



# Memorandum

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** Scott P. Johnson  
John Stufflebean  
Jennifer A. Maguire

**SUBJECT:** SEE BELOW

**DATE:** December 8, 2008

Approved

*Deanne Johnson*

Date

*12/15/08*

**COUNCIL DISTRICT:** City-Wide

**SUBJECT: APPROVAL OF THE SALE AND ISSUANCE OF BONDS AND RELATED BOND DOCUMENTS FOR SAN JOSE-SANTA CLARA CLEAN WATER FINANCING AUTHORITY SEWER REVENUE REFUNDING BONDS, SERIES 2009A AND ADOPTION OF RELATED APPROPRIATION ORDINANCE AMENDMENTS**

## RECOMMENDATION

- a. Adopt the following 2008-2009 Appropriation Ordinance amendments in the San Jose-Santa Clara Treatment Plant Capital Fund (512):
  1. Increase the appropriation for Transfer to the Clean Water Financing Authority for Series 2005A/B Bond by \$3,700,000;
  2. Establish an appropriation for 2005A Bonds Reserve Fund in the amount of \$5,402,000; and
  3. Decrease the Ending Fund Balance by \$9,102,000.
- b. Adopt a resolution authorizing the Governing Board of the San José-Santa Clara Clean Water Financing Authority (the "Authority") to issue its Sewer Revenue Refunding Bonds, Series 2009A (the "2009A Bonds") in an aggregate principal amount not to exceed \$35,000,000, in connection with the refinancing of certain public capital improvements to the San José-Santa Clara Water Pollution Control Plant, to be sold through negotiated sale, and authorizing the execution of certain financing documents and other actions as necessary in connection with the issuance of the 2009A Bonds.

## **OUTCOME**

Approval of these recommendations will allow the issuance of the San José–Santa Clara Clean Water Financing Authority Sewer Revenue Refunding Bonds, Series 2009A for the purpose of refinancing certain capital improvements financed with variable rate debt of the Authority.

## **EXECUTIVE SUMMARY**

This staff report recommends the issuance of fixed rate sewer revenue refunding bonds to refinance the Authority's existing series of variable rate sewer revenue refunding bonds and fund related financing costs. The staff report also describes the terms and conditions of the financing documents that require City Council approval. In addition, this report recommends certain budget actions related to the San José–Santa Clara Clean Water Financing Authority's variable rate sewer revenue refunding bonds reflecting increased debt service costs in fiscal year 2008-09 and the need to cash fund a portion of the bond reserve requirement due to the recent disruption in the municipal bond market.

## **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 Variable Rate Sewer Revenue Refunding Bonds, Series 2005B (the "2005B Bonds"). The Authority is a joint exercise of powers agency formed in 1981 by the City of San José and the City of Santa Clara to finance the acquisition and construction of improvements to the San José–Santa Clara Water Pollution Control Plant (the "Treatment Plant") pursuant to the Second Amended and Restated Joint Exercise of Powers Agreement, dated as of October 17, 1995 ("CWFA Agreement").

In 2005, the Authority issued its Sewer Revenue Refunding Bonds, Series 2005A in the aggregate principal amount of \$54,020,000 (the "2005A Bonds") and the 2005B Bonds in the aggregate principal amount of \$27,130,000 in order to refund the Authority's Sewer Revenue Bonds, Series 1995A and its Sewer Revenue Bonds, Adjustable Rate Series 1995B (collectively, the "1995 Bonds"). The 1995 Bonds financed a portion of the cost of facilities for recycling highly treated wastewater produced by the Treatment Plant ("South Bay Water Recycling Project"). The 2005A Bonds and 2005B Bonds (collectively, the "2005 Bonds") are secured by a pledge of the Net System Revenues from San José's Wastewater Enterprise.

The 2005 Bonds were issued pursuant to a Master Indenture between the Authority and The Bank of New York Mellon Trust Company, N.A. as successor to J.P. Morgan Trust Company, National Association, dated as of October 1, 2005 (the "Master Indenture") as supplemented by a First Supplemental Indenture and a Second Supplemental Indenture.

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The 2005B Bonds were issued as variable rate demand bonds with bond insurance provided by Financial Security Assurance ("FSA") and a liquidity facility provided by Depfa Bank plc ("Depfa") under a Standby Bond Purchase Agreement. The ratings on the 2005B Bonds at the time of issuance and as of the date of this memo are summarized in the table below.

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**San José-Santa Clara Clean Water Financing Authority  
Sewer Refunding Revenue Refunding Bonds, Series 2005B  
Ratings Summary**

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<u>Rating Agency</u>	<u>Short-term Rating</u>	<u>Insured Rating</u>	<u>Underlying Rating</u>
<b>At time of Issuance:</b>			
Moody's Investors Service	VMIG 1	Aaa	Aa3
Standard and Poor's	A-1+	AAA	AA
Fitch Ratings	F1+	AAA	AA
<b>As of 12/8/2008</b>			
Moody's Investors Service	VMIG 1	Aa3	Aa3
Standard and Poor's	A-2	AAA	AA
Fitch Ratings	F1	AAA	AA

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The uncertainty in the financial markets related to the default potential of subprime mortgages has continued to disrupt the variable rate municipal bond market and has spread to the broader financial markets as evidenced by the bankruptcy of Lehman Brothers and the near collapse of AIG. For the financial institutions providing credit support to the 2005B Bonds, the disruption has resulted in downgrades of Depfa's short-term ratings in September 2008 by Standard and Poor's and Fitch Ratings from A-1+ and F1+ to A-2 and F1, respectively, and a downgrade of FSA's long-term rating in November 2008 by Moody's Investors Service from Aaa to Aa3.

As a result of these downgrades, the marketability of the 2005B Bonds has been drastically impaired resulting in interest rates on the 2005B Bonds in excess of the rates typically paid on variable rate bonds. Additionally, the 2005B Bonds have experienced failed remarketings causing 2005B Bonds to be tendered to Depfa and held as bank bonds under the Standby Bond Purchase Agreement.

### ANALYSIS

The decline of the subprime mortgage market and the significant loss of value of mortgage-backed securities have led to a liquidity crisis in the variable rate debt market. This lack of liquidity has caused Banks to be unable to allocate capital to support municipal issuers' variable

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rate bond programs. Furthermore, typical variable rate municipal bond investors, such as money market funds, have seen large fund outflows as investors seek the safety of U.S. Treasury securities. As a result, the interest the Authority pays on its variable rate bonds has increased significantly over the last two months.

### **Refunding and Bond Financing Structure**

The 2005B Bonds are currently outstanding in the amount of \$27,130,000 and are remarketed weekly by Citigroup Global Markets Inc. ("Citigroup"). The Standby Bond Purchase Agreement expires on November 15, 2020. The 2005B Bonds mature on November 15, 2020, but can be optionally redeemed at par at any time.

The 2009A Bonds will be issued by the Authority pursuant to a Third Supplemental Indenture to the Master Indenture under the authority of the CWFA Agreement, the resolution to be adopted by the Authority, and the laws of the State of California in a not-to-exceed par amount of \$35,000,000. Per the CWFA Agreement, both the City of San José and the City of Santa Clara must authorize the Authority's issuance of the 2009A Bonds. The Santa Clara City Council is scheduled to authorize its approval on January 13, 2009.

Under the Master Indenture, the Authority may issue refunding bonds if it meets the refunding test or the additional bonds test. In this case, the Authority meets the additional bonds test as Net System Revenues will be equal to at least 115% of the debt service on the 2005 Bonds and the 2009A Bonds.

The bond proceeds will be the primary source of funding to refund the outstanding 2005B Bonds (See "Estimated Sources and Uses of Funds" below). The 2009A Bonds will be secured by the Net System Revenues of the San José Wastewater Enterprise, as pledged by the City under the Improvement Agreement dated November 1, 1995, as amended to date and by the Third Amendment to the Improvement Agreement proposed in this memorandum, executed by and among the Authority, the City and the City of Santa Clara. The City of Santa Clara is not responsible for repayment of the 2005 Bonds or the proposed 2009A Bonds as it cash funded its portion of the cost of the South Bay Water Recycling Project.

The financial advisor to the City, Public Resources Advisory Group ("PRAG") provided a comparative analysis of issuing variable rate bonds and fixed rate bonds in the current market. The outcome of the analysis was that there would be minimal all-in interest cost benefit to issuing variable rate bonds while exposing the City to interest rate volatility risk, credit support renewal risk, and counterparty risk. Based on this analysis and internal discussions, City staff recommends that the 2009A Bonds be issued as fixed rate bonds with principal maturities from November 15, 2010 through November 15, 2021. Early redemption provisions for the 2009A Bonds will be set at the time of pricing of the 2009A Bonds in January 2009; however, it is possible that the 2009A Bonds will be sold as non-callable bonds.

The 2009A Bonds will be sold on a negotiated basis. The underwriter, Citigroup, will oversee the negotiated sale with assistance from City staff and PRAG. Currently, the financing schedule calls for the negotiated sale of the 2009A Bonds to occur the week of January 19, 2009.

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**San José-Santa Clara Clean Water Financing Authority**  
**2009A Sewer Refunding Revenue Refunding Bonds**  
**Estimated Sources and Uses of Funds <sup>(1)</sup>**

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**Sources of Funds**

Par Amount of Bonds.....	\$ 30,780,000
Net Original Issue Discount.....	(149,558)
<b>Total Sources of Funds .....</b>	<b>\$ 30,630,442</b>

**Uses of Funds**

Redemption of Series 2005B Bonds .....	\$ 27,130,000
Debt Service Reserve Fund.....	3,078,000
Cost of Issuance <sup>(2)</sup> .....	253,152
Underwriter's Discount .....	169,290
<b>Total Uses of Funds.....</b>	<b>\$ 30,630,442</b>

<sup>(1)</sup> Preliminary; subject to change.

<sup>(2)</sup> Includes fees and expenses of bond counsel, disclosure counsel, financial advisor, issuer fee, rating agencies, trustee, printer and various other costs of issuance.

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**Tributary Agency Payoff Opportunity**

The tributary agencies to the Treatment Plant pay a proportionate share of debt service on the 2005B Bonds with the exception of the City of Milpitas. The City of Milpitas elected to pay their pro-rata share of the project costs with cash in lieu of paying debt service.

The refunding provides an opportunity for the tributary 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 2009A Bonds. City staff is currently working with the tributary agencies to determine their interest in this payoff opportunity. A supplemental memo will be forthcoming prior to January 13, 2009 with the terms and conditions of the Payoff Agreement(s) with Tributary Agencies, if applicable.

**Ratings and Credit Enhancement**

The City intends to seek credit ratings on the 2009A Bonds from Moody's Investors Service, Standard & Poor's, and Fitch Ratings, respectively. The credit ratings are expected to be released in early January 2009 prior to the pricing of the 2009A Bonds.

Based on the expected high credit ratings on the 2009A Bonds, it is unlikely that bond insurance will be necessary in order to provide the lowest borrowing cost. City staff and PRAG will evaluate the potential benefit from bond insurance in January 2009.

### **Budget Actions**

**Debt Service Adjustments** The \$21,180,000 of 2005B Bonds that are currently held by Depfa (the "Bank Bonds") are subject to the terms and conditions of the Standby Bond Purchase Agreement. Among the provisions related Bank Bonds are requirements that the City begin accelerated amortization of principal if the Bank Bonds are not purchased or remarketed within 120 days from the date that the Bank Bonds were initially purchased by Depfa. If the Bank Bonds are not remarketed by February 5, 2009, the Authority will be required to make a principal amortization payment of approximately \$1 million. If the Bank Bonds are not remarketed by May 5, 2009, the Authority will be required to make a second principal amortization payment of approximately \$1 million.

Although the 2005B Bonds are scheduled to be refunded prior to the required principal amortization payment on February 5, 2009 as described below, City staff recommends that the City Council increase the debt service appropriation for the 2005B Bonds by \$3.7 million in order to accommodate the principal amortization payments in the event that it is not possible to consummate the financing in a timely manner due to market access issues or for any other reason.

**2005A Bonds Reserve Fund** The reserve requirement for the 2005A Bonds is currently equal to 10% of the 2005A Bonds par amount at the time of issuance, or \$5,402,000. The reserve requirement was initially met through the purchase of a surety bond policy provided by FSA. In order for the surety bond policy to qualify as a valid Reserve Financial Guaranty under the terms of the Master Indenture, FSA is required to be rated in the highest rating category by Standard and Poor's and Moody's Investors Service. Since FSA was downgraded by Moody's as mentioned above, the surety bond policy no longer fulfills the reserve requirement for the 2005A Bonds and it is necessary to meet the reserve requirement through an alternative method.

City staff recommends meeting the 2005A Bonds reserve requirement by making the 2009A Bonds Reserve Fund available to the holders of the 2005A Bonds in conjunction with a cash contribution of approximately \$2,400,000; however, if this arrangement is determined to be infeasible then it will be necessary to cash fund the full reserve requirement of \$5,402,000.

### **Bond Financing Documents**

There are a number of bond financing documents that require City Council approval to proceed with the issuance of the 2009A Bonds. In addition, there are number of documents requiring only the approval of the Authority. 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 December 23, 2008. The documents to be executed by the City will be posted on the City's website. The Preliminary Official Statement will be transmitted to the City Council on January 5, 2009.

City staff recommends that the City Manager, Director of Finance, Deputy of Director of Finance, and Debt Administrator or their authorized designees (collectively, "Designated Officers") be authorized to execute documents on behalf of the City. As modifications may be required prior to the closing of the 2009A Bonds, City staff also recommends that the Designated Officers each be authorized to execute the final version of each of these documents as may be modified upon consultation with the City Attorney's Office.

**Preliminary Official Statement** The Preliminary Official Statement, or prospectus, has been prepared for the Authority by bond counsel/disclosure counsel. Appendix A to the Official Statement describes the current demographic information and financial information related to the City with the focus upon the San José Wastewater Enterprise, and provides other information useful to investors regarding the City. It has been prepared by City staff in close coordination with the City Attorney's Office, the Environmental Services Department, and other City departments as necessary, the financial advisor and bond counsel/disclosure counsel.

The Preliminary Official Statement generally discloses material information on the bond issue, such as the project to be refinanced, the repayment source, investment risks and credit ratings. Investors use this information to evaluate the credit quality of the 2009A Bonds. Following the sale of the 2009A Bonds to the underwriter and prior to the closing, bond counsel/disclosure counsel will prepare a final Official Statement for the 2009A Bonds. City staff has carefully reviewed the information contained in the Preliminary Official Statement and believes it to be accurate and complete in all material respects.

City staff recommends that the Designated Officers each 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 the purpose of marketing the 2009A Bonds.

***If any councilmember has any personal knowledge that any of the material information in the Official Statement is false or misleading, the councilmember must raise these issues prior to approval of the distribution of the document.***

City staff, bond counsel/disclosure counsel, and the financial advisor will be available at the City Council meeting on January 13, 2009, to address any questions, issues and/or concerns.

**Third Amendment to the Improvement Agreement** The Improvement Agreement is by and among the Authority, the City, and the City of Santa Clara. The Third Amendment to the Improvement Agreement amends the Improvement Agreement in order to authorize the issuance of the 2009A Bonds and to make technical changes.

**Continuing Disclosure Certificate** The Continuing Disclosure Certificate is executed by the City for the benefit of the bondholders and obligates the City to immediately disclose to the marketplace the occurrence of any material events that are required to be disclosed by federal Securities Laws. It also requires the City to prepare an annual report to the marketplace, the contents of which are outlined in the Continuing Disclosure Certificate. These actions are taken in accordance with Rule 15c2-12(b) adopted by the Securities and Exchange Commission.

**Third Supplemental Indenture** The Third Supplemental Indenture is an agreement between the Authority and the Trustee. It sets forth the specific terms of the 2009A Bonds. In addition, in reviewing the Master Indenture in connection with the issuance of the 2009A Bonds, City staff identified amendments that should be made to the Master Indenture. These include technical changes in order to clarify ambiguities in the Master Indenture and the clarifications and changes described below.

The proposed amendments related to the Master Reserve Fund will apply to the 2005A Bonds, the 2009A Bonds and any future bonds issued pursuant to the Master Indenture. The other amendments will be effective upon the consent of the requisite percentage of bondholders. The consent of the 2009A bondholders will be automatic as they will be purchasing the bonds subject to these provisions.

**Refunding Test.** Revisions to the requirements for issuing refunding bonds so that the Authority may issue refunding bonds to pay off bonds that have become Bank Bonds without having to meet the current requirements in the Master Indenture for the issuance of refunding bonds or additional bonds.

**Master Reserve Fund.** Under the Master Indenture, the Authority may issue multiple series of bonds. The amendment will allow the Authority to establish, at the Authority's option, a master reserve fund for multiple series of bonds.

**Surety Requirements.** The Master Indenture permits the Authority to satisfy the reserve requirement for a series of bonds with a surety bond. The issuer of the surety bond must meet certain rating requirements. The Master Indenture now provides that in the event the issuer of the surety bond is downgraded by either Standard & Poor's or Moody's, then the Authority is obligated to either provide a replacement surety that meets the rating requirements or deposit cash in the amount of the reserve requirement. The proposed amendment will eliminate these requirements. Instead, the test for whether the surety bond meets the requirements in the Master Indenture is whether the rating requirements are met on the date the surety bond is issued.

**Bond Purchase Agreement** The Bond Purchase Agreement is a contract between the Authority and the underwriter as the purchaser of the 2009A Bonds. The Bond Purchase Agreement specifies the representations and warranties of the Authority and the City, the

documents to be executed at closing, the final interest rates and prices of the 2009A Bonds and the conditions that allow the purchaser to cancel the purchase of the 2009A Bonds.

### **Financing Team Participants**

The financing team participants consist of:

- Financial Advisor                                      Public Resources Advisory Group
- Bond and Disclosure Counsel                      Nixon Peabody LLP
- Underwriter    Citigroup Global Markets, Inc.
- Trustee    The Bank of New York Mellon Trust Company N.A.

### **Financing Schedule**

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

- San José City Council Approval                                      January 13, 2009
- Santa Clara City Council Approval                                      January 13, 2009
- Authority Approval    January 14, 2009
- Negotiated Sale of 2009A Bonds                                      Week of January 19, 2009
- 2009A Bonds Closing and 2005B Bonds Refunding                                      January 29, 2009

### **EVALUATION AND FOLLOW-UP**

This memorandum presents the set of recommendations related to the City Council's approval of the issuance of the 2009A Bonds and requires no follow-up to the City Council.

### **PUBLIC OUTREACH/INTEREST**

City staff will be meeting with the Technical Advisory Committee to the Tributary Agencies ("TAC") on January 5, 2009.

- Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criteria 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)**

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- Criteria 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 Environmental Services Department and the City of San José City Attorney's Office and is scheduled to be heard by the Treatment Plant Advisory Committee ("TPAC") on January 8, 2009.

### **FISCAL/POLICY ALIGNMENT**

The proposed financing plan is consistent with the City's Debt Management Policy which establishes the following equally important objectives in order to obtain cost-effective access to the capital markets:

- Minimize debt service and issuance costs;
- Maintain access to cost-effective borrowing;
- Achieve the highest practical credit rating;
- Full and timely repayment of debt;
- Maintain full and complete financial disclosure and reporting; and
- Ensure compliance with applicable State and Federal laws.

### **COST SUMMARY/IMPLICATIONS**

Costs associated with the refunding will be paid from bond proceeds. The financial advisor and bond counsel/disclosure counsel work on a contingency basis and are only paid upon the successful sale and close of the 2009A Bonds.

### **BUDGET REFERENCE**

The table on the following page identifies the fund and appropriation proposed to fund the action recommended in this memorandum.

SAN JOSE-SANTA CLARA CLEAN WATER FINANCING AUTHORITY BOARD

December 8, 2008

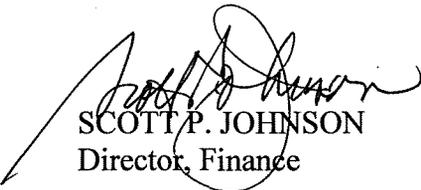
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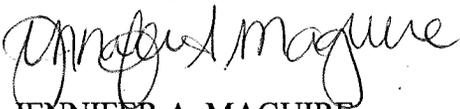
Fund No.	Appn No.	Appn Name	Total Appn	Additional Amount for Debt Service and Reserve Fund	2008-09 Adopted Operating Budget (Page)	Last Budget Action (Date, Ord. No.)
512	8999	Ending Fund Balance	\$14,587,159	\$9,102,000	V-148	10/21/2008, 28422

**CEQA**

Not a project.

  
SCOTT P. JOHNSON  
Director, Finance

  
JOHN STUFFLEBEAN  
Director, Environmental Services

  
JENNIFER A. MAGUIRE  
Budget Director

For questions please contact Scott P. Johnson, Director of Finance, at (408) 535-7001.