COUNCIL AGENDA: 06-21-11
ITEM: 3.6

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson
Jennifer A. Maguire

SUBJECT: **CITY OF SAN JOSE 2011 TAX AND REVENUE ANTICIPATION NOTE**

DATE: June 7, 2011

Approved

Date 6/9/11

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

a. Adopt a resolution:

1. Authorizing the issuance and sale of the City of San José 2011 Tax and Revenue Anticipation Note ("2011 Note") in the not to exceed aggregate principal amount of $125,000,000 to be sold through a private placement; and

2. Approving, in substantially final form, the Note Purchase Agreement and authorizing the Director of Finance or other authorized officers to execute the Note Purchase Agreement and other related documents, as necessary, in connection with the issuance of the 2011 Note and authorizing other related actions in connection therewith.

b. Adopt a resolution authorizing the Director of Finance to negotiate and execute a third amendment to the agreement with Public Resources Advisory Group ("PRAG") serving as the City General Financial Advisor to increase the total not to exceed compensation amount authorized under the agreement from $350,000 to $450,000.

c. Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund for 2011-2012:

1. Increase the estimate for Other Revenue in the amount of $125,000,000;

2. Increase the estimate for Use of Money and Property in the amount of $50,000; and

3. Increase the City-wide appropriation to the Finance Department for TRANs Debt Service by the amount of $125,050,000

OUTCOME

Approval of the recommendations will result in the issuance and sale of the 2011 Tax and Revenue Anticipation Note ("2011 Note"). Based on historical General Fund cash balances and information contained within the *2011-2012 Proposed Operating Budget* the Note proceeds will provide necessary funds for cash flow purposes. In particular, this cash flow borrowing will facilitate the annual prefunding of employer retirement contributions for pension and retiree health benefits, which is anticipated to provide an estimated net benefit to the City of approximately $7.3 million of budgetary savings in the General Fund.

EXECUTIVE SUMMARY

Although General Fund expenditures are relatively level throughout the fiscal year, many General Fund revenue receipts are uneven with a significant portion of revenues received in the second half of the fiscal year. This timing mismatch results in General Fund net cash outflows for the first seven months of the fiscal year and large net cash inflows in the second half of the fiscal year.

If no further action is taken, this timing mismatch, in conjunction with the annual prefunding of employer retirement contributions and a declining General Fund beginning cash balance, is projected to temporarily cause the General Fund cash balance to be negative beginning in July 2011. Staff recommends issuing a short-term note for cash flow borrowing purposes, so that the City can continue to realize the net benefit of prefunding retirement contributions. These budgetary savings are estimated at $7.3 million for the General Fund in 2011-2012. Based on staff's preliminary cashflow analysis projections for 2011-2012, cash flow borrowing will also provide sufficient cashflow to maintain a positive General Fund cash balance throughout the fiscal year.

BACKGROUND

This section of the memorandum provides a discussion of historical General Fund cash flows and the City's past practice of prefunding employer retirement contributions.

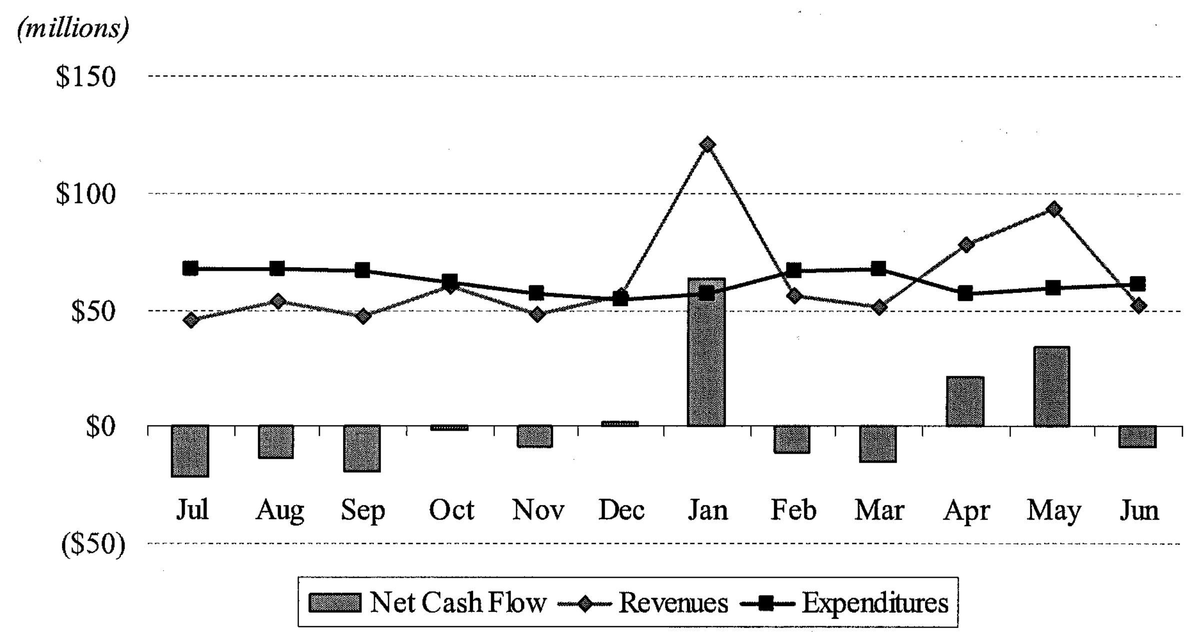
Historical General Fund Cash Flows

Several General Fund revenues are received in an uneven manner based on a predetermined schedule, seasonality, or other economic factors. For example, Property Tax Receipts, the largest General Fund revenue source, are received primarily in January, April, and May based on a schedule set forth by the Santa Clara County Controller-Treasurer's Office. Sales Tax Receipts are received on a monthly basis, but significant spikes in revenue occur in January and May when the Sales and Use Tax Compensation Fund allocations (the so-called "Triple Flip" true-up revenues) are distributed by the State.

In contrast, expenditures in the General Fund are relatively level throughout the fiscal year. This is largely the result of the Personal Services expenditures accounting for approximately two-thirds of General Fund expenditures. These expenditures occur biweekly through payroll disbursements. Months with somewhat higher expenditures occur when there are three payroll disbursements or large one-time transfers (such as debt service), but these months are infrequent and the expenditures are generally predictable based on historical patterns.

The result of this timing mismatch between revenues and expenditures is a net cash flow pattern with net cash outflows (payments for expenditures exceed General Fund revenue received) that occur in the first seven months of the fiscal year and large net cash inflows (General Fund revenues received exceed the amount of General Fund expenditure payments) in January, April, and May. The following chart illustrates this pattern based on average historical data for 2005-2006 through 2007-2008. It should be noted that during this three-year period the City's contributions for pension and retiree health occurred biweekly in conjunction with payroll. This period provides the most recent historical cash flow with biweekly contributions. The first prefunding of retirement contributions occurred in 2008-2009, as described in the section below, and continued thereafter. Prefunding retirement contributions impacts net cash flow by taking what would otherwise be a level expenditure throughout the fiscal year and front loads the expenditure in a single cash outflow at the beginning of the fiscal year. This single disbursement accentuates the timing mismatch between when revenues are received and when expenditures occur.

Historical Monthly General Fund Cash Flows
3-Year Average of 2005-2006 through 2007-2008
(Based on bi-weekly City retirement contribution)



Prefunding of Employer Retirement Contributions

During the development of the *General Fund Structural Deficit Elimination Plan* in 2008, a set of strategies was presented by a team of City staff to the Stakeholder Group. One of the strategies approved by the City Council on May 16, 2008 was to "utilize financial strategies that have positive net present value," which included annually prefunding the City's portion of retirement contributions.

Prior to 2008-2009, the Federated City Employees' Retirement System and the Police and Fire Retirement Plan (collectively, the "Retirement Plans") had not offered a discount to the City for prefunding employer retirement contributions. Other public retirement systems, such as California Public Employees' Retirement System (CalPERS) and the Los Angeles City Employees' Retirement System (LACERS), have established policies permitting prefunding of employer retirement contributions at a discount. Prepayment strategies provide budgetary savings to the plan sponsor (the City) and provide greater access to capital for investment by the Retirement Plans. Prefunding contributions was not an option prior to 2008-2009, so the City made biweekly contributions to the Retirement Plans in conjunction with each payroll distribution. These biweekly contributions were calculated based on actual payroll amounts and the contribution rate approved by the Retirement Plan Boards based on biennial actuarial studies.

As outlined in the *Mayor's March Budget Message for Fiscal Year 2008-2009*, direction was given to the City Manager to "analyze the most cost effective prepayment strategy and report back to the City Council." A recommendation was made by the City Manager for annual prepayments by the City for the employer retirement contribution to the Retirement Plans. In April 2008, the Retirement Plan Boards each directed its respective actuary to provide an analysis of the application of a discount rate to the estimate of the total annual employer contribution if the City chose to prepay its employer retirement contributions.

Based upon the direction in the *Mayor's March Budget Message for Fiscal Year 2008-2009*, the *2008-2009 Proposed Operating Budget* included a proposal to recognize ongoing savings that would result from the prepayment of employer retirement contributions for the Retirement Plans. On June 17, 2008 the City Council approved changes to the San José Municipal Code and on August 1, 2008, the City made its first prefunding of employer retirement contributions, which included only pension contributions. In 2009-2010 the City again prefunded employer retirement contributions, but included contributions for both pension as well as retiree health benefits. A $75 million cash flow borrowing was necessary in 2010-2011 because there was an insufficient cash balance to make the payment for the prefunding without causing a negative cash balance in the General Fund's portion of the City's Investment Pool.

For 2011-2012, this will be the fourth fiscal year for which the City has prefunded employer retirement contributions including retiree health.

ANALYSIS

This section of the memorandum addresses staff's recommendation to proceed with the issuance of the 2011 Note. The subsections include discussion of the projected General Fund budgetary savings from prefunding retirement contributions, General Fund cash balances and cash flow, plan of finance, note financing documents, financing team participants, and financing schedule.

Projected General Fund Budgetary Savings from Prefunding Retirement Contributions

Based on input from the City Manager's Budget Office and the Retirement Services Department, the estimated discount (savings) is $7.3 million in the General Fund for prefunding contributions to the Retirement Plans. The City Manager's *2011-2012 Proposed Operating Budget* assumes prefunding of the annual required contributions to the Plans as a General Fund budget balancing strategy.

General Fund Cash Balances and Cash Flow

To analyze the impact of the annual prefunding of employer retirement contributions on the General Fund's cash position, Finance staff prepared a preliminary projection of General Fund cash flows for 2011-2012. Based on this projection, staff determined that after the payment for the prefunding is made in July 2011 the General Fund cash balance will become negative. If no other action is taken, the cash balance is projected to remain negative through the first half of 2011-2012 as a result of the net cash flow pattern described above.

To ensure that the General Fund cash balance remains positive throughout 2011-2012 and to provide sufficient liquidity for the prefunding payment in July 2011, staff has prepared a short-term financing plan for an amount up to $125 million for the City Council's consideration. This short-term financing plan will enable the City to borrow funds, and still achieve the General Fund budgetary savings associated with prefunding employer retirement contributions.

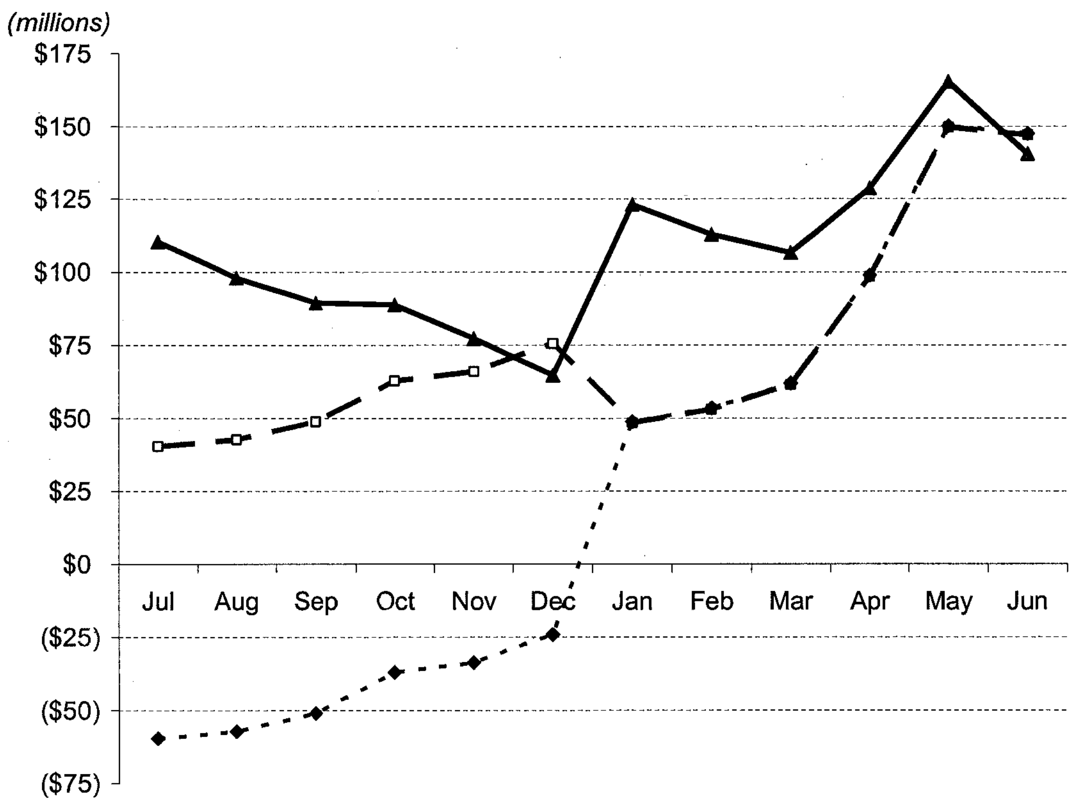
As illustrated in the chart on the following page, staff's cash flow modeling projects that a General Fund cash flow borrowing would not be necessary if the City opted to make retirement contributions on a biweekly basis; however, the trade-off is that the General Fund will not achieve the savings associated with the prefunding. Therefore, in the "no prefunding and no cash flow borrowing" scenario (scenario 3), the ending General Fund cash balance is projected to be $7.3 million lower when compared with the scenario that incorporates the annual prefunding and cash flow borrowing (scenario 2).

The following graph provides a visual representation of projected 2011-2012 General Fund cash balances under three alternative scenarios using staff's estimate of the discount for prefunding retirement contributions:

1) annual prefunding **without** a cash flow borrowing;
2) annual prefunding **with** a cash flow borrowing; and
3) biweekly retirement contributions (**no** prefunding and **no** cash flow borrowing).

These projections are based on staff's estimates of the prefunding discount factor and annual prepayment requirement. The actual prefunding discount rates and annual pre-payment amounts will be determined by the Retirement Plans' actuaries, which may differ from staff's projections.

Projected 2011-2012 General Fund Monthly Cash Balances



Scenario	Chart Symbol	Annual Prefunding Included?	Cash Flow Borrowing Included?	Lowest Cash Balance (*millions*)	Ending Cash Balance (*millions*)
1	- - ◆ - -	Yes	No	(59.6)	147.5
2	—□—	Yes	Yes	40.4	147.1
3	—▲—	No	No	64.7	140.2

Plan of Finance

This section of the memorandum includes a discussion of the private placement process and a description of the 2011 Note.

Private Placement Process

In anticipation of this short-term borrowing, the Finance Department selected JPMorgan Chase Bank, N.A. ("JPMorgan") as the private placement purchaser for the proposed 2011 Note because JPMorgan provided the City with a favorable anticipated borrowing cost and agreed to renew terms and conditions in substantially the same form as the prior year. In a private placement, the City agrees to sell directly to JPMorgan the 2011 Notes. No public offering document is prepared; JPMorgan cannot trade publicly the 2011 Notes and no rating is solicited for the Notes.

Description of the 2011 Note

The 2011 Note is structured such that JPMorgan will purchase up to $125 million in principal amount of the Note. An Initial Note Portion of $100 million is currently anticipated to be purchased by JPMorgan on the closing date of the financing, currently scheduled for July 1, 2011. At the City's discretion, additional borrowings as needed for cash flow purposes may occur at any time up to December 31, 2011 and up to the Unutilized Commitment amount of $25 million. If the City does not draw at least $93.75 million at closing, the City will be required to pay an Unutilized Fee of 15 basis points (0.15%) per annum on the Unutilized Commitment amount. To access the additional funds, the City is required to provide a purchase notice to JPMorgan no less than five business days preceding the purchase date and the additional borrowing is required to have a minimum denomination of $5 million with integral multiples of $1 million in excess thereof. The Unutilized Commitment is decreased with each purchase by JPMorgan, is not reinstated upon repayment of the 2011 Note, in whole or in part, and if the Unutilized Commitment is not used by December 31, 2011, it will no longer be available.

Note portions will bear interest at a variable rate. The rate is based on the LIBOR rate comparable to the interest period selected by the City plus a margin of 0.40%. The 1-month LIBOR rate as of the date of this memorandum is 0.20% and is currently projected to increase to 0.75% over the period that the 2011 Note is outstanding. At the end of each interest period, the City may select a different interest period or, if no notice is provided by the City to JPMorgan, the interest period will be one month. Different interest periods may be selected for each Note Portion. Staff projects interest expense on the 2011 Note to total $650,000. A total of $600,000 of the debt service interest component will be recommended to the City Council for appropriation from savings identified elsewhere in the budget as part of the 2010-2011 Budget Cleanups memorandum that is scheduled for City Council consideration elsewhere on this agenda and as part of 2011-2012 Rebudget actions (MBA #47). Costs associated with the financing will be paid from note proceeds at the closing.

However, since the note proceeds will be invested in the City's Investment Pool, the interest earnings from the note proceeds ($50,000) are projected to offset a portion of the interest expenses related to the 2011 Note.

Security for repayment of the 2011 Note is a pledge of the City's 2011-2012 secured property tax revenues (excluding property taxes levied for general obligation bonds) and sales tax revenues received during 2011-2012 plus all other legally available General Fund revenues of the City, if required. The City shall either pay outstanding principal or make deposits into the Repayment Account according to the following schedule:

Month	Percent
February 1, 2012	20%
May 1, 2012	50%
June 1, 2012	100%

The estimated sources and uses of funds for the 2011 Note are as follows:

City of San José
2011 Tax and Revenue Anticipation Note
Estimated Sources and Uses of Funds [1]

Sources of Funds:	
Note Proceeds	$ 125,000,000
Total Sources of Funds	$ 125,000,000
Uses of Funds:	
Deposit to General Fund for Cash Flow Needs	$ 124,900,000
Cost of Issuance [2]	100,000
Total Uses of Funds	$ 125,000,000

(1) Preliminary; subject to change.
(2) Estimated fees and expenses of bond counsel, bank counsel, and various other costs of issuance.

The final maturity for the 2011 Note is June 30, 2012; however, staff anticipates that repayment of the 2011 Note will begin in January 2012 after the first half of secured property tax revenues is received from the County Controller-Treasurer and General Fund cash balances begin to rise. The City is entitled to prepay any Note Portion, without premium or penalty, in whole or in part on the last day of the applicable Interest Period upon at least five business days notice to JPMorgan. If the City elects to repay a Note Portion on a date other than the last day of an Interest Period, then a breakage fee may apply. The breakage fee may include all reasonable losses, expenses and liabilities which JP Morgan may sustain related to the breakage.

Note Financing Documents

To proceed with the issuance of the 2011 Note, the City Council must adopt the resolution described below. As referenced in the proposed resolution, staff recommends that the Director of Finance or the Assistant Director of Finance be authorized to execute and deliver the 2011 Note and that the Director of Finance, the Assistant Director of Finance or their authorized designees be authorized to enter into and deliver the Note Purchase Agreement and the Side Letter also described below. These documents, in substantially final form, will be available for review on the City Clerk's website on or about June 9, 2011.

Resolution

The City Council's resolution (the "Resolution") sets forth the terms for issuance and sale of the 2011 Note in accordance with the provisions of California Government Code Sections 53850 to 53858, which govern short-term cash flow borrowings by California public entities. Specifically, the Resolution provides for the issuance of the 2011 Note in an amount not to exceed $125million, the form of the 2011 Note, the maximum interest rate of 10% per annum,[1] and the sale of the 2011 Note to JPMorgan pursuant to the Note Purchase Agreement described below.

Note Purchase Agreement

This agreement (the "Purchase Agreement") is between the City and JPMorgan. The Purchase Agreement sets forth the requirements of JPMorgan to purchase the 2011 Note and portions thereof, establishes the interest rate mechanism, establishes the terms and method of repayment, contains certain representations and warranties of the City and JPMorgan, and specifies the conditions to JPMorgan entering into the Purchase Agreement.

Consistent with other agreements that the City has entered into with various banks, the Purchase Agreement provides that both parties waive their respective right to a jury trial in the event of a dispute. Additionally, the City waives any right to consequential damages in the event of JPMorgan's breach and the City agrees, to the extent permitted by law, to indemnify and defend JPMorgan against all liabilities arising out of the Note Purchase Agreement, except for liability arising from JPMorgan's gross negligence or willful misconduct.

Side Letter Agreement

As is customary in the LIBOR market, JPMorgan will enter into arrangements with other financial institutions to provide funding to the City two days prior to the execution of the Note Purchase Agreement and the issuance and sale of the 2011 Note. The Side Letter Agreement sets forth a requirement that the City compensate JPMorgan for all reasonable

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[1] Please see "Plan of Finance - *Description of the 2011 Note*" regarding interest rate terms and current rates in effect based on interest rates set in the LIBOR market.

losses, expenses, and liabilities that may apply if the City chooses not to issue the 2011 Note after JPMorgan has entered into these arrangements.

Finance Team Participants

The financing team participants consist of:

• City's Financial Advisor:	Public Resources Advisory Group
• Bond Counsel:	Hawkins Delafield & Wood LLP
• Note Purchaser:	JPMorgan Chase Bank, N.A.
• Bank Counsel:	Nixon Peabody LLP

Public Resources Advisory Group was selected as the Financial Advisor from the City Council approved Financial Advisory Pool.[2] Hawkins Delafield & Wood LLP was selected as the Bond Counsel through a competitive process. JPMorgan was selected to be the Note Purchaser as described above.

Financing Schedule

The current proposed schedule is as follows:

• City Council approval of 2011 Note financing documents:	June 21, 2011
• 2011 Note closing:	July 1, 2011

Amendment to Public Resources Advisory Group Agreement

In February 2007, the City Council approved a multi-year agreement with Public Resources Advisory Group ("PRAG") to serve as the City's General Financial Advisor. The agreement with PRAG included an initial term through June 30, 2010 and two option years for 2010-2011 and 2011-2012. The City exercised its option to extend for 2010-2011 and intends to exercise the option in 2011-2012. In October 2010, the PRAG agreement was increased from $250,000 to $350,000 to cover the costs associated with letter of credit renewals related to the City's variable rate debt.

PRAG has provided valuable analysis as the City navigated the financial market crisis, a level and scope of services which was not contemplated or predicted when the Agreement was executed in 2007. During the remainder of 2010-2011 and into 2011-2012, staff will continue work on a number of projects which commenced in 2010-2011 that require PRAG's ongoing services. Under the current agreement, the amount to be paid to PRAG during each fiscal year is subject to appropriation of funds by the City Council. The total amount payable under the current agreement is not to exceed $350,000; however, due to ongoing projects to-date, the

[2] Per the Financial Advisory Services Agreements and Pool Assignments approved by City Council on February 27, 2007 (Item No. 3.6).

current contract amount of $350,000 has been almost fully expended as of June 2011 with a remaining balance of approximately $50,000. Staff is requesting that the not to exceed contract authorization be increased by $100,000 to $450,000 to fund projects underway and other future projects through 2011-2012. These projects include, but are not limited to, rating agency presentations, potential revenue securitization, tax revenue anticipation notes, pavement maintenance funding option analyses, one-time money debt defeasance analyses, economic refunding analysis, and renewable energy efficiency financing projects. Compensation is based on time and materials under the Agreement.

EVALUATION AND FOLLOW-UP

This memorandum presents the set of recommendations related to the City Council's approval of the issuance of the 2011 Note and requires no follow-up to the City Council.

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 was prepared by the Finance Department in coordination with the City Attorney's Office and the financing team participants.

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 financing will be paid from note proceeds. Bond counsel is paid on a contingency basis from the note proceeds and the City's financial advisor work is on a time and materials basis and is paid through an existing agreement managed by the Finance Department.

As aforementioned, the 2011 Note bears interest at a variable rate.[3] The recommended amount for the debt service appropriation is based on information available to staff as of the date of this memorandum. If the debt service appropriation needs to be increased to fully repay all principal of and interest due on the 2011 Note, then staff will make the appropriate recommendation in conjunction with the *2011-2012 Mid-Year Budget Review*. The source of funding for any necessary increase in the debt service appropriation would be the Retirement Pre-Payment Reserve or another funding source identified at that time.

A total of $600,000 of the $650,000 debt service interest component will be recommended to the City Council for appropriation from savings identified elsewhere in the budget as part of the 2010-2011 Budget Cleanups memorandum that is scheduled for City Council consideration elsewhere on this agenda and as part of 2011-2012 Rebudget actions (MBA #47). Since the note proceeds will be invested in the City's Investment Pool, the interest earnings from the note proceeds ($50,000) are projected to offset a portion of the interest expenses related to the 2011 Note.

Staff is requesting that the not to exceed contract authorization for the PRAG agreement be increased by $100,000 to $450,000 to fund projects underway and other future projects through 2011-2012. These projects include, but are not limited to, rating agency presentations, potential revenue securitization, tax revenue anticipation notes, pavement maintenance funding option analyses, one-time money debt defeasance analyses, economic refunding analysis, and renewable energy efficiency financing projects. Compensation is based on time and materials under the Agreement, and will be paid from the Finance Department Non-Personal/Equipment appropriation.

[3] Please see "Plan of Finance - *Description of the 2011 Note*" regarding interest rate terms and current rates in effect based on interest rates set in the LIBOR market.

BUDGET REFERENCE

The table below identifies the fund and appropriations proposed to fund the contract recommended as part of this memorandum.

Fund #	Appn #	Appn. Name	Total Appn.	Amt. for Contract	2011-2012 Proposed Operating Budget Page[1]	Last Budget Action (Date, Ord. No.)
001	0492	Finance Non-Personal/Equipment	1,060,232	100,000[2]	VIII - 120	NA
TOTAL FUNDING AVAILABLE			**$ 1,060,232**	**$ 100,000**		

(1) The 2011-2012 Proposed Budget is scheduled for adoption by the City Council on June 14, 2011.
(2) Services may be charged to various funding sources depending on the scope of services and project undertaken.

CEQA

CEQA: Not a project, PP10-069, City organizational and administrative activities.

/s/

SCOTT P. JOHNSON
Finance Director

Jennifer A. Maguire

JENNIFER A. MAGUIRE
Budget Director

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

I hereby certify that there will be available for appropriation in the General Fund in the 2011-2012, monies in excess of those heretofore appropriated there from, said excess being at least $125,050,000.

Jennifer A. Maguire

JENNIFER A. MAGUIRE
Budget Director