
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Subordinated Lease Revenue Refunding Bonds (Series 2010) for the Convention Center Expansion

OVERVIEW

The City Council is being asked to authorize the issuance of Subordinated Lease Revenue Refunding Bonds, Series 2010 (2010 Refunding Bonds) by the Convention Center Expansion Financing Authority in a principal amount not to exceed \$165 million. The requested authorization provides that 2010 Refunding Bonds can be issued, in one or more series, through June 30, 2011 in order to reduce annual General Fund debt service expense. To the extent that interest rates in the capital markets allow, the requested 2010 Refunding Bonds would facilitate economic refunding of the City's Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 1998A (1998A Convention Center Bonds).

Staff is requesting approval of an ordinance (authorizing the 2010 Refunding Bonds and related bond documents) and a resolution (approving the Bond Purchase Agreement and the hiring of Bond and Disclosure Counsel for the 2010 Refunding Bonds). Depending on market conditions, these actions will set the stage for one or more series of 2010 Refunding Bonds through June 30, 2011; however, staff must return to the City Council for approval of a Preliminary Official Statement (POS) for each series of Refunding Bonds before they can be sold.

An overview of the proposed 2010 Refunding Bonds was presented to the Budget & Finance Committee on October 13, 2010. This report briefly comments on Councilmember questions raised at that meeting and further discusses the proposed structure of the 2010 Refunding Bonds.

FISCAL/POLICY DISCUSSION

Questions raised by the Budget & Finance Committee

The City's General Fund is obligated to make annual lease payments related to the 1998A Convention Center Bonds (approximately \$163 million outstanding). Annual lease payments (debt service) on the bonds are approximately \$13.7 million through FY 2028. Based on recent market conditions, staff estimates a partial refunding (approximately \$73 million) of the 1998A Convention Center Bonds would reduce annual lease payments to \$13.3 million, or by approximately \$400,000 annually from FY 2012 through FY 2020.

At the Budget & Finance Committee meeting on October 13, 2010, Councilmember DeMaio asked if the Center City Development Corporation (CCDC) could begin to make the annual lease payments on the 1998A Convention Center Bonds and the proposed 2010 Refunding Bonds. In posing his question, Councilmember DeMaio noted 1) the pending lift of the spending cap on CCDC and 2) the possible opportunity created by the need to approve new Convention Center Expansion lease related documents to facilitate the issuance of 2010 Refunding Bonds. Other Committee members similarly expressed interest in this question. The Office of the City Attorney was asked to review legal considerations associated with the question and Chairman Young asked if the IBA could provide comment in their written report.

In discussing the question with the Office of the City Attorney, the IBA was informed that a confidential attorney to client memorandum on this question was subsequently sent to each Councilmember as they collectively constitute the Board of Directors for the City's Redevelopment Agency. The IBA will necessarily defer further comment on the memorandum to the Office of the City Attorney.

At the Committee meeting, the Chief Financial Officer noted this question could be considered as two separate issues. The first was whether the City Council should proceed to take advantage of bond market conditions and approve the proposed issuance of 2010 Refunding Bonds in order to reduce annual General Fund lease expense. The second issue involved legal analysis to determine whether there can be a change in how annual debt service is paid for the Convention Center Expansion bonds.

Councilmember Emerald asked if the City Council would miss an opportunity to further consider the possibility of CCDC making annual lease payments if they were to approve the issuance of 2010 Refunding Bonds on October 19, 2010. The IBA believes it would be useful for the City Council to hear from the Office of the City Attorney in response to this question. We would further note that 2010 Refunding Bonds cannot be issued until

the City Council approves a resolution authorizing the Preliminary Official Statement in November 2010.

Chairman Young additionally asked if a delayed release of the City's Comprehensive Annual Financial Report (CAFR) would adversely impact the proposed issuance of the 2010 Refunding Bonds. The Debt Management Director responded there would not be a material impact as these bonds are anticipated to be sold in December 2010; however, she indicated the bond market would begin to have concerns were the City to be selling bonds late in the first quarter of 2011 without having an audited CAFR for FY 2010.

Proposed Structure of the 2010 Refunding Bonds

The proposed structure of the 2010 Refunding Bonds results from the need for a minimum amount of debt service (lease payment) savings. A minimum threshold of savings is typically required to ensure that the cost of issuing refunding bonds does not equal or exceed the resulting net savings. The City's Debt Policy requires that a refunding have a net economic benefit. A net economic benefit exists when there are aggregate net present value savings, expressed as a percentage of the par amount of the refunded bonds, of 3% or higher.

As noted in the staff report, the Indenture (an agreement between the Authority and the Trustee on behalf of bondholders) for the 1998A Convention Center Bonds requires that any subsequent refunding bond issuance have a debt service reserve fund equal to one-half year of debt service. The reserve fund requirement can either be satisfied with cash or covered by a surety policy (an outside entity's promise to pay if necessary in return for a fee). If this condition is satisfied, refunding bonds could be issued on a parity basis. Parity means that holders of refunding bonds have an equal right to annual lease payments from the City and therefore would not expect or require a higher than usual interest rate on the bonds.

In the case of the contemplated 2010 Refunding Bonds, the cost of a cash funded debt service reserve fund reduces projected net present value savings below the required 3% threshold. Additionally, the deterioration of surety provider credit ratings in recent years has made investors wary of their worth and unwilling to readily accept sureties in lieu of cash funded reserves. Faced with these circumstances, an economic refunding could not be facilitated in the current market with a more typical bond structure (parity bonds with a debt service reserve fund).

The City's financial advisor and underwriter suggested that staff consider a bond structure using a Convention Center facility sublease and a subordinated lease allowing for a subordinated repayment feature. The City's bond and disclosure counsel concur that this structure allows the City to establish new terms under a separate Indenture just for the 2010 Refunding Bonds. Under this scenario, the City could issue bonds without a debt service reserve fund and on a subordinate basis. Subordinate means the holders of 2010 Refunding Bonds have a subordinate right to annual lease payments from the City after holders of the 1998A Convention Center Bonds receive payment.

It is important to note that perceived debt service payment risk associated with either 1) subordinated debt (which is not uncommon) or 2) no debt service reserve fund (which is uncommon) is borne by the buyer of the bonds and not by the City. Financing expense is reduced for the City without a reserve fund because there is no need to borrow additional funds or pay interest on those funds; however, financing expense can also be increased with this bond structure because bond ratings probably will be lower and bond buyers will require a higher rate of interest on the bonds as compensation for assuming greater payment risk associated with subordinated debt without a debt service reserve fund.

Staff has informed the IBA that current investor demand for municipal bonds is being significantly influenced in part by 1) a relatively low supply of tax-exempt municipal bonds in the market which increases investor demand and reduces their bond interest rate expectations and 2) a desire for bond maturities matching those of the proposed 2010 Refunding Bonds. These two bond market conditions mean the City can receive greater debt service savings if the 2010 Refunding Bonds are issued as subordinated debt without a debt service reserve fund. Given these circumstances, the IBA believes an exception to the City's debt service reserve requirement is appropriate in an effort to realize General Fund savings beginning in FY 2012.

CONCLUSION

The City Council is being asked to authorize the issuance of 2010 Refunding Bonds in a principal amount not to exceed \$165 million. The requested authorization provides that 2010 Refunding Bonds can be issued, in one or more series, through June 30, 2011 in order to reduce annual General Fund debt service expense. Based on current market conditions, staff is proposing to refund approximately \$73 million of \$163 million of outstanding 1998A Convention Center Bonds. Annual General Fund lease savings are currently estimated to be approximately \$400,000 from FY 2012 through FY 2020.

In order for the proposed refunding to achieve aggregate net present value savings of at least 3% as required by the City's Debt Policy, it is necessary for the City to structure the 2010 Refunding Bonds as subordinate debt without a debt service reserve fund. Given bond market conditions and the requirements of the 1998A Convention Center Bonds, the IBA believes the proposed structure is appropriate in an effort to realize General Fund savings beginning in FY 2012.

The IBA believes it would be useful for the City Council to hear from the Office of the City Attorney in response to the question raised at the Budget & Finance Committee regarding the possibility of CCDC making the annual lease payments on the Convention Center Expansion bonds. Pending City Attorney clarification, the IBA recommends approval of this item based on the General Fund savings that will result. We note that the 2010 Refunding Bonds cannot be issued until the City Council approves a resolution authorizing the Preliminary Official Statement in November 2010.

The IBA has been informed that representatives of the City's financing team will be present for the City Council meeting on October 19, 2010. 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 and disclosure counsel, and the underwriters.

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