THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: March 20, 2015 **IBA Report Number:** 15-06 REV.

City Council Date: March 23, 2015

Item Number: 150

Update of the City's Debt Policy: Proposal to Authorize the Use of Commercial Paper

BACKGROUND

The City Council will be asked to adopt a resolution in support of proposed changes to the City's Debt Policy on March 23, 2015. Initially adopted in 2007, the Debt Policy provides policies and parameters for debt instruments/securities issued by the City in public and private capital markets. The Debt Policy was updated annually through 2013 when it was determined that it could thereafter be updated biennially. This is the first biennial review and update.

As noted in their Report to the City Council, staff is recommending ten substantive changes to the Debt Policy. The proposed changes were presented and discussed at the Budget and Government Efficiency Committee on February 25, 2015. The Committee forwarded the Debt Policy to Council without recommendation in order to allow 1) the IBA more time to review the proposed changes with staff and 2) staff more time to respond to requests from Committee members.

The IBA has since reviewed all of the proposed Debt Policy changes. While we support the proposed changes, we also believe it is important the Council understand the potential risks associated with the use of commercial paper and establish guiding parameters in the Debt Policy. Given the Council's interest in our thoughts on the proposed use of commercial paper, this report comments on the benefits and potential risks associated with commercial paper borrowing. Since the Committee meeting, we have appreciated the opportunity to work with the CFO and Debt Management Director to include additional clarifications and requirements regarding the use of commercial paper (discussed later in this report).

This report briefly discusses the best practice rationale for maintaining a comprehensive Debt Policy. In response to a request from Councilmember Alvarez, we also comment on a new Debt

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Policy requirement to provide the Council with information about unpledged and suitable City properties that can be used to facilitate future lease revenue bond issuances.

FISCAL/POLICY DISCUSSION

Purpose of a Debt Policy

The Government Finance Officers Association (GFOA) indicates it is a best practice for cities to have a Debt Management Policy. The GFOA's best practice advisory (dated October 2012) provides the following description of a debt management policy:

> Debt management policies are written guidelines, allowances, and restrictions that guide the debt issuance practices of state or local governments, including the issuance process, management of a debt portfolio, and adherence to various laws and regulations. A debt management policy should improve the quality of decisions, articulate policy goals, provide guidelines for the structure of debt issuance, and demonstrate a commitment to long-term capital and financial planning. Adherence to a debt management policy signals to rating agencies and the capital markets that a government is well managed and therefore is likely to meet its debt obligations in a timely manner. Debt management policies should be written with attention to the issuer’s specific needs and available financing options and are typically implemented through more specific operating procedures. Finally, debt management policies should be approved by the issuer’s governing body to provide credibility, transparency and to ensure that there is a common understanding among elected officials and staff regarding the issuer’s approach to debt financing.

The IBA believes the City has adopted a comprehensive Debt Policy that is in keeping with this definition. The City's Debt Policy is regularly reviewed by Debt Management Department staff and biennially revisited/re-adopted by the Council. When borrowing proposals come to the Council for action, the Debt Policy offers written policy criteria to guide questions and decisions.

Comments Related to the Availability of City Property to Facilitate Lease Revenue Bonds

Lease revenue bonds continue to be the City's primary means of borrowing long-term to finance needed capital projects. The issuance of these bonds is dependent on the creation of General Fund leases for "essential" public assets owned by the City (police stations, fire stations, libraries, operations stations, ground leases, etc.). There are currently 21 public assets that have been leased to facilitate the City's outstanding General Fund-backed lease revenue bonds (see Attachment 1 from the Debt Management Department).

Four more public assets shown in Attachment 1 will be leased in support of the $120 million DC-3 lease revenue bonds planned to be sold in April 2015. Beyond the planned $120 million DC-3 borrowing, the City’s current plan contemplates issuing $90 million of lease revenue bonds annually for three years beginning in FY 2017. Additional public assets will need to be identified for leases to facilitate the sale of these bonds.

Our Office has questioned whether the City has enough suitable, publicly owned assets to support continued lease revenue bond borrowing. Staff previously responded that there are enough suitable public assets for planned borrowings; however, they were less certain about the availability of additional public assets to support future lease revenue bonds. In order to better understand go-forward bonding capacity, Councilmember Alvarez suggested the Debt Policy be amended to require the Council be periodically apprised of the remaining inventory of suitable public property that could be used for future lease revenue bond borrowing. The IBA agrees with this suggestion. Section 4.2 (Affordability Ratios for General Fund-Supported Debt) has been amended to require that whenever authorization is sought for a lease revenue bond the Council be provided with an estimate of the amount of unpledged and suitable City properties that are expected to be available to support additional lease revenue borrowings.

Debt Policy Section 3.15 - Commercial Paper Notes

The CFO and the Debt Management Director are proposing to add Section 3.15 to the Debt Policy to allow for commercial paper borrowing. As stated in the staff report, commercial paper would serve as a short-term cash management tool that will primarily be used to provide interim funding for capital expenditures that will ultimately be funded from another source such as long-term bonds.

In response to a request from the CFO and the Debt Management Director, the IBA scheduled a financial training for the Council on February 10, 2015 entitled "Introduction to Commercial Paper Program and Mechanics of Implementation". The presentation was made by the City's Municipal Advisor - Jim Beamus of Montague DeRose and Associates. During the presentation, Mr. Beamus discussed benefits and considerations (risks, costs, administration) associated with the utilization of commercial paper. Some of the key points are summarized below:

Commercial Paper Benefits:

1) **Helps the City reduce inefficient "negative arbitrage".** When the City issues long-term bonds to raise capital for projects, it borrows more money than it can immediately use for projects. In fact, it has taken the City between three to five years to fully expend bond proceeds. Although idle bond proceeds earn interest in the City's short-term investment pool, interest earned is typically much less than the long-term interest the City must pay on bonds - the difference is referred to as negative arbitrage. Once a commercial paper program is established, the City can quickly issue short-term notes to borrow smaller amounts of money just in time to meet immediate capital project needs. This can significantly reduce inefficient negative arbitrage costs.

2) **Reduces interest costs in the short-term.** Commercial paper notes are issued for shorter periods of time (up to nine months) and therefore require short-term rates of interest which have historically been significantly lower than interest rates on long-term bonds. Staff indicates that commercial paper rates have been approximately 2.7 percentage points lower than the rates on long-term bonds on average over the last 25 years (although the actual difference at any point in time can vary widely depending on market conditions). It is important to note that interest costs are only reduced in the short-term. Overall, the City will almost always pay more interest over

time in absolute terms as the use of commercial paper in conjunction with long-term bonds extends the borrowing period from 30 years to somewhere between 31 and 33 years depending on when long-term bonds are issued to retire the commercial paper notes.

3) **The use of commercial paper creates other capital project efficiencies.** Because commercial paper provides a just-in-time short-term borrowing mechanism, capital project managers do not have to wait for borrowed funds to pay for project costs. Additionally, the availability of commercial paper as a reliable short-term borrowing resource may enable staff to better manage other sources of project capital (e.g., TransNet) and/or relax certain project encumbrance practices in a way that allows more projects to be undertaken sooner.

<u>Commercial Paper Risks</u>:

1) **Interest Rate Risk.** If commercial paper notes are used to fund capital project costs in the short-term, the City will still need to issue long-terms bonds (one to three years later) to replace the commercial paper notes. The decision will always be whether to issue long-term bonds now and lock-in a 30-year fixed rate now OR issue commercial paper now and wait one to three years to lock-in a 30-year fixed borrowing rate. Interest rate risk is the risk that the 30-year fixed borrowing rate will be higher in one to three years than it is today. If so, the additional borrowing costs over time may more than offset the aforementioned benefits of using commercial paper.

It should be noted that long-term bond rates are currently at historic lows and that there is a general expectation that interest rates will rise in the near future (although this can never be accurately known or predicted in advance). In discussing interest rate risk following the training, Councilmember Kersey asked for a break-even analysis to get a sense of how much interest rates would have to increase to offset the fiscal benefits of issuing commercial paper. In response, the Debt Management Director issued a memo to the Council on February 24th (Attachment 2) indicating that if long-term bond rates were to increase by 0.70% to 0.95% (break-even rate), the calculated net present value savings of using commercial paper would not exist.

Having discussed this calculation with Debt Management staff, the IBA would make the following observations:

- The difference in the break-even range (0.70% versus 0.95%) is explained by the assumed interest rate on the long-term bonds. Using current long-term bond interest rates yields a 0.70% break-even differential whereas using the average long term bond interest rate over the past 10 years yields the 0.95% break-even differential.

- Staff's calculated 0.70%-0.95% break-even range assumes the City will wait <u>three years</u> to issue long-term bonds to replace commercial paper, yet the City's current borrowing plan calls for issuing $90 million in lease revenue bonds <u>annually</u> beginning in FY 2016. Given that the City currently has an annual long-term borrowing plan, the IBA believes the break-even calculation should be based on a one-year take out of commercial paper as opposed to three years. If the City issues long-term bonds to replace commercial paper in one-year (in keeping with the current long-term borrowing plan), <u>the calculated break-</u>

even range is reduced to 0.25% to 0.40%. The takeaway is that, based on current market rates, if long-term bond rates were to increase by a quarter of 1% (0.25%) over a year, there would be no savings associated with the use of commercial paper.

2) **Remarketing Risk.** Remarketing risk is the risk that a note can be remarketed to a buyer at a reasonable rate of interest. During the financial crisis of 2007-2009, bank troubles and investor concerns adversely impacted the commercial paper market making it difficult and/or expensive to remarket notes. Although the 2007-2009 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 City's ability to efficiently remarket its commercial paper notes.

3) **Costs associated with administering a Commercial Paper Program.** There will be City staff costs associated with effective administration of a Commercial Paper Program. While this is not a risk, it is a budgetary consideration. The IBA understands that staff contemplates an active Commercial Paper Program where there may be as many as ten notes issued in a month. If so and depending on the term of the notes, there could be numerous notes outstanding at any given time that would need to be monitored, remarketed and accounted for. While the work would be primarily managed by Debt Management, there could be other departments (Comptroller, Treasurer, Financial Management and Engineering & Capital Projects) with supporting responsibilities. The associated staff costs have yet to be determined/evaluated and it is possible that these responsibilities could be partially or fully assumed with existing staff. SANDAG and SDCWA have commercial paper programs that are not as dynamic and their associated staff costs are nominal.

Changes to the Debt Policy Section 3.15 Since Committee

Following the comments made by the IBA at the Budget and Government Efficiency Committee on February 25th, our office has worked with the CFO and Debt Management Director to include additional clarifications and requirements in Section 3.15 of the modified Debt Policy that is being presented to the Council for approval. The following additional clarifications and requirements have been added to Section 3.15 of the amended Debt Policy:

- Commercial paper notes will only be used for capital projects.

- Projects to be financed with commercial paper will be prioritized in accordance with Council Policy #800-14 titled Prioritizing Capital Improvement Program Projects.

- Language now explains what constitutes interest rate risk and remarketing risk. The Policy now explicitly requires the CFO to evaluate these risks in light of capital market conditions before proceeding with any issuance of commercial paper notes.

- The size of the inaugural Commercial Paper Program (planned to come back to Council in the fall) is limited to an amount equal to 110% of the dollar amount of the next planned long-term borrowing for capital projects. Additionally, a not-to-exceed cap on the interest rate that can be paid on the notes will be established.

- When Council approval is sought for the Commercial Paper Program, staff will provide the Council with an overview of capital market conditions, including potential risk considerations, and a comprehensive plan describing how notes will be utilized to finance specific capital improvement projects over the next year.

- Council will be provided with a quarterly memorandum describing all outstanding commercial paper notes and associated capital project financing activity. Additionally, the Policy provides that the Council may periodically request informational update presentations at either Committee or Council meetings.

- For the inaugural Commercial Paper Program, once a long-term bond has been issued to refinance outstanding notes, the CFO will immediately request that the City's Municipal Advisor 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. The Municipal Advisor will then submit a report of their analysis to the City and, if requested, present their analysis to the Budget & Government Efficiency and/or Infrastructure Committee.

CONCLUSION

The City Council is being asked to adopt a resolution in support of proposed changes to the City's Debt Policy. Following a discussion of proposed Debt Policy amendments at the Budget and Government Efficiency Committee on February 25th, the IBA has worked with staff to include additional clarifications and requirements regarding the proposal to allow commercial paper borrowing. We have additionally commented on the potential benefits and risks associated the use of commercial paper notes. If Council approves the amended Debt Policy, staff plans to return to Council in the fall for other approvals needed to implement a Commercial Paper Borrowing Program.

The IBA has now reviewed all of the proposed changes in the Debt Policy that is being presented for approval on March 23, 2015. We recommend support of these changes.

Jeff Kawar
Deputy Director

APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachments: 1. General Fund Lease Financing - Encumbered Properties
2. Commercial Paper - City Council Memo

Property Currently Encumbered Pursuant to General Fund Lease Financings

As of March 2015

Property	Asset Type	Bond Issue	Bond Maturity (Asset Release Date)
Petco Park Ballpark Facility[1]	Building & Land	2007 Ballpark Bonds	February 15, 2032
San Diego Convention Center (Port Ownership)[1]	Building & Land	2012A Convention Center Bonds	April 15, 2028
Site of Dana Inn and Marina	Ground Lease	2010A Master Ref Bonds	March 1, 2040
Site of Islandia Hyatt Regency and Marina	Ground Lease	2010A Master Ref Bonds	March 1, 2040
Site of Paradise Point Resort	Ground Lease	2010A Master Ref Bonds	March 1, 2040
Rose Canyon Operations Station	Building & Land	2010A Master Ref Bonds	March 1, 2040
Police Headquarters	Building & Land	2010A Master Ref Bonds	March 1, 2040
Northwestern Division Police Station	Building & Land	2010A Master Ref Bonds	March 1, 2040
Fire Communications Building	Building & Land	2012A & B CIP Bonds	April 15, 2042
Fire Station 9	Building & Land	2012A & B CIP Bonds	April 15, 2042
Fire Station 11	Building & Land	2012A & B CIP Bonds	April 15, 2042
Fire Station 37	Building & Land	2012A & B CIP Bonds	April 15, 2042
Mission Valley Library	Building & Land	2012A & B CIP Bonds	April 15, 2042
Site of Hilton San Diego Resort	Ground Lease	2012A & B CIP Bonds	April 15, 2042
Site of Lodge at Torrey Pines	Ground Lease	2012A & B CIP Bonds	April 15, 2042
Site of Scripps Health	Ground Lease	2012A & B CIP Bonds	April 15, 2042
Light Rail Transit System Maintenace Yard (MTDB Ownership)	Building & Land	2013A & B CIP Bonds	October 15, 2023
Fire Station 44	Building & Land	2013A & B CIP Bonds	October 15, 2042
Mingei International Museum and Art Institute Building	Building & Land	2013A & B CIP Bonds	October 15, 2042
Northeastern Police Division	Building & Land	2013A & B CIP Bonds	October 15, 2042
Site of a UC San Diego administration building	Ground Lease	2013A & B CIP Bonds	October 15, 2042
Fire Station 16	Building & Land	2015A & B CIP Bonds[2]	October 15, 2044
Southern Division Police Station	Building & Land	2015A & B CIP Bonds[2]	October 15, 2044
Scripps Miramar Ranch Library Center	Building & Land	2015A & B CIP Bonds[2]	October 15, 2044
Carmel Valley Multipurpose Community Complex	Building & Land	2015A & B CIP Bonds[2]	October 15, 2044

[1] Property is the subject of financing

[2] Anticipated April 2015

Prepared by Debt Management

THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: February 24, 2015

TO: Honorable Council President Sherri Lightner and Members of the City Council

FROM: Lakshmi Kommi, Debt Management Director

SUBJECT: Commercial Paper Program

On February 10, 2015, City Council participated in a financial training titled "Introduction to Commercial Paper Program and Mechanics of Implementation." During the training, staff was requested to follow-up on certain questions concerning the potential implementation of a Commercial Paper program. The questions and associated responses are provided below:

Q: Address interest rate risk trends.
A: The difference in borrowing rates between commercial paper and long term bonds primarily stems from the difference in short term and long term interest rates. Below are some observations regarding the interest rate trends for the past 25 years:

- Average long term rates over 25 years were higher than average short term rates by 2.72%
- Current long term rates are higher than short term rates by 2.45%
- Commercial paper rates have been higher than long term bond rates for eleven weeks over the last 25 years, or less than 1% of the time (most of those weeks occurred during the beginning of the Financial Crisis in 2008)

Based on these observations, below is an analysis of present value saving scenarios from using commercial paper as a short term financing instrument:

Scenario	Commercial Paper Rate	Long Term Bond Rate	Rate Difference	Present Value Savings
1. Current Rates	0.60%	3.05%	2.45%	$9.6 Million
2. Average Rates over past 25 Yrs	2.84%	5.56%	2.72%	$10.3 Million
3. Rates during 2007-2008	4.20%	4.64%	0.44%	$7.0 Million

Assumptions

- $100M funding need
- Present Value Savings of 30 Year Long Term Bond compared to 3 Years of Commercial Paper and issue of 30 Year Long Term Bond to refund Commercial Paper (both 30 Year Bonds reflect same levels of long term rates)

The scenarios described above assume 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. Commercial Paper rates would have to be higher than long term interest rates by approximately 4.8% to eliminate these present value savings; such scenario has not occurred in the last 25 years.

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 0.70% - 0.95% (break-even rate) between the issuance of Commercial Paper and the issuance of long term bonds, the present value savings advantage presented above would not exist.

Commercial Paper is recommended for new money borrowing to facilitate a ***just in time*** draw of funds. While movement in the long term interest rate is possible and recognized as a risk factor, the timing and amount of the borrowing need is a critical consideration. With no clear way of predicting future movements in interest rates, a just in time approach to borrowing sufficient amounts to advance projects in the active phase, at short term interest rates, is likely to result in savings in long run.

Q: How will Commercial Paper proceeds be prioritized for CIP projects?
A: CIP projects funded with Commercial Paper proceeds will be prioritized in accordance with City Council Policy No. 800-14 titled *Prioritizing Capital Improvement Program Projects* in the same manner as those funded with capital outlay funds, monies from the General Fund, or long-term bond proceeds.

Q: What is the cost to SANDAG for maintaining their Commercial Paper program?
A: SANDAG has an active $75 million Commercial Paper program to provide advanced funding for eligible projects under the TransNet Program. Administrative costs such as compensation for consultants (financial advisor and bond counsel) and other related fees (letter of credit fees, trustee fees, rating agency fees) are paid from Commercial Paper note proceeds.

According to finance staff for SANDAG, the four program expenses to maintain the Commercial Paper program on an annual basis include: (1) Liquidity Fee, (2) Remarketing Agent Fee, (3) Variable interest rate, and (4) annual surveillance fees from rating agencies Moody's Investor Service and Standard & Poor's. The total annual cost to SANDAG to maintain the $75 million program last year was approximately $450,000.

SANDAG's Commercial Paper program requires staff time of approximately 20 hours of a finance staff position annually and additional external assistance from the remarketing agent.

cc: Scott Chadwick, Chief Operating Officer
Mary Lewis, Chief Financial Officer
Brian Pepin, Director of Council Affairs
Andrea Tevlin, IBA
Jeff Kawar, IBA's Office