

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: January 12, 2007

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City Council Docket Date: January 16, 2007

Item Number: 333

Subject: Subordinated Water Revenue Notes, Series 2007A

OVERVIEW

This item requests the authorization for the issuance of the Public Facilities Financing Authority of the City of San Diego Non-Transferable Subordinated Water Revenue Notes, Series 2007A in an amount not to exceed \$57,000,000, and related documents and actions.

FISCAL/POLICY DISCUSSION

The City Council adopted the Strategic Plan for Water Supply in August 1998 and approved financing for the first phase of improvements. In April 2002, the City Council adopted a series of water rate increases in FY 2003 and FY 2007 to increase water system revenues by 6% per year for five successive years, and authorized the issuance of Water Revenue Bonds to finance the second phase. It was anticipated that additional bond financing would have been initiated by 2005, but has not occurred because of the City's financial situation.

The Water Department is requesting the sale of \$57 million in Water Revenue Notes in order to fund required capital improvements per the DHS Compliance Order, and to reimburse certain eligible capital expenditures previously funded on a cash-basis. As described in the Water Department staff report, capital projects under the previous debt issuance were funded through a combination of 70 percent bond funding and 30 percent cash. However, previous bond funds were depleted as of March 2006, and all project costs since that time have been entirely cash funded.

On June 12, 2006 the City Council passed a Reimbursement Resolution (R-301522) declaring the City's intent to reimburse itself for certain eligible capital expenditures that

were cash-funded. Pursuant to that resolution, the Water Department plans to use \$23.3 million of the total Note proceeds to reimburse prior capital costs that were funded on a cash basis. Cash from this reimbursement will essentially fall to fund balance, and then programmed back into the CIP budget to fund the cash portion of future projects.

The Water Department staff report includes a Use of Bond Funds list that indicates the projects and project costs that will be funded with proceeds from the Water Revenue Notes, including prior projects costs to be reimbursed. As stated in the staff report, the Department intends to reimburse the CIP Reserve in the amount of \$5 million, which was previously used to fund a portion of the Rancho Bernardo Reservoir Rehabilitation. This reimbursement is not shown on the Use of Bond Funds list because it is not an eligible use of bond funds. However, the Water Department plans to return to Council once the Note proceeds are secured to request an amendment to the FY 2007 CIP budget, and the CIP Reserve will be replenished at that time.

It should be noted that documents related to the proposed financing were distributed to the City Council on December 20, 2006, which provided ample time (over three weeks) for sufficient review, in accordance with recommendations made in the Kroll Remediation Plan. The Disclosure Practices Working Group reviewed the proposed financing on December 14, 2006, and its certification was distributed to the Mayor and City Council on January 10, 2007. In addition, the City Attorney's Office has provided a comprehensive memorandum outlining the financing transaction, related documents, and the due diligence obligations of the City Council. Also included were a list of questions and answers to facilitate the City Council's review of the proposed actions. If the requested actions are approved, note closing and receipt of funds could occur by the end of January 2006.

Under the proposed financing, no disclosure document, or official statement, would be required. As outlined in the Note Purchase Agreement, Morgan Stanley & Co. Incorporated (the "Purchaser") make certain representations regarding its investment in the bonds, including, among other things, that it has such sufficient experience to be able to evaluate the risks associated with the Water Revenue Notes and that it is able to bear the economic risks of such investment. It also acknowledges that the City has not filed audited financial statements for FY 2003 through 2006, and it has received the publicly released draft of the City's FY 2003 financial statements.

The January 8, 2007 memorandum from Water Department Director Jim Barrett clarified that the repayment of the Water Revenue Notes is not dependent on the proposed water rate increases, and can be fully repaid from existing rates. It is anticipated that a long-term financing for the Water System will be proposed, should the water rate increases be implemented. The long-term financing is anticipated to include sufficient funds to fully repay the principal amount of the short-term Water Revenue Notes, and provide significant additional funding for planned projects. If the water rate increases are not

approved, the short-term Water Revenue Notes would be restructured as a long-term financing to fully amortize the amount borrowed, with estimated annual payment of approximately \$4.3 million. Additional City Council actions would be required to restructure the short-term Water Revenue Notes. No General Fund revenues are pledged to the repayment of Water Revenue Notes, and there is no impact to the City's General Fund

CONCLUSION

The IBA supports the request for authorization for the issuance of the Public Facilities Financing Authority of the City of San Diego Non-Transferable Subordinated Water Revenue Notes, Series 2007A in an amount not to exceed \$57,000,000, and related documents and actions, in order to make needed improvements to the Water System and to ensure conformance with the State Department of Health Services Compliance Order.

[SIGNED]

Tom Haynes
Fiscal & Policy Analyst

[SIGNED]

Elaine DuVal
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst