



# AGENDA ITEM 7a

## STAFF REPORT

TYPE MEETING:	Regular Board Meeting	MEETING DATE:	March 3, 2010
SUBMITTED BY:	<i>JRB</i> Joseph R. Beachem, Chief Financial Officer	W.O./G.F. NO:	DIV. NO. All
APPROVED BY: (Chief)	<i>JRB FOR G.A.</i>		
APPROVED BY: (Asst. GM):	German Alvarez, Assistant General Manager, Administration and Finance		
SUBJECT:	Information Concerning Long-Term Debt Financing		

### GENERAL MANAGER'S RECOMMENDATION:

This is an informational item only.

### COMMITTEE ACTION: \_\_\_\_\_

Please see Attachment A.

### PURPOSE:

To inform the Board of the details related to the proposed debt issuance to finance the District's capital infrastructure.

### ANALYSIS:

This staff report will review why this debt issuance is recommended at this time, for this amount, how it differs from prior bond issuances, and what actions are required by the Otay Board and the Otay Water District Financing Authority's governing board.

Staff recommends the issuance of debt to finance approximately \$47 million of the capital projects, allocated as follows:

- \$24,000,000 in Expansion Projects
- \$22,000,000 in Betterment Projects
- \$1,000,000 in Replacement Projects

After additional borrowing to cover \$550,000 of estimated issuance costs and the \$3,750,000 funding of a reserve, the total issuance is expected to be approximately \$51.3 million.

### Timing of the Debt Issuance

The last debt issuance was in 2007 and was expected to fund two years of the Capital Improvement Program (CIP). Due to the economic slowdown, this debt issuance has been moved out by one year. At the May 2009 budget workshop, where the Board approved the 2010 budget, staff highlighted the need for a debt issuance in Fiscal Year 2010. Staff had targeted an issuance around March of 2010. Staff has reconfirmed, using the latest information available, the need to issue additional debt as the District's reserve balances are expected to drop below the reserve fund target levels by year-end absent the borrowing. The proposed debt issuance will replenish the District's reserves and fund the capital projects for an expected two to three years before the District will again approach the reserve target levels.

### Build America Bonds

Due to the availability of the special financing structure "Build America Bonds" (BABs), authorized by the American Recovery and Reinvestment Act, financing costs can be locked in today at a low cost to the District. The lower overall financing cost of the BABs results from a federal government reimbursement to issuers of 35% of interest costs over the life of the issue. Currently, that brings the cost of issuing long-term BABs bonds approximately 50 basis points below comparable term tax-exempt bonds on the longer maturities. The special financing structure is currently only available to issuers until December 31, 2010. While President Obama has recommended making these provisions permanent in his 2011 budget proposal, the benefit as compared to the regular tax-exempt bonds is expected to be eliminated.

As described below, staff expects the District will benefit from issuing a portion of the debt as BABs.

### Capital Improvement Funding

The latest refinement of the proposed Capital Improvement Program has a total three-year CIP of \$107.9 million. In 2011 through 2013 approximately \$26M is anticipated to be funded from water rates and \$30M from grants, capacity and other restricted fees. This is approximately 52% of the necessary funding over the next three years leaving approximately \$51.9M to be funded through debt or increased water revenues. This would result in a debt issuance of approximately \$57M after taking into account

costs and debt reserve funding. This amount of debt, as discussed below can not be supported currently and also meet the other financial objectives of the District.

#### Amount of the Debt Issuance

In May of 2009, at the budget workshop, the projected amount of the debt issuance was \$41 million. Over the past year, staff has revised the rate model multiple times as updated or new information became available. Using the current version of the District's rate model, staff is presented with a range of options for debt financing.

At the higher end, the debt issuance is sized at approximately \$57 million to cover all capital facilities over the next three years, as well as costs and the funding of a debt reserve. At the lower end of possible debt issuances is an issue of approximately \$36.1 million to cover only two years of capital infrastructure needs. A smaller debt issuance would cause unnecessary issuance costs resulting from back-to-back debt issuances.

There are a number of factors in determining the recommended option among this range of sizing options. In the general sense, the preferred option is to select the amount of debt that best meets the overall goals of the District. All options meet the reserve requirements and fund the capital infrastructure, as presented in the most recent projected CIP, discussed below. The differences center around how the options manage debt coverage ratios, interest rate risk, and their effect on customer rates. These factors are discussed immediately below.

#### Debt Coverage

In order to issue debt at a low cost the District must demonstrate a strong ability to pay the annual debt service. This ability is measured by the debt coverage ratio which is calculated by dividing net water revenues by annual debt payments. For many years the District has used the rate model to monitor the debt coverage ratio and set rates so that this ratio is at or above 150%. Historically, this level of debt coverage has been considered strong, and this along with many other factors has warranted the high AA credit rating given to the District by Standard & Poor's.

This year has presented a number of challenges which have negatively affected the debt coverage ratio. Economic pressures

and conservation have reduced the District's sales to a projected 8% below budget. This, as well as the CWA and MWD rate increases, has directly affected the debt coverage ratio. The amount of debt the District is able to issue in this year is limited to an amount less than \$57M if the District is to maintain its high credit rating.

Historically, a coverage ratio of 150% has been considered strong. With the changes in the market and the special challenges that face California, it is important that the District continue to meet this target. A debt coverage of at least 150% at the current time, is the most prudent way of satisfying the rating agencies potential concerns over the effect of the recession and water supply on District finances. Certain debt coverage levels are established as a means to offset potential revenue declines resulting from further water sales reductions, both as a result of conservation efforts during the water supply crisis and from the consumer's need to reduce household expenses, as well as a decline in new development fees.

In consultation with the District's Financial Advisor, staff has determined that an acceptable amount of debt is \$51.3 million, which will bring the District's debt coverage ratio to approximately 151%. Staff and the Financial Advisor are confident that this new level will maintain the District's high credit ratings. This determination is only possible due to the Board's long standing support of financial strength and excellent management.

#### Interest Rate Risk

Issuing \$51.3 million in debt takes the maximum advantage of low interest rates, and based on the rate model projections, produces the lowest overall financing costs. This is after taking into account the negative arbitrage, which is the net cost of holding additional debt. Issuing a larger amount of debt has a cost and benefit. The cost, or negative arbitrage, results from borrowing funds at a higher interest rate than they can be reinvested. The benefit of issuing a larger amount of debt in the current year is the expectation of avoiding higher issuance costs or interest rates in the future.

The cost, or negative arbitrage, is realized only for the first two years as compared to 28 years of benefit realized over the remaining life of the bonds. Staff compared the issuance of \$51.3M in debt today compared to a \$36.1M issue today and a

\$15.2M in debt issued two years from now. It is projected that an increase of only 13 basis points in interest rates over the next two years is the threshold over which it is financially beneficial to issue the larger amount of debt in the current year. This projection assumes that the Build America Bonds (BABs) option will not be available or that it will have been cut back to eliminate their benefit over tax-exempt bonds.

The current interest rates are at low levels which make the timing for a debt issuance one of the best since September 2008. Interest rates were relatively stable from January 2006 to March 2007. Leading up to September 2008 and since that time, rates have been unusually volatile, with numerous interest rate swings of over 50 basis points. Four of those swings exceeded one full percent, each occurring in a very short period. By issuing a larger amount of debt at this time the interest rates are locked in and the District is not susceptible to the variability of interest rates for at least three years.

There are a number of factors that can affect interest rates. Long-term treasuries are expected by many economists to increase between 50 and 60 basis points over the next year. While municipal bond interest rates do not track closely to treasury bonds, they are both affected by general inflationary factors. This level of anticipated inflation in the treasury rates over just one year is supportive of the assumption that municipal bonds will increase more than 13 basis points over the next two years.

Both the increase in interest rates and the elimination of the benefit of BABs are reasonable assumptions to build into this analysis. Based on this evaluation, staff will recommend a larger debt issuance at this time.

#### Customer Rates

With the issuance of the larger amount of debt, \$51.3M, net revenues must increase proportionately in order to maintain the debt coverage ratio to acceptable levels. The option of issuing \$36.1M in debt would have a two year effect of lowering rates by approximately 1.7% in each year; however with the higher priced 2012 debt, which would accompany a 2010 lower debt issuance, there would be a net increase in customer rates of approximately 2% beginning in 2013 and beyond.

Consistent with the District's Debt Policy, Policy No. 45, the recommended financing strategy is expected to reduce the overall

cost to customers by maintaining a strong credit rating and by minimizing the District's overall debt service.

### Bond Structuring

In order to obtain the most favorable interest rates, staff recommends that the financing be split into two components, a long-term taxable portion of Build America Bonds, and a short-term tax-exempt portion. While the initial interest rate on BABs is higher than traditional tax-exempt bonds, the effective rate after taking into account the federal reimbursement is lower than traditional tax-exempt bonds for certain longer term maturities. The break-even point is usually about 12-15 years, and BABs are more cost effective for debt maturing from 2025 through 2040.

It is recommended that the financing be structured as one series of BABs, maturing from approximately 2025 through 2040, and one series of traditional tax-exempt bonds maturing from approximately 2011 to 2024, to take the best advantage of the financing options available to the District and incur the lowest overall effective interest costs. Most bond sales utilizing a BAB component are structured in a similar fashion to take advantage of lowest cost of two different types of bonds.

At this time, the estimated overall true interest cost is 4.25%, net of the BABs interest reimbursement. The estimated true interest cost without using BABs would be approximately 4.75%, or .5% higher than with the use of BABs. The use of BABs will save the District approximately \$275,000 annually in debt service costs. Final rates will not be determined until the bonds are actually offered for sale, which is expected to occur on March 17, 2010.

### Revenue Bonds/JPA

The investors in Build America Bonds generally prefer the bonds to be issued in a "revenue bond" structure, rather than the traditional "Certificates of Participation" (COPs) that the District has issued in the past. Substantively, there is no difference between a revenue-secured COPs and a revenue bond issued by the District; the security for both forms of debt is identical. However, there is a difference in investor perception, and that could lead to higher interest costs on this financing if the BABs are issued as COPs.

In order to issue revenue bonds instead of COPs, the District needed to partner with another public agency to form a Joint Powers Authority (JPA) to act as a conduit issuer of the revenue bonds. In February 2010, the Board became a member of the California Municipal Finance Authority (CMFA). Membership in CMFA was the first step in the process of forming a JPA between the District and CMFA. The JPA, to be known as the "Otay Water District Financing Authority," is a single purpose entity controlled by the District for the sole purpose of issuing revenue bonds for the benefit of the District. CMFA will have a very limited role in the bond transaction, and all financial decisions regarding the bonds will be made solely by the District. In the recent CWA debt financing this exact structure was used.

The Board of the CMFA will consider approving the JPA agreement at its February 19, 2010 meeting. If CMFA approves the formation of the Otay Water District Financing Authority ("Authority") and approves the form of JPA agreement, as anticipated, the JPA agreement will be presented to this Board for approval on March 3, 2010.

In addition, the first regular meeting of the Authority will be noticed for March 3, 2010, as required under the Brown Act. This Board will be designated to serve as the Authority Commission for the Authority and, after approving the Bylaws and appointing officers for the Authority, the Authority Commission will consider a resolution to authorize the issuance of debt and approve the form of the bond documents.

#### Negotiated Sale of Bonds

The District used a competitive bidding process for sale of its COPs in 2004 and 2007 and for the recent sale of its General Obligation Refunding Bonds in 2009. These transactions were standard, tax-exempt financings with typical call provisions with no major change in maturity or structure required once the bids were received.

In general, Build America Bonds are not sold through a competitive bidding process. The desire to move maturities of the bonds between taxable BABs and tax-exempt bonds in response to market conditions (the break-even point between effective rates on the two series of bonds) on the day of the bond sale requires flexibility to implement. This flexibility can only be achieved by selecting one underwriter to negotiate for the sale of bonds. In a negotiated sale, the underwriter is better able

to canvass their investor base and gauge response to a change in maturity. In addition, optional redemption provisions are not standard for taxable bonds like BABs. The underwriter needs to work with investors to accept the most liberal provisions it can to provide the District cost effective call options.

The District solicited proposals from six firms with the most experience in marketing California BABs. Citigroup Global Markets, Inc. ("Citi") was selected for this issue, based on their ability to market both the BABs and the tax-exempt bonds at the lowest possible cost to the District, as well as a competitive fee structure. The Financial Advisor will assist the District in determining that the bonds sold by Citi are sold at competitive interest rates.

In selecting Citi, staff and the Financial Advisor assessed three factors:

1. the demonstrated ability to market BABs at the lowest costs;
2. the demonstrated ability to market tax-exempt bonds at the lowest cost; and
3. proposed fees.

#### Financing Participants

In addition to the underwriter, who will purchase the bonds from the JPA and sell them to investors, the District has selected the following firms to assist in the financing:

GCR, LLP is acting as Bond Counsel and will prepare all legal documents required to provide valid pledge of revenue to the bonds, as well as provide an opinion as to the tax treatment of interest on either series of bonds.

Harrell & Company Advisors, LLC was selected as Financial Advisor and will assist with structuring the bonds, negotiating fees and interest rates with the underwriter and preparing the Official Statement.

Stradling Yocca Carlson & Rauth is acting as Disclosure Counsel and will review the Official Statement to make sure all information material to an investor's decision to purchase the bonds is included in the document.

Union Bank is acting as Trustee, receiving debt service payments from the District and transmitting them to bond owners.

Fees for the professionals involved in the financing are all contingent on the bond closing and will be paid from the proceeds of the bonds. In addition, fees charged by CMFA to assist in the creation of the JPA and the issuance of the bonds will be paid from proceeds of the bonds.

### Actions

Several actions are required to accomplish the financing as described.

1. The District will be asked to consider Resolution No. 4154 approving the Joint Powers Agreement by and between the District and CMFA which will create the Otay Water District Financing Authority (Authority) and allows the District's financing to be structured as revenue bonds. The CMFA board approved the Joint Powers Agreement on February 19, 2010.
2. The District will be asked to consider Resolution No. 4155 approving the form of the following financing documents:
  - Installment Purchase Agreement by and between the District and the Authority;
  - Trust Agreement;
  - Continuing Disclosure Agreement;
  - Official Statement relating to the Bonds; and
  - Bond Purchase Agreement.

The resolution also provides the designated District officials and staff with the authorization to approve changes to the form of, and to execute and deliver the various financing documents in connection with the bonds, circulate a Preliminary Official Statement and an Official Statement and execute a Bond Purchase Agreement with the underwriter, Citigroup Global Markets, Inc. The resolution provides that the bonds may be issued in two series, with a combined maximum amount not-to-exceed \$52,000,000, at a true interest cost not-to-exceed 7.0% with respect to BABs and not-to-exceed 5.0% with respect to the series of bonds that will be tax-exempt. The underwriter's discount or takedown will not exceed \$4.41 per \$1,000 for the tax exempt bonds and \$6.26 per \$1,000 for the BABs.

