

THE CITY OF SAN DIEGO
REPORT TO THE CITY COUNCIL

DATE ISSUED: October 27, 2008 REPORT NO. 08-147
ATTENTION: Council President and City Council, Docket of
SUBJECT: Water System Capital Improvements Program Report
REFERENCE: Companion Report – Fiscal Year 2009 Water System Public Offering

REQUESTED ACTION: Accept this report.

STAFF RECOMMENDATION: Accept this report.

SUMMARY:

Proceeds from the sale of an estimated \$329,000,000 of Public Facilities Financing Authority of the City of San Diego Water Revenue Bonds, Series 2009B (the "2009B Bonds") will be needed in order to refund \$150 million in outstanding 2008A Notes (as defined in the Fiscal Year 2009 Water System Public Offering Report), fund necessary reserves and expenses related to the 2009B Bonds financing, and fund the continuation of improvements to the Water System initiated under financing programs in previous years. Details of the proposed financing plan are discussed in the Fiscal Year 2009 Water System Public Offering Report.

BACKGROUND:

In mid-2006, the Water Department entered into an agreement with Raftelis Financial Consultants, Inc., a financial services consulting firm, to complete a Water Cost of Service Rate Study (the "Study"). The Study was to review the then-current water rate structure, the projected expenditures, including the proposed capital improvements and corresponding anticipated debt issuances, and the anticipated revenue requirements for the period of fiscal year 2008 through fiscal year 2011.

The completed study, presented in December 2006, recommended modifications to user classifications, cost allocations, and increases to water rates over the specific study period of fiscal year 2008 through fiscal year 2011. The additional anticipated revenue generated from the increased water rates was anticipated to support the Water System including addressing debt service from planned future bond issuances, cash funding contributions to capital improvement projects, and allowing sufficient reserves to be established.

In January 2007, the Water Department issued \$57 million in privately placed notes (the 2007A Notes, as defined in the Fiscal Year 2009 Water System Public Offering Report), in order to fund the continuation of the capital improvement projects. Based on the construction schedules for the

Water Department's capital improvement projects, the Water Department intended to undertake a public bond offering in 2005, however, due to the City's lack of audited financial statements, the City was unable to access the public bond market. As a result, the Water Department was resigned to significantly restructuring construction schedules and delaying projects. By Spring 2006, the bond proceeds from the 2002 Bonds (as defined in the Fiscal Year 2009 Water System Public Offering Report) had been fully expended. The Water Department used pay-as-you-go funding to continue the reduced capital program. The issuance of the 2007A Notes was intended to fund the capital improvement program until a public bond offering was possible, anticipated to be in early 2008. The debt service associated with the 2007A was to be addressed from the water rate increases approved in 2002. The 2007A Notes provided funding for capital projects including water main replacements, the Alvarado Water Treatment Plant, the Miramar Water Treatment Plant, the Otay Water Treatment Plant, and the Rancho Bernardo Reservoir.

On February 26, 2007, the City Council was presented with a proposal to increase water rates by six and a half percent annually from fiscal year 2008 through fiscal year 2011 in order to support the Water System, specifically addressing the continuation of the multi-year capital improvement program to meet regulatory requirements and upgrade the water infrastructure. From fiscal year 2008 through fiscal year 2011, it was anticipated that approximately \$585 million in capital improvement projects would be undertaken by the Water Department. The funding for the proposed capital program was to be supported by two public bond offerings (the first to be in early fiscal year 2008), with the corresponding debt service to be addressed by the additional revenue generated from the proposed water rate increases. A large majority of the proposed capital improvement projects, approximately 82%, were either identified or were directly related to projects identified in a Compliance Order from the State of California Department of Public Health (formerly the Department of Health Services). The Compliance Order, stemming from a compliance agreement between the City of San Diego and the State of California Department of Public Health (DPH) entered into in 1994, identified a list of projects the City must complete to correct operational deficiencies, stated the need to begin needed capital improvements, and required the development of a corresponding funding plan for these identified capital improvements.

Upon review of the Study and assuring the compliance with proper noticing requirements, the City Council approved the proposed series of four consecutive annual six and a half percent increases to water rates. The first approved water rate increase went into effect on July 1, 2007.

As the City still lacked audited financial statements, the bond issuance anticipated in early fiscal year 2008 was delayed until February 2008. On February 19, 2008, the City Council approved actions leading to the issuance of \$150 million of privately placed notes (the 2008A Notes). The proceeds from the 2008A Notes are being used for a variety of capital improvements to the City's Water System to: continue compliance with the DPH Compliance Order – Amendment 11, meet Environmental Protection Agency (EPA) requirements for enhanced drinking water treatment systems, improve the reliability of the water system, repair or replace aged infrastructure, and increase the capacity of the system. The most recent quarterly update report to the DPH is attached (Attachment 1). Based upon construction cost estimates and construction schedules, the 2008A Notes proceeds are anticipated to be exhausted by May 2009. Project expenses after May 2009 will need to be funded entirely with cash if additional debt financing is not available. Affected projects would include the completion of enhancements to the Alvarado Water

Treatment Plant, Otay Water Treatment Plant, Miramar Treatment Plant, Water Main Replacements, and various other improvements to the water system.

DISCUSSION:

Prior to FY 2009, the City was not able to access the public bond market due to a suspended credit rating and lack of current audited financial statements. However, as the City has worked diligently on becoming current with their audited financial statements, the City released audited financial statements through Fiscal Year 2007 and had their credit ratings reinstated. As such, in early 2009, the City anticipates re-entering the public bond market with the Public Facilities Financing Authority of the City of San Diego Water Revenue Bonds, Refunding Series 2009A (the "Series 2009A Bonds"). The Series 2009A Bonds will refund the \$57 million in outstanding privately placed short-term notes (the 2007A Notes) which were issued as the City endeavored to continue the Water Capital Improvement Program while the City was unable to access the public bond market.

As previously mentioned, in February 2008, the City issued the 2008A Notes to continue the Water Capital Improvement Program. Based on construction cost estimates and construction schedules, it is projected that by June 2009, the Water Department will reach a point where it will be unable to continue ongoing projects or unable to initiate new projects without additional financing proceeds being available. At that point, the Water Department will be in jeopardy of falling out of compliance with the DPH Compliance Order. Therefore, the Water Department is requesting the proposed public financing in an estimated amount of \$329 million to: (1) refund the \$150 million in outstanding 2008A, (2) fund the required debt service reserve fund and pay cost of issuance expenses associated with the 2009B Bonds, and (3) fund \$150 million in anticipated Water System Capital Improvements Program needs through June 2010.

The anticipated projects, the project types, and the justification for inclusion to the list of capital improvement projects anticipated to receive proceeds from the 2009B Bonds are listed in Attachment 2. From the listed projects in Attachment 2, 16 projects, encompassing approximately 86% of the anticipated proceeds or approximately \$129 million, are either required by or related to the DPH Compliance Order.

In order to continue the improvements to the Water System required by the DPH Compliance Order and to address the capital improvements which supported the justification for the water rate increases approved in 2007, additional debt financing is required. The Water Department estimates that Water Department capital improvement expenditures for FY 2009 through FY 2011 will total approximately \$489 million. Financing for this program is expected to come from usage of the proceeds from the 2008A Notes, the proposed 2009B Bonds, and a subsequent long term bond issue in FY 2011. The approved four consecutive annual water rate increases, from FY 2008 through FY 2011, already reflect the anticipated debt service that will be associated with these bond issuances.

Engineering and Financial Feasibility Study

In anticipation of the 2009A Bonds, the Water Department contracted with Camp, Dresser & McKee (CDM), an engineering consultant firm, to conduct an Engineering and Financial Feasibility Report (Attachment 3). The purpose of this report is for an independent review of the feasibility of the planned bond issuances. CDM conducted a review and evaluation of the Water

Department's capital improvement program, an institutional analysis, a review and evaluation of the operation and maintenance policies and programs, and a detailed review of the projected revenues and expenses of the Water Department for fiscal years 2008 through 2013. Based on their findings, CDM concluded that based on the financial projections presented in their report, the Water Department would be able to adequately finance the five-year CIP, meet all cash requirements of the Water System, and comply with all debt service coverage requirements during the study period.

FISCAL CONSIDERATIONS:

Debt service for the 2009B Bonds is estimated at approximately \$25.7 million per year which will be paid from the previously approved four consecutive annual water rate increases that went into effect on July 1, 2007.

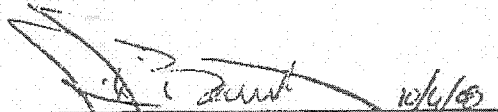
PREVIOUS COUNCIL and/or COMMITTEE ACTION:

None.

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:

None.

KEY STAKEHOLDERS AND PROJECTED IMPACTS: Residents of San Diego will see continued improvements to that the Water System and on-going compliance with the State Department of Public Health Compliance Order.



J. M. Barrett
Director of Public Utilities

- Attachments: (1) DPH Quarterly Status Report, dated August 18, 2008
(2) Projects to be funded with proceeds from 2009B Bonds
(3) Report on the Engineering and Financial Feasibility Study – Revenue Bonds Series 2009