COUNCIL AGENDA: 02-12-08
ITEM: 3.7

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson

SUBJECT: **AIRPORT 2004 AUCTION RATE SECURITIES OPEN AUCTIONS**

DATE: January 22, 2008

Approved Christine J. Shippey Date 1-25-08

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

Adoption of a resolution of the City Council authorizing the Director of Finance or the Director's authorized designee to:

a. negotiate and execute the Broker-Dealer Agreement among the City of San José, U.S. Bank National Association, and Citigroup Global Markets, Inc. relating to the City of San José Airport Revenue Bonds, Series 2004B;

b. negotiate and execute the Broker-Dealer Agreement among the City of San José, U.S. Bank National Association, and Lehman Brothers, Inc. relating to the City of San José Airport Revenue Bonds, Series 2004A; and

c. enter into broker-dealer agreements with other broker-dealers to participate in the auctions of the Series 2004A and the Series 2004B Bonds and make amendments to the broker-dealer agreements within the parameters specified in the resolution.

OUTCOME

City staff, as part of its ongoing market-monitoring responsibilities, has determined that the interest rates that the City pays on its City of San José Airport Revenue Bonds, Series 2004A (AMT) ("2004A Bonds") and City of San José Airport Revenue Bonds, Series 2004B (AMT) ("2004B Bonds") (collectively, the "2004A/B Bonds") have been increasing due to recent disruptions in the financial markets related to the default potential of subprime mortgages. City staff is currently reviewing options to convert the 2004A/B Bonds from auction rate securities to an alternative interest rate mode. Once the options have been thoroughly reviewed and a course of action has been determined, City staff will bring forward a recommendation for City Council approval in March with the conversion to be completed in April 2008. In the interim period, City staff is recommending that the City open its 2004A/B Bonds auctions to both Lehman and

Citigroup to increase the pool of potential investors and consequently reduce the interest cost of the 2004A/B Bonds.

Approval of these recommendations will allow the City to open the auctions for 2004A/B Bonds to both Citigroup Global Markets and Lehman Brothers. Opening these auctions to both broker-dealers is expected to reduce the interest expense of the 2004A/B Bonds.

BACKGROUND

On June 24, 2004, the City issued its City of San José Airport Revenue Bonds, Series 2004A (the "2004A Bonds"), Series 2004B (the "2004B Bonds"), Series 2004C (the "2004C Bonds"), and Series 2004D (the "2004D Bonds") (collectively, the "2004 Bonds") for the purpose of financing a portion of the Airport's improvement projects which were referred to as the 2004 Security Projects. These projects included the North Concourse Project, which is under construction. Subsequent to the issuance of the Series 2004 Bonds, the City issued the City of San José Airport Revenue Bonds, Series 2007 in order to provide funding for Phase I of the Airport Development Program including funding for the completion of the North Concourse Project.

The 2004 Bonds were issued under a Master Trust Agreement that contains provisions for the 2004 Bonds to be converted to and from a variety of interest bearing modes. The 2004A/B Bonds were initially issued as auction rate securities insured by MBIA Insurance Corp. ("MBIA") to provide lower overall borrowing costs to the Airport's debt portfolio. The auctions for the 2004A/B Bonds are currently closed auctions whereby only the designated broker-dealer may participate in the auction. The auction agent for the 2004A/B Bonds is U.S. Bank National Association. For the 2004A Bonds, of which $70 million is currently outstanding, the designated broker-dealer is Citigroup Global Markets, Inc. ("Citigroup") and the auction period is seven (7) days. For the 2004B Bonds, of which $70 million is currently outstanding, the designated broker-dealer is Lehman Brothers, Inc. ("Lehman") and the auction period is thirty-five (35) days. Appendix A to this memorandum describes the mechanics of auction rate securities including the functions of the broker-dealers and auction agent. The 2004C Bonds and 2004D Bonds were issued as fixed rate bonds.

ANALYSIS

The following sections will address City staff's recommendations to the City Council.

Open Auctions Strategy

City staff, as part of its ongoing market-monitoring responsibilities, has determined that the interest rates that the City pays on its 2004A/B Bonds have been increasing due to recent disruptions in the financial markets related to the default potential of subprime mortgages. Based on consultation with the Airport's financial advisors and investment bankers, City staff is currently reviewing options to convert the 2004A/B Bonds from auction rate securities to an alternative interest rate mode. Once the options have been thoroughly reviewed and a course of action has been determined, City staff will bring forward a recommendation for City Council approval in March with the conversion to be completed in April 2008.

In the interim period, City staff is recommending that the City open its 2004A/B Bonds auctions to both Lehman and Citigroup to increase the pool of potential investors and consequently reduce the interest cost of the 2004A/B Bonds. Due to the lower rates recently provided by the 7-day auctions, and upon the advice of the Airport's financial advisors and investment bankers, the City may also change the auction period for the 2004B Bonds from 35 days to 7 days.

Broker-Dealer Agreement

The Broker-Dealer Agreement is among the City, the Auction Agent and the Broker-Dealer for each series of 2004A/B Bonds. This Agreement describes the procedures to be followed by each Broker-Dealer with respect to the 2004A/B Bonds and compensation to the Broker-Dealer. The Broker-Dealers will be paid a fee at the rate of 0.25% of outstanding 2004A/B Bonds for which they serve as Broker-Dealer; the same rate currently paid on the 2004A/B Bonds.

The Agreement, in substantially final form, will be available for review in the City Clerk's Office on or about February 1, 2008. City staff recommends that the Director of Finance or the Director's authorized designees ("Authorized Officers") each be authorized to execute the Agreement. As modifications may be required prior to the closing, City staff also recommends that the Authorized Officers each be authorized to execute the final version of the Agreement as may be modified upon consultation with the City Attorney's Office.

In order to be able to respond to changing market conditions expeditiously, City staff also recommends that the Authorized Officers each be authorized:

1. to amend the broker-dealer agreements to address changes in auction rate procedures provided that the amount of compensation paid to the broker-dealer does not increase;

2. enter into broker-dealer agreements with additional broker-dealers to participate in the auctions of the 2004A/B Bonds provided that the entity selected meets the requirements to serve as broker-dealer specified in the Master Trust Agreement.

EVALUATION AND FOLLOW-UP

This action will allow the City to move forward with opening the auctions for the 2004A/B Bonds and requires no follow-up by the City Council.

PUBLIC OUTREACH/INTEREST

Not applicable.

- ☐ **Criterion 1**: Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**
- ☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

COORDINATION

This report was prepared by the Finance Department in coordination with the City Attorney's Office, Airport Department, and financing team participants.

COST SUMMARY/IMPLICATIONS

Although City staff currently anticipates that these measures will provide interest cost savings to the Airport, the amount of savings is uncertain due to the rapidly changing market conditions.

CEQA

Resolution Nos. 67380 and 71451.

Scott P. Johnson
SCOTT P. JOHNSON
Director, Finance

For questions please contact Julia H. Cooper, Deputy Director of Finance, at 535-7011.

Attachment: APPENDIX A

APPENDIX A

TECHNICAL ASPECTS OF AUCTION RATE SECURITIES AND MULTI-MODAL VARIABLE RATE DEMAND BONDS

The Series 2004 A and 2004 B Bonds will carry variable interest rates until their maturity or earlier redemption. The Third Supplemental Trust Agreement ("Supplemental Agreement") permits the City to issue the Bonds as either multi-modal variable rate demand bonds ("VRDB") or as Auction Rate Securities ("ARS") and to switch between these two options from time to time. Both structures provide the City with an interest cost that varies depending on market interest rates over time. There is a significant difference between the methodologies used to establish the interest rates under the two options. The purpose of this Appendix is to briefly describe the options available to the City.

AUCTION RATE SECURITIES

Auction Rate Securities differ from VRDBs in the methodology used to establish the periodic interest rate to be paid by the City. The interest rate on the ARS is established through a periodic auction wherein investors place bids through authorized Broker Dealers to the Auction Agent. The Auction Agent establishes the interest rate to be paid for the given auction period at the market-clearing rate based on the auction bids received. The City determines which firms will serve as authorized Broker-Dealers and appoints a commercial bank to serve as Auction Agent. The City will pay periodic fees to the firms serving in these capacities.

The City can select auction periods of different lengths, generally 1, 7, 28 or 35-day, or 6-month intervals. Both longer and certain customized auction periods are also allowable under the Supplemental Agreement. The primary cost difference between Auction Rate Securities and Variable Rate Demand Bonds is expected to be support costs.

Auction Rate Securities do not provide the investor with the ability to "put" the bond back to a bank referred to as a Tender Agent. Therefore it is not necessary for the City to have a liquidity facility in place to provide funding for the purchase of the bond if there is no buyer for the bond that has been put. (See "Multi-Modal Variable Rate Demand Bonds" below.) The only way an investor holding ARS can sell its bonds is to submit a sell order at the next occurring auction. If there are sufficient bidders with buy orders at the auction, then the investor's ARS is purchased with the proceeds received from the new investor. Thus, the investor in ARS takes the liquidity risk rather than a bank providing the liquidity facility.

If all existing investors decide to keep their bonds and there are no sell orders at an auction, the interest rate on the ARS is determined based on a formula (the "All-Hold Rate"). In the unlikely event that there are not sufficient bids to clear the auction because there are more sell orders than buy orders (a so-called "failed auction"), the interest rate on the Bonds would rise to the maximum rate of 12% until such time as a successful auction is held.

The Supplemental Agreement permits the City to convert the ARS to VRDBs by providing sufficient notice to various parties and satisfying the conditions set forth in the Supplemental Agreement. One of these conditions is that the City secures a liquidity facility.

MULTI-MODAL VARIABLE RATE DEMAND BONDS

The interest rate on a multi-modal VRDB is established by a Remarketing Agent appointed by the City. The rate can be reset as often as daily or can be fixed for longer periods. The most common reset frequency is weekly. Interest reset periods are also referred to as "modes", thus the characterization of the VRDBs as "multi-modal." The Remarketing Agent is required to set the rate based on its impression of current market interest rates. If an investor no longer wishes to hold the VRDB, the investor is permitted to notify the Tender Agent and "put" the bond back to the City and "demand" repayment - hence the term "demand bond."

In such an event, the Remarketing Agent will attempt to remarket the bonds so "put" to another investor. If the Remarketing Agent is unable to find a substitute investor, for any reason, the Tender Agent is authorized to draw on a liquidity facility established by the City for this purpose. The liquidity facility is a line of credit that provides immediate funding to the Tender Agent to repay the bonds that have been "put" by an investor and the Remarketing Agent has not remarketed. The "put" feature associated with VRDBs is essential to the ability and willingness of investors to purchase the bonds and a liquidity facility is required in order to provide substance to the "put" ability. The City pays a quarterly fee to the bank providing the liquidity facility.

Under the Supplemental Agreement, the City can choose to have the interest on the VRDBs reset with different frequencies. The interest rate modes are (1) commercial paper rate; (2) daily; (3) weekly; and (4) a term as selected by City. The City can also choose to convert the VRDBs to a fixed interest rate to their maturity.

Each Series of VRDBs can bear interest at a different mode. In order to switch between interest rate modes, the City must give notices to bond investors and other identified parties and satisfy the conditions set forth in the Supplemental Agreement. The ability to change interest rate modes provides the City with the ability to manage its interest rate risk during the term of the bonds.