COUNCIL AGENDA: 06-19-12
ITEM: 3.5

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Julia H. Cooper
Jennifer A. Maguire

SUBJECT: **CITY OF SAN JOSE 2012 TAX AND REVENUE ANTICIPATION NOTES**

DATE: June 1, 2012

Approved [signature] Date 6/5/12

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

a. Adopt a resolution:

1. Authorizing the issuance and sale of the City of San José 2012 Tax and Revenue Anticipation Notes ("2012 Notes") 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 Acting 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 2012 Notes and authorizing other related actions in connection therewith.

b. Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund for 2012-2013:

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

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

OUTCOME

Approval of the recommendations will result in the issuance and sale of one or more 2012 Tax and Revenue Anticipation Notes ("2012 Notes"). Based on historical cash balances, specifically those balances in the General Fund, and information contained within the *2012-2013 Proposed Operating Budget* (the "Proposed Budget"), the proceeds of these notes 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 across all funds, which is anticipated to provide an estimated net benefit to the City of approximately $5.5 million in the General Fund and $5.5 million in all funds based on the 2012-2013 Proposed Budget, offset by the estimated cost of note issuance, loss of interest earnings, and debt service costs.

BACKGROUND

During the development of the *General Fund Structural Deficit Elimination Plan* in 2008, a set of strategies was developed. 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. As a result, 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.

The *2008-2009 Proposed Operating Budget* included a proposal to recognize ongoing budgetary 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.

To prefund this contribution, a $75 million tax and revenue anticipation note borrowing in 2010-2011 and a $100 million borrowing in 2011-2012 were necessary because there were insufficient funds on a cash flow basis to make the payment without causing a negative cash balance in the General Fund's portion of the City's Investment Pool. It should be noted that the recommended prefunding of the City's retirement contributions and the issuance of the tax and revenue anticipation notes ("TRANs") is evaluated on an annual basis. Since its inception, it has been determined that prefunding continues to provide significant budgetary savings each year to the City. In addition, the City's retirement actuary, Cheiron, solidified the efficacy of prefunding and the possible benefits it provides for the retirement plans in its October 2011 response to the Impact Analysis of Prefunding to the San Jose Federated Retirement Board and OPEB Plans.

ANALYSIS

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 and June 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 April 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 General Fund revenues and expenditures is large net cash outflows (expenditures exceed revenue received) in the first seven months of the fiscal year and large net cash inflows (revenues received exceed the amount of expenditures) in January, April, and June. To analyze the impact on the General Fund's cash position of the annual prefunding of employer retirement contributions, Finance staff prepared a projection of General Fund cash flows for 2012-2013. Based on this projection, after the payment for the prefunding is made in July 2012, the General Fund cash balance will be negative and would remain negative through the first half of 2012-2013. To avoid a negative cash balance, staff recommends the issuance of the 2012 Notes.

The estimated discount (savings) is $6.9 million in the General Fund and $9.1 million in all funds for prefunding contributions to the Retirement Plans based on amounts included in the 2012-2013 Proposed Budget, offset by the estimated cost of note issuance, loss of interest earnings, and debt service costs ($1.4 million) resulting in a net savings of $5.5 million in the General Fund and $7.7 million in all funds. The 2012-2013 Proposed Budget assumes prefunding of the annual required contributions to the Plans as a General Fund budget strategy.

Plan of Finance

In anticipation of this short-term borrowing, the City, through a competitive process, solicited qualified financial institutions to serve as private place purchaser for the proposed 2012 Notes. The City received seven responses from which U.S. Bank, N.A. (the "Bank") was selected. The Bank was selected because it provided the City with a favorable anticipated borrowing cost and agreed to terms and conditions in substantially the same form as the prior year issuance. In a private placement, the City agrees to sell directly to the Bank the 2012 Notes. No public offering document is prepared; the Bank cannot trade publicly the 2012 Notes and no rating is solicited for the Notes.

Description of the 2012 Notes

This transaction is structured such that the Bank will purchase up to $125 million in principal amount. An initial Note in the amount of $100 million ("Initial Note") is currently anticipated to be purchased by the Bank on the closing date of the financing, currently scheduled for July 2, 2012. At the City's discretion, additional borrowings as needed for cash flow purposes may occur at any time up to December 31, 2012 and up to the Unutilized Commitment amount of $25 million which will be secured by a separate Note ("Subsequent Note") in an amount up to $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 the Bank 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 the Bank, it is not reinstated upon repayment of the 2012 Note in whole or in part, and if the Unutilized Commitment is not used by December 31, 2012, it will no longer be available.

The Initial Note (anticipated to be $100 million) will bear interest at a fixed rate determined on the date of closing. The rate is based on the 8-month LIBOR rate plus a margin of 0.10% for Bank fees. The 8-month LIBOR rate as of June 1, 2012 was 0.855%.

Any amounts drawn and secured by the Subsequent Note will bear interest at a variable rate based on 30-day LIBOR rate plus a margin of 0.25% for Bank fees. The 1-month LIBOR rate as of June 1, 2012 was 0.240%. At the end of each interest period, the City may select a different interest period for the amount secured by the Subsequent Note or, if no notice is provided by the City to the Bank, the interest period will be one month. As discussed above, an initial note of $100 million is anticipated to be issued with a projected interest expense estimated at $850,000 as well as costs associated with the financing of approximately $100,000. Included in the Proposed Budget is $800,000 for these expenses. In addition, a recommended rebudget of $150,000 is included in the Recommended Amendments to the 2012-2013 Proposed Budget Manager's Budget Addendum (MBA) that the City Council will consider as part of the 2012-2013 Mayor's June Budget message on June 12, 2012. This rebudget is recommended in order to provide funding for increases in interest rates from those used in the initial cost calculation and the addition of other financing costs. It should be noted that in order to provide funding for the rebudget, a recommended clean-up action is included elsewhere on this agenda in the 2011-2012 Year End Clean-up memorandum that will be considered by the City Council. Should the full $125 million be drawn upon in Subsequent Notes, additional interest costs will be incurred at the variable rate outlined above and may require funding for additional debt service costs to be allocated during 2012-2013.

Security for repayment of the 2012 Notes is a pledge of the City's 2012-2013 secured property tax revenues (excluding property taxes levied for general obligation bonds) and sales tax revenues received during 2012-2013 plus all other legally available General Fund revenues of the City, if required. The final maturity for the fixed rate portion of the 2012 Notes is February 14, 2013 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 final maturity of any subsequent variable rate draws will have a final maturity of June 28, 2013. For any subsequent variable draws, the City shall either pay outstanding principal or make deposits into the Repayment Account according to the following schedule:

Date	Percent
February 1, 2013	20%
May 1, 2013	50%
June 1, 2013	100%

The estimated sources and uses of funds for the 2012 Notes are as follows:

City of San José
2012 Tax and Revenue Anticipation Notes
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	$ 125,000,000
Debt Service/Cost of Issuance (2)	950,000
Total Uses of Funds	$ 125,950,000

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

Note Purchase Agreement

To proceed with the issuance of the 2012 Notes, the City Council must adopt the resolution described below. As referenced in the proposed resolution, staff recommends that the Acting Director of Finance or the Acting Assistant Director of Finance be authorized to execute and deliver the 2012 Notes and that the Acting Director of Finance, the Acting Assistant Director of Finance or their authorized designees be authorized to enter into and deliver the Note Purchase Agreement also described below. These documents, in substantially final form, will be available for review on the City Clerk's website on or about June 7, 2012.

This agreement (the "Purchase Agreement") is between the City and U.S. Bank, N.A. The Purchase Agreement sets forth the requirements of the Bank to purchase the 2012 Notes and portions thereof, establishes the interest rate mechanism, establishes the terms and method of repayment, contains certain representations and warranties of the City and the Bank, and specifies the conditions to the Bank 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 the Bank's breach and the City agrees, to the extent permitted by law, to indemnify and defend the Bank against all liabilities arising out of the Note Purchase Agreement, except for liability arising from the Bank's gross negligence or willful misconduct.

Finance Team Participants

The financing team participants consist of:

- City's Financial Advisor: Public Resources Advisory Group
- Bond Counsel: Hawkins Delafield & Wood LLP
- 2012 Notes Purchaser: U.S. 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.[1] Hawkins Delafield & Wood LLP was selected as the Bond Counsel through a competitive process. U.S. Bank, N.A. was selected to be the 2012 Notes Purchaser through the competitive process as described above.

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

Financing Schedule

The current proposed schedule is as follows:

- City Council approval of 2012 Notes financing documents: June 19, 2012
- 2012 Notes closing: July 2, 2012

EVALUATION AND FOLLOW-UP

This memorandum presents the set of recommendations related to the City Council's approval of the issuance of the 2012 Notes 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)**

This memorandum will be posted on the City's website for the June 19, 2012 City Council meeting.

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.

Debt service and costs of issuance are conservatively estimated at $950,000 for a $100 million draw reflecting costs for debt service interest, bond counsel, bank counsel, financial advisor, and various other costs of issuance though costs could increase as high as $1.3 million should a Subsequent Note be issued to draw additional funding. Included in the Proposed Budget is $800,000 for these expenses. In addition, a recommended rebudget of $150,000 is included in the Recommended Amendments to the 2012-2013 Proposed Budget Manager's Budget Addendum (MBA) that the City Council will consider as part of the 2012-2013 Mayor's June Budget message on June 12, 2012. This rebudget is recommended in order to provide funding for increases in interest rates from those used in the initial cost calculation and the addition of other financing costs. It should be noted that in order to provide funding for the rebudget, a recommended clean-up action is included elsewhere on this agenda in the 2011-2012 Year End Clean-up memorandum that will be considered by the City Council. Should the full $125 million be drawn upon in Subsequent Notes, additional interest costs will be incurred at the variable rate and may require funding for additional funding for the additional debt service costs to be allocated during fiscal year 2012-2013.

The debt service and cost of issuance is offset with gross budgetary savings of $6.9 million in the General Fund and $9.1 million all funds due to the prepayment of the annual required contribution to the Retirement Plans, offset by approximately $1.4 million in cost of note issuance, loss of interest earnings, and debt service costs, resulting in a net General Fund savings of $5.5 million and a net all funds savings of $7.7 million. As the issuance of the TRANs ensures sufficient cash balances to pre-fund the City's retirement contributions across all funds, costs associated with this issuance will be apportioned as appropriate at a future date.

CEQA

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

JULIA H. COOPER
Acting Finance Director

JENNIFER A. MAGUIRE
Budget Director

For questions please contact Julia H. Cooper, Acting Director of Finance, at (408) 535-7011.

I hereby certify that there will be available for appropriation in the General Fund in the 2012-2013, monies in excess of those heretofore appropriated there from, said excess being at least $125,000,000.

JENNIFER A. MAGUIRE
Budget Director