



CITY OF SAN DIEGO
M E M O R A N D U M

November 19, 2007

TO: Honorable Members of the City Council

FROM: Mayor Jerry Sanders

SUBJECT: City's Strategy for Accessing the Capital Markets and for Issuing Outstanding Audits

It's in the taxpayers' best interests for the City to have access to the public bond markets. This memo will outline how we intend to pursue that goal while simultaneously continuing to fund immediate infrastructure improvements and financial obligation needs.

A few weeks back, the City of San Diego received an unqualified audit opinion for Fiscal Year 2005 from our independent auditors. This audit opinion joins those previously released for FY03 and FY04. The City is now being told by Standard and Poor's (S&P) that the completion of the FY06 Comprehensive Annual Financial Report (CAFR) will be necessary for S&P to reinstate the City's credit rating. Assuming we receive the City Attorney's cooperation, our plan is to complete the FY06 CAFR by the end of January 2008. Any delays in the completion of the CAFR will have an increasingly negative impact on our ability to finance critical improvements at reasonable borrowing costs.

Upon completion of the 2006 CAFR, the City would immediately send the audit to the three rating agencies. This, along with the other three CAFR's which have already been received and reviewed by the rating agencies, should bring closure to this chapter in the City's history and reopen access to the public capital markets. In order to expedite our acquisition of funds from the public markets by late April 2008, we intend to bring certain actions before you within the next few months so that we can proceed in the most efficient manner possible.

The City of San Diego currently has ratings from two of the three credit rating agencies, Moody's Investors Service and Fitch Ratings. As previously noted, Standard & Poor's, has told us that they will need to evaluate our FY06 audit before they can consider restoring the City's rating. At the same time, we will want the first two rating agencies to reconsider our current ratings and the "negative outlook/watch" they have attached to them.

Listed below are highlights of a few of the financing proposals currently being developed for your consideration.

WATER SYSTEM IMPROVEMENTS

In February 2007, the City Council approved a series of four 6.5% annual water rate increases for fiscal years 2008-2011. These rate increases are intended to support financings to meet critical California Department of Health Services Compliance Order timelines and mandates imposed by the Federal Safe Drinking Water Act. The Compliance Order requires the City to rehabilitate or replace aging pipes, pumps and other infrastructure and to reduce the number of pipeline breaks and emergency repairs. Failure to adhere to the Compliance Order could result in penalties under the state's Health and Safety Code.

In January 2007, the City Council authorized \$57 million in short-term notes to support the Water System's needs through the end of calendar year 2007. All of these funds have now been encumbered.

My office is in the process of securing additional funding in order to continue Capital Improvements Projects through January 2010. In January 2008, the following plan, with two separate components, will be presented to you:

- The first component will be to secure approximately \$120 million in interim, or short-term, funding to continue critical water system improvements through June 2008. This first transaction can be done by resolution.
- The second component is a permanent, long-term public offering. Based upon our working assumption that the City has a completed 2006 CAFR in late January, the City would conceivably be able to access public funds by the end of April. Because this transaction requires an ordinance, and in order to proceed in the most efficient manner, the legal documents authorizing a public offering will be brought before the Council in January. Staff will then return to Council in March with an Offering Statement related to this transaction once the 2006 CAFR has been completed.

My staff is already working with Bond Counsel, Disclosure Council and the Disclosure Practices Working Group to prepare the City's Offering Statement for your authorization once we have access to the public markets.

Funds from this permanent long-term financing proposal will be programmed:

- to repay the \$57 million short-term notes from 2007;
- and the proposed \$120 million interim financing for fiscal year 2008.
- Approximately \$175 million in new funding would be procured to continue priority system improvements through January 2010.

Additionally, if interest rates remain favorable, we would also refinance approximately \$300 million in outstanding water bonds to realize economic savings that will benefit the Water system's cash flow.

WASTEWATER SYSTEM IMPROVEMENTS

In February 2007, the City Council approved a series of four annual wastewater rate increases for fiscal years 2008-2011. These rate increases support in part critical infrastructure improvements that are part of a Consent Decree with the U.S. Environmental Protection Agency. The rate increases will allow the City to make improvements to an aging wastewater system and will help to minimize future spills of raw, untreated sewage into local streams, the ocean and streets; and ensure City compliance with the federal "Clean Water Act." Wastewater System improvements include the repair, replacement or rehabilitation of 250 miles of pipeline by 2013.

The latest City Council debt issuance authorization was for short-term financing in May 2007. At that time, the Council authorized the issuance of a two-year Sewer Revenue Notes of approximately \$224 million in order to retire the Wastewater Series 2004 Bonds (\$144 million) and to fund additional Wastewater System Capital Improvement immediate needs through early fall 2008.

The Wastewater System's anticipated bonding program of \$700 - \$800 million is planned as a public offering for the fourth quarter of calendar year 2008. The funding from this debt tranche would be used to take out the 2007 Sewer Note; if interest rates continue to remain favorable, refund a significant number of outstanding sewer debt series to generate debt service savings; and provide additional funds for capital improvements for 2009 and 2010.

FUNDING TO ADDRESS DEFERRED MAINTENANCE NEEDS

One of the most important reform commitments made in my Five Year Financial Outlook is to fund deferred maintenance and capital improvements. The end result of this goal will be City building improvements such as roof repairs, heating and cooling system upgrades, painting, floor covering repair, structural repairs, and repairs and improvements to storm drains, streets and sidewalks.

In order to begin the fulfillment of this commitment, early next year, we are exploring a short-term financing strategy that will generate approximately \$100 million in funding to address funding needs for fiscal years 2008 and 2009. This interim financing mechanism would eventually be refinanced at more favorable rates once we can access the public markets.

The Five-Year Financial Outlook identified close to \$580 million in project spending for General Fund deferred maintenance needs between fiscal years 2008 and 2012. It is planned that \$380 million in deferred maintenance needs will be financed by the issuance of debt.

LEVERAGING OF EMPLOYEE CONCESSIONS

In 2006, the City negotiated with its employee unions a reduction to the City “pick-up” of the employee pension contribution. In exchange, the City agreed to leverage the savings to the City in order to help address the unfunded pension liability.

In June 2006, I brought forward a plan to leverage approximately \$10.3 million of the employee pick-up savings, which generated \$108 million for the pension system, by securitizing future tobacco settlement revenues. The remaining amount, approximately \$7.0 million in annual pick-up savings is expected to be leveraged before June 30, 2008.

Work is in progress to study how these funds can be leveraged. The annual pick-up savings that could result would bring an estimated contribution of \$65 million in funding. This also would be a short-term financing subject to refinancing once we have access to the public markets.

CONDUIT FINANCINGS

The City issues debt from time to time to support community facilities for which there are dedicated revenue streams. The debt service for these conduit financings are paid from special taxes levied upon taxable property within the Community Facility Districts (CFD). The City has no fiscal obligation to pay the debt service on these bonds, and the City’s CAFR is not included in the offering statement for the bonds. However, there is a requirement that the continuing annual disclosure reports include the City’s CAFR.

We are now in the process of developing the following bond financing proposals:

- A second series of CFD bonds for NTC/Liberty Station of approximately \$4.0 million; and
- A first series for CFD No. 4 (“Black Mountain Ranch Villages”) bonds of approximately \$13.0 million.

The CFD bond issuance for NTC would provide the remaining CFD funding for the regional park improvement in connection with the Naval Training Center Redevelopment Project, and the CFD No. 4 bond issuance would provide funding for certain road improvements included in the Black Mountain Ranch Public Facilities Financing Plan.

It is anticipated that City Council authorization will be requested in February 2008 for a public offering of the NTC/Liberty Station bonds, and in March 2008 for a public offering of the CFD No. 4 bonds. The bonds would be issued approximately 30 days after City Council approval of the transactions.

CONCLUSION

I want San Diegans to know that we are doing everything possible to have our City once again back in the public markets. While I think it's prudent that we utilize short-term private financing vehicles to fund critical infrastructure improvements, access to the public markets will allow the City to fund major capital improvements and meet financial funding obligations in a more cost-efficient manner.

As I stated earlier, our plan is to issue the FY06 CAFR in late January. The City Attorney's cooperation will be critical to the fulfillment of this goal. His cooperation is also necessary in the preparation of the documents that go along with the various financing vehicles outlined above. It is important that the City Council know that his obstructionism resulted in a delay of approximately 8 weeks to the release of our FY05 CAFR. Delays associated with the release of the 2006 CAFR will impede our access to the public credit markets thereby costing taxpayers more money and have a negative impact on our ability to provide critical improvements to our basic infrastructure.

Thank you.

cc: Jay M. Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst
Michael Aguirre, City Attorney