

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: April 5, 2007

IBA Report Number: 07-41

City Council Docket Date: April 9, 2007

Item Number: 202

Subject: Wastewater System Financing - Subordinated Sewer Revenue Notes Series 2007

OVERVIEW

On April 9, 2007, the City Council will be asked to adopt a resolution authorizing the issuance of 2-year Subordinated Sewer Revenue Notes – Series 2007 (the “Series 2007 Notes”) in a principal amount not to exceed \$225 million. The same resolution would also authorize associated financing expenditures for bond counsel (not to exceed \$220,000) and financial advisory services (not to exceed \$15,000). The IBA has reviewed the two companion Reports to the City Council (#07-056 and #07-057) issued by the Debt Management Department and the Metropolitan Wastewater Department (MWWD). We have also reviewed a memorandum issued by MWWD on April 5, 2007 that proposes to increase the par amount of the Series 2007 Notes without increasing the total requested authorization amount of \$225 million. This report comments on the wastewater system’s financing history, provides information related to the Series 2007 Notes, and discusses MWWD capital improvement needs.

FISCAL/POLICY DISCUSSION

Wastewater System Financing History

As noted in the Report to the City Council issued by MWWD, the City issued approximately \$1.165 billion in four public bond issuances during the 1990s to primarily fund upgrades to the Metropolitan Wastewater Treatment System. The remaining outstanding principal on this debt is \$952.6 million with associated annual debt service of approximately \$77 million in 2007. System improvements have also been financed with approximately \$106 million of low interest rate loans from the State Revolving Loan

Fund. It should be noted that all of the above debt was executed as long-term, fixed-rate financing with relatively low interest rates.

Following a series of rate increases approved in October 2001 intended to fund system improvements to comply with a Stipulated Order and the Partial Consent Decree, the City was prepared to issue \$505.5 million of bonds in the public markets in 2003 (a portion of which was to refund prior wastewater debt) until the City's fiscal circumstances halted the issuance. Unable to access the public capital markets, the City was able to privately place \$152 million of non-transferable Subordinated Sewer Revenue Bonds with Bank of America in June of 2004 (the "Series 2004 Bonds"). These variable rate bonds have also been accorded relatively low interest rates since being issued (last rate was reset at 4.33% for a 60-day term ending on April 5, 2007) and have enabled MWWD to continue working on pipe replacement/rehabilitation in accordance with the Partial Consent Decree. Although these bonds have an amortization period that runs through December 15, 2011, they also carry some interest rate risk, an escalating pricing component on the periodic resets and a requirement that no additional wastewater system debt can be issued until the bonds are paid off.

Information Related to the Series 2007 Notes

Recent wastewater system rate increases have enabled the City to again access the private capital markets. Last year, the Debt Management Department issued a Request for Proposals (RFP) to assess interest and solicit proposals from financial institutions for a direct purchase or private placement borrowing for the wastewater system. The RFP elicited a competitive response from 11 financial institutions. After a thorough review of all proposals, Citigroup and Goldman Sachs were judged to be most responsive and asked to submit supplemental proposals to further address debt structure, transfer limitations and pricing. In June 2006, Debt Management staff recommended that the City would be best served by utilizing both lenders; however, an unanticipated March 2007 change in Goldman Sachs' corporate policy that imposed limitations on holding securities forced them to opt out of this transaction. Citigroup subsequently indicated a willingness to handle the entire financing and honor all negotiated terms of the bid.

The companion Reports to the City Council (#07-056 & #07-057) discuss issuing a par amount of \$209.25 million in Series 2007 Notes with a "cushion" to borrow as much as \$225 million, if necessary, should market conditions adversely change between the time Notes are expected to be authorized (April 16, 2007) and when they will actually price (anticipated to happen on April 25, 2007). However, on April 5, 2007, MWWD issued a memorandum indicating their desire to increase the par amount of the Series 2007 Notes in order to fund additional capital improvements through FY 2008. Although this change eliminates the "cushion" in order to finance additional wastewater system improvements, the Debt Management Department has indicated that market conditions are currently stable and that new project funds could be reduced, if necessary, to accommodate unanticipated market changes at the time of pricing.

MWWD is now proposing to issue/borrow a par amount of **\$223.7 million** and receive an original issue premium (explained in the paragraph below) of \$1.3 million from Citigroup for total proceeds of **\$225 million** to:

1. Refund the outstanding Series 2004 Bonds - **\$144.4M**;
2. Reimburse the wastewater system for prior and eligible CIP expenditures as discussed in greater detail below - **\$41.9M**;
3. Raise new money to fund critical capital improvement needs until the department is able to enter the public bond market, currently anticipated to occur early in FY 2009 - **\$38.2M**; and
4. Cover associated costs of issuance - **\$500,000**, which includes fees and expenses for bond counsel and trustee, as well as the management fee and expenses of the underwriter.

Because the Series 2007 Notes will bear a coupon of 5.00%, while the current market yield is slightly below that level, Citigroup will be paying the City an original issue premium of \$1.3 million which effectively increases the total proceeds to the department to \$225 million. The original issue premium is a pricing mechanism whereby Citibank pays slightly more for the City's notes and, in return, is allowed a slightly higher interest payment (annual coupon rate) on the notes, which enhances their marketability. This pricing mechanism is standard in the municipal bond industry.

Report to the City Council No. 07-056 mentions that the Series 2007 Notes will be priced at a fixed 87 basis point spread (0.87%) over the two-year natural "AAA" Municipal Market Data Index (MMD). The Debt Management Department was able to negotiate this spread down with Citigroup by approximately 15 to 30 basis points under the spread that might otherwise be imposed by the market. It is important to note that only a portion of the negotiated 87 basis point spread (roughly 25 to 45 basis points) represents the market penalty that the City must pay because of its fiscal circumstances (not current with financial statements, lacking credit ratings and hence unable to borrow from the public markets). The balance of the negotiated 87 basis point spread that will be used to price the Series 2007 Notes covers the credit spread and structuring features described below:

- Credit spread - the wastewater system is currently equated with a "BBB" credit in the financial markets and therefore investors demand additional basis points to achieve higher yields than they would require for a "AAA" credit (the MMD); and
- Structuring features - the City is opting for favorable financing features (a one-year call and limited note transferability provisions).

Once the City is able to access the public capital markets, perhaps in late FY 2008, MWWD can reasonably anticipate pricing future debt anywhere from 25 to 45 basis points cheaper in the public markets.

As mentioned in the related memorandum from the Office of the City Attorney dated April 4, 2007, the Series 2007 Notes have been structured as a private placement with a sophisticated financial institution. The Series 2007 Notes do not have an associated disclosure document. Citigroup, as the purchaser, will be signing a Note Purchase Agreement with the City that makes numerous representations about their capabilities in evaluating any risks associated with the Notes, their analysis/due diligence with respect to the Notes and their ability to ask questions and receive requested information from the City. On March 19, 2007, the City's Disclosure Practices Working Group issued a group certification for the Series 2007 Notes indicating that the information provided by the City to the purchaser is in accordance with its obligations under federal and state securities law.

Reimbursement of Prior Capital Expenditures

All bond proceeds from Series 2004 Bonds were expended in calendar 2005 forcing MWWD to fund subsequent wastewater system improvements entirely with cash. It is a prudent and recommended financial practice to largely fund long-term capital assets with long-term debt. In recent years, MWWD has endeavored to fund approximately 70% of system improvements with long-term debt and the remaining 30% with cash. The go-forward funding ratio objective has recently been adjusted in the rate case to target 80% debt and 20% cash.

Anticipating possible delays in accessing the capital markets and utilizing relevant tax law, the City adopted wastewater system reimbursement resolutions in 2002 and 2006. These resolutions enable the City to use future bond proceeds to reimburse the wastewater system for prior eligible system expenditures. Since MWWD was forced to entirely cash fund system improvements beginning in calendar 2005, using proceeds from the current debt issuance to reimburse prior eligible system expenditures helps the City begin to rebalance its use of debt and cash to fund system improvements.

Wastewater System Capital Improvement Needs

In order to finance the critical capital improvement needs required by the Partial Consent Decree that expires on June 30, 2007 and the Proposed Final Consent Decree, the City recently approved sewer rate increases of 8.75% effective May 1, 2007 and May 1, 2008, and 7% effective May 1, 2009 and May 1, 2010. Report to City Council No. 07-057 provides a list of capital projects and associated costs that are anticipated to be financed and/or reimbursed with the proceeds of the Series 2007 Notes. With their memorandum dated April 5, 2007 MWWD augmented the above referenced project list, increasing the total dollar amount for future capital improvement projects from \$23.7 million to \$38.7

million. The memorandum indicates that borrowing additional funds now will enable MWWD to fund their capital program through the end of Fiscal Year 2008.

The additional funding (approximately \$15 million) will be used to increase “new money” project expenditures, while the amount designated for reimbursement of prior capital expenditures will remain the same. The IBA cross-checked the updated project list attached to the April 5th memorandum against the list of projects that accompanied the sewer rate increase in February 2007, and we confirm that the current project list is consistent with the capital needs contemplated in the rate case. Based on information provided previously by MWWD, the IBA calculated that of the total anticipated “new money” project funding, approximately \$29.1 million, or 75.0 percent, is directly related to the Proposed Final Consent Decree.

One item that should be noted is the funding allocated for pipeline rehabilitation. In the original proposal, when total proceeds of the bond were anticipated to be \$209 million, approximately \$11 million in new bond funding was allocated for pipeline rehabilitation. However, the revised allocation for pipeline rehabilitation, based on current anticipated proceeds of \$225 million, has been reduced to \$6.5 million. MWWD staff has indicated that this \$4.5 million reduction simply reflects the reallocation of bond funding to other projects, and that total funding for pipeline rehabilitation has not changed. Instead, pipeline rehabilitation projects will rely more heavily on pay-go funding than first anticipated.

Overall, the projects that will be funded through this issuance are consistent with the capital requirements contemplated in the rate case, and are critical in terms of complying with the Final Consent Decree.

CONCLUSION

The IBA recommends adopting the resolution authorizing the issuance of the Series 2007 Notes. This financing will enable MWWD to continue funding critical capital improvement needs in compliance with the Partial Consent decree and the Proposed Final Consent Decree. The Series 2007 Notes also provide bridge financing to MWWD until the Department can access funds in the public capital markets. Subsequent financings in the public markets will be necessary to fund additional capital projects and to refinance portions of the outstanding Wastewater system debt.

Attachment A to the City Attorney’s Memorandum dated April 4, 2007 provides a list of questions for the City Council to either review or ask of the financing team for the Series 2007 Notes. The IBA has been informed that representatives of the entire financing team will be present for the City Council meeting on April 9, 2007. We would encourage members of the City Council to ask any questions they might have directly to members of the City’s financing team including the City’s financial advisor, bond counsel and even the purchaser of the Series 2007 Notes. The availability of financing consultants to the

City Council at or before City Council meetings where approval is sought for debt issuances is a component part of the comprehensive financial training program adopted by the City Council on December 6, 2006.

[SIGNED]

Tom Haynes
Fiscal & Policy Analyst

[SIGNED]

Jeff Kavar
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst