Council approved Debt Policy, the 2008A Notes will be priced on a fixed rate basis; with the interest rate determined at the time of the pricing. The fixed interest rate on the 2008A Notes will be at 98 basis points (0.98%) above the two-year natural, AAA-rated Municipal Market Data (“MMD”) index and will be set upon signing of the Note Purchase Agreement on or about February 25, after the City Council approval of the proposed transaction and financing documents. The MMD is an industry standard bond index associated with long term municipal debt. For reference, the indicative interest rate would be 3.30% on the proposed notes, based on the MMD index of 2.32% on January 28, 2008 plus 98 basis points.

The principal amount will be \$150 million. Semi-annual interest only payments will be made on August 1, 2008, February 1, 2009 and August 1, 2009. The final interest payment due, along with principal, will be paid upon maturity 18 months from the date of execution of the 2008A Notes, anticipated to be at the end of August 2009.

### **2) Sources and Uses of Funds \***

#### **Sources of Funds**

Par Amount of Subordinated Water Revenue Notes, Series 2008A	\$ 150 million
<b>Total Proceeds</b>	<b>\$ 150 million</b>

#### **Uses of Funds**

CIP Expenditures (includes rounding)	\$ 149.75 million
Costs of Issuance	
Purchaser’s Counsel fees	\$ 40,000
Bond Counsel fees	\$ 90,000
Disclosure Counsel	\$ 25,000
Trustee	\$ 3,500
Financial Advisor	\$ 50,000
Out of Pocket Expenses**	\$ 14,000
Contingency (approximately 12%)	<u>\$ 27,500</u>
Subtotal	<u>\$250,000</u>
<b>Total Uses of Funds</b>	<b>\$ 150 million</b>

\* Preliminary and Subject to Change.

\*\* Reasonable out of pocket expenses will not exceed \$3,500 per item for Counsels and Financial Advisor.



## **Capital Improvement Program (CIP) Expenditures**

The Water Department Companion Staff Report details CIP expenditures, totaling \$149.7 million, from the anticipated 2008A Notes proceeds. Of this total, \$111.3M is related to Department of Health Services (“DHS”) requirements. A breakdown is included below:

Pipelines	\$ 55.0M
Reclaimed Water	\$ 2.7M
Pump Stations	\$ 4.6M
Storage	\$ 2.2M
Groundwater	\$ 1.5M
Water Treatment Plants	\$ 65.6M
Security Upgrades	\$ 6.8M
Misc.	\$ <u>11.3M</u>
<b>TOTAL</b>	<b>\$149.7M</b>

A reimbursement resolution authorizing the reimbursement of up to \$10 million is included in the City Resolution. In the event that the 2008A Notes transaction is not completed by the end of February 2008, the reimbursement resolution will allow the Water Department to reimburse any cash funded CIP expenditures incurred between the end of February 2008 and when the 2008A Notes transaction is completed.

## **ALTERNATIVES**

Do not approve the requested actions necessary to issue the 2008A Notes for the upgrade and expansion of the Water System. Without proceeds from the short term financing, the Water Department will not have sufficient funding to continue CIP Projects mandated in the DHS compliance order. Non-compliance could lead to fines or sanctions imposed upon the Water Department.

## **COMMUNITY PARTICIPATION AND OUTREACH EFFORTS**

There were no community participation or outreach efforts.

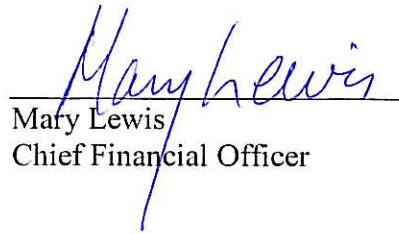
## **KEY STAKEHOLDERS & PROJECTED IMPACTS**

Business entities involved in this transaction are: J.P. Morgan Securities Inc. (purchaser); Hawkins Delafield & Wood LLP (disclosure counsel); Nixon Peabody LLP (purchaser’s counsel); Fulbright & Jaworski L.L.P. (bond counsel); Wells Fargo Bank, National Association (trustee) and Montague DeRose and Associates LLC., (financial advisor).

Respectfully submitted,



Lakshmi Kommi  
Director of Debt Management



Mary Lewis  
Chief Financial Officer

**Attachments:**

1. Water System Summary of Outstanding Obligations
2. Projected Debt Coverage Ratios