CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

# Memorandum

**TO:** HONORABLE MAYOR AND CITY COUNCIL

**FROM:** Scott P. Johnson

**SUBJECT:** **AIRPORT COMMERCIAL PAPER PROGRAM LETTER OF CREDIT EXTENSION**

**DATE:** October 26, 2010

Approved

Date 10/27/10

**COUNCIL DISTRICT:** City-Wide

## RECOMMENDATION

It is recommended that the City Council:

Adopt a resolution of the City Council of the City of San José to authorize the negotiation, execution and delivery of the amendment to the Second Amended and Restated Letter of Credit and Reimbursement Agreement by and among the City, JPMorgan Chase Bank, N.A., Bank of America, N.A., and Dexia Credit Local, acting through its New York Branch, related to the City of San José Airport Commercial Paper Program in order to extend the term of this agreement, remove Dexia Credit Local as a party to the agreement, reduce the amount of available credit, and to authorize other related actions.

## OUTCOME

Approval of this recommendation will result in the extension of the Second Amended and Restated Letter of Credit and Reimbursement Agreement for two months from December 2, 2010 to February 2, 2011. The amendment will also remove Dexia Credit Local as a party to the agreement, reduce the amount of available credit, and amend other terms of the agreement as discussed in the Analysis section. This extension is anticipated to provide staff with additional time to complete ongoing negotiations with multiple banks for replacement letters of credit and other credit facilities related to the Airport Commercial Paper Program.

## EXECUTIVE SUMMARY

The Airport has a $600 million commercial paper program that has been used to finance a portion of the Terminal Area Improvement Program. 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. The technical aspects of how commercial paper works are described in the attached Appendix A. The Airport CP 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.

Of the $600 million authorized amount, the amount of approximately $435 million is outstanding as of October 26, 2010. The commercial paper program is supported by multiple letters of credit, including 1) $450 million of letters of credit that expire on December 2, 2010 that are provided by JPMorgan ($200 million), Bank of America ($83 million), and Dexia Credit Local ($167 million) and 2) a $140 million letter of credit that expires on May 7, 2011 that is provided by Lloyds TSB Bank.

On August 12, 2010, the City released an RFP for $450 million of letters of credit in anticipation of the letters of credit expiring in December. Four commercial banks responded to the RFP and their proposals, in aggregate, would provide $340 million of capacity. The reduction in capacity is primarily driven by changes in the credit markets post-2008 and broader economic conditions rather than a reflection on the City or the Airport. Negotiations are in process and several banks have indicated that they may be able to increase their proposed capacity. Discussions with Lloyds will take place soon to determine if they will renew their $140 million letter of credit when it expires in May 2011. To allow additional time for these negotiations relating to the letters of credit expiring in December 2010, the City requested a short extension of the Agreement and received approval for a two-month extension from JPMorgan and Bank of America. Dexia declined to participate in the extension citing direction from European authorities to exit this line of business in the United States. Staff anticipates bringing forward a recommendation and the final agreements for City Council consideration in either December 2010 or January 2011.

The amendment that staff is recommending for approval in this memorandum will extend the term of the letters of credit from December 2, 2010 to February 2, 2011 to provide additional time to complete the ongoing negotiations, remove Dexia Credit Local as a party to the agreement, reduce the amount of available credit, and amend other terms as discussed in the Analysis section.

## BACKGROUND

### History of the City's Airport Commercial Paper Program

On November 2, 1999, the City Council adopted Resolution No. 69200 approving the implementation of a commercial paper program (the "Airport CP 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 CP 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. The technical aspects of how commercial paper works are described in the attached Appendix A.

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, the Claims Loss Reserve for the Airport's Owner Controlled Insurance Program for the North Concourse Project, the Terminal Area Improvement Program, and to fund associated interest costs during construction of these projects.

On June 20, 2006, the City Council approved an expansion of the Airport CP 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 CP 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 Series A-C Notes of the Airport CP Program are secured by letters of credit issued on a several, not joint, basis by JPMorgan Chase Bank, N.A. ("JPMorgan"), Bank of America, N.A. ("Bank of America"), and Dexia Credit Local, acting through its New York Branch ("Dexia")[1], pursuant to the Second Amended and Restated Letter of Credit and Reimbursement Agreement (the "Agreement").

On March 25, 2008, the City Council approved an expansion of the Airport CP Program from $450 million to $600 million primarily to refund Airport Auction Rate Securities that were adversely impacted by disruptions in the financial markets related to auction rate securities. This expansion was accomplished through a combination of three additional series of commercial paper notes: Series D (Non-AMT), Series E (AMT), and Series F (Taxable), and is secured by a letter of credit issued by Lloyds TSB Bank plc pursuant to a Letter of Credit and Reimbursement Agreement (the "Lloyds Agreement").

On September 1, 2009, the City Council adopted a resolution authorizing the issuance of tax-exempt private activity non-AMT commercial paper notes as provided for in the American Recovery and Reinvestment Act of 2009. At that time, the Series A Notes were redesignated as

---

[1] Dexia Credit Local is a subsidiary of Dexia SA, which is a limited liability company and is incorporated and domiciled in Belgium.

Series A-1 (Non-AMT) and Series A-2 (Non-AMT/Private Activity) and the Series D Notes were redesignated as Series D-1 (Non-AMT) and Series D-2 (Non-AMT/Private Activity).

**The Agreement**

The Second Amended and Restated Letter of Credit and Reimbursement Agreement (the "Agreement") was entered into between the City and Morgan Guaranty Trust Company of New York, predecessor of JPMorgan, and dated as of November 1, 1999. Since 1999, the Agreement has been amended on a number of occasions to increase the capacity of the Airport CP Program, add or remove banks, or modify specific provisions in the Agreement. The letters of credit related to the Agreement currently provide $450 million of capacity to the Airport CP Program and expire on December 2, 2010. The current participation of the banks in the letters of credit is presented in the following table.

| Bank | Participation Percentage | Commitment Amount |
|---|---|---|
| JPMorgan | 44.44% | $ 199,980,000 |
| Bank of America | 18.52% | 83,340,000 |
| Dexia | 37.04% | 166,680,000 |
| Total | 100.00% | $ 450,000,000 |

## ANALYSIS

**Amendment to the Agreement**

On August 12, 2010, the City released an RFP for credit facilities in anticipation of the Agreement expiring on December 2, 2010. Negotiations with the banks that responded to the RFP are in process and the new letters of credit and alternative credit facilities are expected to be in place in late December 2010 or early January 2011. To allow additional time for these negotiations, the City requested a short extension of the Agreement and received approval for a two-month extension from JPMorgan and Bank of America. Dexia declined to participate in the extension citing direction from European authorities to exit this line of business in the United States.

The amendment to the Agreement (the "Amendment") will extend the term of the Agreement for two months from December 2, 2010 to February 2, 2011. This extension is anticipated to provide staff with additional time to complete ongoing negotiations related to the new letters of credit and alternative credit facilities. Once new agreements have been negotiated and executed, the Agreement will be terminated.

As of October 25, 2010, the outstanding balance of commercial paper notes related to the Agreement is approximately $327 million of the $450 million supported by the Agreement. The City will reduce the outstanding amount of commercial paper notes related to the Agreement to fit within the lower amount of the restructured letter of credit commitment amount of approximately $283 million by moving $30 million of the outstanding balance into the portion of the Airport CP Program related to the Lloyds Agreement and by using $14 million of unspent commercial paper note proceeds to redeem outstanding commercial paper notes.

The participation of the banks in the restructured letters of credit for the extension period is presented in the following table.

| | Current Structure | | Amended Structure | |
|---|---|---|---|---|
| **Bank** | **Participation (%)** | **Commitment Amount** | **Participation (%)** | **Commitment Amount** |
| JPMorgan | 44.44% | $ 199,980,000 | 70.58% | $ 199,980,000 |
| Bank of America | 18.52% | 83,340,000 | 29.42% | 83,340,000 |
| Dexia | 37.04% | 166,680,000 | 0.00% | 0 |
| Total | 100.00% | $ 450,000,000 | 100.00% | $ 283,320,000 |

As a condition of the extension, JPMorgan and Bank of America require that certain terms and conditions of the Agreement be amended as follows. The fee payable for the letters of credit (the "Base Fee") will be increased from the current fee of 0.15% of the current commitment amount (current fee is approximately $56,000 per month) to the new renegotiated fee of 1.40% of the reduced commitment amount (amended fee is estimated at approximately $330,000 per month). This represents an increase of approximately $548,000 in fees over the two-month period of the extension, attributable to the continued disruption in the financial markets and the difficulty municipalities are encountering when requesting credit facilities. The amended fee structure is consistent with the City's recently negotiated letter of credit fees for the variable-rate lease revenue bonds and the City's lease revenue commercial paper program (0.95% - 1.25%) and comparable to the Redevelopment Agency's recently negotiated letter of credit fees with JPMorgan for their variable-rate tax allocation bonds (1.95%), after taking into consideration the long-term credit ratings and other factors related to each entity.

The revised pricing is subject to maintenance of the current underlying credit ratings on the Airport bonds of A2/A/A- (Moody's/Standard & Poor/Fitch). In the event that the underlying credit ratings on the Airport bonds are withdrawn by one or more rating agencies, the annual commitment fee will be increased by one percentage point. The fee will be determined according to the following table with the lower of the two highest ratings used to determine the fee. The Base Fee during the 2-month extension period is 1.40%, which is consistent with the pricing that has been negotiated with JPMorgan and Bank of America for the longer-term credit facility.

| Level | Moody's Rating | S&P Rating | Fitch Rating | Annual Fee |
|---|---|---|---|---|
| 1 | A2 or above | A or above | A or above | Base Fee (1.40%) |
| 2 | A3 | A- | A- | Base Fee + 0.20 % |
| 3 | Baa1 | BBB+ | BBB+ | Base Fee + 0.45 % |
| 4 | Baa2 | BBB | BBB | Base Fee + 0.75 % |
| 5 | Baa3 or below | BBB- or below | BBB- or below | Base Fee + 1.00 % |

The Amendment also includes other amended terms and conditions that are summarized as follows. The rates outlined below apply when the there is a draw on the letter of credits and the City is unable to repay the draw within the time limits specified in the Agreement.

| | |
|---|---|
| Base Rate: | Highest of (i) JPMorgan Prime + 1.5%, (ii) Federal Funds + 2.0%, or (iii) 3-month LIBOR + 1.5%; with a minimum of 7.5% per annum.<br><br>The Agreement has lower spreads in (i) and (ii) and does not include either (iii) or a minimum rate; however, the existing agreement does include provisions for higher base rates if the Airport bonds are downgraded. |
| Default Rate: | Base Rate + 3.0%. This is the interest rate charged to the City if an Event of Default occurs and is uncured.<br><br>The Agreement's Default Rate is the Base Rate (as currently defined) + 2.0%. |
| Draw Rate: | Drawings shall bear interest at a rate per annum equal to (i) for the period from and including the date of such drawing through and including the 90th day following such drawing, the Base Rate; (ii) from and including the 91st day following such advance and thereafter, the Base Rate + 1.00%.<br><br>In the Agreement, drawings bear interest at the Base Rate (as currently defined) for a period up to 60 days. On the 61st day, drawings bear interest at the Default Rate (as currently defined) or, if the drawing is converted to a Term Loan, the Term Loan Rate. |
| Term Loan Period: | Principal on term loans shall be payable in six equal semi-annual installments.<br><br>In the Agreement, term loans shall be payable in ten equal semi-annual installments. |
| Term Loan Rate: | Term Loans bear interest at the Draw Rate.<br><br>In the Agreement, Term Loans bear interest at the Base Rate (as currently defined) + 0.50% for the first 30 days, the Base Rate + 0.75% from the 31st day through the 60th day, and the Base Rate + 1.00% thereafter. |

**Delegation of Authority**

Staff recommends that the City Manager, Director of Finance, or their designees (the "Designated Officers") be authorized to execute this amendment on behalf of the City with such modifications as the Designated Officer determines to be desirable or appropriate, upon consultation with the City Attorney.

Staff also recommends that the Designated Officers each be authorized to enter into one or more extensions of the Agreement, as amended, on the same terms and conditions, provided that the annual fees for each extension do not exceed 2.25% per annum of the commitment under the Agreement.

**Financing Team**

The financing team participants consist of:

| | |
|---|---|
| • City's Co-Financial Advisors: | Public Financial Management<br>Public Resources Advisory Group |
| • Bond Counsel: | Orrick Herrington & Sutcliffe LLP |
| • Letter of Credit Banks: | JPMorgan Chase Bank, N.A.<br>Bank of America, N.A. |
| • Bank Counsel: | Chapman and Cutler LLP |
| • Issuing and Paying Agent: | Deutsche Bank Trust Company Americas |

**Financing Schedule**

The current proposed schedule for the short-term extension is as follows:

| | |
|---|---|
| City Council approval of amendment: | November 9, 2010 |
| Document closing: | November 10, 2010 |

Staff anticipates that the agreements for the replacement credit facilities will be agendized for City Council consideration and approval in December or early January, 2011.

**EVALUATION AND FOLLOW-UP**

This memorandum presents a recommendation related to the City Council's approval of various actions related to the City of San José Airport Commercial Paper Program and requires no follow-up to the City Council.

## POLICY ALTERNATIVES

***Alternative #1: Do not extend letter of credit expiration date***
**Pros:** None.
**Cons:** Results in significantly higher interest costs over the two-month period. Triggers a required payment to the Internal Revenue Service. Eliminates the future option of refunding a portion of the commercial paper notes at lower long-term interest costs. May act as a signal of weak financial management to credit markets and other business partners (City does not exhaust all available remedies to resolve issues).
**Reason for not recommending:** This alternative is not recommended for all of the reasons listed under "Cons."

## PUBLIC OUTREACH/INTEREST

☑ **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

Compensation for the City's consultants and the costs of issuance will be paid from Airport operating funds or taxable commercial paper note proceeds and are estimated to be $59,000.

## BUDGET REFERENCE

Not applicable.

## CEQA

Not a project, File No. PPIO-066, Agreements/Contracts (New or Amended)

/s/
SCOTT P. JOHNSON
Director, Finance Department

For questions, please contact Scott P. Johnson, Director of Finance, at (408) 535-7000.

# APPENDIX A

## TECHNICAL ASPECTS OF COMMERCIAL PAPER

### *The Mechanics of Commercial Paper*

Commercial paper is debt that is sold with a maturity of between 1 and 270 days. The maturity of an individual commercial paper note is determined by the commercial paper dealer and the issuer at the time it is sold. Each commercial paper note bears interest at a fixed rate for the 1-270 day period of time it is outstanding; or is sold at a discount, and such interest or discount is payable when the note matures. (The procedures for the payment of interest on the commercial paper are described below under "Payment of Principal and Interest on Commercial Paper".)

Municipal commercial paper programs typically require the issuer to obtain credit support through one of more letters of credit provided by a commercial bank. Upon each note maturity, the paying agent is authorized and required to draw on the supporting letter of credit in the amount of principal and interest due on that date. The issuer may then "roll over" the commercial paper notes by issuing renewal notes and using the proceeds of the renewal notes to reimburse the draw on the letter of credit. To the extent that the commercial paper dealer is unable to find an investor for the renewal notes, the draw on the letter of credit remains unreimbursed and the issuer is responsible for repaying the bank or banks that provided the letter of credit. The terms and conditions governing the letter(s) of credit and the reimbursement process are memorialized in a reimbursement agreement entered into by and between the issuer and the bank or bank(s) that provided the letter of credit.

The renewal notes may be sold through a commercial paper dealer either to a new investor or to the investor who held the maturing note. The process of rolling over commercial new paper is not considered to be the issuance of additional debt as long as the amount of commercial paper outstanding is not increased as a result of the "roll over." Through the "roll over" mechanism, commercial paper can be kept outstanding indefinitely, as individual commercial paper notes continually mature and new commercial paper notes are issued.

Commercial paper is considered a form of variable-rate debt. Even though the interest rate on each commercial paper note is fixed at the time such note is issued, the rate on each commercial paper note will be based on market conditions at the time. The rates on new commercial paper notes will thus vary from one week or month to another. The actual cost of the program to the issuer will be the average rate on all of its outstanding commercial paper notes over time. Most issuers calculate such average rates on a quarterly or annual basis. Overall, commercial paper rates tend to be among the lowest available in the tax-exempt and taxable markets for municipal debt.

The buyers of commercial paper are considered short-term investors, because their investments in commercial paper mature in 270 days or less. One of the attractive features commercial paper offers to an investor is that the maturities can be matched to the specific timing needs of an investor (such as 27 days, or 112 days). This helps an investor invest amounts for a very precise period of time until such funds are needed for a specific known payment obligation in the future. Buyers of commercial paper include major corporations and money market funds. Commercial paper is attractive to money market funds because it complies with the maturity limitations imposed on such funds, and the flexibility in setting the maturity of commercial paper may help the fund achieve or maintain the average maturity it is seeking. Money market funds are likely to continue to buy a given issue of commercial paper as it rolls over, and thus may own an issue for an extended period of time.

***Payment of Principal and Interest on Commercial Paper***

Commercial paper is not sold with a fixed principal repayment schedule. Instead, the issuer maintains almost complete flexibility with respect to the timing and amounts in which the principal amount of commercial paper will be repaid. Basically, the issuer can repay commercial paper on any date on which a commercial paper note is scheduled to mature by providing the funds to repay such note to the paying agent for the issue. The paying agent uses such funds to pay the holder of the commercial paper. At the same time, the issuer instructs its commercial paper dealer not to attempt to sell new commercial paper to roll over the paper, which is maturing. Hence, if such steps were taken, the amount of commercial paper outstanding at the end of the day is reduced.

The individual commercial paper notes are likely to have different maturities, so an issuer repaying a commercial paper program would do so in a series of steps as the individual notes mature. However, since each note would have a maximum maturity of 270 days, an entire program could be repaid at the option of the issuer in not more than 270 days from the time the issuer decided to commence such a repayment. It is likely that an issuer planning to pay a program off in the near future would instruct its commercial paper dealer to issue the paper with short maturities as it rolls over, so that the issuer could retire the commercial paper quickly when it begins the repayment process.

As noted above under "The Mechanics of Commercial Paper" interest or discount is payable on each commercial paper note as it matures. During the construction period for a project, the interest payable can be "capitalized" by adding the amount of interest due on the maturing commercial paper to the amount of new paper being sold. If this approach is used, the principal amount of paper outstanding over time will increase as additional interest is capitalized (subject to the maximum authorized amount of notes permitted to be outstanding at any one time under the program).

Interest on tax-exempt debt generally cannot be capitalized following completion of the projects financed with commercial paper. At that point, the issuer must provide to the paying agent the interest due at the time each note matures. The paying agent then pays such interest to the investor together with the proceeds received from rolling over the principal amount of the commercial paper. Since the interest at that point is being paid by the issuer, and not by increasing the amount of paper being rolled over, the principal amount of commercial paper outstanding will stay constant after the projects are completed. That principal amount outstanding could either be reduced in the future if the issuer decides to repay some, or all, of the program, or increased if the issuer decides to undertake additional projects (which may require an increase in the authorized amount of the program).