OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Wastewater System: Authorizing the Issuance of Sewer Revenue Bonds and Sewer Refunding Bonds

OVERVIEW

The City Council is being asked to introduce an ordinance that 1) authorizes the Public Facilities Financing Authority (PFFA) to sell not more than $1.4 billion of sewer revenue and sewer refunding bonds to finance wastewater system improvements and refinance outstanding debt to achieve annual debt service savings and 2) approves the form and authorizes the delivery/execution of the necessary bond documents to facilitate proposed Wastewater System debt issuances. Additionally, the City Council is being asked to adopt a resolution authorizing agreements with Nixon Peabody LLP to serve as bond counsel for the City (not to exceed $236,000 including expenses) and Hawkins Delafield & Wood LLP to serve as disclosure counsel for the City (not to exceed $255,000 including expenses).

The IBA received a briefing from the City's financing team including representatives from the Debt Management, City Attorney and Wastewater departments. A number of questions related to the proposed financing were discussed. This report briefly describes the Wastewater System's outstanding debt and the proposed financing. The report additionally provides responses to questions raised by the IBA during the briefing and comments to supplement or clarify information provided with the staff report.

FISCAL/POLICY DISCUSSION

Outstanding Wastewater System Debt

As noted in Attachment 1 of the staff report, the City issued approximately $1.165 billion of public bonds during the 1990s (Series 1993, 1995, 1997 A&B, and 1999 A&B) to finance upgrades to the Metropolitan Wastewater Treatment System. The principal outstanding on this debt is $893.7 million. Unable to access the public capital markets for long-term financing in 2003, the City issued short-term notes via private placements in 2004 and 2007. The 2007 Notes were used to entirely refund the 2004 Notes. The 2007 Notes have $223.8 million of principal outstanding that must be repaid on May 15, 2009. The Metropolitan Wastewater Department (MWWD) has also financed wastewater system improvements with low-interest State Revolving Fund loans. There are currently 11 loans with approximately $85.9 million of principal and interest to be repaid.

Need for the Proposed Financing

As referenced above, the City needs $223.8 million to pay off the 2007 Notes on May 15, 2009. Additionally, MWWD anticipates that additional project funds will be required by June 2009 and proposes to borrow approximately $145 million to finance their Capital Improvement Program (CIP). The $145 million is requested to cover the continuation of improvements to the sewer system in accordance with the Final Consent Decree and other priority CIP projects. Funding for these two needs is planned to be provided by the Series 2009A bonds, which would be the first in a series of public bonds the City could issue if the proposed ordinance is adopted. Coupled with funds for a debt service reserve ($29.1 million) and related costs of issuance ($2.3 million), the Series 2009A bonds are currently estimated to be approximately $400 million.

The proposed financing ordinance further authorizes the refunding of all or a portion of the outstanding Sewer Revenue Bonds issued in the 1990s (Outstanding Senior Bonds). As noted above, there is an outstanding principal balance of $893.7 million on the Outstanding Senior Bonds. The ordinance authorizes the issuance of not more than $900 million of Sewer Refunding Bonds provided that the refunding bonds: 1) not extend the maturity of the outstanding bonds; 2) result in net present value savings (NPV) of at least 3% of the principal amount of the bonds being refunded in accordance with the City's Debt Policy; 3) preliminary official statement will first be approved by the Disclosure Practices Working Group (DPWG) and the City Council; and 4) will be issued on or before June 30, 2010.

As noted in the staff report, approximately $557 million of the Outstanding Senior Bonds were recently eligible for refunding at interest rates yielding net debt service savings of 7.1%. Although market rates will fluctuate up and down from these levels, it is important to note that for every $100 million of Outstanding Senior Bonds refunded at NPV savings of 3% there are annual debt service savings of $290,000 – so considerable annual debt service savings stand to be realized depending on the interest rate environment. Staff has informed the IBA that refunding bonds could be issued almost immediately after the sale of the 2009A bonds if the required NPV savings threshold can be achieved.

The final component of the proposed financing involves authorizing bonds to cash fund the reserve requirements on the Outstanding Senior Bonds (excluding the 1999 bonds). The reserve requirements for these bonds are currently being satisfied with Ambac surety policies; however, Ambac's credit quality has significantly deteriorated since 2008 and it may be advantageous, from a future financing perspective, to replace the Ambac surety policies with cash to both satisfy existing reserve fund requirements and protect holders of City debt. The proposed financing ordinance authorizes the sale of not more than $65.1 million for this purpose as part of either the 2009A bond issuance or a subsequent refunding bond issuance. Cash funded reserve funds may ultimately be used to pay debt service in the final year of the bonds.

<u>Clarifying Responses to IBA Questions</u>

Why is the City Council being asked to authorize the financing and the facilitating bond documents before they approve the Preliminary Official Statement (POS), which is the primary market disclosure document?

There are a couple of reasons for this. The first is timing. Authorizing the financing and the facilitating bond documents must be approved by ordinance which requires two public readings at Council at least 12 calendar days apart and a subsequent 30-day referendum period. This requires roughly two months time and there is a hard requirement to pay off the 2007 Notes ($223.8 million) on May 15, 2009.

The second reason is that the POS is still being developed and has yet to be comprehensively reviewed by the DPWG. The POS will make reference to the City's FY 2008 Comprehensive Annual Report (CAFR) which is currently being reviewed in draft form by the DPWG and audited by the City's outside auditor. Staff indicates that it is their intent to seek Council approval of the POS by resolution in the second week of April 2009. They further intend to present the FY 08 CAFR to the Council during this week. The FY 2008 CAFR would first need to be reviewed by the Audit Committee at two different meetings which may require that an extra meeting be scheduled.

Given a May 15, 2009 deadline to pay off the 2007 Notes and the need to distribute a Council approved POS to the investor marketplace a few weeks prior to pricing the bonds in the first week of May 2009, can the POS and FY 2008 CAFR be reviewed/approved as planned? If the FY 2008 CAFR were to experience an unexpected delay, how will the City manage the requirement to pay off the 2007 Notes?

The CFO acknowledged that the anticipated schedule for the proposed financing is very tight and that document preparation/review has priority attention from her staff, the DPWG, the outside auditor and the Audit Committee. The POS can be reasonably completed and reviewed by the DPWG in this timeframe, but it is dependent upon completion and audit of the FY 2008 CAFR. The CFO indicated that the FY 2008 CAFR review and the auditor interactions to date have gone very well and that she does not expect delays to be a problem. If there were to be an unexpected delay in the FY 2008 CAFR which delayed approval of the POS, the CFO would try to negotiate an extension of 2007 Note with Citigroup or another borrower.

There is uncertainty in the financial markets and interest rates continue to fluctuate more significantly than they have historically. In response to this market environment and the hard obligation to pay off the 2007 Notes, the proposed ordinance authorizes the interest rate on the Sewer Revenue Bonds up to 10% even though recent rates for this type of credit have ranged from 5.4% to 6%. Does the interest rate cap in the ordinance make sense?

Under similar circumstances last October relating to the 2009 Water System Bonds, the IBA recommended that a significant interest rate cushion (we recommended a 10% interest cap) to ensure that the hard obligation to retire the 2007A Water Notes could be satisfied. While it is unlikely that interest rates would push up to these levels in the next two months, an interest rate cap at this level provides additional flexibility to repay the 2007 Note. The Council could reduce the interest rate cap on the $168 million authorization ($145 million of which is proposed) for the CIP program (say from 10% to 8%) as there may be other ways to manage/finance the Wastewater CIP in the short term were rates to spike; however, the IBA acknowledges that significant delays in long-term financing could have other detrimental impacts to wastewater system compliance and maintenance. Based on current market conditions and the financing need, the IBA believes a 10% interest rate cap is reasonable.

Up to $900M of Sewer Refunding Bonds will be authorized by the ordinance if market conditions result in 3% net present value savings (NPV) in accordance with the City's Debt Policy. Staff reports that approximately $557 million of the Outstanding Senior Bonds were recently significantly above this threshold. Given the significant annual debt service savings potential, when will staff seek to refund the above threshold bonds? Will staff attempt to time market conditions (interest rate levels) for above-threshold bonds or simply refund them as soon as possible to lock in existing savings?

The CFO indicated that her staff will not try to increase annual debt service savings by timing market conditions and will instead proceed with refunding as soon as savings can be realized in accordance with the City's Debt Policy. As a significant portion of the Outstanding Senior Bonds are currently above the Policy's 3% NPV threshold, Sewer Refunding Bonds may need to be issued very soon after the issuance of the 2009A Sewer Revenue Bonds. In order for this to be possible, the financing team plans to concurrently prepare a POS for the Sewer Refunding Bonds to additionally be reviewed by the DPWG in the coming weeks. Once approved by the DPWG, this POS would also need to be approved by City Council resolution prior to the sale of the Sewer Refunding Bonds.

If it is decided that the Ambac surety policies covering certain Outstanding Senior Bonds need to be replaced with cash funded reserve funds, will the $65.1 million authorized by the financing ordinance be issued with the Sewer Revenue Bonds in May 2009 or issued as part of one of the subsequent Sewer Refunding Bond series?

As discussed earlier, the financing ordinance allows for either option. Debt Management staff is still evaluating the need to replace the Ambac surety policies. At this time, they do not believe they will need to replace the Ambac surety policies before they issue the Sewer Refunding Bonds in May 2009. For technical bond structuring reasons, it makes better sense to issue bonds to cash fund these reserves as part of a Sewer Refunding Bond issue and that is staff's intent if it is decided that the surety policies need to be replaced.

CONCLUSION

Based on our review of the financing plan, financing documents, and discussions with representatives of the City's financing team, the IBA recommends approval of the ordinance facilitating the proposed Sewer Revenue Bonds and Sewer Refunding Bonds. This financing plan will better match long-term debt with the long-term capital assets being financed in keeping with MWWD's goal of using debt to finance 80% of its CIP projects. To the extent they can be utilized, Sewer Refunding Bonds will enable the City to refinance outstanding debt so as to realize significant annual debt service savings.

The IBA points out that staff is pursuing a very aggressive schedule to issue the first series of Sewer Revenue Bonds in time to pay off the 2007 Notes. As there is little leeway for the schedule to slip more than a week and the Note repayment obligation is firm, it will be imperative for the City's financing team to comprehensively finish their preparation/review of the POS and the FY 2008 CAFR. It will be equally important for staff to quickly respond to any questions/needs from the outside auditor and work with the Audit Committee to coordinate/schedule review of the FY 2008 CAFR.

The action before the City Council today authorizes the framework and documentation for the proposed financing. Bonds cannot be issued until the City Council has approved the POS by resolution following DPWG approval of the same document. The Securities Law Disclosure Training received by the Council on March 2, 2009 will be most relevant for this approval as the POS is the primary market disclosure document associated with any financing.

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