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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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**Date Issued:** February 14, 2008

**IBA Report Number:** 08-16

**City Council Meeting Date:** February 19, 2008

**Item Number:** 331

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# Water System Financing (2008A Notes)

## OVERVIEW

The City Council is being asked to adopt a resolution authorizing the issuance of Series 2008A Subordinated Notes (the “2008A Notes”) in a principal amount not to exceed \$150 million. Proceeds from the issuance of 2008A Notes are required to fund the continuation of improvements to the water system. This report briefly comments on the background for the water system financing, the 2008A Notes and the current financing plan, and other considerations associated with the requested action.

## 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 (\$254 million outstanding) and 2002 (\$278 million outstanding) 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. The City’s financial situation precluded the Water Department from issuing bonds in the public markets early in 2006. In order to temporarily restore debt-cash financing objectives, the Water Department requested authority to sell two-year notes in the private capital markets to reimburse approximately 80% of cash-funded projects and finance other capital projects in the CIP. The City Council authorized the private placement of \$57 million of two-year notes (“2007 Notes”) in January 2007.

### 2008A Notes and the Current Financing Plan

Proceeds from the 2007 Notes are expected to be exhausted in March 2008 and the Water Department requires additional financing to continue compliance with the Department of Public Health (“DPH” – formerly DHS) Compliance Order. The Debt Management Department has developed a financing plan to secure additional funding for FY 2008 and FY 2009. The plan calls for an immediate private placement of 18-month 2008A Notes and a subsequent long-term bond issuance in the public markets later in calendar 2008.

It is anticipated that the subsequent bond issuance will be large enough to finance needed water system improvements into FY2010 and additionally refinance the 2007 Notes, 2008A Notes and, if rates remain close to current levels, portions of the two prior public bond issuances. If the City is still unable to access the public markets later in 2008, the Debt Management Department has indicated that other sources of private capital will be available to finance water system improvements. Another bond issuance will likely be required in FY 2010 to continue funding needed water system improvements through FY 2011.

The Water Department estimates the total cost of the CIP to be approximately \$570 million from FY 2008 through FY 2011. Of this amount, roughly \$458 million of “new money” debt (exclusive of refinanced debt) will be required. In February 2007, the City Council approved a series of four 6.5% annual water rate increases to fund the CIP during this period. As noted in the staff report (Report No. 08-113), the City’s new Debt Policy requires that a debt coverage ratio of at least 110% be maintained for all revenue bond debt. The outstanding 1998 water bonds actually require a higher 120% coverage ratio. Attachment 2 to the staff report factors in the above referenced \$458 million in new debt to illustrate that the existing water rate structure allows for the additional contemplated debt while maintaining strong debt service coverage ratios (greater than 160%) in excess of both requirements. Rating agencies and potential investors should evaluate these projected debt service coverage levels to be very favorable.

The interest rate on the 2008A Notes is estimated to be approximately 3.30%, which is 98 basis points (.98%) higher than the very best (AAA) tax-exempt rate in the public markets. It should be noted, however, that other factors (the City’s Water System is currently a lower single A-rated credit, the cost of the call provision, etc.) account for most of this 98 basis point differential. The Debt Management Department estimates that roughly 25 of the 98 basis point differential is attributable to the City having to borrow from private rather than public capital markets. The cost of 25 basis points on the \$207 million private water system loans that will be outstanding (total of 2007 and 2008A Notes) equates to

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approximately \$518,000 of additional interest expense a year. When coupled with our inability to take advantage of currently low long-term rates to optimally refinance other outstanding long-term City debt, additional borrowing costs attributable to the City's inability to access the public capital markets are considerable.

#### Other Considerations Associated with the Requested Action

The City Council is also being asked to authorize not more than \$93,500 for Fulbright & Jaworski L.L.P. to serve as Bond Counsel and not more than \$28,500 for Hawkins Delafield & Wood ("Hawkins") to serve as Disclosure Counsel for the City in connection with the issuance of 2008A Notes. Hawkins currently serves as General Disclosure Counsel providing expert disclosure advice to the City on a broad array of disclosure matters. In his role as General Disclosure Counsel to the City, John McNally of Hawkins has reviewed and commented on disclosure in financing documents for the 2008A Notes.

The Office of the City Attorney has additionally engaged another attorney at Hawkins to separately serve as Disclosure Counsel specifically for the 2008 A Notes (the requested \$28,500 authorization) with direction to also prepare advance disclosure documentation for the public water bond issuance planned for the end of calendar 2008. The IBA recommends that the City Council ask the Chief Deputy City Attorney for Finance and Disclosure to clarify differences in the services and associated costs Hawkins provides to the City in their role as General Disclosure Counsel versus their role as deal-specific Disclosure Counsel.

In contemplating the legal authority to borrow money for necessary water system projects, the IBA reviewed sections 90 (Contracting Bonded Indebtedness) and 90.1 (Waterworks) of the City Charter. The IBA finds these sections of the City Charter to be outdated and confusing regarding the City Council's authority to contract bonded indebtedness. In particular, there are debt limits tied to assessed valuation that have little applicability; fixed dollar debt limitations that appear to be arbitrary; and voter approval requirements that do not apply to the City's current long-term plan for financing the water system CIP.

The Office of the City Attorney has informed the IBA that authority to issue the 2008A Notes is not necessarily limited by these sections of the City Charter and instead relies upon charter city authority to enter into contracts or agreements (in this case, an Installment Purchase Agreement) to facilitate a borrowing whereby repayment is made from a special fund (in this case, net system revenues of the Water Utility Fund). The City's Bond Counsel for this borrowing is of the opinion that the City's authority to issue the 2008A Notes is valid and the Office of the City Attorney concurs. The IBA believes that the City Council may reasonably rely upon these expert opinions.

Although perhaps not relevant to the issuance of the 2008A Notes, the IBA recommends that these and other financial sections of the City Charter be reviewed by the CFO and the Office of the City Attorney, and modernized/updated as may be necessary for subsequent voter consideration.

## CONCLUSION

Based on the companion staff reports and discussions with Water Department representatives, the IBA recommends approval of the 2008A Notes to fund water system improvements and continue compliance with the DPH Compliance Order. Water Department staff indicates that delays in the requested financing could have undesirable consequences including continued deterioration of infrastructure, escalating costs of repairs, increased system liability exposure, system limitations and possible fines.

The Office of the City Attorney issued a thoughtful due diligence and disclosure obligation memorandum related to the 2008A Notes on February 13, 2008. In addition to providing guidance to the City Council regarding due diligence obligations under federal securities laws, the memorandum briefly describes the related financing documents (as does staff Report No. 08-013) and provides useful questions and answers for the City Council to consider. A certification by the Disclosure Practices Working Group has also been attached indicating that financial information disclosed in the 2008A Notes has been reviewed to ensure accuracy.

The IBA has been informed that representatives of the entire financing team will be present for the City Council meeting on February 19, 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 and even the purchaser of the 2008A Notes (J.P. Morgan Securities Inc.). The availability of financing consultants to the City Council at or before City Council meetings where approval is sought for debt is a recommendation within the comprehensive financial training program adopted by the City Council on December 6, 2006.

**[signed]**

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**[signed]**

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