CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

COUNCIL AGENDA: 08-30-05
ITEM: 3.6

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson
Carl Mosher

SUBJECT: **SAN JOSE – SANTA CLARA CLEAN WATER FINANCING AUTHORITY, SEWER REFUNDING REVENUE BONDS, SERIES 2005A AND 2005B**

DATE: August 10, 2005

Approved Kay Winer Date 8/12/05

COUNCIL DISTRICT: Citywide

RECOMMENDATION

a. Adoption of a resolution of the City Council:

1. Authorizing the issuance of San José – Santa Clara Clean Water Financing Authority Sewer Refunding Revenue Bonds, Series 2005A (tax-exempt fixed rate) in a not to exceed amount of $65,000,000; and Series 2005B (tax-exempt variable rate) in a not to exceed amount of $30,000,000, (collectively the "Bonds")

2. Approving in substantially final form and authorizing the execution, as applicable, of the Second Amendment to the Improvement Agreement, two Preliminary Official Statements, two final Official Statements, Master Indenture, First Supplemental Indenture, Second Supplemental Indenture, Continuing Disclosure Agreement, Standby Bond Purchase Agreement, one or more Escrow Agreements, Financial Guaranty Agreement, Bond Purchase Agreement, Remarketing Agent Agreement, one or more Payoff Agreements with Tributary Agencies and authorizing the City Manager, Director of Finance or their designees to execute and, as appropriate, to negotiate and deliver these documents and other related financing documents and to take other actions as necessary in connection with the issuance of the Bonds.

3. Authorizing the City Attorney to negotiate and execute an Agreement with Nixon Peabody LLP for bond and disclosure counsel services in an amount not to exceed $175,000.

BACKGROUND

The City of San José (the "City"), on behalf of the San José-Santa Clara Clean Water Financing Authority (the "Authority"), is recommending the refunding of the Authority's outstanding Sewer Revenue Bonds, Series 1995A (the "1995A Bonds") and Series 1995B (the "1995B Bonds" with the 1995A Bonds, collectively the "1995 Bonds").

The Authority is a joint exercise of powers agency formed in 1981 by the cities of San José and Santa Clara to finance the acquisition and construction of improvements to the San José-Santa Clara Water Pollution Control Plant (the "Treatment Plant").

The Authority issued the 1995 Bonds to finance facilities for recycling highly treated wastewater produced by the Treatment Plant ("South Bay Water Recycling Project"). The 1995 Bonds are secured by a pledge of the Net System Revenues from San José's Sewer Enterprise[1]. The 1995A Bonds were issued as fixed rate bonds with bond insurance provided by Financial Guaranty Insurance Company ("FGIC"). The 1995B Bonds were issued as variable rate demand bonds in a weekly rate mode also insured by FGIC with a Bank of Nova Scotia standby bond purchase agreement to provide the necessary liquidity support. The 1995 Bonds have underlying long-term ratings of "A1" from Moody's, "AA-" from Standard & Poor's and "AA" from Fitch.

ANALYSIS

This portion of the report is divided into several sections to address the items in staff's recommendation to proceed with the financing. These sections include: a description of the refunding and bond financing structure, bond financing documents, discussion of the financing team participants, and a review of the financing schedule.

Refunding and Bond Financing Structure

The 1995A Bonds are currently outstanding in the par amount of $65,335,000 at interest rates ranging from 4.80% on the 2005 maturity to 5.375% on the final 2020 maturity. The 1995A Bonds are callable beginning on November 15, 2005 with a 1% redemption premium.

The 1995B Bonds are currently outstanding in the amount of $26,700,000 and are remarketed weekly by Citigroup. The Bank of Nova Scotia's Standby Bond Purchase Agreement expires on November 30, 2007. The 1995B Bonds mature on November 15, 2011. The 1995B Bonds can be optionally redeemed at par on any interest payment date.
The refunding bonds will be issued by the Authority in two separate series as described below (the "2005 Bonds"):

[1] While the Authority is a joint powers agency between the City of San José and the City of Santa Clara, the 1995 Bonds are a liability of only San José. Santa Clara elected to fund their obligation for the South Bay Water Recycling Program with an up-front cash payment.

- Sewer Refunding Revenue Bonds, Series 2005A (the "2005A Bonds"). The 2005A Bonds will be issued in a not to exceed par amount of $65,000,000 and will be the primary source of funding to refund the outstanding 1995A Bonds (See *"Estimated Sources and Uses of Funds"* below). The 2005A Bonds will be issued as fixed rate bonds with principal maturities from November 15, 2006, through November 15, 2017.

- Sewer Refunding Revenue Bonds, Series 2005B (the "2005B Bonds"). The 2005B Bonds will be issued in a not to exceed par amount of $30,000,000 and will be the primary source of funding to refund the 1995B Bonds (See *"Estimated Sources and Uses of Funds"* below). The 2005B Bonds will be issued as variable rate bonds with principal maturities from November 15, 2017, through November 15, 2020.

The 2005 Bonds will be secured by the Net System Revenues of the San José Wastewater Enterprise, as pledged under the Improvement Agreement dated November 1, 1995, as amended to date and by the Second Amendment to the Improvement Agreement proposed in this staff report, executed among the Authority, the City and the City of Santa Clara.

Estimated Sources and Uses of Bond Proceeds The estimated sources and uses of Bond proceeds are shown in the following table:

San José-Santa Clara Clean Water Financing Authority
2005 Sewer Refunding Revenue Bonds
Estimated Sources and Uses of Funds[1]

	Series 2005A	Series 2005B	Total
Sources of Funds			
Par Amount of Bonds	$ 55,475,000.00	$27,070,000.00	$82,545,000.00
Net Premium	350,235.70	-	350,235.70
1995A Bond Reserve Fund	6,660,709.00	-	6,660,709.00
November 15, 2005 P&I Payment	5,627,681.88	-	5,627,681.88
Total Sources of Funds	$ 68,113,626.58	$27,070,000.00	$95,183,626.58
Uses of Funds			
Refunding Escrow	$ 67,405,046.38	$ 26,707,241.92	$ 94,112,288.30
Cost of Issuance[2]	201,562.07	144,885.41	346,447.48
Underwriter's Discount	277,375.00	135,350.00	412,725.00
Bond Insurance	146,430.63	82,522.67	228,953.30
Surety Reserve	83,212.50	-	83,212.50
Total Uses of Funds	$ 68,113,626.58	$27,070,000.00	$95,183,626.58

(1) *Preliminary; subject to change*
(2) *Includes bond counsel, financial advisor, issuer fee, rating agency, trustee, printer and various other costs of issuance.*

Tributary Agency Payoff Opportunity The tributary agencies to the Treatment Plant pay a proportionate share of debt service on the 1995 Bonds. All of the tributary agencies participated in the bond financing of the South Bay Water Recycling project with the exception of Milpitas. The City of Milpitas elected to pay their pro-rata share of the project costs with cash.

The refunding provides an opportunity for the agencies to pay off all or a portion of their respective obligations in cash and either eliminate or reduce their debt service obligation on the 2005 Bonds. On August 8, 2005, City staff presented the pay off opportunities to staff from the tributary agencies. If any of the agencies choose to pay off all or a portion of their obligation, they will be required to deposit their pay off amount with the current bond trustee by September 1, 2005, and execute an irrevocable payoff agreement between the City and the appropriate tributary agency(ies). This agreement is required to insure the financing is not compromised. Staff will survey the agencies and provide an update on the status of any payoffs in a supplemental memo to be sent to Council on or before Tuesday, August 23.

Debt Service Savings The 2005 Bonds are being issued to refund the outstanding 1995A and 1995B Bonds, respectively, for aggregate debt service savings. The combined refunding is anticipated to produce net present value savings of approximately $7.8 million representing approximately 8.5% of the refunded bonds (the 1995 Bonds), which is well above the 3% benchmark established in the Council-adopted Debt Management Policy.

A refunding of the 1995B Bonds on a variable rate basis does not by itself generate debt service savings – since interest rates vary weekly with market conditions. However, it does provide an opportunity to restructure principal amortization, with the variable rate bonds amortizing at the end of the financing, rather than in the middle as is the current debt structure. This restructuring provides the opportunity for the Authority to sell the fixed rate bonds at the lowest point in the yield curve, maximizing the savings produced by refunding the 1995A Bonds. Additionally, the restructuring of the variable rate bonds provides an opportunity to solicit proposals for alternative, lower costing credit enhancement facilities. The current Bank of Nova Scotia Standby Bond Purchase Agreement expires November 30, 2007.

Ratings and Credit Enhancement The 2005 Bonds are expected to carry long-term ratings of Aaa/AAA/AAA from Moody's, Standard & Poor's and Fitch, respectively, as a result of a guaranty policy of principal and interest payments on the 2005 Bonds to be provided by Financial Security Assurance ("FSA"). The City is also soliciting updated underlying ratings for the 2005 Bonds which are currently assigned. Staff will provide the Council with the ratings in a supplemental report. No changes in the current underlying ratings are expected of A1/AA-/AA from Moody's, Standard & Poor's and Fitch, respectively for the 1995 Bonds. The 1995B Bonds currently have short-term ratings of Aaa/VMIG1, AAA/A-1+, and AAA/F-1+ from Moody's, Standard & Poor's and Fitch, respectively.

Selection Process for Credit Enhancement/Liquidity Providers The City undertook a Request for Qualifications ("RFQ") process initiated and administered by City Finance Department staff for the purpose of selecting credit enhancement and/or liquidity providers for the Bonds. A summary of the process is described below.

Bond Insurer FSA was selected pursuant to a competitive process in which proposals to provide bond insurance were received from four national AAA bond insurance firms. Of the four, FSA proposed the most economically feasible insurance premium and premium structure.

Liquidity Provider Five banks responded to the RFQ soliciting either liquidity or credit support for the 2005B Bonds. The respondents included: DEPFA, Dexia, Bank of America, Scotia Capital and BNP Paribas. Offers to provide letters of credit and/or standby liquidity were provided from five banks meeting the City's requirements and accepting the terms and conditions applicable to the 2005B Bonds. The offer from DEPFA was determined to provide the lowest cost financing to the Authority with a commitment to the term of the 2005B Bonds. DEPFA's ratings are P-1/A-1+/F-1+ from Moody's, Standard & Poor's and Fitch.

The FSA bond insurance and a standby bond purchase agreement to be issued by DEPFA Bank ("DEPFA") will together guarantee principal and interest payments on the Bonds while providing liquidity for remarketing purposes (See Appendix B for description of variable rate bonds). FSA will charge an up front bond insurance premium of 21 basis points or 0.21% times the total debt service on the 2005A and 2005B Bonds. FSA will also provide a surety bond policy for the Debt Service Reserve Fund for a premium of 1.50% of the reserve requirement. DEPFA will charge an annual fee of 16.5 basis points (0.165%) of the outstanding principal amount of the 2005B Bonds plus an industry standard number of days of interest (not to exceed 31) calculated at 12%, the maximum interest rate for these Bonds. The Standby Bond Purchase Agreement will have a term of fifteen years, expiring on the final maturity date of the 2005B Bonds.

Underwriters and Remarketing Agent The fixed rate 2005A Bonds will be sold through a competitive sale on or about September 13, 2005. An underwriter and remarketing agent for the variable rate 2005B Bonds will be selected through a competitive request for qualification process. Responses were received on August 5, 2005, from eleven firms. Staff is in the process of reviewing the responses and will identify the final selection of underwriter/remarketing agent in the supplemental memo to be distributed on or about August 23, 2005.

Bond Financing Documents

There are a number of bond financing documents that require City Council approval to proceed with the issuance of the Bonds. The major documents are described below. These documents, in substantially final form, will be available for review in the City Clerk's office on or about August 23, 2005. Staff recommends that the City Manager, Director of Finance or their authorized designees (collectively, "Designated Officers") be authorized to execute agreements on behalf of the City. As modifications may be required prior to the closing of the Bonds, staff also recommends that the Designated Officers each be authorized to execute the final version of each of these agreements as may be modified upon consultation with the City Attorney's Office.

Official Statements These are the public offering statements for the issuance of the Bonds that will be prepared on behalf of the City and the Authority. The Official Statements thoroughly describe the financing program, the Authority, the Treatment Plant, the City and the San José Wastewater Enterprise. Investors use this information to evaluate the credit quality of the Bonds. Both a preliminary and final Official Statement will be distributed in connection with the 2005A Bonds; in addition, an Official Statement for the 2005B Bonds will be distributed in final form only.

Copies of the draft Official Statements along with the appendix which generally describes the City's demographics and economics, in substantially final form, will be distributed under a supplemental memo on or about August 23, 2005. Staff has carefully reviewed the information contained in the draft Official Statements and believes the Statements to be accurate and complete in all material respects. If any Council member or Authority board member has any personal knowledge that any of the material information in the Official Statements is false or misleading, the member must raise these issues prior to approval of the distribution of the document. City and staff, bond counsel, and the financial advisor will be available at the City Council meeting on August 30, 2005, to address any questions, issues and/or concerns.

Staff recommends that the Designated Officers of the City be authorized to sign the Official Statements for the 2005 Bonds 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 Designated Officers each be authorized to execute certificates regarding these documents as required to comply with securities law and to authorize the underwriters to distribute these documents for purpose of marketing the Bonds.

Master Indenture The current Master Indenture is between the Authority and USBank National Association, the existing trustee. A new Master Indenture will be executed in conjunction with the refunding. City staff will be conducting a competitive Request for Qualification ("RFQ") process for a new trustee for the Bonds (the "Trustee"). Staff will identify the Trustee in the supplemental memo to be distributed on or about August 23, 2005.

The Master Indenture pledges system revenues of the San José Wastewater Enterprise to the repayment of the Bonds; sets forth terms of the Bonds (including the mechanism for setting the variable rates, the terms and conditions of optional and mandatory redemption of the Bonds and the mechanisms to convert the Bonds to fixed rate) establishes the funds and account to be held by the Trustee; sets forth the requirements for the administration, investment and treatment of investment earnings generated by each fund and account; and contains the responsibilities and duties of the Trustee and the rights of the bondholders. The Master Indenture obligates the Authority to pay compensation to the Trustee for services rendered under the Master Indenture.

First Supplemental Indenture The First Supplemental Indenture contains the responsibilities and duties of the Trustee and the rights of the bondholders in connection with the Master Indenture and the Series 2005A Bonds.

Second Supplemental Indenture The Second Supplemental Indenture contains the responsibilities and duties of the Trustee and the rights of the bondholders in connection with the Master Indenture and the Series 2005B Bonds.

Notice Inviting Bids This document describes the competitive bidding process, the bidding parameters governing the submission of bids by potential underwriters for the Series 2005A Bonds, and the basis for awarding the 2005A Bonds to an underwriter. The Notice Inviting Bids is provided to potential bidders with the Preliminary Official Statement. The City/Authority's bond counsel will publish a notice of intention to sell the 2005A Bonds, in the form on file with the City Clerk, in *"The Bond Buyer,"* a financial publication generally circulated throughout the State of California, at least 5 calendar days prior to the date for submission of bids.

Continuing Disclosure Agreement This Agreement is between the City and the Trustee. It is executed by the City for the benefit of the bondholders and in order to assist the participating underwriters in complying 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.

Standby Bond Purchase Agreement The Standby Bond Purchase Agreement is an agreement by and among the Trustee, the Authority and DEPFA (the "Bank") as liquidity provider for the Bonds. The Bank agrees to purchase any 2005B Bonds that cannot be remarketed by the Remarketing Agent while the 2005B Bonds bear interest in a Daily or Weekly interest rate mode. In the event of a failed remarketing, the Bank provides the funding necessary for the purchase of the outstanding bonds that cannot be remarketed. The 2005B Bonds purchased by the Bank then become "Bank Bonds" and accrue interest at an interest rate based on a formula specified in the Standby Bond Purchase Agreement, subject to an interest rate cap.

Financial Guaranty Agreement The Financial Guaranty Agreement is an agreement by and between the Authority and FSA, the bond insurer. FSA agrees to provide a Debt Service Reserve Policy (the "Surety") in exchange for a premium to be paid by the Authority from proceeds of the Bonds. The Authority agrees to reimburse FSA with interest for any payment made by FSA pursuant to the Surety at a specified rate of interest.

Bond Purchase Agreement The Bond Purchase Agreement (the "Purchase Agreement") is a contract between the Authority and the Underwriter as the initial purchaser of the 2005B Bonds. The Purchase Agreement specifies the representations and warranties of the Authority and the City, the documents to be executed at closing, the final pricing of the 2005B Bonds and the conditions that allow the purchasers to cancel the purchase of the 2005B Bonds.

Remarketing Agreement The Remarketing Agreement is between the Authority and the Remarketing Agent for the 2005B Bonds. This agreement describes the procedures and compensation for arranging the remarketing of the 2005B Bonds which will be issued in variable rate mode and remarketed every seven days. The agreement will include the annual fees for ongoing remarketing services.

Financing Team Participants

The financing team participants consist of:

• Financial Advisor	Stone & Youngberg LLC
• Bond and Disclosure Counsel	Nixon Peabody LLP
• Trustee	(to be provided in supplemental memo)
• 2005A and 2005B Bond Insurer	Financial Security Assurance
• 2005B Liquidity Provider	DEPFA Bank
• 2005A Bond Underwriter	Competitive Sale
• 2005B Bonds Underwriter/Remarketing Agent	(to be provided in supplemental memo)

Financing Schedule

The key dates in the balance of the financing schedule are as follows:

• Treatment Plant Advisory Committee Meeting	August 25, 2005
• City of San José Council Approval	August 30, 2005
• City of Santa Clara Council Approval	August 30, 2005
• Clean Water Financing Authority Approval	August 31, 2005
• Competitive Sale of 2005A Bonds	September 13, 2005
• Sale of 2005B Bonds	September 28, 2005
• Bond Closing	September 29, 2005

OUTCOMES

If the City Council approves the recommended action, the City will be authorized to execute the documents to which it is a party in connection with the issuance by the Authority of the Bonds for the purpose of refinancing outstanding sewer revenue bonds resulting in lower debt service for the San José Wastewater System and its rate payers.

PUBLIC OUTREACH

City staff met with the Technical Advisory Committee to the Tributary Agencies on August 8, 2005, and is scheduled to present this staff report to the Treatment Plant Advisory Committee at a special meeting on August 25.

COORDINATION

This report has been prepared by the Finance Department in coordination with the Environmental Services Department and the City Attorney's Office.

COST IMPLICATIONS

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

CEQA

Not a project.

Scott P. Johnson
SCOTT P. JOHNSON
Director, Finance

for
CARL MOSHER
Director, Environmental Services

EXHIBIT A

TECHNICAL ASPECTS OF MULTI-MODAL VARIABLE RATE DEMAND BONDS

The 2005B Bonds will be issued as multi-modal variable rate demand bonds ("VRDBs"). The purpose of this Exhibit is briefly to describe the mechanics of these kinds of bonds and the options available to the Authority.

The interest rates on multi-modal VRDBs will reset from time to time during the bond term. The rates can be reset as often as daily or can be fixed for longer periods. These interest reset periods are also referred to as "modes", thus the characterization of the VRDBs as "multi-modal". The interest rate on the 2005B Bonds will be established from time to time by a remarketing agent (the "Remarketing Agent") based on prevailing market conditions.

If an investor no longer wishes to hold the VRDBs, they are permitted, with prior notice to the Trustee, to tender the bond back to the Authority and "demand" full repayment - hence the term "demand bond". In such event, the Remarketing Agent will attempt to remarket the tendered bonds to another investor. If the Remarketing Agent is unable to find a substitute investor, for any reason, the Trustee is authorized to draw on the letter of credit to be issued by DEPFA Bank to fund the purchase price of the unremarketed bonds. The "tender" feature of VRDBs is essential to the ability and willingness of investors to purchase VRDBs. A letter of credit or other kind of "liquidity facility" is required to assure investors that sufficient funds will exist at all times to purchase any bonds that are tendered. The Authority will pay a quarterly fee to the DEPFA Bank for providing the letter of credit.

The 2005B Bonds will be issued in a weekly mode with weekly rate resets. This is the most common frequency in the bond market. The Second Supplemental Indenture permits the Authority to convert the 2005B Bonds to different modes with notice to bond investors and affected parties. The other choices besides weekly are: (1) daily, (2) commercial paper, (3) auction rate, (4) term and (5) fixed rate through maturity. The Authority may also switch between various interest rate modes from time to time or cause the 2005B Bonds to be remarketed in different modes. This bond structure provides the Authority with an interest cost that varies over time and the ability to manage its interest rate risk during the term of the 2005B Bonds.

The selection of a different interest rate mode does not require City Council or Authority Board approval for the daily or weekly rate modes. An authorized representative of the Authority may select the daily or weekly interest rate mode and notify the affected parties. However, to issue Auction Rate Securities, the City Council and the Authority Board would need to approve amendments to the financing documents and a new Official Statement. Similarly, in order to implement the commercial paper, term or fixed rate modes, new disclosure documents would need to be approved by the City Council and the Authority Board.