

# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Julia H. Cooper  
Margaret McCahan

**SUBJECT:** CITY OF SAN JOSE  
2018 TAX AND REVENUE  
ANTICIPATION NOTE

**DATE:** May 30, 2018

Approved

*D. D. SyL*

Date

*6/8/18*

## RECOMMENDATION

- (a) It is recommended that the City Council adopt a resolution:
- (1) Authorizing the issuance and sale of the City of San José 2018 Tax and Revenue Anticipation Note (the “2018 Note”) in the not to exceed principal amount of \$150,000,000 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 2018 Note and authorizing other related actions in connection therewith.
- (b) Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund for Fiscal Year 2018-2019:
- (1) Increase the estimate for Other Revenue in the amount of \$150,000,000; and
  - (2) Increase the Citywide TRANs Debt Service appropriation to the Finance Department in the amount of \$150,000,000.

## OUTCOME

Approval of the recommendations will result in the issuance and sale of the City of San José 2018 Tax and Revenue Anticipation Note (“2018 Note”). Based on historical cash balances, specifically those balances in the General Fund, and information contained within the *2018-2019 Proposed Operating Budget* (the “Proposed Budget”), the proceeds of the 2018 Note 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.

## **EXECUTIVE SUMMARY**

The City began prefunding the employer retirement contributions for the two retirement plans in 2008 for budgetary savings. Beginning in 2010 and in each fiscal year thereafter, the City entered into short-term borrowings to avoid a negative cash balance in the General Fund's portion of the City's Investment Pool. Annually, staff evaluates the budgetary benefit of both the issuance of tax and revenue anticipation notes ("TRANs") and prefunding of the City's retirement contributions. The strategy of prefunding continues to provide budgetary savings to the City. For 2018-2019, the budgetary savings are estimated at \$3.9 million in all funds and \$2.6 million in the General Fund.

For 2018-2019, the City intends to issue a TRAN with Bank of America, N.A. (the "Bank") in the amount of \$150 million on July 2<sup>nd</sup>. The City will sell the 2018 Note directly to the Bank in a private placement. The estimated interest expense is \$2,059,000 and costs associated with the financing are estimated at \$55,000, resulting in a total projected cost of borrowing at approximately \$2,114,000.

## **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") required the City to make biweekly contributions to the Retirement Plans in conjunction with each payroll distribution. Those biweekly contributions were calculated based on actual payroll amounts and the contribution rate approved by the Retirement Plan Boards were 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.

Beginning in 2010-2011, short-term borrowings were necessary given insufficient funds on a cash flow basis to make the payments without causing a negative cash balance in the General Fund's portion of the City's Investment Pool to prefund the pension and retiree employer contributions. In each of the last eight years, the City issued tax and revenue anticipation notes ("TRAN") in amounts ranging from \$75 million to \$150 million to prefund the retirement contributions. Annually, staff evaluates the budgetary benefit of both the issuance of the TRANs

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and prefunding of the City's retirement contributions. Since 2008-2009, the analysis has demonstrated that prefunding continues to provide significant budgetary savings to the City.

Based on the figures included in the 2018-2019 City Manager's Budget Request and 2019-2023 Five-Year Forecast, specifically the section entitled "Elements of the General Fund Forecast - Expenditure Forecast", the prepayment budgetary savings were estimated at \$4.6 million in all funds and \$3.3 million in the General Fund. However, after adjusting for higher debt service costs than originally anticipated as outlined later in this memorandum, budgetary savings is reduced to \$3.9 million (\$2.6 million in the General Fund). The increased costs associated with the TRAns (revised from \$1.4 million assumed in the 2018-2019 Proposed Budget to \$2.1 million) was included in Manager's Budget Addendum (MBA) #29, Recommended Amendments to 2018-2019 Proposed Operating and Capital Budgets, that will be incorporated into the final adoption of the 2018-2019 Operating and Capital Budgets pending City Council approval of the Mayor's June Budget Message for Fiscal Year 2018-2019.

## **ANALYSIS**

Several large General Fund tax revenues are received in an uneven manner based on predetermined schedules, seasonality, and 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 and vary based on seasonal factors such as holiday sales.

In contrast, expenditures in the General Fund are relatively level throughout the fiscal year. This is largely the result of 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 periodic expenditures 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 six 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 2018-2019. Based on this projection, after the payment for the prefunding is made in July 2018, the General Fund cash balance will become negative at several points in time during the first half of 2018-2019 absent issuance of the 2018 Note. To avoid a negative cash balance, staff recommends the issuance of the 2018 Note.

### **Plan of Finance**

Based on the needs for the short-term borrowings in previous fiscal years, the City issued a Request for Proposals on March 28, 2016 (the "2016 RFP") to solicit qualified financial institutions to serve as a private placement purchaser for the TRAN in 2016-2017 ("2016 Note"). In the 2016 RFP, the City also expressed interest in a multi-year agreement with the same financial institution to fund a similar intra-year financing program for each of the following three fiscal years through 2018-2019. The City received five responses to the 2016 RFP, from which, Bank of America, N.A. (the "Bank") was selected by staff to serve as private placement purchaser for the 2016 Note based primarily on its lowest cost bid and secondarily on its willingness to use previously negotiated documents and its generally more flexible terms. The second place bank provider, Wells Fargo, was not as flexible in interest rate offerings, had a higher overall interest rate cost and required full repayment of principal by May 31 instead of June 30 as required under the terms with the Bank. The Bank has served as the Note Purchaser since 2013 and their RFP response included an agreement to use previously negotiated documentation reflecting substantially the same terms and conditions as provided for in previous agreements. This, coupled with the proposed interest rates and fees, resulted in the all-in lowest cost proposal to the City.

In this transaction, the City agrees to sell the 2018 Note directly to the Bank in a private placement. Similar to previous year's Notes, a public offering document is not required or prepared, the Bank cannot publicly trade the 2018 Note, and ratings are not required.

### **Description of the 2018 Note**

The Bank will purchase the 2018 Note in a principal amount not to exceed \$150 million with a stated maturity date of June 28, 2019 (the "Maturity Date"). The full amount of \$150 million is currently anticipated to be purchased by the Bank in a single note on the closing date of the financing, scheduled for July 2, 2018. Prepayment of the 2018 Note in whole or in part may be made at the City's option, with written notice to the Bank of at least three (3) business days prior to such prepayment date (for prepayment on a date other than the end of the monthly interest period, a breakage fee may be due to the Bank). Partial prepayment of principal cannot be less than \$5 million and must be in \$1 million increments in excess thereof.

The outstanding amounts on the 2018 Note will bear interest at a variable rate based on a LIBOR<sup>1</sup> rate effective for any given interest period ("Interest Rate"), plus a margin of 0.32% for Bank fees (the "Applicable Margin"). The Applicable Margin is lower than last year by 3 basis points (0.03%) and still in line with the market rate as surveyed by the City's Municipal Advisor. Further, the all-in-cost, including the transaction costs is well below the market rate. The Interest Rate shall be the effective LIBOR rate as published two (2) London Banking Days prior to the commencement of such interest period. After the Bank's purchase of the 2018 Note on July 2, 2018, the Interest Rate is initially based on the daily LIBOR rate plus the Applicable Margin.

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<sup>1</sup> LIBOR stands for London Inter-Bank Offered Rate. The LIBOR rate is a benchmark interest based on the interest rate charged for interbank loans in London.

The interest rate automatically converts to a fixed rate, effective on the third London Banking Day from and including the Effective Date (expected to be July 2, 2018), based on the 30-day LIBOR rate plus the Applicable Margin, until the earlier of the maturity date (June 28, 2019) or the date the 2018 Note is paid in full. During the fixed rate LIBOR period, the interest rate on the Note will be reset monthly based on the monthly LIBOR rate. Interest on the Note is payable on the first business day of each month. The City will also have the option to convert the interest rate from the 30-day LIBOR fixed rate to a daily LIBOR rate.

The estimated interest expense on the 2018 Note is \$2,059,000 and coupled with the financing costs of approximately \$55,000, results in a total projected cost of borrowing at approximately \$2,114,000.

Security for repayment of the 2018 Note is a pledge of the City's 2018-2019 secured property tax revenues (excluding property taxes levied for general obligation bonds) and all other legally available General Fund revenues of the City, if required. The 2018 Note will have a stated maturity of June 28, 2019, but as noted above, can be prepaid at the City's option without prepayment penalty on the last day of any monthly interest period.

### **Note Purchase Agreement**

To proceed with the issuance of the 2018 Note, the City Council must adopt the resolution described above. As referenced in the proposed resolution, staff recommends that the Director of Finance or her authorized designees be authorized to execute and deliver the 2018 Note and that the Director of Finance, or her authorized designees be authorized to enter into and deliver the Note Purchase Agreement (the "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 8, 2018.

The Purchase Agreement is between the City and the Bank. The Purchase Agreement sets forth requirements under which the Bank will purchase the 2018 Note, establishes the interest rate mechanism, outlines repayment terms, contains representations and warranties of the City and the Bank, and specifies conditions precedent 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 Purchase Agreement, except for liability arising from the Bank's gross negligence or willful misconduct. As is the case with a number of the City's agreements with banks, the law governing interpretation of the Purchase Agreement is New York law, the law governing the City's duties and obligations under the Purchase Agreement and the 2018 Note is California law, and any lawsuits concerning the Purchase Agreement and the 2018 Note are to be filed in New York.

### **Finance Team Participants**

The financing team participants consist of:

- City's Municipal Advisor: Public Resources Advisory Group
- Bond Counsel: Hawkins Delafield & Wood LLP
- 2018 Note Purchaser: Bank of America, N.A.
- Purchaser Counsel: McGuire Woods LLP

Public Resources Advisory Group was selected as the Municipal Advisor from the Municipal Advisory Pool.<sup>2</sup> Hawkins Delafield & Wood LLP was selected as the Bond Counsel through a competitive process. Bank of America, N.A. was selected to be the 2018 Note Purchaser as described above.

### **Financing Schedule**

The current proposed schedule is as follows:

- City Council approval of 2018 Note financing documents: June 19, 2018
- 2018 Note closing: July 2, 2018

### **EVALUATION AND FOLLOW-UP**

This memorandum presents the set of recommendations related to the City Council's approval of the issuance of the 2018 Note and requires no follow-up to the City Council.

### **PUBLIC OUTREACH/INTEREST**

This memorandum will be posted on the City's website for the June 19, 2018, City Council meeting.

### **COORDINATION**

This report was coordinated with the City Attorney's Office and the financing team participants.

### **COMMISSION RECOMMENDATION**

This item does not have input from a board or commission.

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<sup>2</sup> General Municipal Advisors were selected and Municipal Advisory Pools were established in August 2017 through a Request for Proposals process.

**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**

Based on a final analysis of anticipated retirement contributions and General Fund cash flow, the par amount of TRAN to be issued is anticipated at \$150 million to pre-pay the City's contribution to the retirement funds. The \$150 million in TRAN will be repaid in 2018-2019. Debt service and costs of issuance for the 2018 Note are conservatively estimated at \$2,114,000 reflecting costs for debt service interest, bond counsel, purchaser counsel, and municipal advisor. The 2018-2019 Proposed Budget initially included debt service and costs of issuance at \$1,400,000. However, after reevaluating anticipated interest rates and debt issuance costs for 2018-2019, this amount was revised upward by \$714,000 to \$2,114,000 as part of Manager’s Budget Addendum #29, which was subsequently incorporated into the Mayor’s June Budget Message for Fiscal Year 2018-2019.

**BUDGET REFERENCE**

The table below identifies the fund and appropriations to fund the 2018 Note. As the issuance of the 2018 Note ensures sufficient cash balances to prefund the City’s retirement contributions across all funds, costs associated with this issuance will be apportioned at a later date, typically as part of the overhead allocation plan.

Fund #	Appn #	Appn. Name	Proposed Appn.	Proposed Budget Action	2018-2019 Proposed Operating Budget Page <sup>1</sup>	Last Budget Action (Date, Ord. No.)
001	R130	Other Revenue	\$10,867,471	\$150,000,000	III-1	N/A
001	3904	TRAN Debt Service <sup>2</sup>	\$1,400,000	\$150,000,000	IX-20	N/A

<sup>1</sup> The 2018-2019 Proposed Operating Budget is scheduled for approval by the City Council on June 12, 2018 and adopted on June 19, 2018 and adopted on June 19, 2018.

<sup>2</sup> An increase in the debt service due and cost of issuance amount (from \$1,400,000 to \$2,114,000) is included in MBA #29.

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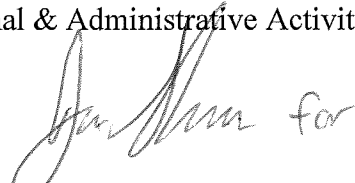
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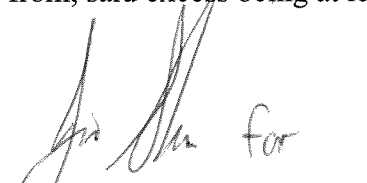
Not a project, File No. PP10-069(a), City Organizational & Administrative Activities.

/s/

JULIA H. COOPER  
Director of Finance

  
MARGARET MCCAHAN  
Budget Director

I hereby certify that there will be available for appropriation in the General Fund in 2018-2019, monies in excess of those heretofore appropriated there from, said excess being at least \$150,000,000.

  
MARGARET MCCAHAN  
Budget Director

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