COUNCIL AGENDA: 06-01-04
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson
Ralph G. Tonseth

SUBJECT: **APPROVAL OF ISSUANCE OF AIRPORT REVENUE BONDS SERIES 2004A, 2004B, 2004C & 2004D**

DATE: May 14, 2004

Date

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

1. Hold a TEFRA (Tax Equity and Fiscal Responsibility Act) hearing for the issuance of debt pursuant to a plan of finance for the Airport's security-related improvements, including Airport Revenue Bonds and Airport Commercial Paper in an aggregate principal amount not to exceed $575,000,000 for the purpose of financing and refinancing the total costs of security-related improvements to the Airport and the associated financing costs.

2. Adoption of the Fourteenth Supplemental Resolution of the City Council:

   a. Authorizing the issuance of City of San José Airport Revenue Bonds, AMT Series 2004A (the "2004A Bonds") and AMT Series 2004B (the "2004B Bonds") (collectively, the "2004 Auction Rate Bonds") in the not-to-exceed aggregate principal amount of $140,000,000 to be sold through a negotiated sale for the purpose of financing and refinancing a portion of the costs of certain security-related improvements to the Airport, funding capitalized interest on the 2004 Auction Rate Bonds, funding a debt reserve fund and paying the costs of issuance of the Bonds.

   b. Authorizing the issuance of City of San José Airport Revenue Bonds, AMT Series 2004C (the "2004C Bonds") and non-AMT Series 2004D (the "2004D Bonds") (collectively, the "2004 Fixed Rate Bonds") in the not-to-exceed aggregate principal amount of $110,000,000 to be sold through a negotiated sale for the purpose of financing and refinancing a portion of the costs of certain security-related improvements to the Airport, funding capitalized interest on the 2004 Fixed

Rate Bonds, funding a debt reserve fund and paying the costs of issuance of the Bonds.

c. Authorizing the execution of certain financing documents, including the Third Supplemental Trust Agreement, Fourth Supplemental Trust Agreement, Broker-Dealer Agreements, the Auction Agreement, and other related documents, authorizing the negotiated sale of the Bonds and the execution of the Bond Purchase Agreements, approving in substantially final form the Preliminary Official Statements for the Fixed Rate Bonds and the Auction Rate Bonds and authorizing the distribution of the Preliminary and Final Official Statements for both the Auction Rate and Fixed Rate Bonds, declaring the official intent of the City to reimburse certain expenditures from the proceeds of indebtedness and authorizing certain related actions in connection with the issuance of the Bonds.

BACKGROUND

The Series 2004 Bonds are being issued (a) to pay (and to refund commercial paper notes issued to pay) a portion of the costs of designing and constructing certain security-related capital improvements at the Airport; (b) to pay all or a portion of the interest to accrue on the Series 2004 Bonds for a period of 36 months; (c) to fund a debt service reserve fund; and (d) to pay the costs of issuing the Series 2004 Bonds. Repayment of the Series 2004 Bonds will be on parity with the Airport's five series of Airport Revenue Bonds currently outstanding in the amount of $262.5 million.

The Airport has developed a plan to satisfy federal security mandates in a manner that is compatible with future development of the Airport's terminal facilities (the "2004 Security Projects"). As described below, most of the 2004 Security Projects result from federal mandates and, in the opinion of the City Attorney's Office, do not require consent of the airlines under the terms of the airline lease agreements.

The 2004 Security Projects include a two-story North Concourse Building project to be constructed between Terminal C and the International Arrivals Facility. The North Concourse Building project is being designed to provide the explosive detection system ("EDS"), permanent in-line baggage screening and sorting facilities, and replacement of the temporary baggage-inspection facilities added after September 11, 2001. The ground floor of the North Concourse Building is being designed to house the in-line baggage screening and sorting facilities, the EDS, new temporary ticket counters and baggage claim areas. The second floor of the North Concourse Building is being designed to provide additional passenger screening checkpoints and waiting rooms.

In addition to the North Concourse Building, the 2004 Security Projects include cargo security improvements; Security Identification Display Area improvements; improvements to the security checkpoints in Terminal A and Terminal C and the existing baggage screening systems;

planning, infrastructure and utility improvements needed to support the North Concourse Building; relocation, demolition and/or refurbishment of certain Airport and tenant facilities; and consolidation of certain functions necessary as a result of the implementation of the security-related projects.

The total projected capital cost of the 2004 Security Projects is estimated to be $389.5 million. There are included in the 2004 Security Projects, associated capital costs that are not related to federal security mandates. Based on the conceptual design of the 2004 Security Projects, staff estimates that of the $389.5 million estimated total costs, approximately $26.5 million is the cost of the non-security portion of the projects which will be paid from Airport funds.

The Series 2004 Bonds will provide funding for approximately $200 million of the 2004 Security Projects. The remaining costs for the 2004 Security Projects, not funded from Airport funds, will initially be funded by using the Airport's commercial paper program. Permanent financing for the remaining costs of the 2004 Security Project will come from the issuance of additional Airport Revenue Bonds currently anticipated to be issued in 2006.

ANALYSIS

The following sections of the report address the items in staff's recommendation to proceed with the issuance of the Bonds. These sections include: TEFRA Hearing, Declaration of Intent, Plan of Finance, Bond Financing Documents, Financing Team Participants and Financing Schedule.

TEFRA Hearing

Section 147(f) of the Internal Revenue Code requires that, before private activity bonds and commercial paper notes may be issued, the City must approve the issuance of such obligations after conducting a public hearing. This hearing, known as a TEFRA hearing, is scheduled to be held as part of the action items on the June 1, 2004, 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 the commercial paper notes and private activity Airport revenue bonds that will provide short- or long-term financing for the 2004 Security Projects. The notice for the public hearing, which will be published no later than May 18, 2004, in the *San Jose Mercury News*, states the City's non-binding intent to issue up to a cumulative total of $575 million of tax-exempt commercial paper notes and private activity bonds for the 2004 Security Projects pursuant to a plan of finance. For a breakdown of the plan of finance, refer to the table in Appendix A attached.

Declaration of Intent

Federal tax regulations allow issuers of tax-exempt bonds to use bond proceeds for reimbursement of certain costs previously expended on the project to be financed. However, such reimbursement can only occur if the issuer has adopted an official resolution declaring its intent to reimburse the expenditure with bond proceeds. The City's declaration of intent to

reimburse itself from the proceeds of debt obligations in an amount not expected to exceed $575 million (composed of tax-exempt revenue bonds, notes and other obligations, including without limitation commercial paper) will apply to construction expenditures made within 60 days prior to the adoption of the resolution. In general, any reimbursement must be made no later than three years after the expenditure is originally paid.

The holding of the TEFRA hearing, the declaration of official intent and the approval of the plan of financing, are intended solely for purposes of complying with the requirements of the Treasury Regulations and the Internal Revenue Code, and do not bind the City to make any expenditure, incur any indebtedness, or proceed with the 2004 Security Projects or any portion thereof.

Plan of Finance

Issuance of Additional Airport Revenue Bonds

The City has five series of Airport Revenue Bonds outstanding. Two of these series were issued pursuant to Resolution No. 57794, as amended and supplemented, originally adopted by the City Council in 1984 (the "1984 Resolution"). In 2001, the City adopted Supplemental Resolution No. 70532 approving the amendment and restatement of the 1984 Resolution in the form of the Master Trust Agreement dated as of July 1, 2001, (the "Master Trust Agreement") between the City and BNY Western Trust Company, as Trustee. Under the Master Trust Agreement the City has issued the Series 2001A Bonds pursuant to the First Supplemental Trust and the Series 2002A and 2002B Refunding Bonds pursuant to the Second Supplemental Trust Agreement.

Under the Master Trust Agreement, the City is authorized to issue additional bonds pursuant to certain tests being met. The Series 2004 Bonds are proposed to be issued under the historical additional bonds test. Net revenues available for debt service for the fiscal year ending June 30, 2003 must be at least equal to 125% of Maximum Annual Debt Service on all outstanding Bonds after the Series 2004 Bonds are issued.

Description of the Series 2004 Bonds

The Series 2004 Bonds will be issued pursuant to the Third and Fourth Supplemental Trust Agreements and will include both fixed rate bonds and variable rate bonds. The variable rate bonds will be issued initially in the form of Auction Rate Securities. Variable rate bonds will minimize the negative carrying cost associated with the large balances in the project funds and accounts established under the 2004 Bond documents and are expected to provide a lower cost of borrowing to the Airport. In addition, since a large portion of the project costs will be funded by private activity tax-exempt bonds subject to the Alternative Minimum Tax ("AMT"), the use of variable rate debt minimizes the "AMT penalty" (which is the higher interest rate paid on bonds subject to the AMT). Variable rate debt may be refunded at any time which will give the City the flexibility to refund the AMT Bonds with non-AMT Bonds

in the future, as permitted by federal tax laws. Additionally, the Airport continues to pursue federal funding opportunities for security-related projects and if federal funding were to be received, it could be used to repay principal on the variable rate debt earlier than scheduled without penalty, which is not the case with fixed rate debt.

The 2004 Auction Rate Bonds are expected to have a final maturity date of June 1, 2034, and are subject to mandatory sinking fund redemption beginning in 2024, although they can be redeemed at the option of the City on any interest payment date. The estimated par amount of the 2004 Auction Rate Bonds is expected to be $140 million, to be sold in two series of $70 million each. All of the 2004 Auction Rate Bonds will be subject to the AMT. Interest on the 2004 Auction Rate Bonds will be capitalized during the construction of the 2004 Security Projects through late June 2007, which is three years from the projected date of issuance of the 2004 Bonds at an average assumed interest rate of 2.17%.

The 2004 Fixed Rate Bonds are expected to have a final maturity date of March 1, 2024. The aggregate par amount is estimated to be $110 million and will be allocated between the Series 2004C (AMT) and Series 2004D (non-AMT) Bonds based on the analysis of the tax status of the projects. Interest on the 2004 Fixed Rate Bonds will also be capitalized through late June 2007.

The estimated sources and uses of funds for the financing are shown below:

City of San José
Airport Revenue Bonds
2004 Auction Rate Bonds and 2004 Fixed Rate Bonds
Estimated Sources and Uses of Funds [(1)]

	Series 2004 A/B Auction Rate AMT[(2)]	Series 2004 C Fixed Rate AMT	Series 2004 D Fixed Rate Non-AMT
Sources of Funds:			
Principal Amount	$140,000,000	$ 60,400,000	$ 49,600,000
Net Original Issue Premium	--	1,687,416	(769,607)
Total Sources	$140,000,000	$ 62,087,416	$ 48,830,393
Uses of Funds:			
Improvement Funds	$111,455,536	$ 11,922,230	$ 36,313,092
Commercial Paper Repayment	--	34,400,000	--
Capitalized Interest Funds	9,939,182	8,459,304	6,420,523
Capitalized Fees Funds	1,005,442	--	--
Reserve Funds	14,000,000	6,040,000	4,960,000
Cost of Issuance Funds [(3)]	3,599,840	1,265,882	1,136,778
Total Uses	$140,000,000	$ 62,087,416	$ 48,830,393

[(1)] Preliminary, subject to change
[(2)] Par amount of bonds split equally between Series A Bonds and Series B Bonds
[(3)] Includes bond insurance premium, underwriter's discount, and costs of issuance

Bond Insurance and Reserve Fund Surety Bonds

The Bonds are expected to be insured by one or more municipal bond insurers. The City is soliciting proposals for municipal bond insurance prior to the issuance of the bonds and will select the bond insurer based on the proposal that is expected to provide the lowest all-in cost to the Airport. In addition, the required deposit in the bond reserve fund may be satisfied by securing one or more reserve fund surety bond policies by the bond insurer. The selected bond insurer(s) information will be provided in the supplemental memo transmitting the Official Statement on or about May 24.

Auction Rate Securities

The 2004 Auction Rate Bonds will be issued initially as auction rate securities. Pursuant to the Third Supplemental Trust Agreement, the City may convert the Bonds to fixed rate bonds or variable rate demand bonds at a later date. The Auction Agent, Wachovia Bank, was selected following the issuance of a request for proposals for auction agent services distributed to five commercial banks. The Trustee, BNY Western Trust Company, is the trustee for the Airport's outstanding revenue bonds.

While the City has issued variable rate demand bonds in the past, this financing will represent one of the first issuances of auction rate securities by the City with the other being the auction bonds expected to be issued by the City of San Jose Financing Authority for the improvements to the Ice Centre in early June 2004. Appendix B provides a discussion of the primary differences between variable rate bonds and auction rate securities.

The City can select auction periods of different lengths from time to time in response to market conditions. The Series 2004A Bonds are expected to be issued with a 7-day auction period and the Series 2004B Bonds with either a 28 or 35-day auction period. The interest rates set at each auction are expected to be similar to the rates on variable rate demand bonds. The maximum interest rate cannot exceed 12% per year.

The primary cost difference between auction rate securities and variable rate demand bonds is expected to be support costs. The total annual broker-dealer and auction agent fees for the 2004 Auction Rate Bonds are expected to be approximately 0.25% of the outstanding par amount. It is expected that the annual support costs for the issuance of variable rate demand bonds would be considerably higher than such fees, due in part to the necessity of providing a liquidity facility with the variable rate demand bonds.

Bond Financing Documents

There are a number of bond financing documents that require City Council approval to proceed with the issuance of the Bonds. All of these documents in substantially final form will be available for review in the City Clerk's Office on or about May 24, 2004.

Official Statement The Official Statements are the public offering statements for the issuance of the Bonds. In this case, Disclosure Counsel, on behalf of the City, has prepared separate Preliminary Official Statements for the Fixed Rate Bonds, Series 2004C and Series 2004D and the Auction Rate Bonds, Series 2004A and Series 2004B. These documents describe the projects to be funded with the Bonds, activity information on the Airport and the financial condition of the Airport. Investors use this information to evaluate the credit quality of the Bonds. Following the sale of the 2004 Fixed Rate Bonds to the underwriters and prior to the closing, Disclosure Counsel will prepare separate final Official Statements for the 2004 Auction Rate Bonds and the 2004 Fixed Rate Bonds.

Staff recommends that the Director of Finance and the Director of Aviation be authorized to sign the final Official Statements for the 2004 Fixed Rate Bonds and for the 2004 Auction Rate Bonds on behalf of the City and to make such modifications to these documents as may be necessary upon consultation with the City Attorney's Office. Staff also recommends that the Director of Finance and the Director of Aviation be authorized to execute certificates regarding these documents as required to comply with securities laws and to authorize the underwriters to distribute these documents for purpose of marketing the 2004 Fixed Rate Bonds and the 2004 Auction Rate Bonds.

A copy of the draft Preliminary Official Statements for the 2004 Fixed Rate Bonds and for the 2004 Auction Rate Bonds, in substantially final forms, will be distributed to the City Council under separate cover on or about May 24, 2004. Staff has carefully reviewed the information contained in these offering documents and believes each document to be accurate and complete in all material respects.

If any Council member has any personal knowledge that any of the material information in either document is false or misleading, the Council member must raise these issues prior to approval of the distribution of the document.

City staff, bond counsel, and the financial advisors will be available at the Council meeting on June 1, 2004, to address any questions, issues and/or concerns.

Staff recommends that the Director of Finance or the Director's authorized designees be authorized to execute each of these agreements described below. As modifications may be required prior to the closing, staff also recommends that the Director of Finance be authorized to execute the final version of each of these agreements as may be modified upon consultation with the City Attorney's Office.

Third Supplemental Trust Agreement The Third Supplemental Trust Agreement contains the responsibilities and duties of the Trustee and the rights of the bondholders in connection with the Master Trust Agreement and the 2004 Auction Rate Bonds.

Fourth Supplemental Trust Agreement The Fourth Supplemental Trust Agreement contains the responsibilities and duties of the Trustee and the rights of the bondholders in connection with the Master Trust Agreement and the 2004 Fixed Rate Bonds.

Bond Purchase Contracts The Bond Purchase Contract is a contract between the City and the underwriter as the purchaser of the Bonds. The Purchase Contract specifies the representations and warranties of the City, the documents to be executed at closing, and the conditions that allow the purchaser(s) to cancel the purchase of the Bonds. The City will be entering into three Purchase Contracts: one with Citigroup Capital Markets Inc. for the Series 2004A Bonds, one with Lehman Brothers Inc. for the Series 2004B Bonds and one with Citigroup Capital Markets Inc. as representative of the underwriters for the Series 2004C and Series 2004D Fixed Rate Bonds. The underwriters will be paid a takedown for the Series 2004A and Series 2004B Bonds of $3.00/$1,000 and a takedown of $3.50/$1,000 for the Series 2004C and Series 2004D Bonds. In addition, the City will reimburse the underwriters for their expenses, including underwriters' counsel.

Auction Agreement The Auction Agreement is among the City, the Trustee and Wachovia Bank as Auction Agent for the 2004 Auction Rate Bonds. This Agreement appoints Wachovia Bank as the initial Auction Agent and describes the procedures to be followed by the Auction Agent and compensation to be paid to the Auction Agent. The Auction Agent will be paid an annual fee based on the amount of 2004 Auction Rate Bonds outstanding. The fee is 0.0035% of outstanding bonds ($4,900 for the initial year). Staff recommends that the Director of Finance be authorized to replace the Auction Agent with another bank that meets the qualifications set forth in the Third Supplemental Trust Agreement, if the Director determines that it is in the best interest of the City to do so and that the compensation for the replacement Auction Agent does not exceed $10,000 per year.

Broker-Dealer Agreement The Broker-Dealer Agreement is among the City, the Auction Agent and the Broker-Dealer for each series of 2004 Auction Rate Bonds. This Agreement describes the procedures to be followed by each Broker-Dealer with respect to the Auction Rate Bonds and compensation to the Broker-Dealer. The City will initially enter into two Broker-Dealer Agreements, one with Citigroup for the Series 2004A Bonds and one with Lehman Brothers for the Series 2004B Bonds. The Broker-Dealers will be paid a fee of 0.25% of outstanding 2004 Auction Rate Bonds for which they serve as Broker-Dealer.

Market Agent Agreement The Market Agent Agreement is among the City, the Trustee and the Market Agent. This Agreement provides that the Market Agent will perform its responsibility to set a percentage used to calculate the All-Hold Rate for the 2004 Auction Rate Bonds in accordance with the provisions of the Third Supplemental Trust Agreement. The All-Hold Rate is the interest rate for the 2004 Auction Rate Bonds when all of the owners of these bonds determine to retain their existing bonds and not participate in an auction. Changes to the All-Hold Rate must be with the consent of the City and the Bond Insurer. The City will initially be entering into two Market Agent Agreements, one with

Citigroup for the Series 2004A Bonds and one with Lehman Brothers for the Series 2004B Bonds. There is no compensation paid to the Market Agents.

The City has the ability to replace either Market Agent at any time. Staff recommends that the Director of Finance be authorized to replace either or both Market Agents with another securities dealer that meets the qualifications set forth in the Third Supplemental Trust Agreement, if the Director determines it is in the best interest of the City to do so and that the compensation for the replacement Market Agent does not exceed the compensation to be paid to Citigroup and Lehman Brothers as described above.

Continuing Disclosure Agreement This Agreement is executed by the City for the benefit of the bondholders and in order to assist the participating underwriters comply with Securities and Exchange Commission Rule 15c2-12(b)(5). In executing this document, the City commits to notify certain parties if certain listed events occur and to file annually an update to certain information contained in the Official Statements. There may be two separate continuing disclosure agreements, one for the Auction Rate Bonds and the other for the Fixed Rate Bonds.

Financing Team Participants

The financing team participants consist of:

• City's Financial Advisors:	Fullerton & Friar Public Resources Advisory Group
• Bond Counsel:	Orrick, Herrington & Sutcliffe, LLC
• Disclosure Counsel:	Orrick, Herrington & Sutcliffe, LLC
• Underwriters, Broker-Dealers and Market Agents for Series 2004 Auction Rate Bonds:	Citigroup Capital Markets Inc. and Lehman Brothers Inc.
• Underwriters for the Series 2004 Fixed Rate Bonds:	Citigroup Capital Markets Inc. and Lehman Brothers Inc. as co-senior managers
• Auction Agent:	Wachovia Bank, National Association
• Trustee/Paying Agent:	BNY Western Trust Company

Financing Schedule

The current proposed schedule is as follows:

Council approval of bond documents:	June 1, 2004
Distribute Preliminary Official Statement to Investors:	June 2, 2004
Price Fixed Rate Bonds:	June 9, 2004
Price Auction Rate Bonds:	June 23, 2004
Bond Closing:	June 24, 2004

PUBLIC OUTREACH

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. The public hearing notice will be published by no later than May 18, 2004, in the *San Jose Mercury News* announcing the time and location of the public hearing.

COORDINATION

This report has been prepared by the Finance and Airport Departments in coordination with the City Attorney's Office and the financing team participants.

COST IMPLICATIONS

No appropriation of funds is required at this time. Compensation for the consultants and other financing team participants (financial advisor, bond counsel and underwriter) are contingent upon successful sale and closing of the Bonds and will be paid from Bond proceeds.

CEQA

Reference: Resolutions Nos. 67380 and 71451, PP04-05-146.

SCOTT P. JOHNSON
Director, Finance Department

RALPH G. TONSETH
Director, Airport Department

APPENDIX A

TEFRA HEARING
PLAN OF FINANCE

Estimated Principal Amount of Private Activity Airport Revenue Bonds or Commercial Paper	Type of Obligation	Estimated Issuance Date	Purpose
$35,000,000	Airport Subordinated Commercial Paper Notes, Series B	May 2003-June 2004	Short-term financing of $35 million of 2004 Security Project costs, including capitalized interest
250,000,000	Airport Revenue Bonds	June 2004	Long-term financing of approximately $163 million of additional project costs and refunding of $35 million outstanding commercial paper
90,000,000	Airport Subordinated Commercial Paper Notes, Series B	Between June 2004 bond issuance and the final bond issuance expected to occur in 2006	Short-term financing of up to $90 million of additional project costs, including capitalized interest
200,000,000	Airport Revenue Bonds	Final bond issuance expected to occur in 2006	Long-term financing of approximately $75 million of additional project costs and refunding of $90 million outstanding commercial paper
$575,000,000	Cumulative total of private activity revenue bonds and commercial paper subject to City approval and TEFRA hearing		Estimated total costs financed: $450 million (including $363 million of project costs, $87 million of capitalized interest, capitalized fees and financing costs)

APPENDIX B

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.