

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

DATE ISSUED: October 27, 2008 REPORT NO. 08-148  
ATTENTION: Council President and City Council  
SUBJECT: 2009 Bonds - Water System (Refunding and New Money)  
REFERENCES: Companion Report - Water System Capital Improvements Program Report

**REQUESTED ACTIONS:**

1. Authorize the issuance of the Water Revenue Bonds, Refunding Series 2009A in January 2009 in an amount not to exceed \$309 million and Series 2009B by no later than June 30, 2009 in an amount not to exceed \$329 million, (collectively the "2009 Bonds"), by the Public Facilities Financing Authority of the City of San Diego (the "Authority"). Also authorize the execution of related financing documents to refund certain outstanding Water Revenue Bonds and Notes, finance approximately 80% of the approved Water System Capital Improvement Program encumbrances and expenditures, and finance costs of issuance associated with the 2009 Bonds. The related financing documents are described in detail in Section II.J.i of this report.
2. Authorize the City Attorney to appoint Fulbright & Jaworski L.L.P. as Bond Counsel in connection with the issuance of the 2009A Bonds and pay an amount not to exceed \$175,000, plus reasonable out-of-pocket expenses not to exceed \$5,000; provided however the fees payable to Bond Counsel shall be contingent upon the closing of the 2009A Bonds and paid out of the proceeds from the 2009A Bonds.
3. Authorize the City Attorney to appoint Fulbright & Jaworski L.L.P. as Counsel to Facilities and Equipment Leasing Corporation, in connection with the issuance of the 2009A Bonds and pay an amount not to exceed \$15,000, plus reasonable out-of-pocket expenses not to exceed \$1,000; to be paid from funds identified in the Water and Debt Management Departments.
4. Authorize the City Attorney to appoint Hawkins Delafield & Wood LLP as Disclosure Counsel for the City in connection with the issuance of the 2009A Bonds and pay an amount not to exceed \$250,000, plus reasonable out-of-pocket expenses not to exceed \$5,000; provided however the fees payable to Disclosure Counsel shall be contingent upon the closing of the 2009A Bonds and paid out of the proceeds from the 2009A Bonds.

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

**SUMMARY:**

**I. BACKGROUND**

The City entered into a compliance agreement (the "Compliance Order") with the State of California Department of Public Health ("DPH") in 1994 requiring the City to correct operational deficiencies and begin critical capital improvements to its aging infrastructure. The Compliance Order requires the City to rehabilitate or replace deteriorating infrastructure. Failure to adhere to the Compliance Order could result in penalties under the Health and Safety Code, Section 116725.

The City was notified in 1997 that it was not in compliance with the DPH Compliance Order. As a result, the City Council approved the Water Strategic Plan in 1997 which included an eight-year capital improvements plan. In 1998, the City Council approved a series of three 6% increases to the water system revenues to support a \$385 million bond issuance (the "1998 Certificates") to fund the first phase of the approved Capital Improvement Program (the "CIP").

On April 30, 2002, the City Council adopted a series of annual 6% water rate increases for FY 2003 through 2007 to generate additional water system revenues and authorized the issuance of the Subordinated Water Revenue Bonds, Series 2002 (the "2002 Bonds") to finance the second phase of the improvements.

The Water Department had anticipated to issue bonds by 2005 but was unable to do so because the City was not current on the financial statements. Proceeds of the 2002 Bonds were fully drawn down by March 2006, leading to a significant slow down of CIP activities for the remainder of FY 2006 and the first half of FY 2007.

In order to continue to address priority capital improvement projects subject to the DPH Compliance Order, the City Council authorized the Authority to issue \$57 million Water Revenue Notes (2-year term), Series 2007A ("2007A Notes") on January 16, 2007. The Notes were purchased by Morgan Stanley on January 30, 2007. The proceeds from the 2007A Notes were drawn down by March 2008. Subsequently, the City Council authorized the Authority to issue the 18-month \$150 million Subordinated Water Revenue Notes, Series 2008A ("2008A Notes") on February 19, 2008. The Notes were purchased by JP Morgan Securities on February 28, 2008.

The 2007A Notes and the 2008A Notes were short-term private placements. The Notes were structured on a fixed rate interest-only basis with the principal to be paid by refunding the note obligations through long term bond issuances.

On February 26, 2007, the City Council approved a series of four 6.5% annual water rate increases for FY 2008 through 2011. This additional revenue generated from the increased water rates will assist in providing for future debt issuances including the repayment and restructuring of the 2007A and 2008A short term notes into long term debt issuances. The increase in revenue will also support cash funded contributions to CIP projects.

The Water Department has made substantial progress completing the projects set forth in the DPH Compliance Order, which is explained in detail in the Water Department's Companion Staff Report. The Companion Report also describes the overall CIP in greater detail. The proceeds from the 2007A Notes have been fully expended. The proceeds from the 2008A Notes are expected to be expended or encumbered by May 2009.

See Attachment 1 for a summary of the Water System's outstanding debt obligations and the corresponding debt service payments as of September 1, 2008.

## II. DISCUSSION

### A. Water System Plan of Finance – 2009 Bonds

The proposed financing plan consists of two series of bonds:

- 2009A refunding only financing series scheduled for January 2009; and
- 2009B refunding and new money financing series scheduled for April/May 2009.

Taken together the 2009A Bonds and the 2009B Bonds constitute the 2009 Bonds.

#### **2009A Bonds**

Proceeds from the 2009A Bonds will be utilized to:

- Refund the \$57 million principal of the 2007A Notes due January 30, 2009; and
- Refund eligible maturities of the 1998 Water System Certificates of Undivided Interest that provide at least 3% net present value savings;
- Fund a debt service reserve fund for the 2009A Series; and
- Fund costs of issuance for the 2009A Series

The proposed ordinance provides the authority to refund all outstanding 1998 Certificates that are economical under a current refunding.<sup>1</sup> The exact amount of the 1998 Certificates refunded depends on the market conditions at the time of the sale of the bonds which is planned for January 2009 (see below).

#### **Economic Refunding of the 1998 Certificates**

The 1998 Certificates are eligible for a current refunding under their Trust Agreement as of August 1, 2008. The optional prepayment rate for the 1998 Certificates prior to July 31, 2009 is 101% of Par.

Proceeds from the 2009A Refunding Bonds will be used to refund eligible outstanding 1998 Certificates in an amount up to \$245 million (outstanding principal as of September 1, 2008). The exact amount of refunding depends on the interest rates available at the time the bonds are

<sup>1</sup> A current refunding is a redemption of outstanding debt in which the refunding bonds are issued less than 90 days before the redemption date of the refunded bonds. An advance refunding is any refunding that is not a current refunding.

priced. Due to major market dislocations, the interest rate environment is currently very volatile. The interest rates would have to drop significantly to allow the City to refund the entire \$245 million in outstanding principal. The 1998 Certificates, or selected maturities thereof, will only be refunded if the net present value of the economic savings is at least 3% of the refunding bonds.

For illustration purposes, based on interest rates as of September 11, 2008, refunding approximately \$94 million in outstanding 1998 Certificates would have generated debt service savings to the City. The following table provides a financing comparison between the 1998 Certificates and the refunding opportunity available as of September 11, 2008.

	Existing 1998 Certificates	Refunding Opportunity (Estimate)
Issuance Size	\$94.2 million	\$95.7 million
Average Annual Debt Service Payment <sup>1</sup>	\$9.24 million	\$8.68 million
True Interest Cost	5.06%	4.42% <sup>2</sup>
Maturity Date	8/1/2021	8/1/2021
Total Debt Service	\$129.3 million	\$121.6 million

<sup>1</sup>Average annual debt service payment toward \$94.2 million of the 1998 Certificates adjusted for earnings from cash reserve which offsets actual debt service payment.

<sup>2</sup>Provides 3% Net Present Value Savings

## 2009B Bonds

Proceeds from the Series 2009B bonds will be used as follows:

- Finance Water CIP construction through June 2010 with an estimated \$150 million in new money proceeds;
- Refund the 2008A Notes (principal \$150 million);
- Refund any additional outstanding 1998 Certificates if cost effective; and
- Fund costs of issuance for 2009B Series.

The 2009B Bonds will only be issued upon the approval by the City Council of the 2009B Preliminary Official Statement and the 2009B Bond Purchase Agreement which are expected to be brought to the City Council in March/April 2009.

Dividing the 2009 Bonds into two series (2009A and 2009B) enables the City to borrow funds no earlier than the time the proceeds are needed. As previously noted, principal on the 2007A Notes is due on January 30, 2009 while principal on the 2008A Notes is not due until August 2009. In addition, the Water Department currently has remaining proceeds of the 2008A Notes which will be used for capital projects, and does not require new money proceeds until those funds are expended or encumbered (currently expected to be April/May 2009). The Water Department projects that by April/May 2009, the CIP funding from the 2009B Bonds will be necessary to meet the Compliance Order timeline and Federal Safe Drinking Water Act

mandates. Issuing bonds for new construction as close as possible to the start of the construction will allow the City to minimize the potential of negative arbitrage on the construction fund.<sup>2</sup>

### **B. Method of Sale**

The 2009A and 2009B Bonds will be rated and structured as public offerings to be implemented in January 2009 and April/May 2009, respectively. The 2009 Bonds will be fixed rate obligations with a 30-year term for (i) the refunding portion of the 2007 and 2008 Notes; and (ii) the new money portion. The refunding portion of the 1998 Certificates will maintain the original final maturity of August 2028.

As a condition for a public offering, the City will have to become current on the release of the City audited financial statements. The FY 2003 through FY 2006 Comprehensive Annual Financial Reports (CAFRs) were released by the City in FY 2007 and FY 2008 with unqualified audit opinions. The City expects to receive the audit opinion for the FY 2007 financial statements in October 2008.

On May 15, 2008, Standard & Poor's reinstated the City's credit rating. The Water System's outstanding senior lien 1998 Certificates were given a credit rating of AA- underlying rating (stable outlook) and the subordinate lien 2002 Series at A+ (stable outlook). The Standard & Poor's report cited the Water System's good projected financial performance, strong cash reserves, approved rate increases, stable service area economy and customer base as support for the rating. On March 27, 2008 Fitch changed the City's credit outlook to positive. Fitch currently rates the 1998 Certificates at BBB+ and the 2002 Series at BBB, with a positive outlook on both. Moody's currently maintains an A2 rating on the 1998 Certificates and an A3 rating on the 2002 Series, with a negative outlook. The 2009A Bonds are to be issued on parity with the 1998 Certificates as senior lien bonds. The ratings on the proposed bonds are anticipated to receive the same ratings as the 1998 Certificates.

The City will request credit ratings for the 2009A Bonds from the three rating agencies in November 2008. The request process will entail providing the bond documents and offering statement in their final form, making in depth presentations and responding to all the questions from the rating agencies. The Disclosure Practices Working Group will review the ratings materials prepared by staff with assistance from the financial advisor, underwriters, and the disclosure counsel. Ratings on the 2009A Bonds will be offered to the City prior to the release of the Preliminary Official Statement (POS) which is currently anticipated in mid December 2008.

### **C. Financing Schedule and Key Milestones of the 2009 Bonds**

October 2, 2008	DPWG reviewed and approved Preliminary Official Statement (POS) for 2009A Bonds
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<sup>2</sup> Proceeds for new construction are held in the construction/acquisition fund for no more than the time needed to complete the construction projects for which the bonds are issued. In most interest rate environments, the rate the City can expect to earn on these funds is less than the expected interest expense on the bonds, resulting in negative arbitrage.

October 27-28, 2008	Introduction of the financing ordinance
November 10, 2008	Approval of the financing ordinance and the resolution authorizing the 2009A Preliminary Official Statement and the Bond Purchase Agreement (30-day referendum begins)
Week of December 1, 2008	Receive credit ratings for 2009A Bonds
December 10, 2008	End of 30-day referendum period

**Refunding Series 2009A Bonds**

December 11, 2008	Distribute final changes to the POS to the City Council after DPWG approval
December 17, 2008	Print and distribute 2009A Bonds Preliminary Official Statement
January 13, 2009	2009A Bonds pricing
January 14, 2009	Distribute the Official Statement to the City Council after DPWG review
January 19, 2009	Print and distribute 2009A Bonds Official Statement
January 27, 2009	2009A Bonds closing and receipt of proceeds
January 30, 2009	Water Revenue Notes 2007A principal due

**Series 2009B Bonds**

March/April 2009	City Council to approve the 2009B Preliminary Official Statement and 2009B Bond Purchase Agreement via Council Resolution
March/April 2009	Receive credit ratings for 2009B Bonds
April/May 2009	Print and distribute 2009B Preliminary Official Statement
April/May 2009	2009B Bonds pricing; print and distribute 2009B Official Statement
April/May 2009	2009B Bonds closing and receipt of proceeds. Principal payment on 2008A Notes and fund Water System CIP

**D. Summary of Key Terms and Conditions of 2009 A Bonds**

- Issuer - The Public Facilities Financing Authority of the City of San Diego
- Underwriting Syndicate - Morgan Stanley & Co., Inc. and J.P. Morgan Securities Inc. (Co-Senior Syndicate Managers); Estrada Hinojosa, Ramirez & Co, Seibert Brandford Shank & Co. (Co-Managers)
- Lien Structure - Senior Lien (1.20x coverage of Net System Revenues to Debt Service)
- Market - Public
- Principal – not to exceed \$309 million
- Final Maturity- 2039 (2007A Note Refunding);  
August 2028 (final 1998 Certificates Refunding)
- Debt Service Reserve Fund – Included in the issue size

**E. Summary of Key Terms and Conditions of 2009B Bonds**

- Issuer - The Public Facilities Financing Authority of the City of San Diego
- Underwriting Syndicate - To be Determined. (See below)
- Lien Structure - To be determined closer to the pricing based on market conditions

- Market - Public
- Principal - Not to exceed \$329 million
- Final Maturity - 2039
- Debt Service Reserve Fund – To be determined closer to the pricing based on market conditions.

#### **F. Financing Team**

The City's Financing Team for the 2009A Bonds consists of the Chief Financial Officer, staff from the Debt Management Department, the Comptroller's Office, the Water Department, the City Attorney's Office, and outside consultants, including Montague DeRose and Associates LLC as independent Financial Advisor, Fulbright & Jaworski L.L.P. as Bond Counsel, Hawkins Delafield & Wood LLP as Disclosure Counsel, Camp Dresser & McKee Inc. ("CDM") as Feasibility Consultant, and Wells Fargo Bank, National Association as Bond Trustee.

**2009A Bonds Financial and Legal Services.** Montague DeRose and Associates, LLC (the "Financial Advisor") is serving as the independent financial advisor. The Financial Advisor entered into a three-year contract with the City starting July 24, 2006. Under the agreement (C-13876), the Financial Advisor is authorized to provide financial advisory services, including services related to the proposed 2009A Bonds. Montague DeRose's fee for the 2009A Bonds is at a not-to-exceed \$75,000. In addition to the fees, Montague will be reimbursed for all approved out-of-pocket expenses not to exceed \$2,500.

The City Attorney's Office has selected Fulbright & Jaworski L.L.P. to serve as bond counsel through a Request for Proposals process. Fulbright & Jaworski L.L.P. has proposed to provide such service for 2009A Bonds for a fee in an amount not to exceed \$175,000. Out of pocket expenses are not to exceed \$5,000. The bond counsel fee is contingent upon the successful closing of the 2009A Bonds.

Hawkins Delafield & Wood LLP serves as the disclosure counsel. Hawkins Delafield & Wood LLP has proposed to provide such service for a fee in an amount not to exceed \$250,000 for 2009A Bonds. Out of pocket expenses are not to exceed \$5,000. The disclosure counsel fee is contingent upon the successful closing of the 2009A Bonds.

Camp Dresser & McKee Inc. ("CDM") served as the feasibility engineer. CDM was selected by the Water Department following an interview process of qualified firms on an as-needed list maintained by the Purchasing & Contracting Department. The fee for the feasibility engineer is \$156,761. As feasibility engineer, CDM investigated the status of the Water System to analyze its impact on the security of the proposed 2009 Bonds. CDM provided a Feasibility Report, an independent engineering, institutional, operational, and financial analysis of the proposed bond offering. This Feasibility Study is included as an Appendix to the 2009A Bonds Preliminary Official Statement.

Wells Fargo Bank, National Association was selected through a competitive RFP process as the trustee for the 2009 Bonds. Wells Fargo will receive \$3,800 in acceptance and first year administration fees for the 2009A Bonds and \$1,500 in acceptance and first year fees for the

2009B Bonds. Recurring annual fees will be \$1,800 for the 2009A Bonds and \$1,000 for the 2009B Bonds.

Costs of Issuance, including consultant expenses, and necessary authorizations for the 2009B Bonds will be brought to the City Council in March/April 2009 in conjunction with the 2009B Bonds Preliminary Official Statement and the Bond Purchase Agreement.

**2009A Bonds Underwriting Syndicate.** In May 2006, the City solicited proposals from firms qualified to serve as lender, placement agent, purchaser, or underwriter for a planned Water System borrowing. The Request for Proposals (RFP) indicated that although the City planned to undertake the borrowing as a private placement, direct loan or direct purchase, it was possible, subject to timing considerations and the availability of certain financial information, that the financing would be undertaken as a public offering. The City received a total of 21 bids. Respondents were evaluated as possible candidates for both a private offering and a public offering.

In early 2007, four firms (Morgan Stanley, Lehman, Citigroup, and Bank of America) were selected for the non-public offering short list based on proposed spread to MMD<sup>3</sup>, disclosure requirements, fees, and flexibility to refinance or call debt. The City undertook the full due diligence process with all the highly rated firms. In December 2007, the City requested bids (based on a spread to MMD) from each of the four highly rated firms. Morgan Stanley was awarded the transaction on a competitive basis after submitting the lowest bid conforming to the City's term sheet. The City and Morgan Stanley completed their due diligence and Morgan Stanley subsequently executed the transaction and purchased the Water Revenue Notes, Series 2007A.

After the 2007A Notes were executed, the focus of the City turned to the issuance of a follow-on public debt offering. In addition to the evaluation of firms for the non-public offering, the City evaluated the respondents on the basis of criteria related to a public offering. The City short-listed five highly qualified firms, based on established criteria, which included staff, firm's experience, understanding the City's borrowing objectives, and fee proposal. Morgan Stanley was selected as the senior manager for a public offering on the basis of this evaluation.

During the development of the financing documents for the anticipated debt issuance, it became clear that the proposed issue could not be sold on a public basis since the City was still not current on its CAFRs. In order to meet priority Water CIP requirements, the City and Morgan Stanley agreed to undertake the transaction as a private offering. As the financing process progressed, the City and Morgan Stanley were unable to reach agreement on the terms of the borrowing during the course of the negotiations for a private offering.

In order to select a replacement underwriter, the City relied on a recently completed selection process for the proposed deferred maintenance bond issuance. The City had conducted a RFP process for the deferred maintenance bonds and ranked the respondents. The highest ranked respondent, Bank of America, was selected for the deferred maintenance bonds. The next highest, JP Morgan, was identified as a replacement for Morgan Stanley for the Water

<sup>3</sup> The Municipal Market Data (MMD) rate is a benchmark index for fixed rate municipal debt



Department's second private issuance. JP Morgan completed a due diligence process and subsequently purchased the 2008A Water Revenue Notes on a private basis.

Morgan Stanley and JP Morgan have been retained as co-senior managers for the 2009A Bonds, having been previously selected for Water Revenue Bond public issuances from the 2006 RFP process. The co-managers, Ramirez & Co., Siebert Branford Shank, and Estrada Hinojosa, were selected on the basis of their responses to the 2006 RFP process to broaden the distribution of bonds to a full range of potential retail and institutional buyers. Morgan Stanley will serve as the book running Representative for the senior managers and co-managers. The Representative signs certain legal documents on behalf of itself, the co-senior manager and the co-managers. Nixon Peabody LLP is serving as the Counsel (Underwriter's Counsel) to Morgan Stanley.

**2009B Bonds Underwriting Syndicate.** The syndicate will be identified for the 2009B Bonds through a Request for Proposals process to be conducted in the first quarter of 2009. Staff will report the selection at the time the 2009B Bond Purchase Agreement and the 2009B Preliminary Official Statement are brought to the City Council in March/April 2009.

#### **G. Document Preparation Due Diligence**

The Financing Team has conformed to the Controls and Procedures established by the Disclosure Practices Working Group (DPWG) in preparing the offering statement for the 2009A Bonds. The Disclosure Practices Working Group reviewed and provided required certifications. Consistent with the Kroll Report recommendations, the financing documents for the proposed 2009 Bonds including the Preliminary Official Statement for 2009A Bonds and related appendices were distributed to the City Council offices two weeks prior to the City Council hearing.<sup>4</sup>

As with the recent financings, staff will inquire with the City Council offices and the Independent Budget Analyst's Office for one-on-one briefings after docketing the proposed financing item and will be prepared to meet with the Council staff and the Independent Budget Analyst to review the financing plan and address questions.

In accordance with the DPWG Controls and Procedures, a Disclosure Working Group was convened to assist the Disclosure Counsel in developing the offering statement. The Disclosure Working Group consisted of the Disclosure Counsel, City Disclosure Counsel, Debt Management staff, Water Department Staff, City Attorney staff, and the Financial Advisor. These Departments have provided pertinent information for inclusion in offering statement. Representatives from the underwriting syndicate's co-senior manager firms have also taken an active role in the disclosure document development process.

The Water Department has been involved in all stages of the disclosure document development process and has reviewed the final form of the Preliminary Official Statement to ensure accuracy and completeness of the disclosures pertaining to the Water System. The Water Department also engaged the engineering firm, Camp Dresser McKee, to complete an engineering and financial feasibility study on the bond offering. The feasibility study is included in the POS.

<sup>4</sup> Report of the Audit Committee of the City of San Diego, August 8, 2006.

The DPWG met on August 26, 2008, October 1, and October 2, 2008, to review and approve the 2009A Preliminary Official Statement and the 2009A and 2009B Continuing Disclosure Certificates. Consistent with the DPWG Controls and Procedures, necessary certifications from various officials involved in the preparation or review of the disclosures including the Mayor, the City Attorney, and the Chief Financial Officer, will be distributed to the City Council prior to the Council hearing.

#### **H. Legal Structure**

The following two entities are utilized for the issuance of the proposed 2009 Bonds:

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 property 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 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. The Authority served as the issuing entity for the 2002 Water Revenue Bonds, 2007A Water Revenue Notes, and 2008A Water Revenue Notes.

Under the terms of the Master Installment Purchase Agreement (MIPA), the Corporation assists the City in funding the CIP of the Water System. These components are referred to as the Project and are listed in the 2009A Supplement to the MIPA. The City acts as an agent of the Corporation to construct, acquire, and install the Project. The City purchases components of the Project from the Corporation with installment payments from the net system revenues of the Water Department. The installment payments are assigned to the trustee towards debt service payments for the bonds issued by the Authority on behalf of the City.

The Authority and Corporation will each approve via resolution the 2009A and 2009B Assignment Agreements (described in greater detail in Section II.J below), assigning to the Authority the Corporation's right to receive installment payments made by the City, allowing the Authority to serve as the financing vehicle for the 2009A and 2009B Bonds.

#### **I. City Council Approval Process**

This staff report describes the overall structure of the 2009 Bonds and the specifics of the 2009A Bonds. Council is being asked to approve all financing documents required for the 2009A Bonds, and certain 2009B Bond documents that must be approved via ordinance. Section J below describes the specifics of each document.

The 2009B Bond Purchase Agreement and the 2009B Preliminary Official Statement will be presented to the City Council in March/April 2009 approximately one month prior to the scheduled issuance of the 2009B Bonds. Routing the documents closer to the issuance of the 2009B Bonds will provide the City with a greater degree of flexibility and understanding of the

bonds to meet the requirements of the Water Department with respect to the financial markets and receiving necessary disclosures. Debt Management will prepare a separate staff report to accompany the 2009B Bond documents submitted in March/April 2009.

#### **J. Financing Documents**

A brief description of the financing documents follows:

##### **(i) Documents Pertaining to the 2009A and 2009B Bonds**

The **Financing Ordinance** authorizes the issuance of the 2009A Bonds and 2009B Bonds, the approval of the operative legal documents described below and any other actions of the Mayor or his designees that may be necessary to issue the 2009 Bonds.

The **Amended and Restated MIPA** updating and consolidating 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 by the Second Amendatory Supplement, dated as of January 1, 2007, each by and between the City and the Corporation, to make it a single document and to clarify certain of its provisions.

The **2009A Supplement** to the Master Installment Purchase Agreement between the City of San Diego and the San Diego Facilities and Equipment Leasing Corporation documents the sale of certain components of the City's Water System and provides for installment payments by the City to pay the debt service on the 2009A Bonds.

The **2009A Indenture** between the Authority and the Trustee ("Wells Fargo") provides for the issuance of the 2009A Bonds and sets forth terms, including the specific rights, responsibilities, and obligations of each party with respect to the issuance of the 2009 Bonds.

The **2009A Continuing Disclosure Certificate** details the City's ongoing obligation to file annual reports and material event notices with the Nationally Recognized Municipal Securities Information Repositories for the benefit of the 2009A bondholders.

The **2009A Assignment Agreement** between the Authority and the Corporation assigns to the Authority the Corporation's right to receive installment payments made by the City for the 2009A Bonds. The assignment agreement will be entered into between the Authority and the Corporation to allow for the Authority to make debt service payments on behalf of the City on the proposed 2009A Bonds. Previous assignments agreements established between the Authority and Corporation provided for debt service payments on the 2002 Bonds, 2007A Notes and 2008A Notes. The 2009A Assignment Agreement will be approved via resolutions of the Authority and Corporation. The City Council will acknowledge via the financing Ordinance the City's obligation under the Assignment Agreement to send the Installment Payments to the Trustee, on behalf of the Corporation.

The **2009B First Supplemental Indenture** between the Authority and the Trustee provides for the issuance of the Series 2009B Bonds under the terms of the Indenture and the 2009B Bond Purchase Agreement.

The **2009B Supplement** to the Master Installment Purchase Agreement between the City of San Diego and the San Diego Facilities and Equipment Leasing Corporation documents the sale of certain components of the City's Water System and provides for installment payments by the City to pay the debt service on the 2009B Bonds.

The **2009B Continuing Disclosure Certificate** details the City's ongoing obligation to file annual reports and current material event notices with the Nationally Recognized Municipal Securities Information Repositories for the benefit of the 2009B bondholders.

The **2009B Assignment Agreement** between the Authority and the Corporation assigns to the Authority the Corporation's right to receive installment payments made by the City for the 2009B Bonds. The Assignment Agreement will be entered into between the Authority and the Corporation and allow for the Authority to make debt service payments on behalf of the City on the proposed 2009 Bonds. The Assignment Agreement will be approved via resolutions of the Authority and Corporation in April 2009. The City Council will acknowledge via the financing Ordinance the City's obligation under the Assignment Agreement to send the Installment Payments to the Trustee, on behalf of the Corporation.

**(ii) Documents Pertaining to the 2009A Bonds**

The **Resolution** authorizes the approval of the legal documents described below.

The **2009A Bond Purchase Agreement** between the City, Authority, and underwriters' representative defines the terms and conditions of the 2009A Bonds once they have been priced. The 2009A Bond Purchase Agreement will be approved via resolutions of the City Council and the Authority.

The **Preliminary Official Statement (POS) Water Revenue Bonds, Refunding Series 2009A** is the offering statement for the 2009A Bonds. The POS includes detailed description of the 2009A Bonds, the Water System's financial data and a summary of the pertinent water supply, regulatory, and financial issues. The POS includes the following appendices:

- Demographic information regarding the City of San Diego
- The Engineer's Feasibility Statement
- Information concerning the San Diego County Water Authority and the Metropolitan Water District of Southern California
- Excerpts pertaining to the Water System from the Fiscal Year 2006 and 2007 CAFRs
- Summary of the Principal Legal Documents
- Form of Bond Counsel Opinion
- Form of the Continuing Disclosure Certificate

The preparation and review process for the POS is described in Attachment 2.

### III. FISCAL CONSIDERATIONS

#### Estimated Sources and Uses of Bond Proceeds (Preliminary and Subject to Change)

##### 2009A Bonds

The presentation of the Sources and Uses of Funds below provides the most likely financing scenario under current market conditions. As discussed in Section II.A, the actual size of the economic refunding of outstanding 1998 Certificates will depend on the available interest rates when the 2009A Bonds are priced.

The following estimate assumes none of the 1998 Certificates are economical to refund. Based on the interest rates as of October 2, 2008, the estimated True Interest Cost is 6.00%. Staff will provide updated estimates to the City Council at the time of the Council hearing.

##### Estimated Sources of Funds

Par Amount of 2009A Bonds	\$ 62.7 million
Premium <sup>1</sup>	\$ 0.2 million
TOTAL	\$ 62.9 million

##### Estimated Uses of Funds

2007A Note Repayment	\$ 57.0 million
Deposit to Reserve Fund	\$ 4.5 million
Costs of Issuance <sup>2</sup>	\$ 1.4 million
TOTAL	\$ 62.9 million

<sup>1</sup>The 2009A Bonds are anticipated to be issued as premium bonds. The City will receive an up-front payment (premium) from the bond underwriter in excess of the par value of the bonds. This will allow the bond underwriter to structure the bonds with a competitive coupon rate. In effect, the premium the City receives is offset by a higher coupon paid on the bonds. The bonds are structured in this manner to increase their marketability. It does not increase or decrease the overall borrowing costs to the City. The issue size is reduced by the corresponding amount paid in premium up-front which also allows the City to have a lower issuance size compared to when the bonds are issued on a par basis.

<sup>2</sup>Costs of Issuance include legal fees, consultant costs, underwriting fees, feasibility engineer fees, rating agency fees, and certain other expenses related to the issuance of the bonds. The estimated Costs of Issuance are detailed in Attachment 3.

**City Council Authorization Parameters.** The legal documents authorize the issuance of the 2009A bonds in an amount not to exceed \$309 million. Of this authorization amount, \$245 million is to refund all or portions of the 1998 Certificates if economical. The City will only refund portions of the 1998 Certificates which are consistent with the City's Debt Policy and generate at least 3% net present value savings. Any portion of the \$245 million from the 2009A Bonds not used to refund the 1998 Certificates will be applied to the not-to-exceed amount authorization under the 2009B Bonds. The financing ordinance also authorizes the repayment of the 2007A Notes (\$57 million).

The financing ordinance authorizes documents that are necessary but not sufficient to issue the 2009B Bonds. The 2009B Bonds would still require the approval, via resolution of the City Council and the Authority, of the Bond Purchase Agreement and the Preliminary Official Statement for the 2009B Bonds. The not to exceed amount of the 2009B Bonds is \$329 million.

The not to exceed True Interest Cost requested in the financing ordinance for the 2009A and 2009B Bonds is as follows:

<i>2009A Bonds</i>	
2007A Note Refunding	7.00%
1998 Certificates Refunding	4.85%
<i>2009B Bonds</i>	
2008A Note Refunding:	7.00%
New money for capital projects:	7.00%

Debt Management will provide a closing memorandum to the City Council immediately after the sale of the bonds specifying the actual interest rate, proceeds received from the sale of the bonds, actual amount of 1998 Certificates refunded, and the expected lower debt service payment compared to the outstanding 1998 Certificates.

**Interest Rate and Projected Debt Service.** In accordance with the Council-approved Debt Policy, the 2009A and 2009B Bonds will be priced on a fixed rate basis with the interest rate fixed at the time of the pricing for the life of the bonds. The actual interest rate will be set when the bonds are sold and are based on the market conditions present at the time of the bond pricing. The debt service payments will be paid semi-annually.

Based on interest rates as of October 2, 2008, the portion of the 2009A Bonds used to repay the 2007A Notes is an estimated \$62.7 million. The annual estimated debt service is \$4.4 million with an estimated total debt service of \$132.6 million over a 30 year term. For comparison purposes, at the City Council authorized not-to-exceed interest rate of 7.00%, the annual debt service on the bonds is estimated to be \$5.1 million with the total annual debt service at \$152 million over a 30 year term.

Assuming the entire outstanding principal on the 1998 Certificates is refunded with the 2009A or 2009B Bonds generating at least 3% in net present value savings, the new annual debt service will be an estimated \$12.1 million, FY 2010 - FY 2015, and \$25.3 million FY 2016 - FY 2029, which is approximately \$800,000 lower per year than the current debt service on the 1998 Certificates. The repayment term on the refunded portion will remain unchanged at 21 years.

**Revenue Pledge.** Under the terms of the financing documents, the 2009 Bonds are limited obligations of the Authority payable solely from the Installment Payments made by the Water System. The Installment Payments are secured by and payable solely from the Net System Revenue of the Water System. Net System Revenue is the income derived from the operation of the Water System (primarily water rates and charges) less the maintenance and operation costs.

**Additional Bonds Test.** Section 5.03 of the Amended and Restated Master Installment Purchase Agreement establishes the criteria (Additional Bonds Test) the City must meet to issue additional debt obligations to support the activities of the Water System. Under the criteria, for a

consecutive 12 month period during the preceding 18 months, the Water System's Net System Revenue must be greater than 1.2 times of the new and existing debt service on senior debt obligations, or 1.0 times coverage, of the combined new and existing senior and subordinate debt service. The Additional Bonds Test was performed to ensure that the City is in compliance with the covenant and has the revenue capacity to issue additional bonds in the form of the 2009A and 2009B Bonds for the amounts recommended in the proposed financing plan. The Additional Bonds Test is included as Attachment 4.

### ALTERNATIVES

Do not approve the requested actions necessary to issue the 2009 Bonds to repay the 2007A and 2008A Notes and make available additional funds to upgrade and expand the Water System. However, not approving the requested actions essential to repay the two short term notes will adversely affect the City in meeting its repayment covenants and paying off the Water System's outstanding debt obligations in a timely manner. There is no other viable option to pay off the two Notes or extend the term of the Notes other than through the issuance of long term bond obligations. It is recommended that the requested actions be approved to implement a cost effective financing plan in a timely manner in order to address the repayment obligations and meet the ongoing new capital funding needs of the Water System.

### COMMUNITY PARTICIPATION AND OUTREACH EFFORTS

The Water Department conducted a Proposition 218 noticing process as part of the approval for the rate increases necessary to support bond issuance projections from FY 2009 to FY 2011. Pursuant to Proposition 218, the City provided property owners 45 days advance notice of the Council's formal consideration of rate increases. Notices were mailed to property owners of record and City of San Diego water bill customers, advising them that the City Council would hold hearings on February 26, 2007 to consider adoption of the proposed water rate increases. The hearings were held as scheduled and the rate increases were subsequently approved by the Council.

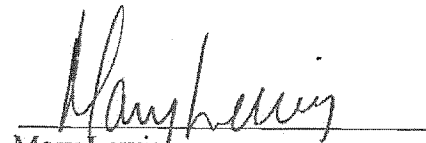
### KEY STAKEHOLDERS & PROJECTED IMPACTS

Business entities involved in the proposed financing measure are: Morgan Stanley & Co. and J.P. Morgan Securities Inc. (co-senior managers); Estrada Hinojosa, Ramirez & Co, Inc, and Siebert Branford Shank & Co. LLC (co-managers); Hawkins Delafield & Wood LLP (disclosure counsel); Nixon Peabody L.L.P. (underwriters' counsel); Fulbright & Jaworski L.L.P. (bond counsel); Wells Fargo Bank, National Association (trustee); CDM (feasibility consultant), and Montague DeRose and Associates LLC (financial advisor).

Respectfully submitted,



Lakshmi Kommi  
Debt Management Director



Mary Lewis  
Chief Financial Officer

**Attachments**

- 1. Summary of Outstanding Water Utility Obligations**
- 2. Preliminary Official Statement Development Process**
- 3. Estimated Costs of Issuance Budget**
- 4. Additional Bonds Test**



**Summary of Outstanding Water Utility Obligations**  
As of September 1, 2008

	Original Issue Size	Principal Outstanding	Remaining Interest Payments	Total Principal & Interest	Final Maturity
1998 Certificates	\$385,000,000	\$245,010,000	\$176,357,848	\$421,367,848	FY 2029 (08/01/2028)
2002 Bonds	\$286,945,000	\$272,845,000	\$157,918,258	\$430,763,258	FY 2033 (08/01/2032)
2007A Notes	\$57,000,000	\$57,000,000	\$1,150,672	\$58,150,672	FY2009 (01/30/2009)
2008A Notes	\$150,000,000	\$150,000,000	\$5,289,000	\$155,289,000	FY 2010 (08/28/2009)
State Revolving Fund Loan (2004)	\$21,525,249	\$18,940,380	\$4,450,295	\$23,390,675	FY 2026 (7/01/2025)

Source: Debt Management

## 2009A Preliminary Official Statement Development Process

The following describes the preparation and review process undertaken for the 2009A Preliminary Official Statement (2009A POS), the marketing document for the 2009A Bonds. The final draft of the 2009A POS is one of the financing documents for the 2009A Bonds and is referenced in the Staff Report.

Three groups were engaged in the POS preparation and review process:

- **The Financing Team** (as defined in the Staff Report) reviewed and provided input to the POS along with other legal documents as part of the effort to execute the 2009A Bonds.
- **The Disclosure Working Group** consisting of the Disclosure Counsel, City Disclosure Counsel, Financial Advisor, City Attorney's Office, Debt Management, and Water Department, was formed with the principal purpose to develop the POS.
- **The Disclosure Practices Working Group (DPWG)** reviewed and approved the POS including the appendices to the POS. Membership in the DPWG is defined by Section 22.4103 of the Municipal Code. The DPWG consists of the Chief Operating Officer, the City Attorney, the Chief Financial Officer, the Director of Debt Management, the Chief Deputy City Attorney for Disclosure, the Independent Budget Analyst, the Internal Auditor, and the outside Disclosure Counsel, currently John McNally of the Washington D.C. office of Hawkins Delafield & Wood LLP. The independent monitor participates in the DPWG meetings. The position of Chief Deputy City Attorney for Disclosure and Finance has been vacant since May 2008.

The 2009A POS was drafted by the Disclosure Counsel for the 2009A Bonds, from the Los Angeles office of Hawkins Delafield & Wood LLP, relying on the information provided by the City departments and their assessment of the legal, financial, and the Southern California supply issues specific to the City's Water System.

The Disclosure Working Group began work on a Preliminary Official Statement for a planned 2008 public debt issuance in September 2007. The Disclosure Working Group met in early October 2007 to review the methodology and approach to producing an Official Statement. The group reviewed selected Official Statements from Southern California agencies that recently issued water revenue bonds in order to develop an understanding of the current disclosure expectations for a water credit. Water Department and Debt Management staff began to update data elements for the POS and provided the information to the Disclosure Counsel and responded to inquiries as the document was developed by the Disclosure Counsel. The Group reviewed and refined the document over the course of first half of 2008.

Starting July 2008, the Financing Team for the 2009A Bonds reviewed POS drafts and provided comments to the Disclosure Counsel during various legal document review sessions conducted on July 2, July 17, July 30, 2008, September 11, and September 25.

In August, 2008, the POS primary document was received by the DPWG. A final draft of the POS, incorporating as appendices, the Feasibility Report, Southern California water

supply information, regional demographic data, and excerpts pertaining to the Water System from the 2006 CAFR, were reviewed and approved by the DPWG on October 1 and 2, 2008, respectively.

On an ongoing basis, staff from the City Attorney's Office, Water Department, Debt Management Department, Comptroller, and the CFO, receive training on disclosure best practices provided by the City Disclosure Counsel, and the California Debt and Investment Advisory Commission.

**Estimated Costs of Issuance**  
Water Revenue Bonds 2009A

<b>Role</b>	<b>Firm</b>	
Financial Advisor	Montague DeRose and Associates, LLC	\$ 77,500
Bond Counsel	Fulbright & Jaworski L.L.P.	180,000
Disclosure Counsel	Hawkins Delafield & Wood LLP	255,000
External Auditor, FY 07 and 08	Macias Gini & O'Connell LLP	12,000
Feasibility Engineer	Camp Dresser McKee	156,800
Credit Rating Fees		210,000
Trustee	Wells Fargo	3,800
Printing Costs		30,000
Underwriter Discount <sup>1</sup>	2009A Syndicate	404,000
Contingency	3%	27,800
<b>Total Estimated Costs of Issuance</b>		<b>\$ 1,356,900</b>

<sup>1</sup>Based on market conditions. Includes takedown, underwriter's counsel fees and out-of-pocket expenses.

Attachment 4

**Water System  
Historical Additional Bonds Test  
FY 2008**

(\$000s)

<b>Operating Receipts</b>	
Water Sales (a)	288,949
Other Services	9,564
Rentals	5,695
Other Revenue	2,992
<b>Total Operating Receipts</b>	<b>307,200</b>
<b>Operating Expenditures</b>	
Water Purchases	128,114
Operations & Maintenance	135,225
<b>Total Operating Expenditures</b>	<b>263,339</b>
<b>Operating Income</b>	<b>43,862</b>
<b>Other Income</b>	
Interest Earnings	18,252
Capacity Charges	8,459
Other Income (b)	2,746
<b>Total Other Income</b>	<b>29,456</b>
<b>Net Income</b>	<b>73,318</b>
<b>Less: Reserve Earnings on Parity Obligations</b>	<b>1,370</b>
<b>Adjusted Net System Revenue</b>	<b>71,948</b>
<b>Maximum Annual Debt Service on all Parity Obligations</b>	<b>54,627</b>
<b>Test (c)</b>	<b>1.32</b>

(a) Includes service charges and reclaimed water sales

(b) Includes cancelled prior year encumbrances, recovered damages, and land sales

(c) Ratio of Net System Revenue to Parity Obligations  $\geq$  1.20

Source: Report on the Engineering and Financial Feasibility Study – Revenue Bonds Series 2009, Table 5-1.