CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

COUNCIL AGENDA: 05-17-11
ITEM: 7.1

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: John Stufflebean

SUBJECT: SEE BELOW

DATE: 05-05-11

Approved

Date 5/6/11

COUNCIL DISTRICT: 3

SUBJECT: NEW MARKETS TAX CREDIT FINANCING FOR THE CONSTRUCTION OF THE ENVIRONMENTAL INNOVATION CENTER

RECOMMENDATION

Adopt a resolution authorizing the City Manager:

(a) To establish an independent Qualified Active Low-Income Community Business with nonprofit status under the Internal Revenue Code section 501c3 for the purpose of participating in the federal New Markets Tax Credit program to secure additional financing to fund the construction of the San José Environmental Innovation Center;

(b) To appoint the five members of the Qualified Active Low-Income Community Business Board of Directors, and replacement board members if any of the appointees are unable to serve through the closing of the New Markets Tax Credit transaction;

(c) To negotiate and prepare the agreements necessary to complete the New Markets Tax Credit financing transaction for the City Council's consideration in June 2011; and

(d) Evaluate the feasibility of use of Commercial Paper as an interim or alternative financing mechanism for New Markets Tax Credits.

OUTCOME

Adoption of the proposed resolution would enable the City to take steps to leverage private capital from the sale of New Markets Tax Credits (NMTCs) to pay for a portion of the costs related to the construction of the Environmental Innovation Center (EIC). A successful transaction may also serve as a model in future City sponsored low-income community development projects.

BACKGROUND

Environmental Innovation Center

The EIC is located at 1608 Las Plumas Avenue on a 4.2 acre lot. Staff proposes to apply for U.S. Green Building Council (USGBC) Leadership in Energy and Environmental Design (LEED) Platinum certification for this facility. The Clean Tech Demonstration Center of the EIC is a critical component of the City's Economic Development Strategy adopted by Council on April 27, 2010. The Office of Economic Development estimates that the EIC Clean Tech Demonstration Center could lead to the creation of 1,000 new jobs in the region. Moreover, the EIC advances several of the City's Green Vision goals such as: creating clean tech jobs, receiving electrical power from renewable sources, retrofitting buildings to be green, diverting waste from landfills, running public fleet vehicles on alternative fuels, and replacing streetlights with smart zero emission lights. The project will also provide extensive workforce training for local and low-income community residents to prepare them for jobs in the green economy. As part of the City's Pilot Program Prioritization Effort during the 2010-2011 budget planning process for 550 programs, the community and City Council ranked the EIC as a Level 1 program.

The City completed Phase I of the EIC in June 2010. Phase I includes several sustainable technologies such as an advanced stormwater mitigation system, pervious sidewalk pavements, and Light Emitting Diode (LED) streetlights. Phase II will include the renovation of the existing 46,000 square foot warehouse into a state-of-the-art Clean Tech Demonstration Center. The Clean Tech Demonstration Center would allow entrepreneurs to test prototypes in renewable energy, energy efficiency, green building, and alternative clean transportation. A second portion of the warehouse would provide conference space for environmental workshops and the job training program. The remainder of the warehouse will be reserved for a Habitat for Humanity ReStore to sell discounted new or like-new construction materials. A new 10,000 square foot permanent Household Hazardous Waste (HHW) drop-off facility shall also be constructed in Phase II for the convenient and safe disposal of hazardous household items by property owners.

The City has spent approximately $12,000,000 to acquire the site, develop a master plan, complete environmental review, construct Phase I, upgrade utility connections, and consult with architects and engineers. Phase II is estimated to cost $10,600,000 for the base construction. However, an additional $7,400,000 is necessary to pay for the photovoltaic (PV) panels on the rooftop and car shelters, construction contingency, public art, additional architectural services, and Public Works soft costs as detailed in the table below.

Remaining Project Costs	Estimate
Phase II Construction	$11,500,000
PV Panels & Car Shelters	$2,800,000
Contingency (10% for both Phase II & PVs)	$1,430,000
Public Art	$192,000
Architectural Services (Group 4)	$919,000

Public Works Soft Costs	
Phase II Construction	$240,000
PV Panels & Car Shelters	$910,000
Total	**$18,021,000**

On March 30, 2011, Public Works released the Phase II construction documents for the EIC as part of a low-bid procurement for construction services. The bid was advertised on the City's Internet Bid Hotline and Post Record for 30 days to maintain the project's eligibility for a pending grant. On April 20, 2011, Public Works also released the performance specifications for the PV panels and car shelters as part of a low-bid design and build procurement. The proposed PV system would be capable of generating a minimum of 492,000 kilowatt hours per year (kWh/yr), and will be placed on the rooftops of the existing warehouse, new HHW building, and car shelters. The NMTC financing will allow the City to include the solar PV system, which will allow the project to achieve LEED Platinum certification. Without the PV system, the City could apply for Silver LEED certification from the USGBC.

Staff anticipates returning to Council on May 24, 2011 to award contracts to the lowest bidders for both the Phase II construction services and installation of the PV panels and car shelters. The memorandum to Council on these actions will discuss how staff proposes to implement these contracts, and finance the work proposed to be paid from the proceeds of the NMTC financing in case the transaction does not close.

Funding Alternatives

On June 7, 2010, staff updated the Transportation and Environment Committee on the site development and programming for the EIC. The Committee was informed of available City funds and several grant funding opportunities to assist with the remaining project costs. One of the opportunities identified was a $4,000,000 grant from the U.S. Department of Commerce's Economic Development Administration (EDA). The City submitted a proposal to the EDA in September 2009, but the final decision for award is still pending before the EDA's Washington D.C. office. Staff subsequently submitted several grant applications to other agencies and programs but has not been successful in securing additional awards. Further research into the funding mechanisms for construction of similar facilities across the country revealed that some of these facilities participated in the NMTC program in addition to other programs.

Staff would also evaluate City's Commercial Paper program for interim and/or alternative financing mechanism. Commercial Paper notes may be issued as an interim financing mechanism should there be a delay in the receipt of the NMTC proceeds, or as an alternative to the NMTC program if the City was unable to close to a NMTC transaction. The Commercial Paper notes may be used to finance the base level work, but will likely be insufficient to fund the fully-formed project, including the PV system, that would be financed with NMTCs. In addition, the City would need to identify appropriate funding sources to repay the Commercial Paper notes.

New Markets Tax Credit Program

The NMTC program, administered by the U.S. Department of the Treasury, was created by the Community Renewal Tax Relief Act of 2000 to promote economic development in distressed areas and authorized by Congressional action as reflected in Internal Revenue Service Code Section 45D. Each year, the Treasury's Community Development Financial Institution (CDFI) Fund allocates tax credits to community development entities (CDEs). CDEs then solicit private equity investments—typically from major financial institutions such as JP Morgan Chase, U.S. Bank, Bank of America, and Wells Fargo—in exchange for a federal income tax credit totaling 39% of the qualified investment into a low-income community project. An investor's sole interest in a project is the ability to claim the tax credits over seven years to reduce the investor's federal tax liability. Through a complex financing structure, these investments are ultimately provided to a qualified active low-income community business (QALICB). A seven-year compliance period follows the closing wherein all investments must remain in the project.

Consultant Services

Due to the complexity of the transaction, the City retained the National Development Council (NDC) in December 2010 and Kantor Taylor Nelson & Boyd PC (Kantor) in February 2011 to assist in negotiation and completion of the financing. Specifically, NDC advises ESD in the structuring of the NMTC transaction, identifying interested CDEs and investor, and closing the transaction. Kantor serves as the City's special legal counsel and working under the direction of the City Attorney's Office has the responsibility of drafting the required documents for the transaction and providing advice to the City in this specialized area.

ANALYSIS

The proposed financing structure is required because the project must be owned by a private entity in order for the investment to qualify for tax credits and to ensure that the private capital remains with the project for the seven-year compliance period. As parties to the financing, the City, the investor, CDEs, and QALICB would have specific responsibilities. The purpose of this memorandum is to inform the City Council of the proposed NMTC transaction, each party's role, and the potential risks and liabilities for the City in its various capacities as the leveraged lender, developer, master tenant, and guarantor or indemnitor. A more detailed explanation of the final terms and conditions of each agreement would be provided if Council directs staff to return for authority to execute the documents required for the NMTC financing. (See Attachment for a diagram of the flow of funds.)

Qualified Active Low-Income Community Business

Staff proposes to establish a QALICB, a nonprofit corporation with tax exemption status under the Internal Revenue Code section 501c3. A QALICB qualifies for the NMTC program if it conducts a business which benefits the low-income community, rents improved real estate located in a low-income census tract, or owns a project located in a low-income census tract. In this case, the QALICB would (i) hold a long-term ground lease from the City of the land on which the EIC will be built, (ii) build the EIC on the land leased to the QALICB, and (iii) would master lease the EIC to the City. As a nonprofit tax-exempt entity, the real property should continue to be exempt from property taxes and protect the QALICB from recognizing income tax on any potential taxable income. The EIC is located in a low-income census tract.

The proposed board would be comprised of five members with expertise in real estate, development, finance, and environmental programs. Staff recommends appointing three executive level employees from the City's Public Works Department, Office of Economic Development, and Environmental Services Department, a professional from the private sector, and a member of the community-at-large as the EIC's QALICB board members for an initial term of three years. Staff recommends that the Council authorize the City Manager to appoint Matt Morley from Public Works, Jeff Ruster from the Office of Economic Development, Kerrie Romanow from the Environmental Services Department, Brenda Santoro from Silicon Valley Bank, and former Vice-Mayor Judy Chirco. If any of the appointees are unable to serve before the closing of the NMTC transaction, staff recommends authorizing the City Manager to appoint replacement board members with comparable qualifications.

These board members would have an independent fiduciary duty to the QALICB and be authorized to execute agreements on behalf of the QALICB. For the purpose of closing the transaction, the QALICB board would be expected to execute qualified low-income community investment loans (QLICI), and various agreements with the City to enable the QALICB to own the project for tax purposes, and authorize the City to finish construction of the EIC and operate the facility thereafter. These agreements between the QALICB and the City would include a ground lease, master lease, and development agreement.

During the seven-year compliance period, the QALICB would conduct quarterly board meetings to monitor progress in the project and to ensure compliance with the NMTC program. The QALICB would be required to comply with all State and federal laws related to California nonprofit corporations. These would include applying for federal and state tax exemption, completing annual information returns, filing annual statements with the California Secretary of State, and adopting recommended nonprofit corporate practices such as instituting appropriate disclosure procedures. The annual operating expenses for the QALICB are estimated to be approximately $160,000 and consist of asset management fees and reimbursement for auditing and tax related costs to the CDEs during the seven-year compliance period. These costs will be reserved from the NMTC proceeds at the closing of the transaction. The QALICB will then draw down on these reserves to pay costs as they are incurred during the compliance period.

Making the Private Investment Eligible for New Markets Tax Credits

An NMTC investor provides capital to projects through the purchase of an equity interest in an investment fund held by the investor. For the EIC transaction, the investment fund will also receive a low interest loan from the City as a leveraged lender. The funds from the investor and City will be combined to make a Qualified Equity Investment (QEI) in a CDE with the investor as a 99.99% member of the CDE with the remaining 0.01% held by the CDE. The CDE will provide the tax credits in the amount of 39% of the QEI over the course of seven years to the investor. The CDE is required as part of its allocation agreement with the federal program to commit "substantially-all" or at least 85% of the QEI funds into a qualified project. These funds are made available to the QALICB through two QLICI loans secured by the QALICB's interest in the EIC. Loan A is equivalent to the QEI from the City's leveraged loan, and Loan B is equivalent to the QEI from the NMTC equity investment after deducting for fees from the CDEs.

Based on previous and future qualifying costs, the EIC project is valued at approximately $30,000,000 and is estimated to generate approximately $12,000,000 in tax credits. The EIC QALICB is projected to receive a net benefit of approximately $6,000,000 after accounting for depreciation in value of the tax credits claimed over seven years, approximately $1,600,000 in CDE fees, and $1,300,000 for closing and compliance monitoring costs. The net benefit to the City for participating in this type of financing is the $6,000,000 that would be generated to pay for the installation of PV system, a 10% contingency for both Phase II construction and installation of PVs, public art, and architectural services (Group 4), and Public Works soft costs.

Restructuring the City's Interest in the EIC and Assumption of Liabilities

The proposed financing structure requires the City to divest its ownership interest in the EIC project for a minimum period of seven years through the ground lease of the EIC with the QALICB, as described below. A municipal corporation is not eligible to be a QALICB. Moreover, the value of the project must be increased by the value of the ground lease in order to generate sufficient revenue from the sale of the tax credits after payment of expenses. For these reasons, the proposed transaction would require the City to restructure its interest in the EIC and to assume certain liabilities.

Ground Lease (City and QALICB)
The proposed financing would require the City to enter into a ground lease of the EIC with the QALICB for a term of 75 years. A QALICB with a long term ground lease is considered the owner for tax purposes. The ground lease of the EIC would assign the City's interest in the EIC, valued at approximately $12,000,000, and the right to develop the site to the QALICB. The $12,000,000 includes the value of the building and land acquisition, advanced storm water mitigation system, utility upgrades, LED streetlights, security fencing and gates, and expended design services. At the end of the seven-year compliance period, the QALICB would have the option to exercise the right to terminate. The QALICB cannot be compelled to terminate its interest in the ground lease for tax purposes. As consideration for the ground lease, the QALICB would pay the City an upfront capitalized lease payment of $12,000,000.

The City will borrow approximately $12,000,000 in the form of a one-day bridge loan as reimbursement for the acquisition and predevelopment costs that the City has incurred to date. Proceeds from the bridge loan will be combined with the City's new funds to make a leverage loan into the investment fund. The bridge loan increases the size of the QEI to generate additional tax credits. A leverage loan from the City will be combined with the tax credit equity to make the QEI into the CDEs. The QALICB will use the proceeds of the $12,000,000 one-day loan to purchase the leasehold security interest from the City. The City will then use the ground lease payment to repay the bridge loan. The cycling of the bridge loan proceeds typically occurs within a 24 hour period at the time of the transaction closing. There will be a fee associated with borrowing the $12,000,000 which has been incorporated into the development budget.

Leveraged Loan (City and Investment Fund)
The proposed financing would require the City to execute a loan agreement with the investment fund in the amount of approximately $23,500,000 to be secured by the investment fund's interest in the CDE. The loan becomes a debt of the investment fund, and the City would not have a direct security interest in the assets of the CDE (i.e. EIC project). The $23,500,000 loan from the City to the investment fund includes the $12,000,000 one-day loan and an additional $11,500,000 that will be appropriated for the EIC's construction. In making this loan, the City would be assuming the risk that the CDE could foreclose on the loan, and redeploy the funds to another qualified project. The limited circumstances that would require a redeployment of funds are discussed in greater detail below.

Master Lease (City and QALICB)
The City would enter into a master lease agreement with the QALICB so the City may operate the EIC after completion of construction. As a master tenant, the City would be required to make rent payments of approximately $260,000 per year as consideration for beneficial use of the facility. Beneficial use for each new year is required in multi-year leases to comply with the California debt limitation. The City proposes to satisfy this rent obligation through the revenue from subleases with the Habitat for Humanity's ReStore and the Clean Tech Demonstration Center and revenue from the use of the conference rooms and available space for solar demonstrations. In the event that the City is unable to generate sufficient revenue from these sources, the City would need to identify eligible funds to meet its rent obligation for that particular year so long as the City had beneficial use of the EIC. Special use funds may only be used in proportion to the benefit received by the program. Failure to meet the rent obligation could compromise the financing structure and trigger a redeployment of funds by the CDE. As discussed below, this rent payment would be returned to the City in the form of an interest payment.

Development Agreement (City and QALICB)
The City would enter into a development agreement with the QALICB to oversee the construction of the EIC. As consideration for assuming the responsibility for the development of the EIC, the City would have access to construction funds to complete Phase II construction, the installation of the PVs and car shelters, and may earn a developer fee payment to the City.

The QALICB would pay the City for the construction cost through its loans from the CDEs. The loans from the CDEs include both the NMTC equity investment after CDE fees, transaction related costs, and the $11,500,000 of available funds that the City loaned to the investment fund.

These funds will be held in a trust account on behalf of the QALICB to be released by a servicer upon a draw request from the City similar to the process required of private developers by banks on construction loans. Public Works staff, acting as the project manager, would need to compile a construction progress report, lien waiver, pay letter, certificate for payment and any other payments required by the CDE lenders—and submit them as a "draw request package" for the release of funds for payment. Once a package is signed by the authorizing QALICB board member and is submitted to the servicer of the account, the CDE and investor will be given a limited timeframe to review and approve the draw request. If the CDE and/or investor fails to respond within the agreed-upon period, the request package shall be deemed approved and payment will be disbursed from the QALICB's account.

The City as a developer would assume the liability for payment of construction costs to the extent that the draw request is delayed. A draw request may not be approved if it is for payment of unrelated cost to the project or a large discrepancy from the budget.. The City would need to identify eligible funds to pay the contractor should these events occur. As mentioned above, one option staff could consider is Commercial Paper as long as an appropriate source of funding is identified as well. However, the City can mitigate the risk of construction cost overrun by withholding approval of change orders and through use of the 10% contingency in the development budget. Further, the City's current contract administration practices in Public Work are set up to mitigate overpayment or paying for services outside the scope of the construction agreement.

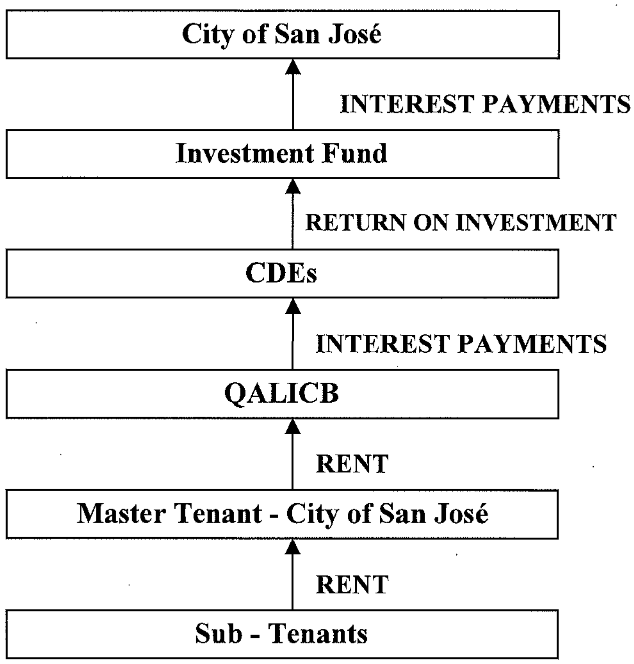
Guaranty Agreements
NMTC financing transactions generally involve private development, and the CDEs and investor require the project sponsor to provide guaranties to ensure that the project continues to qualify for tax credits, and the financing structure remains in place for the seven-year compliance period. Due to legal prohibitions on public agencies, the City cannot provide such guaranties, but may be able to agree to more limited obligations. Staff will not know until the parties begin negotiation whether the CDEs and investors will accept these terms.

1) The CDEs will seek a completion guaranty from the City to finish construction of the project including payment to the contractor for any cost overruns. The loans from the CDEs to the QALICB can only be used for approved construction related costs, compliance and closing costs. Since the funds for construction, including a 10% contingency, will be available at the close of the financing, the City could agree to use the development budget for its stated purposes. However, under the California constitution, cities are prohibited from assuming an obligation that is in excess of its current general fund revenue or is a current promise to pay from future general fund revenues. Specifically, the City could not agree to pay for the cost of construction beyond the available funding, or to rebuild the EIC in the event of a catastrophic event such as a fire or earthquake. If a catastrophic event occurred such as an earthquake destroying all or a portion of the facility, the loan agreement would need to address expectations as to any insurance proceeds recovered from the damaged building.

2) CDEs may seek a payment guaranty from the City to promise to pay debt service on the QLICI loan. Since the City as a master tenant would otherwise have an obligation to pay rent equivalent to the debt service, Kantor has advised that the investors may not require a payment guaranty.

The City's rent to the QALICB for the master lease, estimated to be $260,000 per year, would be used by the QALICB to pay debt service on its low interest QLICI loans. The interest rate on the QLICI loans will be substantially below market rate at approximately 1%. Payments would be interest only during the seven-year compliance period. The CDEs will then use these interest payments to provide the investment fund a return on its QEI. The investment fund must then use the $260,000 to make interest payments on the $23,500,000 loan from the City. The interest rate on the City's leverage loan will be approximately 1.0%. In short, the City has substantial control over the circumstances which would trigger a default by the QALICB since the rent payment would ultimately return to the City in the form of an interest payment, (See Figure 1 below for the flow of funds to pay for debt service, and Attachment for the source of funds to pay for construction of the EIC.)

Figure 1



The events that could cause a redeployment of funds will correspond to the events of default in the QLICI loan agreements with the CDEs. Any defaults that occur beyond a reasonable cure period could trigger default and foreclosure proceedings by the CDE lenders, which in turn, would require the CDEs to redeploy the funds into another qualified NMTC project. Events which would trigger a default under the QLICI loan agreements and potentially cause a redeployment of funds are:

- failure by the QALICB to pay interest payments in a timely manner (monetary default);
- failure by the QALICB to complete the construction of the project as proposed; and
- bankruptcy by the QALICB.

An occurrence of default and corresponding remedy actions, in and of themselves, will not cause a recapture of tax credits. For example, in the event of default, the CDEs may exercise the right to accelerate the payment on its loan made to the QALICB, initiate foreclosure proceedings, or assume the QALICB's role and complete the project. If the CDEs call their loans and force repayment, the QALICB must pay the outstanding loan amount in full. If the QALICB fails to do so, the CDE may exercise its foreclosure rights and sell the leasehold security interest in the EIC project to another party. Any repayments received by the CDEs, whether from the acceleration of debt or sale of the leasehold interest, must be redeployed into another QALICB and eligible project within 12 months of receiving those proceeds. If the CDEs succeed in doing so, a recapture of tax credits will be avoided. In the case of a foreclosure action, the EIC QALICB would lose its security interest in the project but the City would retain its ownership of the site. The City could also step in at any time to remedy an event of default or purchase the leasehold interest from the CDEs.

Because the City will be serving in every key capacity in the project—including as a leverage lender, property owner, developer and master tenant—the likelihood of an event of default and redeployment of funds occurring is extremely low. All the key activities and payment obligations that could lead to an event of default are within the City's control.

Indemnification Agreements
1) The investor may require the City to indemnify the investor in the event that the City causes the QALICB to trigger a recapture of the tax credits. As an indemnitor, the City could assume significant potential liability to the investor for the value of the tax credits purchased by the investor estimated at $12,400,000, and such additional funds as would make the investor "whole" for the any investor loss caused by the City's bad acts. The specific events that can cause tax credit recapture are: (1) the CDE ceases to be a qualified CDE; (2) the QEI made by the investor into the CDE is redeemed; or (3) substantially-all of the proceeds of the QEI are not invested as either a loan or equity in a QALICB. The first two events would not be triggered by the QALICB and accordingly would not create liability for the City to indemnify the investor.

The third recapture event occurs if less than 85% or "substantially-all" of the QEI remains invested as either debt or equity by the CDE in the QALICB throughout the seven year compliance period. Failure to meet the "substantially–all" requirement could only occur if the QALICB did not remain a qualifying business throughout the compliance period, or the CDE received a return of the investment prior to the end of the seven years.

If the QALICB failed to continue to meet NMTC requirements, this will not cause recapture provided that the financing parties had a reasonable expectation at the time of the NMTC transaction's close that the QALICB would satisfy these requirements throughout the seven-year investment period—essentially a safe harbor protection for unforeseen future occurrences unless caused by "bad acts" of the QALICB such as fraud or material misrepresentations.

The QALICB may also trigger recapture if it defaults on the QLICI loan agreements, and the CDE forecloses on the ground lease. Upon foreclosure to the extent the CDEs receive a return of any portion of their debt investment and if the CDEs do not deploy the returned funds into another qualifying project, the CDEs may be in noncompliance with the "substantially-all" requirement. However, in such occurrence, the CDEs would have 12 months to redeploy the proceeds into another qualified project. If the redeployment is unsuccessful, the CDEs and the QALICB may question which party bears responsibility (i.e. the CDE because it failed to reinvest or the QALICB because it defaulted on its loan).

2) The CDEs and the investor will seek an indemnification from the City to protect them from any claims arising out of environmental contamination on site. This is of low concern as staff anticipates that the City will have control over the use of the site. The City should, however, also include an indemnification clause in its subleases for potential environmental contamination caused by its tenants' activities. The subleases would also include limitations on the tenants' use and handling of hazardous materials.

Unwinding of the Financing Structure

Once all the tax credits have been claimed at the end of the seven-year compliance period, the CDEs and investor will likely desire to exit the transaction. The City can protect its interest in the EIC through a Put/Call Agreement with the investor. Pursuant to this agreement, the investor would have an option to "put" its interest in the investment fund up for sale at a nominal price that will be negotiated with the investor. The City could purchase this interest and become the owner of the investment fund which has the CDEs' interest in the EIC. By purchasing the "put", the City also assumes the investor's 99.9% interest in the CDE to which the City made its loan. In this position, the City then is both the lender and the borrower, and can effectively dissolve the financial structure.

Alternatively, if the investor does not exercise the "put", the City will have a right to "call" for the sale of the investor's interest at fair market value. Fair market value would be considerably more than the "put" price but is diminished by a variety of factors including, but not limited to, the outstanding loan from the City to the investment fund, and uncertainty of the EIC's future revenue stream. The City does assume a potential risk that their net benefit from the transaction of $6,000,000 will be diminished by the need to pay fair market value for the put. Moreover, since the City would have already expended the development funds, the City would need to identify additional funds before it can exercise the "call." Staff proposes to use late fees, and if necessary general fund to pay for the "call."

Term Sheet and Assumption of Cost for Failure to Close

Once the CDEs and investor are identified, the parties will begin negotiation on the terms of the transaction. While terms can be subject to change, and final approval by all parties, the term sheet does include certain nonnegotiable financial obligations. The most significant obligation is the CDEs and investor will require the City to assume any costs incurred during the negotiation process if the transaction fails to close. These costs include legal services, accounting services, environmental and other due diligence work required to close the transaction. This potential financial liability could be upwards of $400,000. Staff will seek to cap the potential exposure at $200,000, or will return to Council for authority to execute the term sheet if the exposure could exceed $200,000.

Time is of the Essence and Nonrefundable Initial Deposit

In order for the CDEs and investor to prepare a term sheet for the transaction, the City will be required to pay the CDEs, and investor $25,000 each for a total of $50,000 to retain legal counsel. The City Manager intends to execute a letter agreement to provide the CDEs and investor to remit the nonrefundable initial deposit so that the parties may begin negotiations on a term sheet for the transaction.

Staff is concerned that as the economy recovers the construction contractors' bids will increase with the market demand, and recommends proceeding with the proposed NMTC financing transaction as soon as possible to mitigate a potential increase in the cost of construction. Moreover, various equity and tax credit investor have expressed strong interest in the EIC, especially if the City is able to close its NMTC transaction by June 30, 2011. The CDEs are very interested in committing their tax credit allocations in a project by June 2011 to be competitive for the next round of allocations. The challenges to meeting this deadline include, but are not limited to, identifying CDEs with adequate tax credit allocation, investor or CDE delays, and the party's ability to resolve potential issues that may arise during the course of closing.

If the City is unable to close the NMTC transaction or needs more time to complete the transaction, staff is considering the use of Commercial Paper. Commercial Paper notes issued for the completion of the EIC could be repaid from a combination of the following revenues: AB939 Fees, utility rate payer funds, late fees, and other unrestricted funding sources in the Integrated Waste Management fund. Special use funds may only be used in proportion to the benefit received by the program.

EVALUATION AND FOLLOW-UP

Staff may return to the City Council for authority to execute the term sheet. Staff proposes to return to the City Council in June 2011 with a recommendation to approve in substantially final form the Investment Fund Loan Agreement, Ground Lease, Master Lease, Development Agreement, New Markets Tax Credit Indemnification, Completion Guaranty, Environmental Indemnification, Put/Call Agreement, ReStore Sublease Agreement, and authorize the City Manager, or other authorized designees, to execute and deliver these documents and other related documents as necessary in connection with the closing of the New Markets Tax Credit financing transaction.

PUBLIC OUTREACH/INTEREST

☐ **Criterion 1**: Requires Council action on the use of public funds equal to $1 million or greater.

☐ **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.

☐ **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.

This recommendation does not meet any of the criteria listed above. This memorandum will be posted on the City's Internet website for the May 17, 2011, Council Agenda.

COORDINATION

This memorandum has been coordinated with the Office of the City Attorney, Office of Economic Development, Finance Department, the Department of Public Works, and the Budget Office.

COST SUMMARY/IMPLICATIONS

Staff estimates that a deposit of $50,000 will be required to engage the investor and CDEs legal counsel. This deposit will be made from the Integrated Waste Management Fund's Non-personal Services Appropriation and offset by late fee, AB939 fee, and rate payer revenue. This deposit would be refunded to the Integrated Waste Management Fund when the NMTC transaction closes.

The term sheet may also require the City to assume the cost incurred by other parties during the negotiation process if the NMTC transaction fails to close. Staff would return to Council for authority to execute the term sheet if the additional cost exceeds $200,000. If needed, the difference between the deposit and the remaining closing costs would be paid from the Integrated Waste Management Fund's 2011-2012 non-personal services revenues and offset by late fees and other unrestricted revenues, AB939 Fees, and ratepayer funds.

CEQA

A CEQA Negative Declaration for the renovation of the EIC was adopted on December 1, 2009 (PP09-138).

/s/
JOHN STUFFLEBEAN
Director, Environmental Services

For questions please contact Jo Zientek, Deputy Director, Integrated Waste Management Division, at 408-535-8557.

Attachment: San Jose Environmental Innovation Center NMTC Leveraged Equity Structure

ATTACHMENT

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SAN JOSÉ ENVIRONMENTAL INNOVATION CENTER
NEW MARKETS TAX CREDITS LEVERAGED EQUITY STRUCTURE

INVESTMENT FUND LEVEL					
		int rate		annual int.	Loan Terms:
City Leverage Loan - New Funds	11,539,000	1.00%		115,390	1% Interest-only / 7-year term; annual payments.
City Leverage Loan - Previous Investment (One Day Loan)	12,000,000	1.00%		120,000	1% Interest-only / 7-year term; annual payments.
NMTC Investor Equity	9,100,000				
QUALIFIED EQUITY INVESTMENT (QEI)				**32,639,000**	
NMTCs generated (at 39% of QEI)			12,729,210		
CDE LEVEL					
CDE Fee Load	1,600,000				
QLICI (Loans to Project)				**31,039,000**	
QALICB LEVEL					Annual Payments / 30 yr term / 7 yrs I/O
		int rate		annual int.	
QLICI Loan A (Leverage Loan)	23,539,000	0.7660%		$180,316	
QLICI Loan B (NMTC Equity)	7,500,000	0.7660%		$57,452	
Total QLICIs	31,039,000			$237,768	

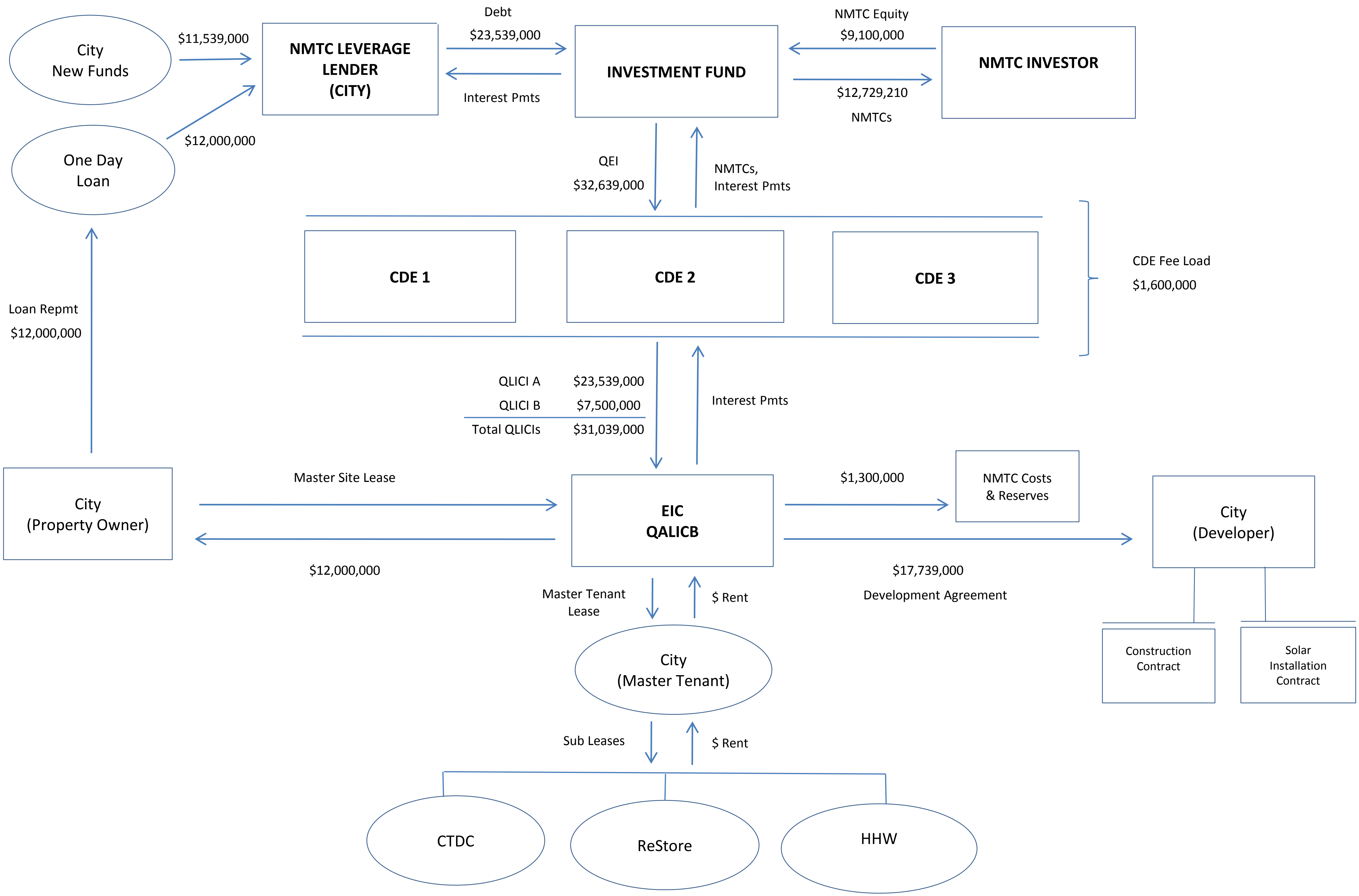
Investor Benefit Schedule	
Year	(Equity)/Credit
	(9,100,000)
1	1,615,631
2	1,615,631
3	1,615,631
4	1,938,757
5	1,938,757
6	1,938,757
7	1,938,757

Financing Gap Analysis		
Total QLICIs	31,000,000	
Total Development Cost	31,000,000	
Total Financing Surplus/(Gap)	**0**	
NMTC-Specific Transaction Expenses		
Estimated NMTC Legal / Accounting / Other Costs	200,000	
Estimated NMTC Capitalized Reserves	1,100,000	
Total NMTC-Specific Transaction Expenses	**1,300,000**	
Gross NMTC Equity (Upper Tier)	**9,100,000**	
Net-Net NMTC Equity @ Closing	**6,200,000**	19%
(including all NMTC-related costs)		

Prepared by National Development Council

ATTACHMENT

SAN JOSÉ ENVIRONMENTAL INNOVATION CENTER
NEW MARKETS TAX CREDITS LEVERAGED EQUITY STRUCTURE



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