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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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# 2009 Water System Bonds

## OVERVIEW

The proposal to approve not more than \$638 million of 2009 Water System Bonds involves a **two-phase** financing plan to 1) refinance outstanding short-term and long-term water system debt and 2) finance the continuation of improvements to the water system.

The **first phase** involves the issuance of **2009A Bonds** with two objectives in mind. The first objective is to refund \$57M of two-year, privately placed notes (2007A Notes). These notes were purchased by Morgan Stanley in January 2007 (due January 30, 2009) and will be refunded with publicly offered, fixed-rate bonds with a 30-year term. Depending on bond market conditions and in order to reduce borrowing costs, the second objective is to refund the maximum amount of 1998 Water System Certificates of Undivided Interest (1998 Certificates) provided that the net present value of the economic savings is at least 3% of the refunding bonds in accordance with the City's Debt Policy. Approximately \$245M of the 1998 Certificates are currently outstanding. The 2009A Bonds will be issued in January 2009.

The **second phase** involves the issuance of **2009B Bonds** and has three objectives. The first objective is to debt finance \$150M of projects within the Water Department Capital Improvement Program (CIP) through June 2010. The second objective is to refund a \$150M eighteen-month, private note (2008A Notes). These notes were purchased by JP Morgan Securities in February 2008 (due August 28, 2009, but refundable without penalty beginning in February 2009) and will be refunded with publicly offered, fixed-rate bonds with a 30-year term. The third objective is refund any of the remaining eligible maturities of the 1998 Certificates, again provided that the net present value of the economic savings is at least 3% of the refunding bonds. The 2009B Bonds are planned to be issued in April or May 2009.

This IBA has reviewed the staff reports issued by the Water Department (#08-147), Debt Management (#08-148), and other bond related documents that have been distributed. Additionally, we have met with the City's financing team to discuss the proposed 2009 Water System Bonds. This report provides comments on various elements of the contemplated financing that may not have been addressed in the staff reports.

## FISCAL/POLICY DISCUSSION

### Background for Water System Financing

In response to a California Department of Health Services (DHS) Compliance Order, the City Council adopted a Water Strategic Plan in August 1998 that included an eight-year plan for capital improvements. Bonds sold in the public capital markets in 1998 and 2002 largely financed the first two phases of the Water Capital Improvement Program (CIP). Because capital assets financed in the CIP typically have a long-term useful life, the Water Department appropriately strives to fund 80% of these long-term capital assets with long-term debt and the remainder with cash. This ensures that the cost of long-term assets will be more equitably shared by generations of beneficial users.

By March 2006, the Water Department had fully expended bond proceeds and began to entirely cash fund capital projects required by the DHS Compliance Order. Until recently, the City's financial situation precluded the Water Department from issuing bonds in the public financial markets. In order to begin to restore the Water Department's 80%-20% debt-cash financing objectives in 2007, the City Council authorized a \$57M private placement of the 2007A Notes in January 2007. Proceeds from the 2007A Notes were used to reimburse approximately 80% of cash-funded projects and finance other capital projects in the CIP. The City Council subsequently authorized a \$150M private placement of the 2008A Notes in February 2008.

As discussed in the Water Department's Report (#08-147), proceeds from the 2008A Notes are anticipated to be exhausted by May 2009 based on construction cost estimates and construction schedules. Project expenses after May 2009 will be entirely cash funded unless additional debt financing is available.

### Planned Review and Approval Process for the 2009A Bonds and the FY 07 CAFR

With the exception of the Preliminary Official Statement (POS) and the Bond Purchase Agreement (BPA), all of the other necessary documents for the 2009A and 2009B bonds will be approved by the ordinance being introduced on October 27, 2008. This ordinance will receive a second reading at the City Council on November 10, 2008. If approved, the ordinance will become effective 30 days thereafter in mid-December. This timing is necessary to allow the POS to be printed and distributed to the public markets for consideration before the holidays.

Approval of the substantially completed POS and BPA for the 2009A Bonds will be sought by resolution on November 10, 2008 in conjunction with the second reading of the

ordinance. However, the City Council will be able to discuss the POS and the BPA with the financing team on both October 27<sup>th</sup> and November 10<sup>th</sup>. In a related matter, the CFO also plans to docket the audited FY 07 CAFR for City Council review and acceptance on November 10<sup>th</sup>. This is mentioned because the distributed version of the POS has multiple references to unaudited FY 07 figures. Now that an unqualified audit opinion has been received from the City's outside auditors, a revised POS will be distributed to the City Council prior to November 10<sup>th</sup> reflecting the now audited FY 07 data.

#### Timing Requirements and the Proposed Pricing Parameters

In order to pay off the 2007A Notes when they become due on January 30, 2009, the City needs to sell (price) the bonds by mid-January 2009. This allows approximately two weeks to finalize bond documents and receive bond proceeds, which is usual timing for a bond issuance. As shown in the timeline on page 6 of the Debt Management Report (#08-148), the proposed schedule for the 2009A Bonds must be achieved to facilitate timely refunding of the 2007A Notes. Because the need for new bond financed capital is months away and expected to precede the maturity of the 2008A Notes by a few months, there is more flexibility to adjust timing and/or react to bond market conditions when issuing the 2009B Bonds.

Section 4 of the ordinance asks the City Council to authorize two pricing parameters for the 2009 Water System Bonds. The first pricing parameter specifies that the true interest cost not exceed 7% on bonds issued to pay off the 2007A and 2008A Notes as well as the new debt issued to finance the Water CIP. The second pricing parameter specifies that the true interest not exceed 4.85% on bonds issued to refund the 1998 Certificates, which is necessary to achieve the requisite net present value savings threshold of at least 3% of the refunding bonds.

Recent bond market pricing levels for comparably rated credits suggest pricing levels that range between 5.93% and 6.24%. Given the recent volatility in the financial markets, it is possible that these pricing levels could change more even significantly than would normally be the case between now and the pricing in mid-January 2009. In the past, the IBA has supported the City Council's concern that pricing parameters not be authorized at levels that were significantly above current or reasonably forecasted market levels (the statutory maximum interest rate is 12%). However, the IBA notes that the financial markets have been extremely volatile in recent weeks and recommends that City Council consider increasing the pricing parameter to pay off the 2007A Notes to 10% to better ensure that the City can satisfy its hard obligation to retire the 2007A Notes by January 30, 2009. Alternatively, the City Council could ask the financing team to explain if other refunding options exist (restructuring the 2007A Note borrowing directly with Morgan Stanley, City interfund borrowing, etc.).

The IBA notes that the financial markets have been extremely volatile in recent weeks and recommends that City Council consider increasing the pricing parameter to pay off the 2007A Notes to 10% to better ensure the City can satisfy its hard obligation to retire the 2007A Notes on January 30, 2009.

### Approved Water Rates and Debt Service Coverage

In February 2007, the City Council approved a series of four 6.5% annual water rate increases to fund the CIP during this period. The City's Debt Policy requires a debt coverage ratio of at least 110% be maintained for all revenue bond debt. The outstanding 1998 Certificates actually require a higher 120% coverage ratio. Conservatively assuming that 2009 Water System Bonds are priced at 7%, without factoring in any savings attributable to refinancing the 1998 Certificates, the financing team has calculated that the average debt service coverage for all water debt remains above 150% which is strong and should be favorably evaluated by both rating agencies and potential investors. It should also be noted that the Water Department forecasts they will need to debt finance another \$124M of water system project improvements in FY 11 using the above referenced rate increases.

### Improvements to be Debt Financed with 2009B Bonds

The 2009B Bond issuance is anticipated to generate \$150 million in "new money" proceeds for Water infrastructure projects. As discussed in the Water Department Companion Report (#08-147), approximately \$103.8 million is anticipated to fund Department of Public Health (DPH) required projects, while \$25.2 million will fund DPH related projects. Attachment 2 to the Water Department Companion Report provides a list of the projects that will be funded with these new money proceeds. The IBA has cross-checked this list of projects against the rate case approved in February 2007, and with two exceptions, we confirm that these projects are consistent with the capital plan established in the 2007 rate case. The two exceptions are the Carmel Valley Reclaimed Water Pipeline and the Los Penasquitos Canyon Reclaimed Water Project, with respective funding amounts \$3.7 million and \$2.6 million. While these appear to be established CIP projects, it is unclear whether they were included in the 2007 rate case.

In addition to the project list, the Water Department Companion Report also includes a DPH Quarterly Status Report for the period ending June 30, 2008 (Attachment 3 to the Companion Report). This Quarterly Report from the Water Department provides an update to DPH on the status of specific projects required under the Compliance Order. The IBA found this report very useful not only in providing an overview of DPH-required projects, but also in demonstrating the significant progress that the City has made on meeting the requirement of the Compliance Order. The IBA believes that additional funding from the 2009B Bonds will further the progress toward meeting these requirements.

### Actions/Issues Related to the Costs of Issuance

Costs of issuance for the 2009 Water System Bonds are currently estimated to be \$1.36M or 2.13% of the maximum proposed issuance. This does not include certain costs of issuance for the 2009B bonds (bond counsel, disclosure counsel, etc). Several components of the costs of issuance are higher than would normally be the case because

the planned structure of the 2009A Bonds was modified, experienced delays and represents the City's first public offering in several years.

Of the costs of issuance for the 2009A Bonds, the ordinance before the City Council specifically requests authorization and payment for: Bond Counsel (\$180,000 for work on the 2009A Bonds), General Counsel (\$16,000 for bond related services provided to the Facilities and Equipment Leasing Corporation – FELC), and Disclosure Counsel (\$255,000). The General Counsel fee for FELC will be paid by the Water Department and the General Fund because the work (principally an update of the bylaws) benefits water and non-water financings.

In reviewing the costs for Bond Counsel and Disclosure Counsel with the Office of the City Attorney, the IBA learned that final costs for the 2009A Bonds significantly exceeded previously proposed costs for the 2008A Notes and the 2009A Bonds. In both cases, several explanations were provided to and approved by the Office of the City Attorney over time. These included changes to the original financing plan, a longer than anticipated timeframe to execute the financing; delays in the release of the City's audited financial statements, additional meeting requirements (i.e., DPWG), etc. While the IBA understands the circumstances that led to additional bond and disclosure counsel expense, we recommend that going forward the Office of the City Attorney memorialize competitively selected proposals with executed contracts before work begins, including provisions for unanticipated changes in service. Additionally, we recommend that bond and disclosure counsel expenses be more precisely allocated to specific financings rather than shared between related financings.

## CONCLUSION

Based on our review of the documents and discussions with representatives of the City's financing team including the Water Department, the IBA recommends approval of the ordinance facilitating the 2009 Water System Bonds. Final approval for the first phase, the 2009A Bonds, will be granted by adopting a resolution approving the substantially completed drafts of the POS and BPA in conjunction with the second reading of the ordinance at City Council on November 10, 2008.

A further revised POS is targeted for distribution to the City Council by October 31<sup>st</sup>. This version of the POS will incorporate any feedback from the City Council meeting on October 27<sup>th</sup> and also include audited data from the FY 07 CAFR in lieu of previous references to unaudited data. Representatives of the City's financing team for the 2009A bonds will be available to discuss the POS at the City Council meetings on October 27<sup>th</sup> and November 10<sup>th</sup>.

The financing team should be commended for distributing the substantially complete POS and other bond related documents to the City Council on October 9<sup>th</sup>, which is more than two weeks before approval of the ordinance is requested and more than four weeks before approval of the POS by resolution is requested. This is in keeping with the Kroll

Report recommendation to provide the City Council with substantially completed drafts of the POS at least two weeks before they are asked to approve it.

The IBA recommends that the City Council review the Disclosure Responsibilities memorandum distributed by the Office of the City Attorney on October 21, 2008. This memorandum references City Disclosure Ordinance and DPWG procedures that have already been completed or will be provided prior to the November 10<sup>th</sup> Council meeting. Additionally, sample questions and answers have been provided to the City Council to use in reviewing the 2009 Water System Bonds. Finally, a copy of DPWG certifications and a copy a Federal Securities Law Responsibilities memorandum dated July 9, 2008 have been attached to the October 21<sup>st</sup> memorandum to provide guidance to the City Council in reviewing the disclosure documents.

The IBA has been informed that representatives of the entire financing team will be present for the City Council meeting on October 27, 2008. The IBA encourages 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, disclosure counsel, feasibility consultant and/or underwriters. The availability of financing consultants to the City Council at or before City Council meetings where approval is sought for debt is a recommendation that was adopted by City Council resolution on December 6, 2006.

**[SIGNED]**

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