



# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Julia H. Cooper  
Jim Shannon

**SUBJECT: CITY OF SAN JOSE  
2022 TAX AND REVENUE  
ANTICIPATION NOTES**

**DATE:** June 6, 2022

Approved

Date

6/9/2022

## **RECOMMENDATION**

(a) Adopt a resolution:

- (1) Authorizing the issuance and sale of the City of San José 2022 Tax and Revenue Anticipation Notes in an aggregate principal amount not to exceed \$360,000,000 to be sold through a direct bank 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 with Bank of America, N.A. and other related documents, as necessary, in connection with the issuance of the 2022 Notes and authorizing other related actions in connection therewith.

(b) Adopt the following Fiscal Year 2022-2023 Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund:

- (1) Increase the estimate for Other Revenue by \$360,000,000; and
- (2) Increase the Citywide TRAN Debt Service appropriation to the Finance Department by \$360,000,000.

## **OUTCOME**

Approval of the recommendations will result in the issuance and sale of the City of San José 2022 Tax and Revenue Anticipation Notes (2022 Notes). Based on plans to prepay portions of the City retirement costs, and cash balance projections in the City investment pool and information contained within the 2022-2023 Proposed Operating Budget, the proceeds of the 2022 Notes will provide necessary funds for cash flow purposes. Proceeds of this cash flow borrowing, together with pooled cash, will provide for a lump-sum contribution (i.e., prefunding) of the employer retirement contributions and retiree health benefits for Tier 1 members, across

all funds, for Fiscal Year 2022-2023 of \$421.4 million. The City does not intend to prefund any portion of the contributions for Tier 2 members for Fiscal Year 2022-2023.

## **EXECUTIVE SUMMARY**

The City began prefunding the employer retirement contributions for the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan (collectively, Retirement Plans) in 2008 for budgetary savings. Beginning in 2010-2011 and in each fiscal year thereafter except Fiscal Year 2019-2020, the City has entered into a short-term borrowing to mitigate the effect of prefunding on the cash balance in the General Fund portion of the City Investment Portfolio. Annually, staff evaluates the budgetary benefit of both the issuance of tax and revenue anticipation notes (TRAN) and prefunding of the City retirement contributions.

For Fiscal Year 2022-2023, the City intends to issue the 2022 Notes in the aggregate principal amount not to exceed \$360 million on July 1, 2022 to be purchased by Bank of America, N.A. (Bank of America or Bank). The City will sell the 2022 Notes directly to the Bank in a private placement. Assuming issuance of \$360 million, the estimated interest expense, given market conditions as of May 24, is \$5.2 million and the estimated costs associated with the financing are \$105,000, together with estimated interest earnings of \$3.9 million, result in a net projected total cost of borrowing of approximately \$1.35 million. When subtracted from the prefunding savings of \$11.0 million, the net preliminary projected savings across all funds is \$9.6 million; a level of savings greater than the \$6.6 million assumed in the 2023-2027 Five-Year Forecast.

## **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 annual prefunding of the City portion of retirement contributions. Historically, the Retirement Plans require the City to make biweekly contributions in conjunction with each payroll distribution. Those biweekly contributions are calculated based on actual payroll amounts and the contribution rate approved by the Retirement Plans Boards which were based on biennial actuarial studies. Any amounts that are not prepaid continue to be paid in biweekly contributions.

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 Fiscal Year 2009-2010, the City again prefunded employer retirement contributions, but included contributions for both pension as well as retiree health benefits.

Annually, staff evaluates the budgetary benefit of both prefunding of the City retirement contributions and the issuance of a TRAN to facilitate the prefunding. In fiscal years 2008-2009 through 2018-2019, that analysis demonstrated that prefunding provided significant budgetary savings to the City. Beginning in 2010-2011, short-term borrowings were undertaken to prefund the pension and OPEB employer contributions, given insufficient funds on a cash flow basis to make the payments without causing a negative cash balance in the General Fund portion of the City Investment Pool. For eight years, the City issued TRANs in amounts ranging from \$75 million to \$150 million to prefund the retirement contributions. For Fiscal Year 2019-2020, the City did not prefund retirement contributions as at that time the market conditions were not deemed favorable – the savings from prepayment were not sufficient to offset the combination of lost interest earnings on the City’s cash and TRAN debt service costs. For Fiscal Year 2020-2021, the City opted to prefund only the annual Tier 1 employer pension contributions. For Fiscal Year 2021-2022, the City opted to prefund annual Tier 1 employer pension contributions and OPEB. The table below summarized the history of prefunding pension and OPEB contributions.

**Retirement Prefunding History**  
(in millions of dollars)

	Federated		Police and Fire		Total	TRAN Size	Share of Prefunding from TRAN	Cash Funded	Share of Prefunding from Cash	Estimated General Fund Savings
	Prefunding Amount	Discount Rate	Prefunding Amount	Discount Rate	Prefunding Amount					
FY 2008-09	\$63.46	8.250%	\$56.37	8.000%	\$119.83	\$ -	0.0%	\$ -	100.0%	\$2.30
FY 2009-10	\$76.32	7.750%	\$64.38	8.000%	\$140.71	\$ -	0.0%	\$ -	100.0%	Not available
FY 2010-11	\$65.95	7.950%	\$86.13	7.750%	\$152.07	\$75.00	49.3%	\$74.51	50.7%	\$4.30
FY 2011-12	\$108.36	7.500%	\$137.10	7.500%	\$245.46	\$100.00	40.7%	\$99.59	59.3%	\$7.30
FY 2012-13	\$121.00	7.500%	\$105.30	7.250%	\$226.30	\$100.00	44.2%	\$99.56	55.8%	\$6.90
FY 2013-14	\$117.82	7.250%	\$136.65	7.125%	\$254.47	\$100.00	39.3%	\$99.61	60.7%	\$6.80
FY 2014-15	\$132.44	7.000%	\$146.34	7.000%	\$278.78	\$100.00	35.9%	\$99.64	64.1%	\$7.50
FY 2015-16	\$136.43	7.000%	\$148.12	7.000%	\$284.55	\$100.00	35.1%	\$99.65	64.9%	\$7.50
FY 2016-17	\$145.87	6.875%	\$149.26	6.875%	\$295.13	\$100.00	33.9%	\$99.66	66.1%	\$5.30
FY 2017-18	\$168.11	6.875%	\$174.00	6.875%	\$342.11	\$150.00	43.8%	\$149.56	56.2%	\$4.10
FY 2018-19	\$175.40	6.750%	\$183.10	6.750%	\$358.50	\$150.00	41.8%	\$149.58	58.2%	\$2.60
FY 2019-20 <sup>1</sup>										
FY 2020-21	\$170.94	6.750%	\$188.23	6.750%	\$359.17	\$130.00	36.2%	\$129.64	63.8%	\$7.40
FY 2021-22 <sup>2</sup>	\$201.90	6.625%	\$224.40	6.625%	\$426.30	\$285.00	66.9%	\$284.33	33.1%	\$13.9

**Notes:**<sup>1</sup>The City did not prefund in FY 2019-2020.<sup>2</sup>The City prefunded pension and OPEB in FY 2021-2022

The City has requested, and the Retirement Plans Boards each have approved at their respective May meetings, the City’s pre-payment amounts for both Retirement Plans for Tier 1 and OPEB contributions for Fiscal Year 2022-2023. The prepayment amounts are based on the actuary’s calculation of a modified discount rate given the Retirement Boards’ outlook on market conditions. The Board’s modified methodology for the prefunding discount rate calculation, reduces the discount rate by 15% from 6.625% to 5.6313% for pension prepayments and for prepayment of retiree health care, reduces the discount rate from 6.000% to 5.100%.

The TRAN proceeds along with contribution of cash will facilitate prepayment of the City retirement costs in the amount of \$421.4 million for Tier 1 pension costs for both Retirement

Plans including the Tier 1 normal costs and Unfunded Actuarial Liability in each Plan, along with the OPEB for Fiscal Year 2022-2023. The estimated prepayment includes cash (\$61.4 million) and the 2022 Notes proceeds (not to exceed \$360.0 million). The prepayments of the City employer contributions to the Retirement Plans in lieu of biweekly contributions will generate approximately \$11.0 million gross savings (all funds). The table below provides a summary of the source of funds for the prefunding of Tier 1 retirement and OPEB costs along with the use of the funds between the City's two retirement plans.

<b>FY 2022-2023 Retirement Prefunding Summary*</b>	
<b><u>Source</u></b>	
TRANs Proceeds	\$360,000,000
Cash	61,364,762
Total	\$421,364,762
<b><u>Use</u></b>	
Pension – Federated	\$184,422,886
Pension – P&F Plan	190,148,613
OPEB – Federated	18,318,395
OPEB – P&F Plan	28,474,868
Total	\$421,364,762
<i>* Preliminary, subject to change</i>	

Given the current volatility in the market and current expectations showing continued and significant changes in short-term rates in Fiscal Year 2022-2023, the actual size of the TRAN and the proportion of 8-month versus 12-month maturity dates of the TRANs will be determined prior to the rate lock on June 29, 2022. The flexibility to allow for the issuance of TRANs in an amount not to exceed \$360 million will allow for a maximum amount of information to be available, including the response to the Federal Reserve Open Market Committee meeting and any meeting outcomes on June 14 -15.

## **ANALYSIS**

Several large General Fund tax revenues are received in an uneven manner throughout the fiscal year based on predetermined schedules, seasonality, and other economic factors. For example, Property Tax Receipts, the largest General Fund revenue source, are received primarily in the second half of the fiscal year. Under current County policy, the City allocation of total *ad valorem taxes* (excluding supplemental taxes) is received in approximately the following cumulative percentages: 40% by mid-December, 50% by the first week of January, 85% by the third week of April, 90% by the end of April and 100% by the end of June. 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 personnel 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 exceeding the amount of expenditures) in January, April, and June. To smooth out the General Fund cash balance and maintain the City's liquidity level, staff recommends the issuance of the 2022 Notes.

### **Plan of Finance**

Based on the need for a short-term borrowing, the City issued a Request for Proposal for Bank Commitments (RFP) on April 12, 2022, to solicit qualified financial institutions to directly purchase the TRAN for Fiscal Year 2022-2023 prefunding. In the solicitation, the City expressed interest in fixed rate and variable rate arrangements. On April 29, 2022, the City received nine responses offering various fixed rate and variable rate products from banks. The City's Municipal Advisor for this transaction, PFM Financial Advisors LLC (PFM), assisted City staff in summarizing and analyzing the proposals. Based on the proposals submitted, Bank of America was selected by staff to purchase the 2022 Notes based on several factors including a full credit approval, low interest rate bids for fixed Notes, and the Bank's willingness to use the City's proposed documents with only modest changes and flexible terms.

The Bank has served as the City's prior Note Purchaser since 2013, and the Bank's response to the City solicitation included final credit approval reflecting acceptance of the Note Purchase Agreement as provided by the City in the RFP process, with only modest requested revisions. This, coupled with the proposed interest rate spread and fees, resulted in the most advantageous borrowing costs and ease of execution for the City, and the opportunity to streamline the process with a single bank offering low fixed rates.

In this transaction, the City agrees to directly place the 2022 Notes with the Bank. As with the City's prior note transactions sold in a similar manner, a public offering document is not required or prepared, the Bank cannot publicly trade the 2022 Notes, and no presentations to rating agencies or ratings from the credit rating agencies are required. As in the Fiscal Year 2021-2022 TRAN solicitation, the City asked RFP respondents not to require the production of formal cash flows. Not all RFP respondents were willing to accept this requirement; however, not producing a public offering document and respective cash flows eliminates substantial staff work that will be devoted to other priority projects.

**Description of the 2022 Notes**

The Bank submitted a proposal with a credit approval to purchase \$450 million of the 2022 Notes to fully prepay all the retirement costs from TRAN proceeds. Based on the projected availability of cash and need to maintain liquidity until property tax receipts are received in the second half of Fiscal Year 2022-2023, staff recommends issuing an amount not to exceed \$360.0 million of TRANs, with 100% financed on a fixed rate basis. The City has the flexibility to issue the Notes in two tranches, with 8-month or 12-month maturities depending on the market conditions. With the current volatility in the market, staff expects to make that decision a week prior to closing of the 2022 Notes.

The 2022 Notes will have stated maturity date of February 28, 2023, and/or June 30, 2023, with the respective sizing of each component to be established based on the market conduction the week prior to closing of the 2022 Notes. The Bank's proposal prescribes the methodology for determining the fixed rates based on the 8-month and 12-month tenors for the overnight SOFR<sup>1</sup> Curve, plus credit spreads of 0.26% and 0.27%, respectively. The actual interest rate will be determined and locked on June 29, 2022, utilizing this Pricing Formula. No charges for the rate lock will apply.

The City will have the right to prepay the 2022 Notes in whole or in part, prior to February 2023 or June 2023 depending on the maturity selected, at a price equal to the principal amount prepaid, plus interest accrued and any breakage fees<sup>2</sup>, on a business day, by providing the Bank with a written notice of at least three business days prior to such prepayment date.

Security for repayment of the 2022 Notes is a pledge of the City's Fiscal Year 2022-2023 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 2022 Notes will have a stated maturity of February 28, 2023, and/or June 30, 2023, for payment in full.

---

<sup>1</sup> A new benchmark, U.S. Secured Overnight Financing Rate (SOFR), has been developed to serve as a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.

<sup>2</sup> The fixed rate note will have provisions that would allow the City to prepay only upon making the Bank whole for all reasonable losses, expenses and liabilities which the Bank may sustain as a consequence of prepaying or missing fixed payments as due formally called "Breakage Fees" (commonly referred to as a "make whole" provision). The City shall compensate the Bank, in the form of a Breakage Fee, upon the Bank's written request, for all reasonable losses, expenses and liabilities (including, without limitation, any loss, expense or liability incurred by reason of the liquidation or reemployment of deposits or other funds required by the Bank to fund the 2022 Notes) which the Bank may sustain: (i) if any prepayment of the 2022 Notes is not made on any date specified in a notice of prepayment given by the City to the Bank; (ii) [if any one-month SOFR Loan] is converted or prepaid on a date other than the last day of the then current Interest Period; or (iii) as a consequence of any other default by the City to pay the principal of and interest on the notes when required by the terms of this Agreement and the 2022 Notes.

**Estimated Budgetary Savings**

As discussed above, the City has the flexibility to issue the 2022 Notes in two tranches, each with a fixed interest rate. One tranche would mature in 8 months, on February 28, 2023, and the other in 12 months, on June 30, 2023. The fixed interest rate will be set two days prior to closing, on June 29, 2022. The Bank offered a fixed rate to be set at closing based on the 8-month and 12-month SOFR Rates (the current indicative SOFR rates (as of May 24) are 194 basis points or 1.94% for 8 months, and 226 basis points or 2.26% for 12 months) plus a credit spread of 0.26 and 0.27%, respectively or total indicative fixed rates as of May 24 of 2.20% and 2.53%, respectively. Interest rate conditions on June 29 may result in higher or lower actual rates but once set, the rate for each tranche will be fixed until repaid at maturity on February 28, 2023 or June 30, 2023, respectively. The fixed rate notes will have provisions that allow the City to prepay as described above.

The total interest cost on the 2022 Notes will depend on respective par amounts of the 8-month and 12-month tranches of the Notes as well as prevailing market conditions at the time the rates are set on June 29. The estimated interest expense on the 2022 Notes is projected to be approximately \$5.2 million, assuming rates as of May 24, costs associated with the financing estimated at \$105,000, and repayment of the Notes on February 28, 2023 (50%) and June 30, 2023 (remaining 50%) together with estimated earnings of \$3.9 million results in a total net projected cost of borrowing of approximately \$1.35 million. This net interest cost is subtracted from the prefunding savings of \$11.0 million, for a net preliminarily projected savings across all funds of \$9.6 million. This level of estimated savings is greater than the \$6.6 million assumed in the 2023-2027 Five-Year Forecast.

**Note Purchase Agreement**

To proceed with the issuance of the 2022 Notes, the City Council must adopt the Appropriation Ordinance and Funding Sources Resolution recommended above. As referenced in the recommended resolution, staff recommends the Director of Finance or authorized designees be authorized to execute and deliver the 2022 Notes and that the Director of Finance, or authorized designees, be authorized to enter into and deliver the 2022 Note Purchase Agreement (Purchase Agreement) described below. These documents, in substantially final form, will be available for review on the Council Agenda website on or about June 9, 2022.

The Purchase Agreement is between the City and the Bank. The Purchase Agreement sets forth requirements under which the Bank will purchase the 2022 Notes, 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 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 negligence or willful misconduct. California law will govern interpretation of

the Purchase Agreement.

**Finance Team Participants**

The financing team participants consist of:

- **City's Municipal Advisor:** PFM Financial Advisors
- **Note Counsel:** Hawkins Delafield & Wood LLP
- **2022 Note Purchaser:** Bank of America, N.A.
- **Purchaser Counsel:** Nixon Peabody

PFM Financial Advisors LLC was selected through a competitive Request for Proposal process in February 2021 from municipal advisors in the City's Municipal Advisors pool. Hawkins Delafield & Wood LLP was selected as the note counsel from the City's bond counsel pool that was established through a competitive process. Bank of America, N.A. was selected to be the 2022 Notes purchaser through a competitive bank selection process as described above.

**Financing Schedule**

The current proposed schedule is as follows:

- City Council approval of 2022 Notes financing documents ..... June 21, 2022
- Fixed Rate Set ..... June 29, 2022
- 2022 Notes closing: ..... July 1, 2022

**CONCLUSION**

Approval of the recommendations will result in the issuance and sale of the 2022 Notes. The expected issuance of the 2022 Notes cash flow borrowing of an amount not to exceed \$360.0 million, along with approximately \$61.4 million in pooled cash, will provide for a lump-sum contribution (i.e., prefunding) towards the employer retirement contributions for Tier 1 members and retiree health benefits, across all funds, for Fiscal Year 2022-23.

**EVALUATION AND FOLLOW-UP**

This memorandum presents the set of recommendations related to the City Council approval of the issuance of the 2022 Notes and requires no follow-up to the City Council.



### **CLIMATE SMART SAN JOSE**

The recommendation in this memo has no effect on Climate Smart San José energy, water, or mobility goals.

### **PUBLIC OUTREACH**

This memorandum will be posted on the City website for the June 21, 2022, City Council meeting.

### **COORDINATION**

This memorandum was coordinated with the City Attorney's Office.

### **COMMISSION RECOMMENDATION/INPUT**

No commission recommendation or input is associated with this action.

### **FISCAL/POLICY ALIGNMENT**

The proposed financing plan is consistent with the City Debt Management Policy, which establishes the following equally important objectives 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
- 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 aggregate principal amount of the 2022 Notes to be issued is expected to be up to \$360.0 million to pre-pay the City contribution to the Retirement Plans. The final amount will be determined based on the most recent market conditions prior to issuance. The \$360.0 million will be repaid in the same 2022-2023 fiscal year.

Estimated interest expense and costs of issuance for the 2022 Note are conservatively estimated at \$5.2 million. Based on the additional cash the City will receive from the Note, revenue from earned interest is estimated to increase across all funds by approximately \$3.9 million. The net impact of the transaction is a cost of \$1.35 million across all City funds. The 2022-2023 Proposed Operating Budget includes a TRAN debt service expense of \$1.5 million, which was established during the development of the 2023-2027 Five-Year General Fund Forecast without the benefit of the in-depth analysis of note issuance and current market conditions as included in this memorandum. While this allocation in the General Fund provides sufficient capacity to pay the net interest debt service costs after accounting for the additional interest earnings; because the additional interest revenue and debt service should be spread across all applicable City funds, the 2021-2022 Annual Report will recommend technical adjustments to recognize and appropriate these amounts within applicable funds to ensure an equitable allocation of revenues and costs.

### **BUDGET REFERENCE**

The table below identifies the fund and appropriations for the repayment of the 2022 Notes.

<b>Fund #</b>	<b>Appn #</b>	<b>Appn. Name</b>	<b>Proposed Appn.</b>	<b>Proposed Budget Action</b>	<b>2022-2023 Proposed Operating Budget Page*</b>	<b>Last Budget Action (Date, Ord. No.)</b>
001	R130	Other Revenue	\$8,811,587	\$360,000,000	189	N/A
001	3904	TRAN Debt**	\$1,500,000	\$360,000,000	803	N/A

\* The 2022-2023 Proposed Operating Budget is scheduled for approval by the City Council on June 14, 2022 and adoption of the annual appropriation ordinance for 2022-2023 on June 21, 2022.

\*\* Once final costs are determined, an adjustment in the debt service amount will likely be brought forward as part of a future budget process.

HONORABLE MAYOR AND CITY COUNCIL

June 6, 2022

**Subject: City of San José 2022 Tax and Revenue Anticipation Notes**

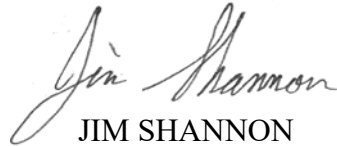
Page 11

**CEQA**

Not a Project, File No. PP17-004, Government Funding Mechanism, or Fiscal activity with no commitment to a specific project which may result in a potentially significant physical impact on the environment

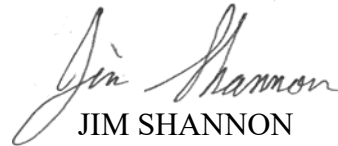
/s/

JULIA H. COOPER  
Director of Finance



JIM SHANNON  
Budget Director

I hereby certify that there will be available for appropriation in the General Fund in 2022-2023, monies in excess of those heretofore appropriated there from, said excess being at least \$360,000,000.



JIM SHANNON  
Budget Director

For questions, please contact Julia H. Cooper, Director of Finance at (408) 535-7011 or via email at [julia.cooper@sanjoseca.gov](mailto:julia.cooper@sanjoseca.gov).