



THE CITY OF SAN DIEGO

Report to the City Council

DATE ISSUED: November 18, 2016 REPORT NO. 16-104
ATTENTION: Council President and Members of the City Council
SUBJECT: Authorization for the Public Facilities Financing Authority of the City of San Diego Subordinated Water Revenue Commercial Paper Notes Program
REFERENCE: Budget and Government Efficiency Committee Report No. 16-090 dated November 4, 2016

REQUESTED ACTION:

1. Authorize the issuance of Subordinated Water Revenue Commercial Paper Notes from time to time in an amount not to exceed \$250 million to provide financing for capital improvements to the Water System; and
2. Authorize the execution of related financing documents which include the forms of the 2017 Commercial Paper Supplement to the Amended and Restated Master Installment Purchase Agreement, the Assignment Agreement, the Fifth Supplemental Indenture, the Issuing and Paying Agency Agreement, the Dealer Agreements, and Reimbursement Agreements and exhibits; and authorize all related actions; and
3. Authorize the form and distribution of the Offering Memorandum in connection with the issuance of Subordinated Water Revenue Commercial Paper Notes; and
4. Authorize the City Attorney to retain and enter into an agreement with Bond and Disclosure Counsel, Hawkins Delafield and Wood LLP for the Subordinated Water Revenue Commercial Paper Notes Program; and
5. Authorize the Chief Financial Officer to establish one or more special interest bearing account(s) for the proceeds of the Subordinated Water Revenue Commercial Paper Notes.

STAFF RECOMMENDATION:

Approve requested actions.

EXECUTIVE SUMMARY OF ITEM BACKGROUND:

This Companion Staff Report should be read in conjunction with Report to City Council No. 16-090 (attached to this report as **Attachment 1**) for the Public Facilities Financing Authority of the City of San Diego Subordinated Water Revenue Commercial Paper Notes ("Commercial Paper Notes") Program that was docketed for the Budget and Government Efficiency Committee meeting on November 16, 2016.

The following are additional items to Report No. 16-090 regarding (i) the Letter of Credit Providers, (ii) the Legal Documents that City Council is requested to approve in connection with this Council item, and (iii) additional information on fiscal impacts.

I. Additional Members of the Financing Team: Letter of Credit Providers

Letter of Credit (“LOC”) Providers: A direct-pay LOC provides credit enhancement and liquidity support for the Commercial Paper Notes and represents the issuing bank’s promise to pay principal and interest on such Commercial Paper Notes when due for a specified period of time and subject to certain conditions. Under this Program, the Issuing and Paying Agent will draw upon the applicable LOC to make principal and interest payments to investors when the related Commercial Paper Notes mature.

In October 2016, the City issued a Request for Proposal (RFP) to banks requesting direct-pay LOCs and/or alternative bank products to support the Commercial Paper Notes Program. A total of six responses to the RFP were received. Based on analysis of financing needs and structure, and evaluations of the proposals, it was determined that Bank of America, N.A. and Bank of the West offered the most competitive pricing for LOCs with terms of two to three years. Bank of America, N.A. will provide a \$175 million LOC and the bank has been assigned short-term credit ratings of P-1 (Stable), A-1 (Positive), and F1 (Stable) by Moody’s, S&P, and Fitch Ratings, respectively, which are the highest short-term ratings. The cost is 0.31% per annum for a term of 2 years. Bank of the West will provide a \$75 million LOC and the bank has been assigned short-term ratings of P-1 (Stable), A-2 (Stable), and F1 (Stable) by Moody’s, S&P, and Fitch Ratings, respectively. The cost is 0.30% per annum for a term of 3 years. The Counsel to the LOC Providers is McGuireWoods LLP.

Key terms include:

	<u>Bank of the West</u>	<u>Bank of America, N.A.</u>	
Total Principal Commitment Amount	\$75,000,000	\$175,000,000	Supports the Subordinated Water Revenue Commercial Paper Notes Program in the maximum principal amount of \$250,000,000.
Term of the Agreement, Expiration	3 years January 2020	2 years January 2019	The market standard is one to three years; three years provides additional stability to the Commercial Paper Notes Program.
Annual Fee	0.30 percent	0.31 percent	This is at the low end of market rates for a two and three year facility. In addition, both banks charge \$250 per draw on the facility. A substantial reduction in the Water Utility’s credit ratings will increase the fee.

Term Loan	Five years	Three years	In the event that the LOC Provider is not immediately reimbursed from proceeds of the sale of notes or from payment by the Water Utility Fund, the outstanding amount is converted to a term loan pursuant to which the Water Utility Fund is to repay the loan in equal installments over the term of the loan.
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II. Financing and Legal Documents

This section contains a general description of the documents and key terms that require the City Council’s approval. The **Financing Resolution** authorizes the issuance of the Commercial Paper Notes, which includes the approval of the form of the operative legal documents and agreements described below and any other actions of the Mayor, the Chief Operating Officer or the Chief Financial Officer or their designees determine may be necessary to issue the Commercial Paper Notes (the docketed documents contain various blank placeholders or items in brackets, which will be filled in by Bond Counsel at the time of closing).

1. *Supplemental Indenture (“Supplemental Indenture”)*. The Supplemental Indenture supplements the Indenture for the Water Revenue Bonds, which was originally executed as of January 1, 2009 by and between the Public Facilities Financing Authority of the City of San Diego (the “Authority”) and U.S. Bank, National Association, as trustee for the Water Revenue Bonds. The Supplemental Indenture sets forth the terms applicable to the Commercial Paper Notes, including the conditions for the issuance and repayment thereof, provisions on the use of proceeds of the Commercial Paper Notes, the nature of the security for the Commercial Paper Notes (i.e., that the commercial paper notes are limited obligations of the Authority payable from subordinated installment payments secured by net system revenues of the Water Utility Fund). The Supplemental Indenture also sets forth the rights, responsibilities, and obligations of each party with respect to the issuance of the Commercial Paper Notes.
2. *2017 Commercial Paper Supplement to the Amended and Restated Master Installment Purchase Agreement (“2017 Commercial Paper Supplement”)*. The 2017 Commercial Paper Supplement supplements the Amended and Restated Master Installment Purchase Agreement, which was originally executed as of January 1, 2009 by and between the City and the San Diego Facilities and Equipment Leasing Corporation (the “Corporation”), and provides for the City to make installment payments equal to debt service on the obligations issued by the Authority. Pursuant to the 2017 Commercial Paper Supplement, in consideration of Water System projects and components of projects to be delivered by the Corporation, the City will make subordinated installment payments on Commercial Paper Notes and any related reimbursement obligations under an LOC solely from net system revenues and certain other funds. The 2017 Commercial Paper Supplement describes the Commercial Paper Notes Components, Commercial Paper Subordinated Installment Payments, and covenants relating to the Commercial Paper Notes.

3. *Assignment Agreement.* Pursuant to the Assignment Agreement between the Authority and the Corporation, the Corporation assigns to the Authority the Corporation's right to receive installment payments made by the City under the 2017 Commercial Paper Supplement, which installment payments will be used pay debt service on the Commercial Paper Notes and any related reimbursement obligations under an LOC.
4. *Issuing and Paying Agency Agreement.* The Issuing and Paying Agency Agreement is an agreement between the Authority and U.S. Bank, National Association, which sets forth the procedures for issuing the Commercial Paper Notes, payment of principal and interest and the application of the proceeds.
5. *Dealer Agreements.* Each Commercial Paper Dealer Agreement is between the Authority and a dealer for the Commercial Paper Notes. Each Dealer Agreement sets forth the procedures, terms, conditions, and compensation for service as a commercial paper dealer. Citigroup Global Markets Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, and RBC Capital Markets, LLC (each a "Commercial Paper Dealer") have been selected as dealers for the Commercial Paper Notes.
6. *Reimbursement Agreement, LOC, Fee Letter, and Bank Note.* The terms and conditions governing each LOC and the reimbursement process are memorialized in the Reimbursement Agreements by and between the City and the each LOC Provider (being Bank of America, N.A. and Bank of the West (each an "LOC Provider")). The LOC Provider agrees to advance funds (for a cost described in the Fee Letter) to the Issuing and Paying Agent in an amount sufficient to pay the principal and interest due on maturing Commercial Paper Notes, provided that such amount (together with amounts already outstanding) does not exceed the stated amount of the LOC. In the event that amounts derived from the sale of Commercial Paper Notes by the Commercial Paper Dealers are not sufficient to repay the advance from the LOC Provider, the City must pay a higher rate of interest to the LOC Provider based on a formula specified in each Reimbursement Agreement. The form of the Bank Note, included as Exhibit B to the Reimbursement Agreement, provides a form of a promissory note which would evidence the reimbursement obligations of the City to the LOC Provider.
7. *Offering Memorandum.* An Offering Memorandum is the public offering statement used in connection with the marketing and sale of the Commercial Paper Notes by the Commercial Paper Dealers. The Offering Memorandum describes, among other things, the terms of the Commercial Paper Notes, the security therefor, the LOC supporting such notes and the LOC Providers. Investors use this information to evaluate the credit quality of the Commercial Paper Notes.

The Disclosure Practices Working Group (the "DPWG") has reviewed a proposed form of Offering Memorandum for the Commercial Paper Notes in accordance with the applicable Disclosure Controls and Procedures.

The Offering Memorandum will be periodically updated on an annual basis, or as necessary if any material information changes, to provide current information to the marketplace. DPWG will review and approve subsequent updates prior to distribution of the Offering Memorandum.

III. FISCAL CONSIDERATIONS

Updates to Market Rates. Since Report No. 16-090 was published, market rates for commercial paper notes have remained stable. As of November 17, 2016, interest rates are at 0.55%. Contrastingly, the municipal bond market has been volatile after the November election and rates have increased to 3.87% as of November 17, 2016. These changes do not affect the projected costs for issuing commercial paper, but do make the decision to pursue commercial paper more financially reasonable in light of a volatile and uncertain bond market.

Payment of Costs Associated with the Commercial Paper Note Program. The Commercial Paper Notes principal outstanding will be taken out with the long term bonds in approximately a two year period. The Water Utility will continue to make the interest payments when due during this period. Commercial Paper program costs and the interest costs will be appropriated annually in the Water Utility Fund budget.

Based on Public Utilities Department projections for project spending and cash flow needs and current market conditions, the projected costs in Fiscal Year 2017 total \$0.3 million (\$0.2 million for program costs and \$0.05 million for interest costs). In Fiscal Year 2018, the projected costs total \$1.6 million (\$0.9 million for program costs, and \$0.7 million for interest costs). For the remainder of the two year period, the projected costs in the first half of Fiscal Year 2019 are \$1.1 million (\$0.5 million for program costs and \$0.6 million for interest costs).

There were annual budgetary debt service savings achieved from refunding the Water Utility's outstanding bonds with the June 2016 issuance of Subordinated Water Revenue Bonds, Refunding Series 2016B. The refunding provided an average annual debt service savings of approximately \$5.0 million annually in Fiscal Year 2017 through 2040. The Water Utility intends to utilize these annual savings to cover the costs for Commercial Paper Notes. In Fiscal Years 2017-19, no long term bonds are anticipated to be issued due to the proposed funding through the Commercial Paper Notes Program. The debt service costs for the long term bonds would have been higher compared to the Commercial Paper Notes Program costs presented above. This is expected to generate incremental savings for the Water Utility Fund during this period.

CITY STRATEGIC PLAN GOAL(S)/OBJECTIVE(S):

Goal #1: Provide high quality public service

Objective #1: Promote a customer-focused culture that prizes accessible, consistent, and predictable delivery of services

PREVIOUS COUNCIL and/or COMMITTEE ACTIONS:

This item was heard by the Budget and Government Efficiency Committee on November 16, 2016, and forwarded to full Council with the recommendation to adopt the resolution.

On March 23, 2015 City Council approved a resolution R-309577 to adopt revisions to the City's Debt Policy to add guidelines and implementation of a commercial paper notes program.

On February 10, 2015 City Council received financial training from the Independent Budget Analyst for an introduction to Commercial Paper Program and mechanics of implementation, presented by the City's Municipal Advisor.

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:

This item was heard at the November 16, 2016 meeting of the Budget and Government Efficiency Committee. A notice of public hearing concerning the adoption of the resolution is published 5 days prior to the City Council hearing.

The Public Utilities Department conducts community outreach on a project basis.

KEY STAKEHOLDERS AND PROJECTED IMPACTS:

Business entities involved in the proposed financings include Montague DeRose and Associates, LLC (Municipal Advisor); Hawkins Delafield & Wood LLC (Bond and Disclosure Counsel); U.S. Bank National Association (Issuing and Paying Agent/Trustee); Bank of America, N.A. and Bank of the West (Letter of Credit Providers); Citigroup, Bank of America Merrill Lynch, and RBC Capital Markets (Commercial Paper Dealers); Moody's Rating Service and Fitch Ratings (Rating Agencies).

Respectfully submitted,



Lakshmi Kommi
Debt Management Director



Mary Lewis
Chief Financial Officer

Attachment:

Attachment 1: Report No. 16-090 to Budget and Government Efficiency Committee dated November 4, 2016



THE CITY OF SAN DIEGO

Report to the City Council

DATE ISSUED: November 4, 2016 REPORT NO. 16-090

ATTENTION: Budget and Government Efficiency Committee

SUBJECT: Authorization for the Public Facilities Financing Authority of the City of San Diego Subordinated Water Revenue Commercial Paper Notes Program

REQUESTED ACTION:

Forward the proposal for establishing the Subordinated Water Revenue Commercial Paper Notes Program to City Council for consideration and approval in accordance with the timeline established for the program.

STAFF RECOMMENDATION:

Forward the requested action for City Council's consideration and approval.

EXECUTIVE SUMMARY OF ITEM BACKGROUND:**I. Background**

Below is an overview of commercial paper, discussion of current market conditions, specific parameters and plan of finance for the Water Revenue Commercial Paper Notes program, and analysis of financial considerations. Debt Management will be issuing a companion report to the City Council to discuss the legal documentation to establish the program subsequent to Committee review. Attachment 1 provides a complete listing of the legal documents to be authorized by the City Council to implement the Commercial Paper Program.

The Chief Financial Officer and the Water Utility have undertaken a multi-part process to streamline cash management in the Capital Improvement Program ("CIP") as efficiently and effectively as possible and to promote a more efficient use of available cash to complete projects. Staff is seeking authorization for a Commercial Paper Program for the Water Utility Fund, which is a strong cash management tool and will provide a "just in time" seamless funding source for several large scale Water System projects.

The authorization will allow the Water Utility to issue short-term debt to fund water capital needs, which will ultimately be refinanced into long-term bonded debt as the capacity nears the not to exceed levels that will be authorized by City Council. *This commercial paper program will be used for the Water System projects only.* The Commercial Paper Program will allow the Water Utility to take advantage of the low short-term borrowing rates and gives the Water

Utility greater financial flexibility. The Commercial Paper Program will enable the Water Utility to:

- Have quick access to the market and the flexibility to tailor borrowings to both market conditions and specific cash requirements,
- Only borrow amounts when funds are required (as capital project spending occurs),
- Immediately receive proceeds from the sale of Commercial Paper, and
- Avoid negative arbitrage and the risk of over-borrowing and incurring additional interest costs.

The Public Utilities Department has an active Water System CIP which supports the water system infrastructure for reliable water supply, the recycled water system, and other critical water projects. From time to time, bonds have been issued and state loans have been obtained to finance portions of the Water System’s CIP. In June 2016, the Water Utility issued new Water Bonds with \$80 million of proceeds and the Public Utilities Department projects to expend these funds by February 2017. As of October 31, 2016, the Water System has \$665 million in outstanding bonds and approximately \$60 million in outstanding Drinking Water State Revolving Fund (“SRF”) loans. Currently, funding for water projects are provided by a variety of sources which includes long-term bond financing, paygo, SRF loans, and grants to complete various Water System capital projects citywide.

II. Discussion

A. Commercial Paper Overview

Commercial paper is a short-term security which can be used as a cash management tool and to bridge capital funding gaps and delays. It is used by most agencies with large capital programs, such as SANDAG, San Diego County Water Authority, Los Angeles Department of Water and Power and the San Francisco Public Utilities Commission.

Key Features

Authorized amount	<ul style="list-style-type: none"> • City Council specified amount that limits the total size of the Commercial Paper program specific to Water Utility
Short-term maturity	<ul style="list-style-type: none"> • Notes will have a maximum maturity of 270 days • Determined for each note at the time it is sold • Commercial Paper Notes are rolled until taken out with bonds
Liquidity support	<ul style="list-style-type: none"> • Provided by 2 highly-rated commercial bank credit facilities (“credit banks”) with irrevocable direct-pay Letters of Credit (“LOC”)
Credit ratings	<ul style="list-style-type: none"> • Requires at least two short-term credit ratings • Based on the credit of the credit banks
Amount outstanding	<ul style="list-style-type: none"> • Water Utility may have any amount from \$0 to the total authorized amount outstanding at any time

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|---------------------------------|---|
| Commercial Paper Dealers | <ul style="list-style-type: none">• Investment banks selected to periodically market the Water Utility's commercial paper notes to prospective investors• Uses an Offering Memorandum to market the Commercial Paper Notes. This disclosure document is different from Official Statements in that it mostly describes the financial position of the credit bank, instead of the Water Utility |
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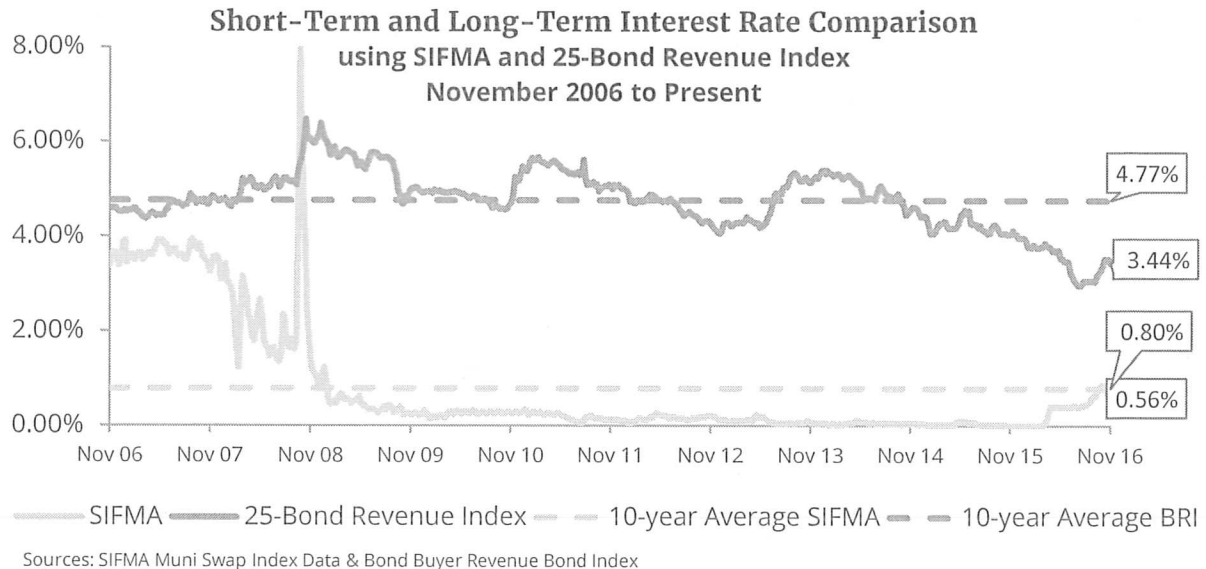
The Water Revenue Commercial Paper Notes can be issued with maturities ranging up to 270 days. The length of the notes are dependent on market conditions. The interest rate is set for the term of each note and interest is paid only at maturity. The principal and interest on each maturing note may be paid from a new commercial paper note (a "rollover"), from the proceeds of long-term bonds ("take out"), or from other funding sources, such as the Water Utility Fund operating budget.

These variable short term periods allows a commercial paper dealer to remarket the commercial paper notes to investors with specific needs, while securing short-term interest rates advantageous to the Water Utility. However, the continuous remarketing requires an available source of funds to repay the investor when the commercial paper notes mature. In order to provide this available source of funds, the commercial paper program requires a letter of credit ("LOC") from a commercial bank, which provides credit enhancement and liquidity for the program. The LOC guarantees liquidity to investors when their notes mature for payment of principal and interest. As a result of the credit bank's guaranty of payment, commercial paper programs hold the short-term credit ratings of the LOC credit bank.

B. Short-Term Market Trends and Current Capital Market Conditions¹

Capital Market Conditions. A key factor for the commercial paper market is short term interest rates. The graph below compares the SIFMA index (short term rate index) with the 25-bond revenue index (long term bond index). The SIFMA index will accurately reflect general municipal market sentiment and enable the City to estimate where its commercial paper "should" trade based on historical relationships. The SIFMA index has been consistently lower than the 25-bond revenue index except for approximately 2 weeks during the last 25 years (those two weeks occurred during the financial crisis in 2008).

¹ Per Office of the Independent Budget Analyst Report 15-06 recommendations, which were adopted in the Debt Policy, to provide an overview of capital market conditions, risk considerations and evaluation of market conditions before issuance of notes.



Money market fund reform has impacted short-term rates with significant volatility over the last few weeks. SIFMA has increased this year from 0.01% to a high of 0.87%, and is currently 0.56%. This has been driven by both seasonal market outflows as well as a sharp decline in tax-exempt Money Market Fund assets by \$124 billion since the beginning of 2016.

There is evidence of the current short term market stabilizing with lower inventory levels compared to that of the last few weeks. With the likelihood for short term rate increases by the Federal Reserve (the market currently forecasts a 66% probability of a rate hike in December), it is not expected that the short-term rates will return to pre-money market reform levels in the near term, unless there is some extraordinary market event. However, the market may have already priced in most of the expected December rate increase. Looking forward to the next 1-2 years, while it is not possible to predict interest rates with certainty, it is likely that short term interest rates will continue to be less than long term interest rates which would result in the Water Utility incurring a lower cost of financing during the commercial paper period compared to long term bonds.

Buyers of Commercial Paper. The buyers of commercial paper are considered short-term investors, because their investments in commercial paper mature in 270 days or less. One of the attractive features commercial paper offers to an investor is individual maturities can be matched to the specific timing needs of an investor (such as 30 days, or 115 days). Buyers of commercial paper include major corporations and money market funds. Commercial paper is attractive to money market funds because it complies with the maturity limitation imposed on such funds, and the flexibility in setting the maturity of commercial paper may help the money market fund achieve or maintain the average maturity it is seeking. Money market funds are likely to continue to buy a given issue of commercial paper as it rolls over, and thus may own an issue for an extended period of time.

C. Risks of Commercial Paper

Capital Market Risks. Just like the market for any other security, supply and demand determine commercial paper note yields. The yield of a specific note depends on the maturity length, the amount financed, and the level of other money market rates and the credit rating of the LOC credit bank. For the issuer, market risks which can arise – driven by the capital markets – could cause the commercial paper note yields to rise.

Remarketing Risk. Commercial paper is subject to rollover remarketing risk—the risk that a note cannot be remarketed to a buyer at a reasonable rate of interest. Although the commercial paper market is often a stable source of financing, there have been some instances like the financial crisis of 2008 where bank troubles and investor concerns adversely impacted the commercial paper market making it difficult and/or expensive to remarket notes. At that time, many issuers were unable to remarket or rollover their notes, causing supporting LOC credit banks to pay principal and interest to noteholders and then offering loans to issuers to repay the LOC credit bank for the immediate liquidity. Although the 2008 financial crisis may have been an aberration and commercial paper markets subsequently returned to normal, it is possible that there could be another financial or market crisis that could hinder the Water Utility's ability to efficiently remarket its commercial paper notes. However, if the market for commercial paper does seize up for any reason, the Water Utility has the ability to turn commercial paper debt into a bank loan with the LOC credit bank until those notes can be remarketed.

Interest Rate Risk. There is concern of whether to lock in bond interest rates now or wait two years to lock in a 30-year borrowing rate. The risk is that the 30-year borrowing rate will be higher in two years than it is today. While commercial paper rates remain significantly lower than long term bond interest rates, they still run the risk of increasing in the future (see Fiscal Considerations for discussion). In addition, occasionally an inverse yield curve exists, where short term rates are higher than long-term rates. When this does occur, market forces usually soon correct this situation but it may alter financial decision making while the condition is present.

Letter of Credit Risks. In relying on the LOC credit bank's credit rating for each commercial paper note, the issuer runs the risk of the LOC's credit rating being reduced, withdrawn or suspended. The Water Utility also runs the risk of higher interest costs due to the bank's rating changes. Over the past ten years, some issuers have faced the need to replace LOC banks with declining creditworthiness. While this process has generally gone very smoothly and ample credit capacity has been available in the municipal market, it is possible that a LOC bank may have deteriorating credit and no replacement bank can be found. In that case, the City would likely face paying higher interest rates until the situation is corrected by finding another LOC bank or taking out the CP notes with fixed rate debt or another funding source. Additionally, although this situation has not occurred, if the LOC credit bank refuses to honor a request for payment to investors for maturing notes, the Water Utility Fund will need to pay principal and interest on all outstanding Commercial Paper Notes immediately.

D. Parameters of Water Revenue Commercial Paper Notes Program²

Updates to the City's Debt Policy (Section 3.15) were adopted in March 2015 for commercial paper borrowing as a short-term cash management tool. Consistent with the requirements of the Debt Policy, the following items are parameters that the Water Utility will establish for commercial paper through legislative authorization and administrative policies and procedures for the program.

- **Interest rate cap.** Following the Debt Policy guidelines, the Resolution to be approved by City Council will establish that commercial paper notes can be issued from time to time, provided that as to each such issuance, the interest rate on commercial paper notes may not exceed the lesser of 11% per annum or the maximum rate per annum permitted by law (currently 12%). Interest rates are not expected to reach these levels as the commercial paper current interest rates are 0.56% and the ten year average is 0.80% (since November 2006).
- **Maximum maturity of notes.** The maximum maturity of notes issued will be 270 days. Staff expects to issue notes up to 90-120 day range, depending on market conditions. Recent trends indicate commercial paper investors have exhibited a marked preference for maturities around 90 days.
- **Sizing and timing new note issuances.** Following the Debt Policy guidelines, the total commercial paper program is limited to an amount not to exceed 110% of the dollar value of the next planned long term borrowing for capital projects, described below under "Plan of Finance."

New commercial paper notes will be issued on a monthly basis to reimburse the prior month's capital expenditures initially funded with cash. The minimum amount of each commercial paper issuance are anticipated to be \$2,000,000 or more to minimize the amount of processing time and costs associated with a new note. The commercial paper dealers and authorized City staff will determine the maturity of each new note. Generally, commercial paper dealers provide maturity indications based on investor requests, market conditions, and/or scheduled economic indicators.

- **Tracking activity and reporting.** Debt Management Department will monitor and track new note issuances and rollover activity, interest rates, and costs on an ongoing basis. A quarterly memorandum will be provided to the City Council by Debt Management describing all outstanding notes and associated capital project financing activity, following the guidelines of the Debt Policy. Once a long term bond has been issued to refinance outstanding notes, pursuant to the Debt Policy, the Municipal Advisor of this transaction will work with staff to develop a retrospective analysis of all costs associated with using commercial paper borrowing in conjunction with long term bonds as compared to the alternative of issuing long term debt to finance capital projects in place of commercial paper borrowing.

² Office of the Independent Budget Analyst Report 15-06 provided recommendations, which were adopted in the Debt Policy, for sizing, not-to-exceed caps, and ongoing reporting which are addressed in program's parameters.

- **Budgeting costs.** All interest costs and ongoing fees related to the administration of commercial paper are to be budgeted and paid out of a newly established Commercial Paper Payments and Fees commitment item within the Water Utility Operating Budget. Debt Management Department will assist Public Utilities Department in preparing estimates of commercial paper-related interest expenses and fees based on estimates of commercial paper draws for eligible project costs provided by Public Utilities Department. Staff will use interest rate assumptions that are higher than the then-current market rates, and document those assumptions so that they are easy to identify at a later date.
- **Policies and Procedures for issuing Commercial Paper Notes.** A comprehensive Commercial Paper Policies and Procedures Manual is being developed by the Debt Management Department, Office of the City Comptroller, Public Utilities Department, Office of the City Treasurer and Financial Management Department to document the policies and procedures that City staff will utilize in the day to day management of the commercial paper program and the other parties involved in the issuance and administration of the program.
- **Future Council Authorizations.** Debt Management will return to City Council to seek authorization for long-term bonds to take out commercial paper when the amount of notes outstanding nears maximum capacity. Additionally, Debt Management will return to City Council to seek approval or renewal of Letter of Credits and Dealer Agreements upon expiration or termination of each respective agreement. Should Public Utilities Department require an increase in the total capacity of the program, Debt Management will return to City Council for authorization to change program limits.

E. Plan of Finance

- **Issuer:** Public Facilities Financing Authority of the City of San Diego (“Authority”).
- **Authorized Amount:** up to \$250 million outstanding at any time.
- **Commercial Paper Term:** this program will be an ongoing program. The authorization is currently sized to cover the next two years of Water System CIP needs.
- **Projects:** The Public Utilities Department projects that approximately \$243 million is needed to fund the next two years of the Water System’s CIP projects. The commercial paper proceeds of up to \$250 million is projected to be utilized for the following CIP needs by asset category:
 - Pure Water \$ 56 million
 - pipeline projects¹ \$ 54 million
 - pipeline transmission projects \$ 60 million
 - pump station projects \$ 10 million
 - storage projects¹ \$ 14 million
 - other projects² \$ 25 million
 - water treatment plant projects \$ 31 million

¹ Includes projects where funding changed from SRF financing to commercial paper financing (Pacific Beach Pipeline and Miramar Clearwells).

² Includes the Advanced Metering Infrastructure (“AMI”) project.

- **Structure:** The Water System-supported Water Revenue Commercial Paper Notes will be issued under the 2009 Master Indenture and the 2009 Amended and Restated Master Installment Purchase Agreement. Water System revenue is the repayment pledge.
- **Ratings:** Moody's and Fitch will issue short-term ratings for the Water Revenue Commercial Paper Notes. These ratings are based on the credit quality and strength of each LOC credit bank supporting the program.
- **Tax Status:** The commercial paper notes will be issued tax-exempt. Interest on the commercial paper notes will not be included in gross income for federal income tax purpose and will be exempt from present State of California personal income taxes.
- **Interest Payments:** The Commercial Paper Program is structured so that the Water Utility Fund will pay interest expenses on an ongoing basis as each note matures.
- **Principal Payments:** Principal on the commercial paper notes will be paid solely from funds drawn under the LOC. The Water Utility's intent is to take out outstanding commercial paper notes with long-term bonds.
- **Security and Repayment:** Under the terms of the financing documents, the commercial paper notes are limited obligations of the Authority payable solely from the Installment Payments made by the Water Utility Fund. The Installment Payments are secured by and payable solely from the Net System Revenues 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. Such Installment Payments with respect to the commercial paper notes will be made on a subordinated basis, on parity with the outstanding Subordinated 2012A Water Bonds, and the Subordinated 2016 A&B Water Bonds.

F. Financing Timeline:

The following are the critical milestones related to the execution of the Commercial Paper Notes:

November 16, 2016	Budget and Government Efficiency Committee approval
December 6, 2016	City Council authorization of documents and financing plan
Mid-January 2017	Distribute Offering Memorandum to investors
Late-January 2017	Document signing and closing
Week of January 30, 2017	First Note issue anticipated to fund Water System CIP

G. Commercial Paper Program Financing Team

The Financing Team consists of staff of the Department of Finance, including the Chief Financial Officer and staff of the Debt Management Department, the Office of the City Comptroller, and the Treasurer's Office. The Financing Team also includes staff of the City Attorney's Office and the Public Utilities Department.

The external Financing Team members maintain and provide access to the financial markets and enhance the marketability of the Water Utility's commercial paper notes. External members include: Montague DeRose & Associates, LLC as the Municipal Advisor; Hawkins Delafield & Wood LLP as Bond and Disclosure Counsel; U.S. Bank National Association as Issuing and Paying Agent and Trustee; and Citigroup Global Markets Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, and RBC Capital Markets, LLC as Commercial Paper Dealers.

Municipal Advisor: Montague DeRose & Associates, LLC was selected to provide municipal advisory services for this program through a competitive RFP process utilizing the City's As-Needed Financial Advisors Pool based on the firm's experience in launching commercial paper programs for numerous agencies and the fee proposal. The fee is a not to exceed \$50,000 plus out of pocket expenses not to exceed \$5,000 to be paid out of note proceeds.

Bond Counsel: The City Attorney's Office has identified, via an RFP process, Hawkins Delafield & Wood LLP to serve as Bond and Disclosure Counsel for the Water System Commercial Paper Notes Program for an amount of \$95,000 for services, plus out-of-pocket expenses not to exceed \$5,000. The fees payable to Bond and Disclosure Counsel are to be paid out of note proceeds.

Issuing and Paying Agent: U.S. Bank National Association was selected to provide Issuing and Paying Agent services for this program through a competitive RFP Process based on their significant experience providing such services and that they provide a user-friendly reporting system for administrative and tracking purposes. The proposed fees are \$7,000 at closing, to be paid out of note proceeds, and annual fees of \$4,000 for administration and \$18 per commercial paper trade.

Trustee: U.S. Bank National Association currently also acts as trustee for the outstanding Water Revenue Bonds. As a Trustee for the commercial paper notes, U.S. Bank's role is to maintain the Costs of Issuance account and to transfer Water Utility's interest payments for commercial paper notes to the Issuing and Paying Agent to reimburse the LOC credit bank.

Letter of Credit Banks: A direct-pay LOC represents a bank's promise to pay principal and interest when due for a defined period of time and subject to certain conditions. Under this commercial paper program, the Issuing and Paying Agent will draw upon the LOC to make principal and interest payments to investors. In October 2016, the City issued an RFP to banks requesting direct-pay letters of credit and/or alternative bank products to support the commercial paper program. Based on analysis of financing needs, structure, evaluations of the proposals, staff in conjunction with the Municipal Advisor, have shortlisted Bank of America, National Association and Bank of the West to provide credit services. The terms and conditions with each credit bank are being finalized.

Commercial Paper Dealers: The role of a commercial paper dealer is to periodically market the Water Utility Fund’s commercial paper to prospective investors, to sell the commercial paper notes at the time of issuance and to resell the rollover commercial paper notes at maturity. Citigroup Global Markets Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, and RBC Capital Markets, LLC were selected to serve as Commercial Paper Dealers for the program. The firms were selected through a competitive RFP process utilizing the City’s qualified list for investment banking services and evaluated based on prior experience with similar commercial paper programs for other California governmental entities, technical approach and proposed marketing approach for the Water Utility commercial paper. The commercial paper dealers offered the remarketing fee of 0.045 percent of each firm’s the weighted average of commercial paper notes outstanding.

FISCAL CONSIDERATIONS:

Rationale for Use of Commercial Paper in Construction Financing.

Using commercial paper as part of a larger financing strategy for a construction program is prudent. Like many public agencies, the Water System lacks the cash resources to finance a program of the magnitude of the Water System CIP on a “pay as you go” basis. As a result, the City is financing the Water System’s CIP using various forms of debt financing, where debt is issued to investors, who receive periodic payments of principal and interest from the City over the life of the debt. As noted above, Commercial Paper is a short-term financing instrument. Because it has a very short maturity compared to a 20-year loan or 30-year bond, the interest rates charged on commercial paper notes are usually significantly lower than the rates for long-term bonds, although the difference between these rates varies based on market conditions.

For public agencies embarking on large construction programs that face uncertainty concerning the timing of their construction cash flow requirements, commercial paper offers much greater flexibility than a long-term bond issue, along with lower interest rates. Commercial paper allows an issuer to obtain funds as they are needed, in whatever amounts and with whatever frequency is necessary, rather than relying on a bond issue that takes months to prepare and implement, and may leave the issuer with either more or less bond proceeds than it needs to meet its near-term cash flow requirements. In this context, commercial paper is typically used as a form of “just in time financing,” to be refinanced at a later date with long-term bonds.

Costs of Issuance. The following is a summary of estimated financing costs (“costs of issuance”) associated with the Subordinated Water Revenue Commercial Paper Notes Program, **excluding interest payments**. The closing costs will be financed with commercial paper notes. The annual program costs assume monthly issuances of commercial paper notes, and these will be budgeted and paid from Water Utility Operating Funds.

<i>Estimated Costs of Issuance for Program size of \$250 million</i>	<i>Costs at Closing</i>	<i>Annual Costs for the Program (based on Fiscal Year 2018 cost projections)</i>
Bond Counsel Fees and Expenses	\$100,000	-
General Disclosure Counsel	3,000	-

Municipal Advisor Fees and Expenses	55,000	-
Letters of Credit Facility Fees	-	\$810,000 ¹
Letter of Credit Counsel	65,000	-
Commercial Paper Dealer Fees	1,000	50,000 ²
Dealer Counsel Fee	7,500	-
Rating Fees	62,000	45,000 ³
Bank Note Rating Fees	13,000	-
Issuing and Paying Agent Fees	7,000	5,300 ⁴
CUSIP Fees	500	-
Misc. Fees and Contingency	14,600	-
Total Estimated Costs	\$329,700	\$910,300

Assumptions for annual costs:

1. Letter of Credit Facility Fees are estimated based on proposals from shortlisted credit banks. Projections assume the maximum cost for draws.
2. Commercial Paper Dealer Fees: All Dealers will charge 0.045% annually of the average amount of outstanding notes sold by each Dealer on a quarterly basis. Projections assume monthly issuances.
3. Ratings: Ongoing surveillance ratings are required to be maintained, to be paid annually each January.
4. IPA Fees: Annual fees are \$4,000; assumes six commercial paper trades per month at a rate of \$18 per trade.

Interest Costs. Based on the projected spending schedule and the issuances required to support the Water System CIP, the projected commercial paper interest costs at current rates for the rest of Fiscal Year 2017 is \$45,300 and in Fiscal Year 2018 it is projected to cost \$684,000. These are projections based on current rates and are subject to change. The interest costs will be budgeted and paid from Water Utility Operating Funds. Interest will be paid on an ongoing basis as commercial paper notes mature.

Commercial Paper and Long-Term Bonds Analysis. In early 2015, City Council received a memo and an addendum from Debt Management that described analysis of Commercial Paper under various scenarios and possibilities. With a more detailed plan in anticipation of the Water Utility Fund needs, an analysis was run to compare the costs for an initial issuance of commercial paper to be taken out in two years by 30-year bonds as compared with an up-front issuance of a 30-year bonds. Below is an analysis of present value savings, based on current rates which are subject to change:

	Commercial Paper Rate	Estimated Long Term Bond Rate	Rate Difference	Estimated Present Value Debt Service Savings from Commercial Paper Notes*
Water Utility Current Rates	0.56%	3.47%	2.91%	\$13.0 Million

Note: based on current rates, subject to change.

* Incorporates all Costs of Issuance for Commercial Paper (Letter of Credit Fees, Dealer Fees), and Long Term Bonds Costs of Issuance (Bond and Disclosure Counsel, Underwriter's Discount, etc.)

The scenario described above assumes \$250 million of commercial paper drawn over a period of two years and no change in long term interest rates between the issuance of commercial paper and the issuance of long term bonds. Under such conditions, due to utilizing commercial paper's lower short term interest rates and as-needed borrowing structure, present value savings are realized.

While present value savings are realized, an increase in long term interest rates between the issuance of commercial paper and the issuance of long term bonds at a later date could result in the elimination of the arbitrage difference. At current interest rate levels, if the long term interest rates would rise 0.75% (break-even rate) between the issuance of commercial paper and the issuance of long term bonds, the present value savings advantage presented above would be eliminated.

CITY STRATEGIC PLAN GOAL(S)/OBJECTIVE(S):

Goal #1: Provide high quality public service

Objective #1: Promote a customer-focused culture that prizes accessible, consistent, and predictable delivery of services

PREVIOUS COUNCIL and/or COMMITTEE ACTIONS:

The City has not issued Commercial Paper in the past but the City Council has received a training in 2015 on commercial paper process and benefits.

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:


This item is docketed for Budget and Government Efficiency Committee. A notice of public hearing concerning the adoption of the resolution is published 5 days prior to the City Council hearing.

The Public Utilities Department conducts community outreach on a project basis.

KEY STAKEHOLDERS AND PROJECTED IMPACTS:

Business entities involved in the proposed financing include Montague DeRose and Associates, LLC (Municipal Advisor); Hawkins Delafield & Wood LLP (Bond and Disclosure Counsel); U.S. Bank National Association (Issuing and Paying Agent/Trustee); Citigroup Global Markets Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, and RBC Capital Markets, LLC (Commercial Paper Dealers); Moody's Rating Service and Fitch Ratings (Rating Agencies).

Respectfully submitted,



Lakshmi Kommi
Debt Management Director



Mary Lewis
Chief Financial Officer

Attachment: 1. Legal Documents for Establishment of the Water Revenue Commercial Paper Notes Program

Attachment 1

Legal Documents to be authorized by City Council to implement the Water Revenue Commercial Paper Notes Program

1. *Resolution of the City Council*
2. Form of the *Fifth Supplemental Indenture* supplementing and amending that certain Indenture dated as of January 1, 2009, as supplemented and amended by and between the Public Facilities Financing Authority of the City of San Diego and U.S. Bank National Association, as Trustee
3. Form of the *2016 Commercial Paper Supplement to the Amended and Restated Master Installment Purchase Agreement ("MIPA")* by and between the City of San Diego and the San Diego Facilities and Equipment Leasing Corporation
4. Form of the *Assignment Agreement* by and between the San Diego Facilities and Equipment Leasing Corporation and the Public Facilities Financing Authority of the City of San Diego
5. Form of the *Issuing and Paying Agency Agreement* by and between the Public Facilities Financing Authority of the City of San Diego and U.S. Bank National Association, as Issuing and Paying Agent
6. Form of the *Dealer Agreement* by and between the Public Facilities Financing Authority of the City of San Diego and Dealers – 3 agreements will be executed
7. Form of the *Reimbursement Agreement and exhibits* by and between the City of San Diego and Letter of Credit Banks – 2 agreements will be executed
8. Form and distribution of the *Offering Memorandums* in connection with the issuance of the Subordinated Water Revenue Commercial Paper Notes – 2 Offering Memorandums will be authorized and distributed