COUNCIL/AGENCY BOARD/FINANCING AUTHORITY: 05-3-11
ITEM: 2

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL/REDEVELOPMENT AGENCY BOARD/CITY OF SAN JOSE FINANCING AUTHORITY BOARD

FROM: Debra Figone
Harry Mavrogenes

SUBJECT: SEE BELOW

DATE: April 22, 2011

SUBJECT: FINANCING PLAN TO FUND THE AGENCY'S SECOND PAYMENT TO THE SUPPLEMENTAL EDUCATIONAL REVENUE AUGMENTATION FUND ("SERAF")

RECOMMENDATION

It is recommended that the City Council, City of San José Financing Authority ("Authority") Board and the Redevelopment Agency ("Agency") Board adopt resolutions authorizing the City Manager, Executive Director of the Financing Authority, and the Executive Director of the Agency to negotiate and execute a First Amendment to the Loan Agreement by and among the City, Financing Authority and the Agency Related to the Supplemental Education Revenue Augmentation Fund dated May 6, 2010 to allow the second installment of the SERAF Loan to the Agency to be made with 20% Housing Funds, and later replenished with a loan of Commercial Paper proceeds from the Authority to the Housing Program.

OUTCOME

Approval of the recommendation will provide the Agency with funding necessary to meet the State mandated payment to the Supplemental Educational Revenue Augmentation Fund on May 10, 2011.

BACKGROUND

City of San José Redevelopment Agency Overview

Since its formation in 1956, the Agency has successfully leveraged tax increment revenues to pursue a comprehensive program to revitalize Downtown, industrial areas, neighborhoods and business districts. The Agency is active in 21 Project Areas comprising 16% of the City's land mass and home to nearly 40% of total San Jose jobs.

The economic returns on Agency investments to San Jose residents and businesses have been significant. The Agency has invested more than $3 billion in its core services of economic development and elimination of blight. The Agency's investment is estimated to have generated approximately $19 billion in private investment. Furthermore, the Agency's investments have resulted in more than $835 million in affordable housing construction projects, increased the housing supply (21,662 affordable and 9,536 market rate housing units), created 114,000 jobs, and generated $31 million in annual sales tax revenue which is nearly 30% of total annual Citywide collections.

SERAF Overview

On July 28, 2009, the former Governor Schwarzenegger signed AB4x26, which provides for a two-year requirement on redevelopment agencies to make payments into a Supplemental Educational Revenue Augmentation Fund ("SERAF"). In May, 2010, the Agency made the first SERAF payment of $62.2 million. The second SERAF payment of $12.8 million is due on or before May 10, 2011.

On February 23, 2010, the City Council, the Board of Directors of the Authority, and the Agency Board authorized, respectively, the City Manager, the Authority Executive Director, and the Executive Director of the Agency to negotiate and execute a loan agreement to provide funds to the Agency for the purpose of making both SERAF payments[1]. On May 6, 2010, the San José Financing Authority, the City of San José and the Agency entered into the Loan Agreement ("SERAF Loan"). The timing and sources of funding for the SERAF Loan are as follows:

- May 10, 2010: $62 million total payment was funded as follows: (1) $10 million loaned to the Agency from the City through Inter-Fund loans and (2) $52 million loaned from the City's Low and Moderate Income Housing Fund (the "Low-Mod Housing Fund"). Of this amount, $40 million was generated through the issuance of Housing Set-Aside Tax Allocation Bonds ("Housing Bonds") and $12 million was generated through the issuance of Commercial Paper ("CP") Notes.

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[1] Copy of the staff report, supplemental memo and presentation can be found on the City's website at http://www.sanjoseca.gov/clerk/Agenda/20100223/20100223a.pdf, item #2 on the Joint City Council/Financing Authority Board/Redevelopment Agency Agenda.

- May 10, 2011: $12.8 million total payment, to be funded through the Low-Mod Housing fund but generated through the issuance of CP Notes.

The Loan Agreement anticipated that the Financing Authority would issue Commercial Paper by May 10, 2011 to make the second installment of the SERAF payment. However, staff evaluated five alternative funding options (see Funding Options section below) to pay the second installment of the SERAF payment and determined that the Housing Department can free up funds set aside for projects to make the second installment of the SERAF Loan from 20% funds, to be replenished with issuances of CP Notes at a later date to fund future committed projects and programs. Therefore, it is necessary to amend the original SERAF Loan Agreement. The proposed amendment to the Loan Agreement will allow the parties to issue the Commercial Paper and lend the proceeds at a later date when funds are needed for these projects. It should also be noted that the Housing Department is proposing to budget funds beginning in FY 2012-13 to repay the CP Notes issued in 2010 for the first installment of the SERAF payment. While the early repayment by Housing will mitigate General Fund risk, a 5% penalty could still be levied against the 80% fund if the Agency fails to repay the SERAF loan to Housing within the five year requirement per current SERAF legislation.

ANALYSIS

Staff conducted detailed analysis on the advantages and disadvantages of making the May 10, 2011 SERAF payment and assessed the feasibility of making the 2011 SERAF payment from alternative funding sources. Based on the analysis outlined below, the benefits of making the SERAF payment outweigh the disadvantages. Funding the May 2011 payment from the Low-Mod Housing Fund through the issuance of CP Notes provides the most cost effective source of funding with the lowest risk to the City's General Fund and is consistent with the SERAF financing plan as adopted by Council, Agency Board, and Authority Board at the February 23, 2010 joint meeting.

Failure to Make the Second SERAF Payment

If the Agency does not make the second SERAF payment by May 10, 2011, the Agency essentially "goes dark". Specifically, the Agency including the Housing Program will be prohibited from taking any of the following actions until the payment is made:

1. Adopting new or expanding existing redevelopment project areas;
2. Issuing new debt; and
3. Encumbering or expending any funds, from any source, except to pay existing obligations; or monthly operations and administration of the agency in an amount not to exceed 75% of the average monthly amount spent for those purposes in 2009-10.

The Agency would also be required to allocate an additional five percent (5%) of tax increment to the Housing Fund starting in July 2011. This would increase the contributions to the Housing Fund from 20% to 25% of tax increment. In addition, although the prohibitions listed as items 1-

3 above would be lifted once the Agency makes the second SERAF payment, the increase in the tax increment to the Housing Fund would remain for as long as the Agency receives tax increment.

Pros and Cons of Making the SERAF Payment

A summary of the advantages and disadvantages of paying the 2011 SERAF payment is outlined in the table below.

	Pros	Cons
Pay SERAF	• Averts risk of Agency and Housing Program from "going dark" • Averts immediate 5% tax increment penalty for non-payment of SERAF • Allows the Agency/Housing to continue building business relationships with Banking institutions (JP Morgan/Wells Fargo Bank) • Maintains Investor/financial market confidence • Allows the Agency and Housing Programs the ability to implement future programs and projects	• Governor's proposal to eliminate redevelopment agencies would make the payment irrelevant • Agency may not have sufficient tax increment to repay funds borrowed from the City and Housing Fund within the five year state mandated timeline • Negatively impacts the cashflow and budget of the City and the Agency
Don't Pay SERAF	• No loss of money if the Agency is eliminated by the State • Funds could be used for other purposes	• Agency and Housing Program will "go dark" • Immediate 5% penalty, increasing the Housing Fund to a 25% Fund • May have serious impacts on the Agency's ratings • May have serious impacts on investor confidence, including Wells Fargo Bank and JP Morgan.

Funding Options

Recommended Funding Option

Staff recommends funding the second installment of the SERAF payment from the Housing Fund which will later be replenished through the issuance of CP Notes as project needs require. This strategy will require an amendment to the SERAF Loan Agreement but is generally consistent with the SERAF financing plan approved by the City Council, Agency Board, and Authority Board at its joint meeting on February 23, 2010.

Alternative Options Evaluated
Staff evaluated four alternative funding options for the SERAF payment due on May 10, 2011. The primary reasons that these options are not recommended are outlined below.

- Agency Cash – This option is not recommended because it would result in less money available to pay ongoing Agency obligations, including City subordinated debt. Any amount paid by the Agency would increase the General Fund 2011-12 budget deficit by a corresponding amount.

- Housing Fund Cash without issuance of additional CP Notes - This option is not recommended because the Housing Fund does not have sufficient unallocated housing funds to fund the payment.

- Issue Commercial Paper through the General Fund – This option is not recommended because it would add additional risk to the General Fund if the Agency is eliminated or is unable to repay the CP Notes due to insufficient tax increment revenues.

- Make the Second Installment pursuant to the Existing Loan Agreement – This option would require CP Notes to be issued by May 10, 2011. The main difference between the recommended funding option and the original financing plan to issue CP Notes by May 10, 2011 is a timing difference in the issuance of CP Notes to Housing to replenish funds that have been allocated to Housing programs and projects. The original financing plan to issue CP Notes by May 10, 2011 is not recommended because the Low-Mod Housing Fund would not need to be replenished until a later date when Housing projects and programs will need to be funded. In addition, this modified strategy would result in lower interest costs to the Low-Mod Housing Fund and the Agency to the extent that the issuance of CP Notes is delayed. This option would not reduce the carrying costs (e.g. letter of credit fees) of the CP Program allocated to the Housing Fund so long as the applicable CP Program capacity as identified in the SERAF financing plan is reserved for Housing purposes. Furthermore, delaying the CP issuance postpones and minimizes the General Fund's risk exposure should Governor Brown's current proposal to eliminate redevelopment agencies in the state be enacted (see Proposed Elimination of Redevelopment Agencies below for more details).

Failure to Repay SERAF Loan

Since the Agency borrowed funds from the Housing Fund to make its SERAF payments, the first installment of the loan (to cover the $52 million 2010 payment) must be repaid in full on or before June 30, 2015 and the second installment by June 30, 2016. Absent changes in current SERAF legislation, if the Agency fails to repay the borrowed funds by the due dates, the Agency would be required to allocate an additional five percent (5%) of tax increment to the Housing Fund starting in July 2015. The increase in the Housing Fund set-aside would also remain for as long as the Agency receives tax increment.

Proposed Elimination of Redevelopment Agencies

If the State eliminates redevelopment agencies as currently proposed by Governor Brown, there does not appear to be any incentive to make the second SERAF payment. The legislation is drafted to avoid the restrictions of Proposition 22, which prohibits the State from shifting redevelopment funds to other entities. As such, the proposed legislation expressly states that upon dissolution, any property taxes that would have been allocated to redevelopment agencies will no longer be deemed tax increment and, instead, will be deemed property tax revenue and will be allocated first to successor agencies to make payments on existing indebtedness and then distributed in accordance with the California Constitution and other applicable laws. Therefore, based on the proposed legislation, any agency funds not used to pay existing indebtedness would pass through to schools, counties, cities and other public entities based on the traditional allocation of property taxes under State law. In essence, the Housing Fund, except for the purposes of paying Housing Fund debt, would no longer exist and any increase as a result of the failure to make a SERAF payment or the failure to repay a SERAF loan would be meaningless under the proposed legislation.

Consequences of Non Payment If Redevelopment Agencies Are Not Eliminated

If the State legislature does not eliminate redevelopment agencies as currently proposed by the Governor, the failure to make the second SERAF payment or the failure to repay the SERAF loans and the resulting increase in the Housing Fund would impact the Agency's ability to repay certain Agency debt and would increase the time it would take for the Agency to have funds available for the Agency's general redevelopment program using 80% Funds.

Existing bonded indebtedness secured by 80% Funds should be senior to any increase in the Housing Fund resulting from the failure to make or repay a SERAF payment. Therefore, annual debt service on all senior debt, including the Merged Area Variable Rate Debt secured by the JPMorgan Letter of Credit, would need to be paid, prior to increasing the Housing Fund. Additionally, City staff believes that the Agency's pledge of tax increment and other revenues to the City to pay debt service on the Convention Center Bonds and the Fourth Street Garage bonds is also senior Agency debt subject to repayment prior to any increase in the Housing Fund.

Payments to the County under the Amended and Restated Agreement dated May 22, 2001 between the Agency, the County and the City ("County Agreement") are expressly subordinate to all of the Agency's loans, bonds or other indebtedness, and any pledge or lien on Merged Area tax increment. Therefore, any amounts owed to the County are junior to any existing Agency debt, including any Agency debt owed to the City. If future payments owed to the County under the County Agreement are not paid, the Agency is required to recognize the obligation and interest accrues on the unpaid amount until paid.

If the Agency fails to make the second SERAF payment and redevelopment is not eliminated, the Agency would be prohibited from conducting any new business as described above, including any expenditure of funds from the Housing Fund and the Housing Fund would be increased by an additional 5% of tax increment and would be increased by an additional 5% if the first SERAF payment was not repaid by June 30, 2015. Given the Agency's financial situation, the allocation of an additional 5% or 10% of tax increment to the Housing Fund would impact the Agency's ability to repay certain Agency debt, including HUD 108 loans, ERAF loans, County payments, and certain other Agency obligations to the City and third parties. A report on the Agency's obligations was presented to the City Council and Agency Board at its joint meeting on February 1, 2011[2].

It should also be noted that the consequences of the Agency/Housing going dark due to non-payment of the second installment of SERAF could result in serious impacts on investor confidence on the Agency/Housing's outstanding debt and the Agency/Housing's ability to extend existing agreements with the Agency's Banking partners (JP Morgan and Wells Fargo Bank).

Current Status of the Governor's Proposal

As of the date of this memorandum, the Governor's proposal to eliminate redevelopment agencies has not passed the Legislature. Based on the current status of the legislative process, staff believes it is highly unlikely that the legislation eliminating redevelopment could be passed and signed by the Governor prior to the May 10, 2011 deadline for making the SERAF payment. However, it is a possible outcome that the legislation eliminating redevelopment could be passed and signed by the Governor subsequent to May 10, 2011.

Were the Governor's proposal to be approved, repayment of the housing funds would be part of the waterfall of payments due as specified in the legislation.

[2] Copy of the staff report can be found on the City's website at:
http://www.sjredevelopment.org/Agendas2011/020111/81bandcSUPPLStateBudgetImpacts.pdf
item #8.1(b)(c) on the Joint City Council/Redevelopment Agency Agenda.

EVALUATION AND FOLLOW-UP

Staff is conducting proactive and ongoing analysis on the City's and Agency's programs and debt obligations and the potential risks and impacts to the General Fund, the Redevelopment Agency and the Housing Program if the Governor's budget proposal were implemented. Staff will continue to monitor and provide updates on the legislative actions to the City Council/Agency Board.

PUBLIC OUTREACH/INTEREST

☒ 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)**

☐ 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 memorandum was prepared by the Finance Department in coordination with the Redevelopment Agency, Housing Department, and the offices of the City Attorney and General Counsel.

COST SUMMARY/IMPLICATIONS

Per the SERAF Loan Agreement executed by the City, the City of San José Financing Authority, and the Agency, repayment of the initial SERAF Loan principal will be due on or prior to June 30, 2015 in the amount of $62 million plus associated costs. Repayment for the second SERAF Loan will be due on or prior to June 30, 2016 in the amount of $12.8 million plus associated costs. Interest on the SERAF Loan, including fees will be paid quarterly by the Agency to the City on each August 1, November 1, February 1 and May 1, commencing August 1, 2010. To the extent that interest and ongoing fees cannot be paid currently, they will be added to principal balance owed, with interest due on the increased amount.

The proposed amendment to the loan agreement will allow the Low-Mod Housing Fund and the Agency to delay incurring interest charges until CP Notes are issued to fund housing projects. The actual amount of savings will depend on the timing of issuance and prevailing market conditions. Based on current interest rates, a one year delay could result in approximately $100,000 in interest savings.

CEQA

Not a Project, File No. PP10-069 City Organization & Administrative Activities.

DEBRA FIGONE
City Manager

for HARRY MAVROGENES
Executive Director