COUNCIL AGENDA: 03-25-08
ITEM: 6.4

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson
William F. Sherry, A.A.E.

SUBJECT: **AIRPORT COMMERCIAL PAPER PROGRAM EXPANSION**

DATE: March 14, 2008

Approved

Date 3/17/08

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

a. Hold a Tax Equity and Fiscal Responsibility Act hearing for the expansion of the City's Airport Commercial Paper Program from a maximum principal amount of $450 million outstanding at any one time to a maximum principal amount of $600 million outstanding at any one time and for the issuance as part of a plan of finance of one or more issues of commercial paper notes to finance and refinance costs of facilities and capitalized interest associated with the implementation of the Airport Master Plan at the Norman Y. Mineta San José International Airport, to refund the City's outstanding Airport Revenue Bonds, Series 2004A and Series 2004B previously issued to pay costs of such facilities and to refund or to pay debt service on other obligations of the City issued to pay such costs.

b. Adoption of a Resolution of the Council of the City of San José amending Resolution No. 69200, as amended, to increase from $450 million to $600 million the maximum principal amount of commercial paper notes that may be outstanding at any one time under Resolution No. 69200, as amended; and to provide for the issuance of such notes to finance and refinance project costs and capitalized interest associated with implementing the Airport Master Plan at the Norman Y. Mineta San Jose International Airport, including to refund the City's outstanding Airport Revenue Bonds, Series 2004A and Series 2004B and to refund or to pay debt service on other obligations of the City issued to pay such costs; and delegating to the Director of Finance and to other Officers of the City authorization to establish terms and conditions for the issuance and payment of said commercial paper notes, and to take other necessary actions and to prepare, execute and deliver the necessary documents in connection therewith.

c. Adoption of a Resolution authorizing the Director of Finance to negotiate, execute and deliver a Letter of Credit and Reimbursement Agreement with Lloyds TSB Bank plc, acting through its New York Branch, a First Amendment and Supplement to the Issuing and Paying Agent Agreement with Deutsche Bank Trust Company Americas and a Dealer Agreement with each of Citigroup Global Markets Inc., Lehman Brothers Inc. and Morgan Stanley & Co. Incorporated relating to the City's Subordinate Commercial Paper

Notes for the Norman Y. Mineta San Jose International Airport; and other necessary documents in connection therewith; and delegating authority to the Director of Finance and to other officers of the City to establish terms and conditions relating thereto.

OUTCOME

Approval of this recommendation will allow the expansion of the existing Airport Commercial Paper Program from $450 million to $600 million, enabling the City to utilize commercial paper to refund the outstanding Airport Revenue Bonds (Auction Rate Securities), Series 2004A and 2004B, which have been negatively impacted by the disruptions in the financial markets related to auction rate securities.

EXECUTIVE SUMMARY

This staff report recommends expanding the Airport Commercial Paper Program to provide additional capacity to use commercial paper to refund the currently outstanding Airport Revenue Bonds (Auction Rate Securities), Series 2004A and 2004B, which have been negatively impacted by the disruptions in the financial markets related to auction rate securities. The Tax Equity and Fiscal Responsibility Act ("TEFRA") hearing must be conducted to notify the community of the City's intent to issue qualified tax-exempt private activity commercial paper notes.

BACKGROUND

Airport Commercial Paper Program

On November 2, 1999, the City Council adopted Resolution No. 69200 approving the implementation of a commercial paper program for the Norman Y. Mineta San José International Airport (the "Airport"), which authorized the issuance of up to $100 million through a combination of three series of commercial paper notes: Series A (Non-AMT), Series B (AMT), and Series C (Taxable). The Airport Commercial Paper Program was established to provide interim financing for Airport capital needs in anticipation of issuance of Airport revenue bonds that would replace the short-term notes with permanent long-term financing. Airport commercial paper notes are debt obligations backed by Net General Airport Revenues and are subordinate to Airport senior lien debt, also backed by these revenues. Net General Airport Revenues are the Airport's gross revenues less maintenance and operation expenses and are first pledged to repay Airport revenue bonds and then Airport commercial paper notes.

Since 1999, the commercial paper notes have been used to initially fund the Airport's runway projects, consolidated rental car garage project design efforts, costs associated with the 2002 Refunding Bonds, the initial costs associated with the implementation of the requirements under the federal Aviation and Transportation Security Act ("ATSA"), the Claims Loss Reserve for the Airport's Owner Controlled Insurance Program ("OCIP") for the North Concourse Project, the Terminal Area Improvement Program ("TAIP"), and to fund associated interest cost during construction of these projects.

On June 20, 2006, the City Council approved an expansion of the Airport Commercial Paper Program from $100 million to $200 million to ensure that funding would be available for the award of the design and construction contracts related to the amended Airport Master Plan projects and to pay costs related to the Airport's lease of the former FMC property.

On January 9, 2007, the City Council approved an expansion of the Airport Commercial Paper Program from $200 million to $450 million to ensure that funding would be available for the design and construction contracts related to the rephased Airport Master Plan projects. The Airport Commercial Paper Program is secured by letters of credit issued on a several basis by J.P. Morgan Chase Bank, National Association, Bank of America, N.A., and Dexia Credit Local, acting through its New York Branch, pursuant to the Second Amended and Restated Letter of Credit and Reimbursement Agreement (the "Existing Reimbursement Agreement").

Various Airport Master Plan projects over the next several years are focused on completion of the North Concourse Project as well as the implementation of the TAIP. Additionally, the Airport Commercial Paper Program was intended to act as a potential source to pay costs related to the Airport's lease of the former FMC property and to pay debt service costs related to the City of San José Airport Revenue Bonds, Series 2004.

Airport Revenue Bonds, Series 2004

On June 24, 2004, the City issued its 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.

The 2004A Bonds and 2004B Bonds (collectively, 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 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. The 2004C Bonds and 2004D Bonds were issued as fixed rate bonds.

On January 22, 2008, the City Council, in response to disruptions in the financial markets related to auction rate securities, approved opening the 2004A/B auctions to allow both Citigroup Global

Markets and Lehman Brothers to participate in both the 2004A auctions and the 2004B auctions. This action was an interim measure intended to increase the pool of potential investors and consequently reduce the interest cost of the 2004A/B Bonds. On the advice of its investment bankers and financial advisors, the City has not opened these auctions, as the potential for negative impacts is now anticipated to be greater than the potential benefits.

ANALYSIS

As noted in the memorandum presented to Council on January 22, 2008, staff has been working with the City's financial advisors and investment bankers to review options for converting the 2004A/B Bonds from auction rate securities to an alternative interest rate mode.

This section of the report addresses staff's recommendation to proceed with the expansion of the Airport Commercial Paper Program. These subsections include discussions of the Airport plan of finance, TEFRA hearing requirements, financing documents, expansion of the delegation of authority for the existing Airport Commercial Paper Program, and the financing team.

Airport Plan of Finance

The Airport capital financing program includes a variety of debt instruments designed to provide the lowest expected cost of capital while maintaining strategic flexibility. Although the majority of the Airport's capital program has been financed with fixed-rate bonds, the Airport has also made effective use of variable rate auction rate securities and commercial paper notes, which typically bear a lower interest rate than fixed rate bonds and give the Airport more opportunities to restructure its debt. Despite the advantage of variable rate financing, prudence dictates that variable rate exposure be limited to a level under which debt service volatility would be manageable under normal circumstances. Accordingly, the bond rating agencies have suggested that variable-rate debt be limited to 25%-30% of an issuer's portfolio. As of December 31, 2007, the City's portfolio of Airport debt included approximately 14% of variable-rate instruments. The City has saved over $8.6 million in interest costs since the original issuance of the 2004A/B Bonds in a variable rate mode as compared to if the bonds had been issued in a fixed rate mode.

As described in the January 22, 2008, staff report, the market for auction rate securities has been deteriorating. This deterioration can be traced, in part, to the rating downgrades of several leading bond insurers. The auction rate market is not expected to recover in the near future. Consequently, it is necessary to convert the 2004A/B Bonds to some other debt structure in order to reduce the interest costs on the debt. Although one approach would be to refund the 2004A/B Bonds with fixed rate Airport revenue bonds, as discussed above it is more advantageous to the Airport to maintain the established level of variable rate exposure in the Airport debt portfolio, consistent with the City Council's previously approved plan of finance. The primary alternative variable rate financing instruments are variable rate demand bonds ("VRDBs") and commercial paper.

Although not as permanently impacted by the financial market disruption as auction rate securities, the market for VRDBs has also been volatile, particularly for insured VRDBs. Moreover, the current costs of credit enhancement and liquidity support, both of which would be necessary for a new Airport VRDB program, have increased significantly. As noted previously, like auction rate securities and VRDBs, commercial paper notes bear interest at lower interest rates than fixed rate bonds, but have not been as adversely affected by recent events. Because the Airport already has an active commercial paper program, staff recommends that the Airport commercial paper program be expanded to accommodate redemption of the 2004A/B Bonds.

The City utilizes its Airport Commercial Paper Program to provide funding for Airport capital projects on an as-needed basis. Typically, staff issues commercial paper during project construction and then restructures the commercial paper into long-term debt once the projects are completed or sufficient commercial paper is outstanding to achieve economies of scale in a take-out financing.

In developing a solution to address the Airport auction rate securities, staff has inquired with Lloyds TSB Bank plc ("Lloyds"), a respondent to the last RFQ to expand the Airport Commercial Paper Program, regarding the bank's ability to provide a three-year letter of credit to support an expansion of the commercial paper program in the amount of $140 million, equal to the principal amount of auction rate securities currently outstanding, but not to exceed $150 million. Lloyds staff has indicated that fees for a three-year letter of credit would be approximately 59 basis points for the utilized portion of the commitment and 29 basis points for the unutilized portion of the commitment, reflecting the higher letter of credit fees in the currently tightening credit markets, however exact fees are still being determined. In contrast, the fees for the letters of credit supporting the existing program are 15 basis points for the utilized portion of the commitment and 11 basis points for the unutilized portion of the commitment.

Although a substantial amount of commercial paper capacity is committed for encumbrance purposes, commercial paper to pay for expenditures is anticipated to be issued over the next several years as construction progresses. By increasing encumbrance capacity using the new letter of credit to be issued by Lloyds, it is possible to take advantage of the lower utilized commitment fees in the existing program while maintaining required encumbrance capacity in the expanded portion of the program. In keeping with this plan, the 2004A/B Bonds will be refunded on a current basis with commercial paper secured by the existing letters of credit.

A current refunding is a refunding in which the refunding bonds or notes are issued not more than ninety (90) days before the redemption date upon which the outstanding bonds become due or are callable, which in the case of the 2004A/B Bonds is any interest payment date. The currently targeted interest payment date is Friday, April 4, 2008. Commercial paper will be issued on that date and the proceeds will then immediately be used to redeem the 2004A/B Bonds.

The City's adopted Debt Management Policy specifies a minimum of 3% net present value savings for a refunding to be considered economically viable, although it also provides for consideration of refundings below the 3% threshold on a case-by-case basis. Staff recommends refunding the bonds based on the above analysis.

Staff expects that it will recommend to the Council that the City refinance the commercial paper issued to refund the 2004A/B Bonds with long-term bonds in conjunction with the previously contemplated refinancing of the commercial paper issued to fund the Phase I projects. This is anticipated to occur on or around the projected completion date of the Phase I projects in 2010; however, this could be subject to change due to market conditions, the Airport's operations and performance, and other factors. No commitment to any such refinancing is being made at this time.

<u>TEFRA Hearing Requirements</u>

Section 147(f) of the Internal Revenue Code requires that, before private-activity bonds may be issued, the City must approve the issuance of such obligations after conducting a public hearing. This hearing, known as a Tax Equity and Fiscal Responsibility Act (TEFRA) hearing, is scheduled to be held as part of the action items on the March 25, 2008, Council agenda, and is intended to provide an opportunity for all interested persons to express their views both orally and in writing on the proposed issuance of qualified tax-exempt private-activity Airport revenue bonds (the Series E Notes) that will provide financing for the redemption of the 2004A/B Bonds. The City previously held a TEFRA hearing on August 14, 2007, in connection with the approval of the 2007 Bonds, which provided long-term financing for the Phase I Airport Master Plan projects.

The notice for the public hearing, which was published on March 11, 2008 in the *San Jose Mercury News*, states the City's non-binding intent to expand the commercial paper program from a maximum authorized principal amount of $450 million to $600 million.

<u>Financing Documents</u>

City Council approval of the amendments to Resolution 69200, as previously amended, the Letter of Credit and Reimbursement Agreement with Lloyds, and the First Amendment and Supplement to the Issuing and Paying Agent Agreement is necessary to increase the aggregate principal amount that may be outstanding at any one time from $450 million to $600 million. All of the documents described below, in substantially final form, will be available for review in the City Clerk's Office on or about March 21, 2008. Staff recommends that the Director of Finance or the Director's authorized designees ("Authorized Officers") each be authorized to execute the agreements described below. As modifications may be required prior to the closing, staff also recommends that the Authorized Officers each be authorized to execute the final version of these agreements as may be modified upon consultation with the City Attorney's Office.

First Amendment and Supplement to Issuing and Paying Agent Agreement – The Issuing and Paying Agent Agreement is between the City of San José and Deutsche Bank Trust Company Americas as the Issuing and Paying Agent. This agreement sets forth the procedures for issuing commercial paper notes, payment of the matured commercial paper notes and the application of the funds received from the sale of commercial paper notes. The amendments to the Issuing and Paying Agent Agreement will create provisions to allow for the issuance of commercial paper notes supported by the new letter of credit and make conforming changes necessitated by the execution of the new Letter of Credit and Reimbursement Agreement.

New Letter of Credit and Reimbursement Agreement – The Letter of Credit and Reimbursement Agreement is an agreement between the City and Lloyds. Lloyds agrees to advance funds to the Issuing and Paying Agent sufficient to pay the interest and maturing amount of commercial paper notes as due in an amount not to exceed $150 million. In the event that the commercial paper dealer is unable to issue additional commercial paper notes to repay the advance from Lloyds, the City must pay interest to Lloyds based on a formula specified in the Reimbursement Agreement. The Letter of Credit and Reimbursement Agreement is necessary in order to increase the amount of commercial paper notes that can be outstanding at one time from $450 million to $600 million.

The annual fee payable for the Letter of Credit is still to be determined although Lloyds staff has provided indicative rates as described above. Information regarding the fees and the terms of the New Letter of Credit and Reimbursement Agreement will be provided in a supplemental staff report.

Commercial Paper Dealer Agreement – The Commercial Paper Dealer Agreement is between the City of San José with each of Citigroup Global Markets Inc., Lehman Brothers Inc. and Morgan Stanley & Co. Incorporated as dealers for the commercial paper notes and describes the procedures and compensation for serving as commercial paper dealer. Currently, Morgan Stanley & Co. is the sole dealer for the City's commercial paper program. In view of the proposed expansion of the program, staff recommends that Citigroup Global Markets Inc. and Lehman Brothers Inc. also be appointed to serve as commercial paper dealers for the program. Citigroup and Lehman are the current auction rate dealers on the 2004A/B bonds and are very familiar with the Airport credit. Having multiple commercial paper dealers will foster competition among the dealers and is anticipated to result in the City paying lower interest costs. The compensation paid to each commercial paper dealer is paid at the rate of 0.05%, which is the same rate paid to Morgan Stanley & Co. under the current agreement.

Delegation of Authority for Commercial Paper Program

The recent market disruption in the municipal bond market has demonstrated the need for staff to be able to have the authority to respond quickly. Accordingly, staff recommend that the City

Council delegate the following authority to the Director of Finance or the Director's authorized designees (collectively, the "Authorized Officers"). The recommended delegation of authority, set forth below, is broader than the current delegation of authority related to the existing Airport commercial paper program.

Letter of Credit and Reimbursement Agreements – With respect to both the Existing Reimbursement Agreement and the New Letter of Credit and Reimbursement Agreement ("New Reimbursement Agreement"), staff recommends that the Authorized Officers each acting alone, be authorized to:

a. select a substitute or additional letter of credit bank or banks, and to approve the assignment of the any of the banks' obligations to another bank or banks pursuant to the terms of the New Reimbursement Agreement or the Existing Reimbursement Agreement, as applicable, and to enter into a reimbursement agreement with each substitute or additional bank on substantially the same terms as contained in the New Reimbursement Agreement or the Existing Reimbursement Agreement, as applicable.

b. negotiate, execute and deliver future amendments to the New Reimbursement Agreement or the Existing Reimbursement Agreement, as applicable as follows: (1) substitutions of any of the banks currently providing credit support pursuant to the New Reimbursement Agreement or the Existing Reimbursement Agreement with other commercial banks having a long-term rating in at least the "A" rating category, without regard to any numerical modifier, plus or minus sign or other modifier, from each rating agency then rating the Notes, and a short-term rating in at least the "P-3" rating category, taking into account any numerical modifier, but not any plus or minus sign or other modifier, from each rating agency then rating the Notes, (2) approve extensions of the Commitment Expiration Date and the Letter of Credit Expiration Date (as such terms are defined in each of the New Reimbursement Agreement and the Existing Reimbursement Agreement) provided that the total compensation paid by the City under the New Reimbursement Agreement or the Existing Reimbursement Agreement, respectively, does not exceed 0.95% per annum of the Maximum Stated Amount (as defined in the New Reimbursement Agreement or the Existing Reimbursement Agreement, respectively; and (3) other amendments that do not materially adversely affect the City or the Airport.

Commercial Paper Dealer Agreements – With respect to the Commercial Paper Dealers, staff recommends that the Authorized Officers, each acting alone, be authorized to select substitute commercial paper dealers and to enter into commercial paper dealer agreements with such substitute dealers on substantially the same terms as contained in the Commercial Paper Dealer Agreements described above with such additions, changes and corrections therein as necessary and desirable, as the Authorized Officer approves upon consultation with the City Attorney; provided that the compensation paid to the Commercial Paper Dealers does not increase.

Financing Team Participants

The financing team participants consist of:

• City's Co-Financial Advisors:	Fullerton & Friar, Inc. Public Resources Advisory Group
• Bond Counsel:	Orrick Herrington & Sutcliffe LLP
• Letter of Credit Provider:	Lloyds TSB Bank plc, New York Branch
• Bank's Counsel:	Chapman and Cutler LLP
• Commercial Paper Dealers:	Citigroup Global Markets Inc. Lehman Brothers Inc. Morgan Stanley & Co. Inc.
• Commercial Paper Dealers' Counsel:	Kutak Rock LLP
• Issuing and Paying Agent:	Deutsche Bank Trust Company Americas

Financing Schedule

The current proposed schedule is as follows:

City Council approval of documents:	March 25, 2008
Refunding of 2004A and 2004B Bonds:	April 4, 2008
Closing of expanded commercial paper program:	April 24, 2008

EVALUATION AND FOLLOW-UP

This action will allow the City to move forward with expanding the Airport Commercial Paper Program to refund the 2004A/B Bonds and requires no follow-up by the City Council.

POLICY ALTERNATIVES

Not applicable.

PUBLIC OUTREACH/INTEREST

The TEFRA hearing to be held as part of the action herein is a method of notifying the community of the City's intent to issue qualified tax-exempt private activity bonds (Series E Notes). The public hearing notice was published on March 11, 2008, in the *San Jose Mercury News*, announcing the time and location of the public hearing.

- ☐ **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 has been prepared by the Finance Department in coordination with the City Attorney's Office, Airport Department, and financing team participants.

COST IMPLICATIONS

As noted above, the disruptions recently experienced in the auction rate securities market have led to significantly higher interest costs than were anticipated when the financing structure for the 2004A/B Bonds was put in place. For fiscal year 2007-08, the debt service on these bonds, including financing costs, is currently estimated to be $7.2 million if no action is taken to refund the bonds in contrast to $5.8 million if the bonds are refunded as described above. The budgeted debt service for these bonds, including financing costs, for the current fiscal year is $5.6 million.

Although by refunding the bonds under the proposed expanded commercial paper program, the Airport will incur higher fees, the lower interest rates received on commercial paper notes are anticipated to result in an overall savings to the Airport.

In fiscal year 2006-07, the Airport paid approximately $360,000 for fees associated with the 2004A/B Bonds. Under the proposed expanded commercial paper program, one-time fees and expenses to establish the expanded program are estimated at $300,000, while ongoing fees are anticipated to be between $576,000 and $940,000 per year.

Compensation for the City's consultants and the costs of issuance will be paid from Airport operating funds or taxable commercial paper note proceeds. The estimated costs of issuance are still being determined because a number of the consultants are working on "time and materials" based agreements rather than fixed-fee contracts. The supplemental report transmitting the financing documents will also provide the terms of the Reimbursement Agreement with Lloyds and a summary of the total estimated costs of issuance.

BUDGET REFERENCE

Not applicable.

CEQA

Resolutions No. 67380 and 71451, PP 08-034.

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