THE CITY OF SAN DIEGO

REPORT TO THE CITY COUNCIL

DATE ISSUED: March 26, 2008 REPORT NO: 08-041

ATTENTION: Council President and City Council
Agenda of April 1, 2008

SUBJECT: General Fund Deferred Maintenance Capital Improvement Projects Financing

REFERENCE: Companion Report – Deferred Maintenance Projects

REQUESTED ACTIONS:

1. Authorize the issuance by the Public Facilities Financing Authority of the City of San Diego (the "Authority") of its Lease Revenue Bonds, Series 2008A (Various Capital Improvement Projects) ("2008A Bonds") in the principal amount not to exceed $108 million and the execution of related financing documents, to finance various General Fund deferred maintenance capital improvement projects and costs of issuance. The related financing documents include:
   a. A Site Lease between The City of San Diego ("the City") and the Authority;
   b. A Lease Agreement between the City and the Authority;
   c. An Assignment Agreement between the Authority and Wells Fargo Bank, National Association (the "Trustee");
   d. A Purchase Agreement between Bank of America, N.A. (the "Purchaser") and the Authority; and
   e. An Indenture between the Authority and Trustee

2. Declare the City's intent to use proceeds of indebtedness to reimburse itself if funds are advanced by the City for eligible capital improvement expenditures related to the General Fund Deferred Maintenance funding program.

3. Authorize the form of the Financial Advisory Services Agreement between the City and Montague DeRose and Associates, LLC to provide financial advisory services for the proposed 2008A Bonds for an amount not to exceed $37,500, plus reasonable out-of-pocket expenses not to exceed $5,000, contingent upon the closing of the transaction.

4. Authorize the City Attorney to appoint Hawkins Delafield and Wood LLP as Bond Counsel for the City in connection with the issuance of the 2008A Bonds, and pay an amount not to exceed $70,000, plus reasonable out-of-pocket expenses not to exceed $5,000, contingent upon the closing of the transaction.

STAFF RECOMMENDATION:

Approve the requested actions.

SUMMARY:

I. Background

The City's Five-Year Financial Outlook ("5-Year Outlook") released in November 2006 and revised in January 2008 lays out the City's General Fund deferred maintenance needs. The 5-Year Outlook identifies the total funding allocated to deferred maintenance capital improvement projects and the proposed breakdown between funding with cash on-hand and funding with proceeds of the 2008A Bonds (see table below). The financing plan for the 2008A Bonds addresses the financing needs identified for the General Fund deferred maintenance capital improvement projects for Fiscal Years 2008 ($24.75 million) and 2009 ($77.5 million) totaling $102,250,000.

	FY 2008 Budget	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
		Five-Year Financial Outlook				
Buildings and Facilities	**$5,300,000**	**$31,800,000**	**$50,000,000**	**$50,000,000**	**$50,000,000**	**$50,000,000**
Cash	$5,300,000	$6,800,000	$25,000,000	$25,000,000	$25,000,000	$25,000,000
Financed	$0	$25,000,000	$25,000,000	$25,000,000	$25,000,000	$25,000,000
Streets and Storm Drains	**$33,000,000**	**$70,000,000**	**$90,000,000**	**$90,000,000**	**$90,000,000**	**$90,000,000**
Cash	$8,250,000	$17,500,000	$22,500,000	$22,500,000	$22,500,000	$22,500,000
Financed	$24,750,000	$52,500,000	$67,500,000	$67,500,000	$67,500,000	$67,500,000
Total Financed Amt	**$24,750,000**	**$77,500,000**	**$92,500,000**	**$92,500,000**	**$92,500,000**	**$92,500,000**

Source: Five-Year Financial Outlook, January 2008

In Fiscal Year 2008, $24.75 million is programmed to fund street-related and storm drain deferred maintenance projects. Of this amount, $18.5 million was estimated to be used for various street resurfacing projects, $4.2 million for storm drain repairs, and $2.05 million for sidewalk repairs.

In Fiscal Year 2009, $52.5 million is proposed to fund street-related and storm drain deferred maintenance projects and $25.0 million under buildings and facilities category. Of the $52.5 million in Fiscal Year 2009, $35 million is estimated to be used for various street resurfacing projects, $10 million for storm drain repairs, and $7.5 million for sidewalk repairs. The $25.0 million in Fiscal Year 2009 deferred maintenance projects relating to buildings and facilities are anticipated to be allocated towards roof replacement projects, public safety facilities, parking lot resurfacing, heating and cooling system repairs and replacements, elevator modernization projects, windows and door replacements, and various electrical and plumbing upgrades to various General Fund supported City Facilities.

For a detail list of projects, refer to the Companion Report – Deferred Maintenance Projects.

II. Discussion

A. Financing Plan & Structure

The 2008A Bonds are an interim financing measure to address the funding needs identified for the General Fund deferred maintenance capital improvement projects in Fiscal Years 2008 and 2009.

The proposed interim borrowing was initially planned as a 2-year short term note obligation with a 2-year lease financing structure. Based on further legal analysis by the Bond Counsel, City Attorney, and the Purchaser's Counsel, the 2-year lease option was converted to a 10-year lease in order to conform to the outstanding legal precedent in structuring lease revenue obligations. It was determined that a 10-year term will provide adequate support and establishes necessary legal parameters to make the lease payments.

The financing plan contemplates refunding the proposed private borrowing in two years (2010) with a 30-year traditional public offering. Therefore, instead of fixing an interest rate for the full 10-year borrowing term which would be higher than for a borrowing term for 2-years, working with the Purchaser, a two-tier pricing (described below) was structured: a lower fixed interest rate (based on a 2-year Index plus fixed spread) for the first two year period and if the City is unable to refund the 2008A Bonds by 2010, a higher interest rate (based on an 8-year Index plus fixed spread) for years 3-10. Based on current interest rate levels as of March 12, 2008, the interest rate for the 2-year term is 3.46% and the interest rate for the 3-10 year term will be 4.45%, a 99 basis point (0.99%) differential in interest rate between the two year lease period and the 3-10 year lease period. Note that under the financing structure, if the City is not able to refund the notes by the two year point, based on the market conditions at that time, and the levels of the 8-year Index, the interest rate fixed for 3-10 year period (at the beginning of year 3) until the City can refund the Bonds could be a maximum of 12% (the maximum permitted legal rate).

Key Aspects of the financing plan and structure

- **Method of Sale**: The proposed 2008A Bonds will be privately placed with Bank of America, N.A ("BofA").
- **Principal**: Not to exceed $108 million.
- **Maturity**: Estimated 10-years from the date of closing, June 2018.
- **Pricing/Interest Rate**:
  - Fixed rate; two-tier pricing.
  - Tier 1: Years 1 and 2 interest only payments. The spread is 1.875% over the 2-year Index[1]; the interest rate will be fixed at pricing which is currently projected to occur during the last week of May 2008.
  - The City covenants to use its reasonable best efforts to refund the Series 2008A Bonds at the end of year 2. If the bonds remain outstanding beyond year 2, the interest rate will be reset as specified under Tier 2 of the pricing structure.

[1] Index is the Cost of Funds Rate (COFR), which is 62.347% of Bank of America's cost of funding rate. As of March 12, 2008, the 2-year Index was 1.58% (62.347% of 2.54%) and the 8-year Index was 2.20% (62.347% of 3.52%).

- Tier 2: Fixed rate for years 3 - 10 with principal amortized on a level basis annually. The spread is fixed at 2.25% over the 8-year Index; interest rate fixed at the beginning of year 3.

- **Transferability**: 2008A Bonds 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. (At the time the 2008A Bonds are closed, the Purchaser intends to treat this borrowing as a balance sheet lending and maintain such borrowing on its balance sheet until the 2008A Bonds are called).
- **Call Provision**: A call provision will allow the City to refund the 2008A Bonds, in whole or in part at any time after two years following the closing of the 2008A Bonds at no premium.
- **Repayment Source**: General Fund revenues to pay interest and principal payments.

For comparison purposes, as of the week of March 10, 2008, "BBB" rated lease revenue bonds in the public market would be priced at 3.08% for a 2-year term and at 4.67% for a 10-year term. The interest rate premium for the proposed 2-year term reflects, among other things, the illiquid nature of the bonds (the fact that the 2008A Bonds will be issued in the private market with resale restrictions), the absence of ratings and that the City does not have current financial statements. The financial advisor has reviewed the proposed pricing and concurs that the interest rate spreads for the initial two and eight-year financing periods are reasonable with the cost of funds of capital to the Purchaser for a 10-year financing term.

B. Legal Structure

Issuing Authority

The issuer of the 2008A Bonds is the Public Facilities Financing Authority of the City of San Diego. 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.

Lease Structure

Lease revenue bonds are based on a lease arrangement between two entities: a governmental entity and typically, a non-profit agency, financing authority, or joint powers authority which issues the bonds, which is also called a lease, lease-back transaction. In the case of the 2008A Bonds, the lease arrangement is between the City and the Authority. The proposed bonds are based on an abatement structure, whereby the City makes lease/rental payments for the duration it has use and occupancy of the facilities leased by the Authority. The City's duty to make lease payments abates if all or a portion of such facilities cannot be used; this applies even if the reason the facilities cannot be used is beyond the control of the City.

The capital improvement projects (for example, street resurfacing, existing facility repairs) being financed by the 2008A Bonds, are not leasable assets under the financing. Therefore, an asset-transfer is necessary in place of pledging the properties being improved with the proceeds of the proposed bonds. Under the proposed structure, the pledged assets are existing City-owned General Fund properties. The City initially leases these properties to the

Authority for a nominal rent of $1. The Authority in turn leases the assets back to the City. The City would make rental payments to the Authority annually for leasing the properties, which is determined to be the fair market rental value of the properties. The Authority receives the rental payments from the City and makes principal and interest payments over the lease term on the proposed 2008A Bonds. The City has used this asset-transfer structure, pledging City properties, for various General Fund outstanding lease financings, including the Certificates of Participation related to the Balboa Park Mission and Bay Park Capital Improvements Program, Series 1996A, Series 1996B, and Series 2003, the Jack Murphy (Qualcomm) Stadium Lease Revenue Bonds, Series 1998, and the Fire and Life Safety Facilities Lease Revenue Bonds, Series 2002B. See attachment 1 for a list of City properties pledged for outstanding General Fund financing transactions.

Following are the General Fund assets being pledged for the 2008A financing and their respective current appraisal values:

1.	Police Headquarters	$64,719,000
2.	Rose Canyon Operations Station	21,120,000
3.	Mission Valley Library	10,579,000
4.	Malcolm X Library	7,879,000
5.	Scripps Ranch Library	6,418,000
	TOTAL	**$110,715,000**

The properties were appraised for current market value by an appraisal firm coordinated by the City's Real Estate Assets Department. A preliminary title report has been obtained for each of the properties, establishing that the properties are not already encumbered and are free and clear of liens, subject to standard exceptions.

C. Financing & Legal Documents

1. A Site Lease between the City and the Authority: The Site Lease is the agreement under which the City leases the pledged assets to the Authority.
2. A Lease Agreement between the City and the Authority: The Lease Agreement is the agreement under which the Authority leases back the pledged assets to the City. The Authority receives the rental payments from the City which will be equivalent to the debt service payments on the proposed 2008A Bonds.
3. An Assignment Agreement between the Authority and the Trustee: Under the Assignment Agreement, the Authority assigns to the Trustee, without recourse, all of its rights to receive lease payments under the Lease Agreement.
4. An Indenture between the Authority and the Trustee: The Indenture provides for the issuance of the 2008A Bonds and sets forth terms, including the specific rights, responsibilities, and obligations of each party with respect to the issuance of the 2008A Bonds.
5. A Purchase Agreement between the Purchaser and the Authority: The Purchase Agreement defines the terms of the 2008A Bonds, purpose of the financing, form of security, transfer restrictions, interest rate, and maturity.

D. Financing Time Line

March 13, 2008	DPWG approval of due diligence materials and financing documents
April 1, 2008	Introduction of the Ordinance for the approval of financing documents related to the 2008A Bonds Approval of the Reimbursement Resolution
April 14, 2008	Approval of the Ordinance for the approval of financing documents related to the 2008A Bonds
April 16, 2008	Public Facilities Financing Authority meeting to approve 2008A Bonds
Week of May 26, 2008	Pricing and execution of Purchase Agreement
Week of June 2, 2008	Closing and receipt of funds

E. Financing Team

The City's Financing Team for the 2008A Bonds consists of staff of the Chief Financial Officer, Debt Management, City Attorney's Office, Comptroller's Office, Treasurer's Office, Risk Management, General Services, and Real Estate Assets Department. Outside consultants, include Montague DeRose and Associates, LLC ("Montague DeRose") as the financial advisor, Hawkins Delafield & Wood LLP as the Bond Counsel, White & Case LLP as Purchaser's Counsel, and Wells Fargo Bank, National Association as Trustee.

Bank of America N.A. was selected as the direct purchaser for the 2008A Bonds through a competitive process. A Request for Proposals ("RFP") was issued on November 16, 2007 to 36 firms including underwriting firms, banks, and municipal fund managers. Six (6) conforming proposals were received – Bank of America, JP Morgan, Wachovia Securities, Goldman Sachs, DEPFA First Albany, and UBS Securities. Bank of America offered the most flexible and cost effective option within the terms and conditions established in the RFP.

Montague DeRose was selected to provide financial advisory services for this transaction from the as-needed financial advisors list based on their experience in General Fund lease revenue bond financings, fee estimate, and knowledge of City requirements for private offerings. The fee to Montague DeRose for this issuance, which is contingent upon the successful closing of the 2008A Bonds, is for an amount not to exceed $37,500, plus out of pocket expenses not to exceed $5,000.

The City Attorney's Office has identified Hawkins Delafield and Wood LLP ("Hawkins") to serve as bond counsel. Hawkins has proposed to provide such service for a fee in an amount not to exceed $70,000. Expenses are not to exceed $5,000. The bond counsel fee is contingent upon the successful closing of the 2008A Bond issue.

Wells Fargo Bank was selected as the Trustee for this transaction through a competitive process. Compensation for the Trustee includes $3,550 for the transaction and ongoing annual fees of $1,750.

F. Reimbursement Resolution

It is anticipated that funding for certain capital expenditures related to the General Fund deferred maintenance capital improvement projects ("Project") may need to be advanced by the City prior to the closing of the 2008A Bonds. In order to reimburse capital expenditures with proceeds from the short-term financing, the City must adopt a reimbursement resolution in accordance with section 1.150-2 of Treasury Regulations ("Regulations").

The City reasonably expects that certain of these expenses will be advanced by the City for any eligible Project expenditures in anticipation of receiving proceeds of the 2008A Bond offering. By adopting a reimbursement resolution, City will satisfy the Official Intent Requirement under the Regulations and be able to reimburse Project-related expenditures using proceeds of the 2008A Bonds.

FISCAL CONSIDERATIONS:

A. Estimated Sources and Uses of Bond Proceeds (preliminary and subject to change)

Estimated Sources		
Par amount of 2008A Bonds		$102,552,000
Total Proceeds		**$102,552,000**
Estimated Uses		
Net Proceeds for the project (acquisition fund)		$102,250,000
Costs of Issuance		
Bond Counsel		$ 75,000
Purchaser's Counsel		45,000
Financial Advisor		42,500
Trustee		3,550
Title Insurance Policy		80,000
Property Appraisals		40,000
CDIAC Fees		3,000
Contingency (approx. 5%)		12,950
	Sub Total	$ 302,000
Total Uses of Funds		**$102,552,000**

B. Interest Rate and Projected Debt Service

The interest rate for the first two years will be fixed at 187.5 basis points (1.875%) above the two-year Index[2]. The interest rate will be set after the City Council approval of the proposed transaction and financing documents and is currently projected to occur during the week of May 26, 2008. As of March 12, 2008, the indicative interest rate is 3.46% for the first two years.

[2] Index is the Cost of Funds Rate (COFR), which is 62.347% of Bank of America's cost of funding rate. As of March 12, 2008, the 2-year Index was 1.58% (62.347% of 2.54%) and the 8-year Index was 2.20% (62.347% of 3.52%).

Interest only payments will be made during the first two years. Based on the principal amount of $102.6 million, the annual interest payment is estimated at approximately $3.5 million. Interest only payments will be made on a semi-annual basis on December 1 and June 1.

The City covenants to use its reasonable best efforts to repay (whether by refunding or otherwise) the Series 2008A Bonds at the end of year 2. If the bonds remain outstanding beyond year 2, the interest rate will be reset as specified under Tier-2 of the pricing for the years 3 to 10 at the beginning of year 3. The fixed interest rate will be at 225 basis points (2.25%) above the eight-year Index at that time. As of March 12, 2008, the indicative interest rate is 4.45% for the years 3 – 10. Beginning year 3, the principal will be amortized on a level basis annually. The first principal payment will be due on June 1, 2011, with annual debt service (interest and principal) projected to total approximately $15.5 million beginning FY 2011, through FY 2018.

The maximum effective interest rate established in the authorizing ordinance is 5.45%. The 2008A Bonds will not be priced as anticipated in the last week of May in the event that the effective interest rate exceeds this limit. It is not currently expected that the actual pricing for Tier 1 will result in an effective interest rate of 5.45%, however, should that occur, the annual debt service (interest only payments) at this rate would be approximately $5.6 million in Fiscal Years 2009 and 2010. As discussed earlier, if the 2008A Bonds remain outstanding beyond year 2, the pricing will fixed in year 3; the maximum interest rate on Tier 2 could be up to 12% (the maximum permitted legal rate).

C. Revenue Pledge

The debt service on the 2008A Bonds is supported by the General Fund. The estimated debt service has been incorporated in the 5-year outlook and will be brought forward for the City Council authorization during the FY 2009 budget process. There will not be any operations and maintenance cost increases associated with the deferred maintenance projects.

D. Impact on current debt ratios

In accordance with the City's Debt Policy, an analysis of the impact of additional General Fund backed bond obligation was conducted. The Debt Policy recommends that debt service as a percentage of General Fund revenues be below 10%.

Under the current outstanding bond obligation levels, the debt service as a percentage of General Fund revenues is at 3.93% for Fiscal Year 2008, and is projected to steadily fall to 2.66% by Fiscal Year 2013.

The issuance of the proposed 2008A Bonds would increase the debt service as a percentage of General Fund revenues from 3.93% in Fiscal Year 2008 to 4.03% in Fiscal Year 2009 and 4.38% in Fiscal Year 2011, before steadily decreasing to 3.83% by Fiscal Year 2013. This assumes interest only payments at 3.46% for the 1st two years, and interest and principal payments at an interest rate of 4.45% commencing in Fiscal Year 2011.

Attachment 2 presents the calculations pertaining to the debt service as a percentage of General Fund revenues, including the underlying assumptions. The analysis supports that the City remains below the 10% threshold established in the City's Debt Policy.

PREVIOUS COUNCIL and/or COMMITTEE ACTION: N/A

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS: N/A

KEY STAKEHOLDERS AND PROJECTED IMPACTS:

Business entities involved in this transaction are: Bank of America, N.A. (Purchaser); Hawkins Delafield & Wood LLP (Bond Counsel); White & Case LLP (Purchaser's Counsel); Wells Fargo Bank, National Association (Trustee); and Montague DeRose and Associates, LLC, (Financial Advisor).

Lakshmi Kommi
Debt Management Director

Mary Lewis
Chief Financial Officer

Attachments:

1. List of General Fund Lease Financings with Asset-Transfer Structure
2. Debt Service as a Percentage of General Fund Revenues