CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

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

FROM: Julia H. Cooper
Kerrie Romanow

SUBJECT: **SEE BELOW**

DATE: September 15, 2020

Approved D. DSyL

Date **9/27/2020**

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

RECOMMENDATION

a. Adopt a resolution of the City Council approving and authorizing the execution and delivery of a Second Amendment to the Credit Agreement and a Second 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 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 extend the term of the Credit Agreement and the Notes and to revise the calculation of interest and fees for the Notes and authorizing other related actions in connection therewith.

b. Adopt a resolution of the City of San José Financing Authority Board approving and authorizing the execution and delivery of a Second Amendment to the Credit Agreement and a Second 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 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 extend the term of the Credit Agreement and the Notes and to revise the calculation of interest and fees for the Notes and authorizing other related actions in connection therewith.

OUTCOME

Approval of these recommendations will result in amendments to the existing 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 (the "Bank"), and the associated Fee Letter Agreement ("Fee Letter") and extension of the Credit Agreement and Fee Letter for three years to October 18, 2023.

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. Such a facility allows the City to borrow funds and pay costs as the funds are needed, thereby minimizing the interest expense compared to a bond issue which requires interest on the full balance to begin upon closing whether the proceeds have been expended or not. As the projects progress and the funds are drawn on the facility, it is anticipated that the Authority will periodically pay off the interim financing facility with long-term financing. 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 current agreement for the interim financing of San José-Santa Clara Regional Wastewater Facility with Wells Fargo Bank expires on October 18, 2020. Staff has negotiated an extension of the agreement with the Bank to continue to provide the Credit Agreement for additional three years to October 18, 2023. It is anticipated that the Authority will pay off the interim financing facility (which bears interest at a variable interest rate) with long-term, fixed rate financing amortized over at least 30 years.

In coordination with the extension, the Bank has proposed amendments to the Credit Agreement related to the Bank's regulatory requirements that remain under negotiation. Staff will update the City Council at the meeting or through a supplemental memorandum to the extent the proposed amendments place increased obligations on the City. The amendments reflect changes in the fee structure, which results in pricing increases on the extended facility, creating a LIBOR Floor, which is subject to an assumed minimum of 50 basis points (LIBOR Floor), and increase in the applicable spread on the Tax-Exempt draws, which are described in more detail in the

Analysis section below. The applicable factor, which was established under the original agreement as amended by the First Amendment, is designed to have the rate mimic a tax-exempt rate when applied to the LIBOR index which is reflective of taxable rates.

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 BidSync, the City's prior internet-based e-procurement system. In May 2017, the City received nine responses to the RFP with 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 revolving direct loan (line of credit) from Wells Fargo Bank, N.A. (the "Bank") was expected to provide the lowest overall cost to the City.

Credit Agreement and Fee Letter Agreement

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[1]. The associated staff memo includes information regarding the Financing Plan, Master Resolution of the City Council relating to the pledge of wastewater net system revenues and the Subordinate Installment Purchase Contract between the City and the Authority, Credit Agreement and Fee Letter, including (1) a summary of the security pledge and structure; (2) pricing; and (3) terms and covenants in the Credit Agreement and Fee Letter.

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

Council and the City of San José Financing Authority (the "Authority") approved actions related the interim financing program, including amendments to the Credit Agreement and Fee Letter, on June 26, 2018[2] to adjust the calculation of interest and fees for tax-exempt Notes in order to address increased borrowing cost under the terms of the agreement resulting from tax changes in the Tax Cuts and Jobs Act ("Tax Act"). The Tax Act, which went into effect on December 22, 2017, changed the federal corporate tax rate from 35% to 21%, had the effect of reducing the value of tax-exempt income to the bank thereby increasing Credit Agreement fees under the

[1] October 3, 2017 joint Council/Authority Meeting: https://sanjose.legistar.com/LegislationDetail.aspx?ID=3160813&GUID=4F5AB017-FAEA-40D4-88BD-929872E259CD&Options=&Search=

[2] June 26, 2018 joint Council/Authority Meeting: https://sanjose.legistar.com/LegislationDetail.aspx?ID=3523897&GUID=34807D4E-EE17-4390-BF06-2421483C15A4&Options=&Search=

terms of the agreement by approximately 22%. City staff negotiated with the Bank to revise the formula in the first amendment to reduce this increase to 14% instead of 22%.

ANALYSIS

City staff has negotiated a three-year extension to the agreements with the Bank to provide for the borrowing of up to $300 million outstanding at any one time, as needed, to finance RWF CIP improvements. This interim financing program is part of a long-term plan to provide funding for the RWF CIP at the lowest possible cost and with the least risk.

In anticipation of the end of the term of the initial agreement on October 18, 2020, staff began evaluating renewal options during the spring, amid the financial market disruption caused by the COVID-19 situation. The COVID-19 pandemic has disrupted the municipal credit market. The City contacted the Bank in May 2020 to get an indication on its ability and willingness to renew the Credit Agreement. In view of the market disruptions, the Bank originally indicated that it could offer only a one-year extension for a reduced amount of $200 million. Based on the CIP for the projects, this would not have been adequate for the program. After a more detailed presentation and further discussions with the Bank, in August 2020, the Bank agreed to extend the Credit Agreement for three years and provide a credit facility of up to $300 million as requested by the City. To reduce the time of completing the amendments to the Credit Agreement, the City indicated its desire to use the original structure as amended in 2018 in substantially the same form, including documents (Credit Agreement and Fee Agreement) and pricing structure (i.e., LIBOR-based, indexed variable rate). The renewal terms of the Credit Agreement result in increased borrowing costs due to the challenging municipal credit market during the COVID crisis and heightened liquidity demands on banks.

To compensate the Bank for reserving capital for the facility, the bank charges an undrawn fee. This fee is currently 25 basis points ("bps") or 0.25% per year on the portion of the $300 million facility that is not yet borrowed or "drawn" from the facility. This fee will increase to 35 bps under the amendment. On amounts that have been drawn from the facility to finance projects eligible for tax-exempt financing, the City pays a tax-exempt variable rate interest rate derived by multiplying an Applicable Factor times the Index plus the Applicable Spread. If the value of tax-exempt income to the bank changes due to changes in the corporate tax rate, the Applicable Factor is further adjusted by a Margin Rate Factor to account for that change. The variable rate on the facility is set by an Index which is the one-month LIBOR[3] index (a widely used taxable interest rate). Under the amendment this Index will be subject to an assumed minimum of 50 basis points (LIBOR Floor); under the existing agreement there was no LIBOR Floor. As of September 4, 2020, the 1-month LIBOR interest rate was 0.15425%, so the rate under the Index

[3] London Interbank Offered Rate (LIBOR) is a standard financial index used in U.S. capital markets and one of the most widely used indices in the world. Rates are widely available and can be readily found quoted in the Wall Street Journal. LIBOR is a taxable index and the adjustments described above and governed by the credit agreement are designed to produce a tax-exempt equivalent.

used would be 0.50%. Under the proposed amendment, the Applicable Factor on the Tax-Exempt draws remains the product of 80 bps (or 0.80%) multiplied by the Margin Rate Factor. Based on the amendments, the Applicable Spread on the Tax-Exempt draws is increased from 39 bps (0.39%) to 95 bps (0.95%). On any Taxable draws, the Applicable Spread will increase from 45 bps to 110 bps.

As of September 4, 2020, the current facility rate for a tax-exempt balance is therefore 80% of 0.15425% plus 39 bps or 0.5134 %. Under the amended agreement, if 1-month LIBOR was 0.15425%, then the facility rate for tax-exempt balances would be 1.35% (80% of the Index, subject to the 0.50% LIBOR Floor, plus 95 bps). While this substantially increases rates, and future rates will be variable and could rise, these still represent remarkably low borrowing rates for the interim borrowing facility. For financial planning purposes, variable rate debt should be budgeted conservatively due to the many variables that can increase overall interest rates during the course of the fiscal year.

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

City staff negotiated with Wells Fargo Bank to continue to provide the Credit Agreement for an additional three years commencing in October 2020 with termination date of October 2023. One of the more significant changes will be the transition from the LIBOR index (which is expected to be phased out in December 2021 during the proposed three-year Credit Agreement extension term) to a new benchmark index as determined by the Bank. The revised Credit Agreement provides procedures for the Calculation Agent (the Bank) to institute the index to replace the LIBOR index.

The Second Amendment to Credit Agreement makes changes to various definitions, including to accommodate potential transition of the benchmark index from LIBOR to another index as the LIBOR index is proposed to be replaced and to establish a LIBOR Floor of 0.50%. The Stated Expiration Date for the Credit Agreement will be October 18, 2023. Upon termination, the Second Amendment requires the Authority to repay unpaid balances within 30 days of the Termination Date or to request repayment to the Bank over a 3-year amortization period assuming there are no defaults or event of defaults and the representations and warranties of the City and the Authority remain true. If the Bank does not grant the request to repay the outstanding balance over a 3-year amortization period, then the unpaid balances must be repaid within 30 days. The City expects to refinance the balance with long term debt before the expiration of the term or negotiated an extension or replacement of the facility.

Other significant changes are to the pricing provisions set forth in the Fee Letter Agreement that will increase borrowing costs. The City pays to have the full $300 million facility available. It pays an "Undrawn Fee" on the portion of the facility that has not yet been used and it pays a "Drawn Fee" for any balance that has been borrowed from the facility. The changes to these fees include:

	Current Agreement	2020 Amendment
Facility Amount	$300,000,000	$300,000,000
Term	3 Years (expiring 10/18/20)	3 Years (expiring 10/18/23)
Undrawn Fee	0.25%	0.35%
LIBOR* (1ML*) Floor	--	0.50%
Current 1ML*	0.15425%	0.15425%
Tax-Exempt Drawn Fee	80% 1ML + 0.39%	80% 1ML + 0.95%
Taxable Draw Fee	1ML + 0.45%	1ML + 1.10%

*London Interbank Offering Rate (LIBOR), an index that changes daily based on prevailing interest rates. 1ML stands for 1-month LIBOR and is a 30-day LIBOR rate, which is an index calculated daily but the rates on this facility are set monthly on the first business day of each month.

- **Undrawn Fee.** This fee increases from 0.25% to 0.35% (difference between the Facility Amount less the outstanding principal amount of advances made to the City)
- **The Tax-Exempt Drawn Rate** – is a rate established by the Calculation Agent (the Bank) each month. Currently this calculation is 80% of the 1-month LIBOR Index plus 0.39%. Under the amendment the index remains 80% of 1-month LIBOR but the LIBOR rate has a 50 bps floor and the Applicable Spread increases from 0.39% to 0.95% for tax-exempt borrowing
- The formula builds in a mechanism for the rate to adjust based on modifications to the tax code that change the value of the tax-exempt income to the Bank (if corporate tax rates go up, the value of receiving tax-exempt income increases for the Bank) and therefore the City's rate declines under a formula in the documents known as the Margin Rate Factor. If the Corporate Tax rate were to be cut, the opposite dynamic would occur.
- The Taxable Drawn Rate is 100% of 1-month LIBOR plus 0.45% currently and increases to 1.10% under the amendment.
    - If one-month LIBOR is less than 50 bps, then the floating rate index remain 50 bps based on the floor.

Pricing Chart

The Commitment Fee and Applicable Spread increases if the credit ratings on long-term, unenhanced (uninsured) debt supported by the pledged Net System Revenues are downgraded, as set forth in the following table. The current long-term, unenhanced ratings on the only outstanding, rated obligation paid from the Net System Revenues, the San Jose-Santa Clara Clean Water Financing Authority ("CWFA") 2009A Bonds, are Aa2/AAA/AAA by Moody's Investors Service, S&P Global, and Fitch Ratings, respectively. These ratings place the current fees into the lowest fee rate category based on the second lowest rating. However, since the current outstanding bonds, CWFA 2009A mature on November 15, 2020 and those ratings will therefore be withdrawn, an alternate pricing methodology was developed if there are no ratings. The fee will be based on debt service coverage ratio levels from adjusted Net System Revenues, which places the current fees into the lowest fee rate category based on the coverage ratio.

Level	***Ratings on Long-Term, Unenhanced Wastewater Obligations*** **(Moody's/S&P/Fitch)**	**Commitment Fee (Undrawn Amount)**	**Applicable Spread (Drawn Amount) [Tax-Exempt / Taxable]**	**Debt Service Coverage Ratio (DSCR)**
Level 1	Equal to Aaa/AAA/AAA	0.350%	0.950% ***I*** 1.100%	>2.0x
Level 2	Equal to Aal/AA+/AA+	0.375%	1.025% ***I*** 1.175%	>1.85x-≤2.0x
Level 3	Equal to Aa2/AA/AA	0.400%	1.100% ***I*** 1.250%	>1.70x-≤1.85x
Level 4	Equal to Aa3/AA-/AA-	0.425%	1.175% ***1*** 1.325%	>1.45-≤1.70x
Level 5	Equal to Al/A+/A+	0.475%	1.325% ***I*** 1.475%	>1.25-≤1.45x
Level 6	Equal to A2/A/A	0.525%	1.475% ***I*** 1.625%	≥1.10x-≤1.25x
Level 7	Equal to A3/A-/A-	0.575%	1.625% ***I*** 1.775%	<1.10x
	A3/A-/A- or below	*NIA*	Default Rate	

Other than the amendments to related to repayment upon termination of the Credit Agreement described above, the key terms of the Credit Agreement set forth below remain unchanged from the current agreement, including the interest rate applicable to the repayment of unpaid amounts of the loan over the 3-year amortization period:

Termination Date	Three (3) years after effective date of Credit Agreement. The Authority can terminate the agreement at any time.
Base Rate	Greatest of (i) Bank's prime rate + 1.0%; (ii) Fed Funds Rate + 2.0%; (iii) 7.0%. In the current interest rate environment, the highest of these three rates is the 7.0% per annum rate.

Bank Rate	Base Rate (Termination Date through 180 days) Base Rate + 1.0% (181+ days after Termination Date) This interest rate is charged when loans have not been repaid and the Credit Agreement has not been extended beyond the Termination Date.
Term Out	Assuming no events of default have occurred and subject to the Authority making certain representations and warranties, if the Authority fails to repay the loans on the Termination Date, and subject to the Bank's agreement, the unpaid loans will carry the Bank Rate described above and will be amortized in equal quarterly installments over a period ending three years after the Termination Date. This provision is similar to a "Term Loan" in a reimbursement agreement for a letter of credit or liquidity facility.
Default Rate	Base Rate + 3.0%. Applicable only in the event of a default.
Optional Prepayment	Loans may be prepaid upon two business days' notice, subject to any make-whole funding costs. Any potential make-whole funding costs can be avoided entirely with 30-days' notice to the Bank
Determination of Taxability	Tax-exempt loans are subject to the City paying a taxable rate of interest to the Bank, as well as any fees, penalties, or other costs, in the event all or a portion of the interest is determined to be taxable, whether through a change in law or a determination of taxability that is made by the IRS or legal counsel.
Waiver of Jury Trial	The City, the Authority and the Bank each waive its right to jury trial. Further, the City and the Bank agree that if a waiver of jury trial is unenforceable (which may be the case under California law), the dispute will be adjudicated by a judicial referee per the provisions of California law.
Increased Bank Costs and Capital Adequacy	Increased costs and changes in capital adequacy requirements include changes resulting from the Dodd-Frank Act and Basel III, regardless of the date of enactment.
Participations by the Bank	While it is the Bank's intention to not participate any of the loans to other lending institutions, the Bank has the right under the Credit Agreement to sell, assign, negotiate or grant participations in the loans.

As is common in agreements with banks, the existing Credit Agreement requires the City and the Authority, to the extent permitted by law, to indemnify the Bank for various claims by third parties, the City or the Authority arising from various aspects of this transaction. The only exception to the Authority's obligation to indemnify the Bank for these claims is where the liability or damages results from the Bank's willful misconduct or gross negligence.

Authorization to Execute Documents

The Second Amendment to the Credit Agreement, the Second 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 September 18, 2020. Staff recommends that the City Manager, Director of Finance, or their designees (the "City Designated Officers"), and the Executive Director, the Treasurer, or their authorized designees, which may include representatives of the City (the "Authority Designated Officers"), be authorized to execute the Second Amendment to Credit Agreement and the Second 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
Note Counsel:	Orrick Herrington & Sutcliffe
Bank:	Wells Fargo Bank, National Association
Bank Counsel:	Kutak Rock LLP

- City Municipal Advisor – Public Resources Advisory Group was selected as the Municipal Advisor from the Municipal Advisory Pool.[4]
- Note Counsel – Orrick Herrington & Sutcliffe was selected as the Note Counsel from the City's bond counsel pool that was established through a competitive process by the City Attorney's Office.

[4] General Municipal Advisors were selected, and Municipal Advisory Pools were established in August 2017 through a Request for Proposals process.

Financing Schedule

The current proposed schedule is as follows:

Council/Authority approval of agreements:	September 29, 2020
Documents closing:	October 16, 2020
Effective date of new fees:	October 18, 2020

CONCLUSION

Approval of the recommendations will result in the extension of the Credit Agreement and the Fee Letter, provide a $300 million Bank Credit Facility that expires in October 2023, and provide 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.

EVALUATION AND FOLLOW-UP

This memorandum presents the set of recommendations related to the City Council and the Authority Board's approval of various actions related to the interim financing program for the RWF CIP and requires no additional evaluation or follow-up to the City Council or the Authority Board.

CLIMATE SMART SAN JOSE

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

PUBLIC OUTREACH

The proposed resolutions of the City Council and the Financing Authority Board, the Second Amendment to the Credit Agreement and the Seconded 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 September 18, 2020.

COORDINATION

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

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.

The proposed financing plan is consistent with the Council approved Guiding Principles for Budget and Financial Management for the City to meet its legal commitments and requirements with respect to repayment of bonds, and 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

The recommended actions will result in increases in the interest and fee cost components applicable to the Notes pursuant to the documents being amended. When compared to the previous Program, the estimated increased costs would represent an increase to the consumers of the Sanitary Sewer Charge rate of 2.5% over the new Program's three-year term. However, the actual cost will vary depending on the pace of capital project construction and the interest rate and will continue to be closely monitored. The estimated revenues and annual debt service payments related to the Program were included in the 2020-2021 Adopted Capital Budget and 2021-2025 Capital Improvement Program. Although no budget or rate adjustments are necessary at this time, financing costs for both the interim financing program and the future amortization of long-term bonds will continue to be included in the calculation of annual rate increases.

As noted in the report to the City Council in 2017, the Interim Financing Program over the longer-term is expected to reduce the City's overall costs of borrowing for the RWF's CIP program. The City pays a lower borrowing cost for the Interim Financing than if it were to issue long-term 30-year bonds to finance the construction of the CIP projects. The long-term bonds will be periodically issued after construction is complete on the CIP projects.

The Notes issued for the identified purposes are expected to be repaid periodically from the proceeds of long-term financing. Future debt service costs are subject to appropriation by the City Council and will be brought forward for review and approval as part of the capital budget development process.

BUDGET REFERENCE

The table below identifies the fund and appropriation to pay debt service costs related to the Program.

Fund #	Appn #	Appn. Name	Total Appn.	Last Budget Action (Date, Ord. No.)
512	402C	Debt Service Repayment for Plant Capital Improvement Projects	$4,426,000	6/23/20, Ord. No. 30437

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 and File No. PP17-007, Preliminary direction to staff and eventual action requires approval from decision-making body.

/s/
JULIA H. COOPER
Director of Finance

/s/
KERRIE ROMANOW
Director of Environmental Services

For questions, please contact Nikolai J. Sklaroff, Deputy Director, Debt and Treasury Management, at (408) 535-7832.