COUNCIL AGENDA: 06/26/18
FILE: 18-938
ITEM: SJFA 1

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR, CITY COUNCIL AND CITY OF SAN JOSE FINANCING AUTHORITY BOARD

FROM: Julia H. Cooper

SUBJECT: SEE BELOW

DATE: June 11, 2018

Approved D.DSyl Date 6/14/18

SUBJECT: ACTIONS AMENDING CERTAIN AGREEMENTS RELATED TO THE INTERIM FINANCING PROGRAM FOR CAPITAL IMPROVEMENTS AT THE SAN JOSE-SANTA CLARA REGIONAL WASTEWATER FACILITY

RECOMMENDATION

1. It is recommended that the City Council:

   a. Adopt a resolution approving and authorizing the execution and delivery of a First Amendment to the Credit Agreement and an Amended and Restated Fee Letter Agreement with Wells Fargo Bank, National Association, related to the issuance by the City of San José Financing Authority of its Subordinate Wastewater Revenue Notes ("Notes") in an aggregate principal amount not to exceed $300,000,000 outstanding at any one time for the purpose of financing or refinancing Wastewater System and Treatment Plant Projects to revise the calculation of interest and fees for the tax exempt Notes and authorizing other related actions in connection therewith.

2. It is recommended that the City of San José Financing Authority Board:

   a. Adopt a resolution approving and authorizing the execution and delivery of a First Amendment to the Credit Agreement and an Amended and Restated Fee Letter Agreement with Wells Fargo Bank, National Association related to the issuance by the City of San José Financing Authority of its Subordinate Wastewater Revenue Notes ("Notes") in an aggregate principal amount not to exceed $300,000,000 outstanding at any one time for the purpose of financing or refinancing Wastewater System and Treatment Plant Projects to revise the calculation of interest and fees for the tax exempt Notes and authorizing other related actions in connection therewith.

OUTCOME

Approval of these recommendations will result in amendments to the Credit Agreement ("Credit Agreement") by and among the City of San José, California, City of San José Financing Authority, and Wells Fargo Bank, National Association, and the associated Fee Letter Agreement ("Fee Letter") to adjust the calculation of interest and fees for tax exempt Notes in order to address increased borrowing costs resulting from the recent changes to the margin rate factor.

EXECUTIVE SUMMARY

The Credit Agreement was established on October 19, 2017 as an interim financing facility to help bridge the financing gap between cash funding of the $1.4 billion Capital Improvement Program ("CIP") for the San José- Santa Clara Regional Wastewater Facility ("RWF") and obtaining long-term financing in the form of bonds. The $300 million interim financing facility is available to meet the cash flow and financing needs of the City's Environmental Services Department during the early construction phases of the major construction process. As the project progresses, it is anticipated that the Authority will periodically pay off the interim financing facility with long-term bonds. Any associated debt service for financing (whether interim or long-term) will be paid by installment payments made by the City to the Authority from pledged system revenues received by the City related to the Treatment Plant and the sewer collection and conveyance system (the "Wastewater System", and together with the Treatment Plant the "Wastewater Treatment System") less maintenance and operation costs of the Wastewater Treatment System ("Net System Revenues"). There is no pledge of funds from the City's General Fund.

The Tax Cuts and Jobs Act became effective on December 22, 2017 (the "Tax Act") and among other changes, reduced the maximum federal corporate tax rate to 21% from 35%. The Credit Agreement contains provisions that formulaically adjust the interest and fees for tax exempt Notes upon a change in the maximum federal corporate tax rate. As a result of the Tax Act, the borrowing costs of tax exempt Notes increased by approximately 22%. City staff has negotiated with the Bank to revise the formula to reduce the increase to 14%, instead of 22% as currently outlined in the Credit Agreement.

BACKGROUND

In April 2017, the City posted a Request for Proposals for Bank Support of a Commercial Paper Program or Revolving Line of Credit to the BidSync solicitation posting system. In May 2017, the City received nine responses of offers to provide bank support for a commercial paper program (letter of credit) and/or a line of credit. City staff, in consultation with its municipal advisor, Public Resources Advisory Group ("PRAG"), determined that a direct loan (line of credit) from Wells Fargo Bank, N.A. (the "Bank") was expected to provide the lowest overall cost to the City.

Council and the City of San José Financing Authority (the "Authority") approved actions related to entering into the Credit Agreement and Fee Letter at the joint Council/Authority meeting on October 3, 2017. The September 18, 2017 staff memo[1] includes information regarding the Financing Plan, Master Resolution, Credit Agreement, and Fee Letter, including (a) a summary of the security pledge and structure, (b) pricing, and (c) terms and covenants in the Credit Agreement and Fee Letter

Impact of The Tax Cuts and Jobs Act of 2017

Subsequent to the establishment of the Interim Financing Program on October 19, 2017, the Tax Act which was introduced on November 2, 2017, became effective on December 22, 2017. Included in the initial versions of the tax bill were reductions in the maximum federal corporate tax rate from 35% to 20%. The Tax Act ultimately adopted a reduction in the maximum federal corporate tax rate to 21%. Prior to the Tax Act, the maximum federal corporate tax rate had not changed since 1993. For the period of 1988 through 1992, the maximum federal corporate tax rate was 34%.

The Credit Agreement contains provisions that adjust the rate on tax exempt Notes as a result of changes to the maximum federal corporate tax rate to maintain the economic benefit of owning the tax exempt Notes. This adjustment to the rate is based on the "Margin Rate Factor" at any given date of calculation and is a common provision in bank credit facilities such as the Credit Agreement. In the Credit Agreement, the Margin Rate Factor is currently calculated by multiplying (a) (1 - minus the maximum federal corporate tax rate) by (b) 1.53846. Examples of the Margin Rate Factor calculations for maximum federal corporate tax rates of (a) 35% and (b) 21% are shown below:

a) (1 - 0.35) multiplied by 1.53846 = 1.0000
b) (1 - 0.21) multiplied by 1.53846 = 1.2154 (approximately 22% increase)

The sum of the following two rate components is then multiplied by the Margin Rate Factor to determine the total rate on tax exempt Notes for the relevant interest calculation period:

1) The Tax Exempt Applicable Spread (which is based on the current long-term, unenhanced ratings on obligations paid from Net System Revenues and is currently 0.35%); and
2) the floating taxable index of One-Month LIBOR (multiplied by 70% as an Applicable Factor.

With the maximum federal corporate tax rate of 35% in effect at the establishment of the Credit Agreement in October 2017, the Margin Rate Factor equaled 1.0 and the borrowing costs of tax

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[1] September 18, 2017 staff report - http://sanjose.legistar.com/gateway.aspx?M=F&ID=6c67411d-f701-4e59-b07a-807017fab19d.pdf

exempt Notes was simply (1) the Tax Exempt Applicable Spread (0.35%) plus (2) 70% of One-Month LIBOR.

If the maximum federal corporate tax rate increases above 35%, the Margin Rate Factor is less than 1.0 and the borrowing costs on tax exempt Notes is less than (1) the Tax Exempt Applicable Spread (0.35%) plus (2) 70% of One-Month LIBOR.

However, the maximum federal corporate tax rate decreased from 35% to 21%, due to the Tax Act, causing the Margin Rate Factor to increase to 1.2154 and therefore each rate component for tax exempt Notes is currently increased by a factor of 21.54% above what each component would have been if the maximum federal corporate tax rate had remained 35%.

The change in the maximum federal corporate tax rate only impacts tax-exempt borrowings, not any taxable borrowings by the City or if issued, taxable Subordinated Wastewater Revenue Notes. In addition, there is no impact on the Commitment Fee (currently 0.25%) associated with any undrawn amounts of the $300 million interim financing facility.

ANALYSIS

The recent reduction in the maximum federal corporate tax rate due to the Tax Act results in each rate component of the Tax Exempt Rate for tax exempt Notes in the Credit Agreement to increase by a factor of 21.54% If the maximum federal corporate tax rate of 21% does not change, the proposal from the Bank results in lower borrowing costs for tax exempt Notes.

Bank Proposal

In November 2017, soon after the discussions on tax reform began, City staff requested that the Bank address the impact on the borrowing costs of tax exempt Notes due to a potential lowering of the maximum federal corporate tax rate. After a number of discussions, the Bank in May 2018 proposed to make adjustments to the Margin Rate Factor. The proposed adjustments to the Margin Rate Factor would reduce the interest cost on tax exempt Notes from the levels required by the current terms of the Credit Agreement.

The Bank is proposing to make the following changes outlined in the table below in both the Amended Credit Agreement and Amended Fee Letter. These charges are expected to reduce the cost to the City of tax exempt Notes.

Components to Determine Tax Exempt Rate	Current Agreement		Proposed Amendments	
	Before Tax Change	After Tax Change	After Tax Change Proposed by Bank	Notes
Margin Rate Factor (b)	1.00	1.22	1.00	Change Proposed by Bank to equal 1.0
LIBOR Index	1.91%	1.91%	1.91%	
Applicable Factor	70%	70%	80%	Change Proposed by Bank
Applicable Spread	0.35%	0.35%	0.39%	Change Proposed by Bank
Corporate Tax Rate	35%	21%	21%	Tax law lowered corporate tax rate
Tax-Exempt Interest Rate ("a" x "b")	*1.69%*	*2.05%*	*1.92%*	result = higher interest rate from Tax change
Percent Increase		22%	14%	
(a) Applicable Spread + (LIBOR Rate x Applicable Factor)	1.69%	1.69%	1.92%	higher percentage from bank proposal
(b) Margin Rate Factor = (1 - Corporate Tax Rate) x 1.53846	1.00	1.22	1.00	Margin Rate Factor = (1 - Corporate Tax Rate) x (1 / (1 - Corporate Tax Rate)

First Amendment to Credit Agreement and Amended and Restated Fee Letter Agreement

In order to reduce the impact on borrowing costs of tax exempt Notes due to the change in the maximum federal corporate tax rate, it is necessary to amend the Credit Agreement and the Fee Letter. The First Amendment to Credit Agreement ("Amended Credit Agreement") makes changes to the definitions of Margin Rate Factor, Applicable Factor, Tax Exempt Applicable Spread, and Tax Exempt Rate as illustrated in the table above. The Amended and Restated Fee Letter Agreement ("Amended Fee Letter") reflects an increase in the Tax Exempt Applicable Spread to 0.39% from 0.35%. The revisions to the Amended Credit Agreement also will be reflected in a revised form of the tax exempt Note. The Bank will surrender the existing tax-exempt Note to the Authority concurrent with the Authority's execution of the revised replacement tax exempt Note. As stated earlier, both amendments effectively reduce the City's borrowing costs relative to the original agreements operating under the current maximum federal corporate tax rate.

Authorization to Execute Documents

The First Amendment to Credit Agreement, the Amended and Restated Fee Letter Agreement, and the authorizing resolutions of the City Council and the Authority will be posted to the agenda webpage for the joint meeting of the City and the Authority on or about June 15, 2018. Staff recommends that the City Manager, Director of Finance, or their authorized designees (the "City Designated Officers"), and the Executive Director, the Treasurer, their authorized designees (the "Authority Designated Officers"), be authorized to execute the First Amendment to Credit Agreement and the Amended and Restated Fee Letter Agreement, as posted, on behalf of the City and the Authority, as applicable, with such modifications as the City Designated Officers and Authority Designated Officers determine to be desirable or appropriate, upon consultation with the City Attorney.

Financing Team Participants

The financing team participants consist of:

City Municipal Advisor:	Public Resources Advisory Group (PRAG)
Note Counsel:	Orrick, Herrington & Sutcliffe LLP
Bank:	Wells Fargo Bank, National Association
Bank Counsel:	Kutak Rock LLP

- Municipal Advisor – PRAG serves as the City's Wastewater Municipal Advisor as selected through a request for proposal ("RFP") process by the Finance Department.

- Note Counsel – Orrick, Herrington & Sutcliffe LLP was selected through a RFP process by the City Attorney's Office.

Financing Schedule

The current proposed schedule is as follows:

Council/Authority approval of agreements:	June 26, 2018
Documents closing:	June 27, 2018

EVALUATION AND FOLLOW-UP

This memorandum presents the set of recommendations related to the City Council and the Authority Board's approval of these actions and requires no additional evaluation or follow-up to the City Council or the Authority Board.

PUBLIC OUTREACH

The proposed resolutions of the City Council and the Financing Authority Board, the First Amendment to Credit Agreement and the Amended and Restated Fee Letter Agreement will be posted to the agenda webpage for the joint meeting of the City and the Authority on or about June 15, 2018.

COORDINATION

This memorandum has been coordinated with the City Attorney's Office, City Manager's Budget Office, and the Environmental Services Department.

COMMISSION RECOMMENDATION/INPUT

There is no commission recommendation or input associated with this action

FISCAL/POLICY ALIGNMENT

The proposed financing plan is consistent with the City's Debt Management Policy which establishes objectives in order to obtain cost-effective access to the capital markets, which includes minimizing debt service and issuance costs; maintaining access to cost-effective borrowing; and ensuring compliance with applicable State and Federal laws.

COST SUMMARY/IMPLICATIONS

The recommended actions will result in reductions in the interest and fee cost components applicable to the tax exempt Notes pursuant to the documents being amended. It is anticipated that total actual costs under the Program in FY 2017-2018 will be less than budgeted due to drawing less funds than programmed, even with the additional cost as a result of the change in the maximum federal corporate tax rate due to the Tax Act. The fees of the Bank and the Bank's counsel as well as the City's advisors will be paid from budgeted funds for the Program. The Notes issued for the identified purposes are expected to be repaid periodically from the proceeds of the issuance of long-term bonds.

BUDGET REFERENCE

Debt service costs from having the interim financing in place as well as debt service costs for advances under the Notes issued were included in the 2017-2018 Adopted Capital Budget in the Debt Service Repayment for Plant Capital Improvement Projects appropriation to fund the agreement recommended as part of this memorandum. The 2017-2018 Adopted Capital Budget assumes that $90 million will be required in interim financing support to cover the cost of capital projects in 2017-2018. Draws on the program will be made monthly shortly after incurrence of the expense and recognition in the City's financial accounting system. Future debt service costs are subject to appropriation by the City Council and will be brought forward for review and approval during the annual budget process in future years requiring debt service payments.

CEQA

San José-Santa Clara Regional Wastewater Facility Master Plan EIR, File No. PP11-043 (Resolution No. 76858).

/s/
JULIA H COOPER
Director of Finance
Treasurer, City of San Jose Financing Authority

For questions, please contact Joe Gray, Debt Administrator at (408) 535-7032.