AGENDA ITEM K-1

CITY OF LODI
COUNCIL COMMUNICATION

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AGENDA TITLE: Provide direction regarding the fixed rate refinancing for the Electric Utility 2002 Variable Rate Demand Obligations and authorize the City Manager to effectuate the financing plan for the 2008 EUD fixed rate project.

MEETING DATE: May 21,2008

PREPARED B Y Deputy City Manager

RECOMMENDED ACTION: Provide direction regarding the fixed rate refinancing for the Electric Utility 2002 Variable Rate Demand Obligations and authorize the City Manager to effectuate the financing plan for the 2008 EUD fixed rate project by the following actions:

Adopt resolution authorizing 1) Stone & Youngberg to serve as Senior Managing Underwriter, directing the City Manager to execute contracts on the City's behalf (payable from proceeds in an approximate amount of $345,000 to $390,000); 2) the City Manager to engage Lamont Financial Services for a not-to-exceed amount of $70,000 to provide financial advisor services; 3) the City Manager to engage Orrick, Herrington & Sutcliffe, LLP to serve as Bond Counsel (payable from proceeds in an approximate amount of $110,000); and 4) the City Manager to incur other costs related to bond issuance not to exceed $77,500.

BACKGROUND INFORMATION: The City has $46.7 million in outstanding variable-rate debt issued in 2002 that is insured by MBIA, at one time the largest and most well-known municipal bond insurer. The insurance boosted the creditworthiness of the Electric Utility bonds to an effective AAA rating.

Investors, however, are losing faith in MBIA's ability to guarantee debt it insures after MBIA reported steep financial losses this year due to its souring investments in the subprime mortgage market. Investors redeemed approximately $5 million in Electric Utility VRDOs earlier this year, some of which were paid back through a financial liquidity arrangement the Electric Utility has with BNP Paribas as part of the 2002 issuance. All those bonds, which carry an interest rate that resets weekly, were later remarketed to other investors.

Because the financial markets no longer consider MBIA a topquality bond insurer, the Electric Utility risks having more of its 2002 notes redeemed by investors in the future. If they are not immediately remarketed, the utility pays interest to BNP Paribas to hold them, rather than repaying the principal amount to the investor.

The letter of credit with BNP Paribas, however, expires in January 2009 and BNP Paribas declined a request to extend the arrangement. Other banks deemed creditworthy by investment banking standards were contacted by Lamont Financial Services. They also declined to provide a liquidity vehicle to the

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APPROVED: ______________________
Blair King, City Manager

utility, which puts the Electric Utility at risk of having to repay investors in cash if any or all of the notes are redeemed after January 2009.

Because that is a risk the Electric Utility can not take, City management has consulted with its financial advisor, Lamont Financial Services, to find a solution to reduce the utility's financial risk. Lamont has diligently explored various options and is recommending the Electric Utility convert the entire debt to a fixed rate. Assured Guaranty, one of two municipal bond insurers not affected by the subprime mortgage state of affairs, has provided a commitment letter to back $66 million worth of new Electric Utility bonds.

The City Manager and Deputy City Manager, along with Lamont and other financial experts advising the Electric Utility, also recommend termination of the 2002 interest-rate swap even though doing so will cost approximately $9.2 million. The swap's purpose was to balance the 2002 variable-rate debt, creating a "synthetic" fixed rate. But as short-term interest rates have declined, the swap's negative value has increased. The City's financial experts are comfortable that the utility's current revenue can absorb the additional debt service required to terminate the swap. Even with the new debt, the Electric Utility does not predict the need for a rate increase for several years.

The City Council is being asked to direct staff if and how to proceed with a refinancing. Here is a synopsis of the various options:

1. Do nothing.
   In choosing this option, the Electric Utility would not incur any refinancing costs. The risk, however, is the utility does not have $47 million in cash on hand in case investors redeem the VRDOs after January. MBIA's financial status could improve, boosting the confidence of investors holding MBIA-backed notes and reducing the likelihood of redemptions. MBIA, however, reported a quarterly loss of $2.4 billion on May 12.

2. Refinance the $46.7 million of VRDO's, converting them to fixed-rate debt, and leave the swap in place.
   This would eliminate the redemption risk looming in January 2009 and lower refinancing costs. It would not, however, eliminate all risk. As long as the swap remains in place, there is a risk some unforeseen event could trigger a default and require immediate repayment. Also, the City's financial experts are of the opinion that the Lodi swap is not as favorable to the Electric Utility as the average municipal swap. However, a case could be made that some of the cost savings could be achieved with the swap in place. A full presentation will be made at the Council meeting.

3. Refinance the VRDO's and terminate the swap.
   This is the most costly option, but the one that will eliminate financial market risk to the Electric Utility for the life of the bonds. The purpose of the swap was to balance the variable-rate notes. Without the VRDO's, the swap is merely a speculative financial instrument.

If the City Council chooses to refinance the VRDOs, it will be necessary to procure the services of financial and legal experts to complete the financing of the project. Time is of the essence due to market risk, the timing of a response needed to Assured, and the call feature of the 2002 bond. Staff will implement Council direction. Final documents prior to closing will require Council approval, expected to occur in July. Each of the professional engagements is discussed below starting with the Investment Banker /Underwriter.

Investment Banker/Underwriter

Due to the need to expediently reissue this debt, staff is recommending that Stone and Youngberg be used as the Bank/Underwriter for the 2008 Electric Utility Debt Issue. In August, 2007 staff along with the

Budget/Finance Committee and two City Council members conducted interviews (related to the 2007 Wastewater Bonds issue) of several underwriting firms and recommended engaging Stone & Youngberg as the Senior Manager on that financing. Staff recommends engaging Stone and Youngberg for the 2008 Electric Issue based on their qualifications and the need to issue this debt on an expedient basis

Bond Counsel
Orrick, Herrington & Sutcliff has provided services to the City of Lodi on numerous occasions related to various debt issues over the course of several years. In particular they have served as Bond Counsel for the 2004 Wastewater COP and 2007 Wastewater COP. Based on their familiarity with the City and their expertise in dealing with the issues associated with the City of Lodi. staff recommends utilization of them as Bond Counsel on a 2008 Electric Utility COP. Their fees are estimated to be $110,000. The scope of services includes preparation of the installment sale agreement, trust agreement, escrow deposit agreement and tax certificate for the transaction, preparation of all required resolutions for the transaction, preparation of closing documents for the City and the corporation, participation in document discussions with the working group, delivery of our standard forms of approving opinion and supplemental opinion and attendance at such meetings of the City Council and corporation board as the City may request.

Financial Advisor
The Citv Council approved the utilization of Lamont Financial Services in February 2007. At that time Council. provided direction for staff to advise them on a project-by-project basis as financial advisory services are needed. Lamont Financial Services has given staff an estimate of $70,000 to provide financial advisory services on this 2008 COP project. Lamont will provide overall financial advisory services for this project, which includes coordinating all of the necessary events through the issuance of the new COP, providing projections on the various options related to sizing and timing of the debt issue, analyzing and confirming the interest rates on the sale of securities by the Investment Banker/Underwriter, coordinating with City staff, Bond Counsel, rating agencies and the Investment Banker/Underwriter related to provision of preliminary documents and Official Statement and all other necessary documents necessary to complete the 2008 COP transaction. Lamont is paid a fee for services that is not related to the issuance of debt.

Attached is a memorandum from Lamont Financial Services related to the 2002 bonds.

FISCAL IMPACT: Fiscal impacts are several and inherent to Council direction.

FUNDING **AVAILABLE:** Funding is provided through Lodi Electric Utility rates.

James R. Krueger
James R. Krueger
Deputy City Manager

cc: Tom Dunphy. LaMont Financial Services
George Morrow, Electric Utility Director
Budget and Finance Committee

RESOLUTION NO. 2008-97

A RESOLUTION OF THE LODI CITY COUNCIL AUTHORIZING THE CITY MANAGER TO EXECUTE CONTRACTS WITH STONE & YOUNGBERG TO SERVE AS UNDERWRITER; LAMONT FINANCIAL SERVICES TO PROVIDE FINANCIAL ADVISOR SERVICES: AND ORRICK, HERRINGTON & SUTCLIFFE, LLP TO SERVE AS BOND COUNSEL IN RELATION TO THE FIXED RATE REFINANCING FOR THE ELECTRIC UTILITY 2002 VARIABLE RATE DEMAND OBLIGATIONS

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WHEREAS, the City of Lodi needs to procure investment banking/underwriting services, bond counsel services, and financial advising services for the refinancing of 2002 Electric Utility Variable Rate Demand Obligations; and

WHEREAS, the City of Lodi reviewed the qualifications of seven investment banking/underwriter firms in August of 2007 for the purpose of underwriting the 2007 wastewater debt issue. Based on the review of the qualifications of all firms at that time, Stone and Youngberg was chosen to underwrite those bonds: and

WHEREAS, Orrick, Herrington & Sutcliffe, LLP has provided bond counsel services for a number of City of Lodi transactions including the 2002 Variable Rate Demand Series and the 2007 Wastewater Revenue Certificates of Participation; and

WHEREAS, the City of Lodi has previously engaged Lamont Financial Services to provide assistance with regard to the Electric Utility 2002 Variable Rate Demand Obligations; and

WHEREAS, due to the need to act expediently to refinance the 2002 Electric Utility Variable Rate Demand Obligation, the City of Lodi deems it appropriate to engage Stone and Youngberg as the underwriter, Lamont Financial Services as financial advisor, and Orrick, Herrington & Sutcliffe, LLP as bond counsel.

NOW, THEREFORE, BE IT RESOLVED that the City Council of the City of Lodi does hereby authorize the City Manager to enter into the following agreements in relation to the fixed rate refinancing for the Electric Utility 2002 Variable Rate Demand Obligations:

- Stone & Youngberg to serve as senior managing underwriter – $345,000 to $390,000 (payable from proceeds):
- Lamont Financial Services to provide financial advisor services – not to exceed $70,000; and
- Orrick, Herrington & Sutcliffe, LLP to serve as bond counsel – $110,000 (payable from proceeds).

BE IT FURTHER RESOLVED that the City Manager is authorized to incur other costs related to bond insurance in an amount not to exceed $77,500.

Dated: May 21, 2008

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I hereby certify that Resolution No. 2008-97 was passed and adopted by the City Council of the City of Lodi in a regular meeting held May 21, 2008, by the following vote:

AYES: COUNCIL MEMBERS – Hansen, Hitchcock, Johnson, Katzakian, and Mayor Mounce

NOES: COUNCIL MEMBERS – None

ABSENT: COUNCIL MEMBERS – None

ABSTAIN: COUNCIL MEMBERS – None

RANDI JOHL
City Clerk

Memorandum

To: Blair King, City Manager
Jim Krueger, Deputy City Manager

From: Lamont Financial Services

Date: May 16, 2008

Re: Series 2002A Electric System Bond Transaction/Status Overview

On March 4, 2002 the City of Lodi was notified by the Bank of New York, trustee for the Series 2002A Electric System Revenue Certificates of Participation ("COP), that $2.5 million of the $46.7 million weekly Variable Rate Demand Obligations ("VRDO") had failed to be remarketed. Since that time, there have been no additional failed remarketings and the $2.5 million of Bank Bonds have been successfully remarketed. All outstanding VRDOs of the Series 2002A issue are being remarketed in the tax-exempt market. The average rate for the week of 5/14-5/20 is 2.2%. However, the City remains venerable to changes in the market that again would place the Series 2002A in the danger of becoming Bank Bonds.

On March 11th the City asked Lamont Financial to assist the City in developing a market strategy to remove market risk to the City of the Series 2002A VRDO again becoming Bank Bonds and the potential steps the City may take to remove market risk associated with a VRDO security.

Tasks Performed Overview

The Lamont team has begun working on a number of parallel strategies to allow the City to maintain access to the tax-exempt market. The majority of the tasks performed were while a partial amount of the Series 2002A VRDOs were Bank Bonds. In early April, the City was notified that the Bank Bonds had been successfully remarketed to tax-exempt investors. Detailed below are the strategies currently under review and the steps taken to advance each:

- Current Standby Liquidity Facility—Lamont entered into discussions with BNP Paribas, current Standby LOC provider, in early March to either extend the current facility, which expires at the end of January 2009, or to provide a full, direct pay letter of credit for both credit and liquidity, for a term of three to five years. We had several discussions with a BNP representative over the last few weeks and we certainly believed that a Direct Letter of Credit ("DLC") would be approved. Unfortunately, in early May BNP turned down the request for the DLC.
- Exercise the City's right under the current documents to convert to a new VRDO mode--Under the documents, Lodi has the sole right to change modes to a one year term. However, without an extension of the liquidity facility from BNP or another LOC provider to cover the full year term, the City could not convert to the one year term. During our initial effort in March to secure a LOC provider over 20 banks, that were deemed credit worthy by investment bank standards, were contacted and only BNP expressed interest.
- Explore the potential of using local banks to assist the City with market access—The urgency associated with the need for local bank assistance has subsided due to the current VRDO market success and the firming of other strategies that are detailed below.

- Refund the existing VRDOs to fixed rate bonds—Preliminary numbers indicate that a current conversion to fixed rate obligations will be slightly more expensive then maintaining the VRDO (approximately 60 basis points). However the term of the LOC (BNP) expires in January 2009 and the experience Lamont had in the interest of providers to commit a LOC to the City would indicate difficulty in getting a substitute for BNP. Converting the bonds to fixed rate may be the only viable option to eliminate variable rate risk of the VRDOs going forward. ***Assured Guaranty has formally submitted a Commitment Letter to the City for bond insurance.*** The AAA rating offered by Assured will permit the City to market fixed rate bonds at approximately a 5.50% in the current market. The Commitment Letter expires June 27, 2008. Assured is only one of two municipal bond insurers that is currently viewed by investors as credit worthy. It should be noted that the City approached FSA, the other credit worthy insurer, and although FSA insured the 2007 $35 million Wastewater Treatment bond, declined to provide a quote for a fixed rate 2008 EUD bond.
- Stand-Alone Ratings—The City has just concluded a rating review with S&P and remains hopeful that a rating upgrade for the Electric System to the A category is a possibility. If successful, the rating improvement will lower the cost of the fix rate financing .
- MBIA participation—The original goal of the finance team was to retain MBIA as credit support for the swap, after replacing them on the VRDOs, with another bond insurer. Bond counsel believes that the City has the right to maintain MBIA on the swap once the VRDOs are refunded. Earlier resistance by MBIA to maintain insurance for the swap has been resolved. However, we are reviewing any potential problems that may arise with Assured if MBIA remains tied to the swap. The issue revolves around payment rights in the case of a termination payment related to the swap.
- Swap Termination—Assured Guaranty has agreed to cover any swap termination payment under their insurance policy (approximately $9 million) with the issuance of the Series 2008 Electric System Bonds. The question before the City is whether the removal of the swap best serves the City's interest. Currently, the swap is under water by 200 basis points on a notional amount of $47,650,000 or $953,000 annually that the City pays the swap counterparty Citigroup.

City of Lodi
2002 Variable Rate Demand Bonds
Series A

Overview and Recommended Action

Outstanding VRDO Electric Utility Debt

- 2002 A Variable Rate COPs (VRDOs) tax-exempt
  - $46.76 million outstanding
  - MBIA insurance
  - BNP Paribas standby liquidity facility
  - Interest rates set weekly in current mode
  - Swap with Citigroup
    - Payments to Citigroup 3.749%
    - Steps up to 4.945% after June 30, 2010
    - Less Payments from Citigroup (1.76%)

      (Based on 62.92% of LIBOR one month index 2.79%)
  - Net swap payment ($930,100) 1.989%
  - VRDO Debt Service 3.27% + 1.989% ~ 5.26%

VRDO and Interest Swap Diagram

3.749% (until June 2010)
4.945% (thereafter)

City of Lodi
1999 Fixed
To 2002
VRDOs

Variable Rate
(–2.2%
currently,
average~3.27%)

[redacted]
Citigroup

62.92% of LIBOR
(= 1.76% currently)

2002A COPs
To Trust
Agent

System’s Underlying Ratings

- Current ratings: S&P BBB+ (stable outlook); Fitch BBB (positive outlook)

- Recent rating review with S&P

- Fitch review is in the next few weeks

Description of Problem

- Trigger Point: Credit Decline of MBIA
- BNP liquidity termination (Jan. 2009) causes bond holders to redeem
- Failed remarketing on March 4, 2008
- $2.5 million became Bank Bonds at 5.25 % interest rate; with remarketing these bank bonds were repaid in early April
- No additional failed remarketings since then
- Current remarketing rates at 2.2% for week of May 14-22
  - Average since early February 3.27%
- Vulnerability to credit/liquidity changes remains
- Swap impacted by credit market and termination risk

Financing Options to Solve Problem

- Option 1: Do nothing, wait for market to stabilize (little or no probability of success)
  - Renew liquidity facility before January 2009 expiration
- Option 2: Maintain variable mode and swap (low probability of success)
  - Extend liquidity facility for longer term mode OR
  - Replace liquidity facility with direct-pay LOC
- Option 3: Refund VRDOs on fixed-rate basis with swap (probably successful) **policy decision**
  - Maintain swap in addition to fixed rate COPs
- Option 4: Refund VRDOs on fixed-rate basis w/out swap (probably most successful) **policy decision**
  - Finance swap termination payment through COPs

Do Nothing - Wait for Market Stabilization

- Retain MBIA insurance & BNP liquidity
- Swap remains in effect
- MBIA insurance maintained on SWAP
- No new transactional costs
- Need to replace or extend BNP liquidity by January 2009

Do Nothing – Best/Worst

Best Case Results:

- Market rates stabilize
- Possibility to renew liquidity in more favorable market within next 6 months
- Retain value of MBIA premiums ($498,000) on 2002 bonds; no new issuance costs

Worst Case Results:

- Additional market turmoil and failed remarketings
- COPs become Bank Bonds
  - Interest rate jumps to prime +2% (1%+1%> 30 days)
  - Must payback $46.76M over 5 year period (vs 24 years), with electric rate increases.
- Liquidity or swap termination
- Risk of SWAP termination due to MBIA/System downgrade with potential termination payment payable without source of funds. Current estimates of termination amount may increase as market changes. Current Market value is ($9.2) million.

Maintain VRDO Mode and Swap

- Convert VRDOs to longer mode (i.e. one-year)
  - Uses existing legal documents and insurance
  - Requires an extension of liquidity facility to cover full term

OR

- Refund VRDOs with alternate credit enhancement
  - Eliminates MBIA exposure
  - Requires new direct-pay LOC
- Some form of LOC necessary for either option

- Contacted 20 banks in March to secure LOC
  - Only BNP expressed any interest
  - BNP denied request for new or extended LOC
  - No LOC available

Local Banks

- Use of local banks to assist the City with market access
  - Broad market access with Investment Bank; no further exploration of this option

Fixed Rate Refunding Retaining SWAP

- Long term fixed rate bonds issued with new bond insurance
- Cash funded reserve to replace surety
- Cost of issuance incurred on long-term refunding
- Loss of value premiums paid to MBIA in 2002, $498,000
- MBIA insurance is maintained on SWAP
- AAA-rated Assured Guaranty has submitted a Commitment Letter to provide bond insurance on a fixed rate refunding

Fixed Rate with Swap Best/Worst

Best Case Results:

- Locks in current relatively low long term rates until 2032 maturity (~5.25%) but net swap payments continue (~2% currently)
- Slightly more expensive than VRDOs (about 60 basis points over existing VRDO/swap interest rate)
- Budget and rate increases are predictable, no short term interest spikes
- Eliminates issues related to Bank Bonds and liquidity

Worst Case Results:

- No benefit from future market stabilization and/or low short-term rates
- Long-term transactional costs of refunding
- SWAP payments to counterparty (Citigroup) may continue to increase in light of an increase in fixed payment to 4.945% in July 2010
- Swap termination risk remains
- Any future Swap termination would be on a taxable basis
- Higher costs to finance swap termination at future date

Fixed Rate Refunding Without Swap

- Long term fixed rate bonds issued with new bond insurance
- Cash funded reserve to replace surety
- Swap is terminated (additional interest payments of 2.0% avoided)
- Swap termination payment (approximately $9.2 million) funded on tax-exempt basis from proceeds of the Series 2008 COPs
- Cost of insurance incurred on long-term refunding, in addition to loss of value premium paid MBIA ($498,000) for Swap & VRDO

Fixed Rate without Swap Best/Worst

Best Case Results:

- Locks in current relatively low long term rates until 2032 maturity (–5.25%)
- Budget and rate increases are predictable, no short term interest spikes
- Eliminates issues related to Bank Bonds and liquidity
- Eliminate Swap Termination Risk and counterparty payments on Swap

Worst Case Results:

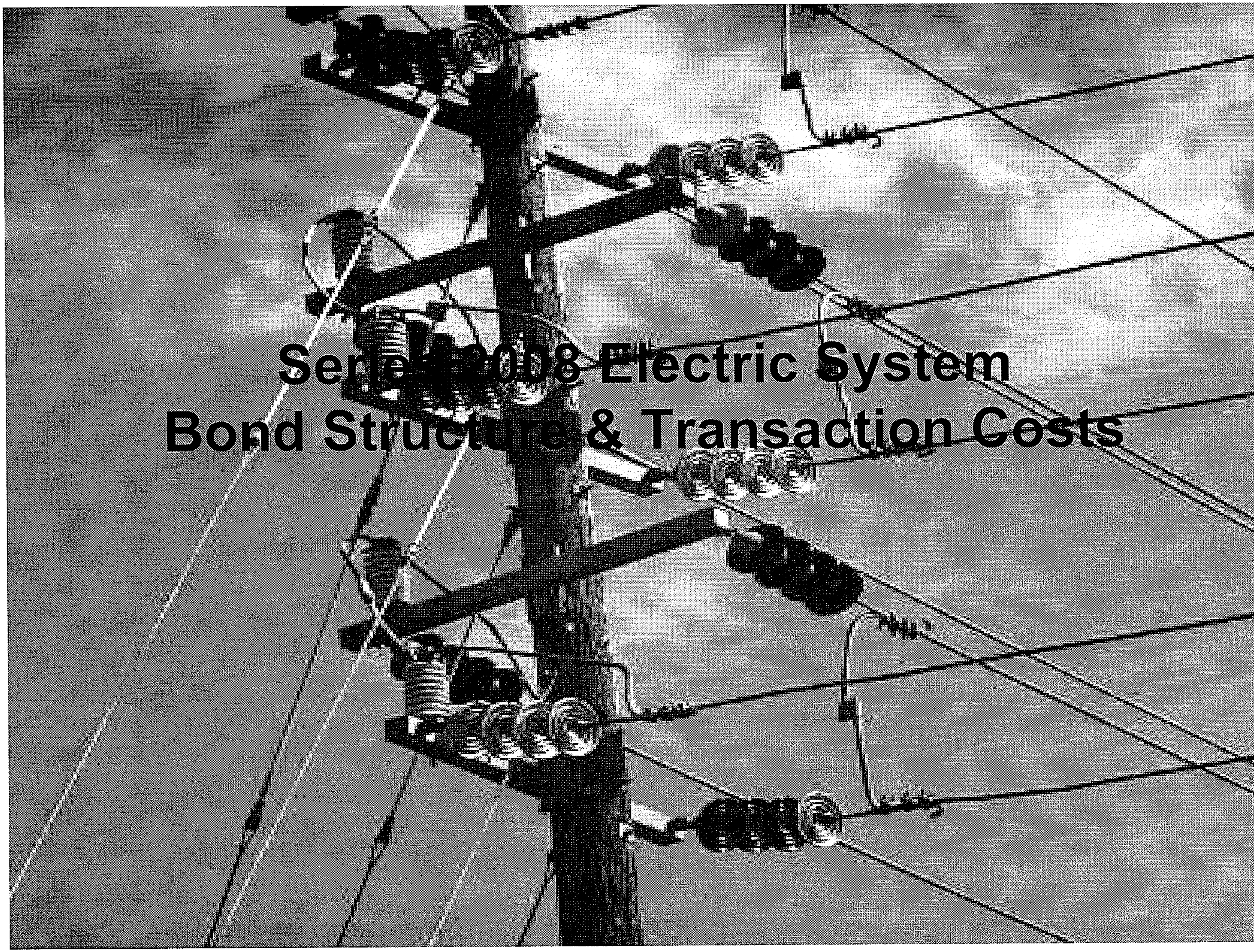
- No benefit from future market stabilization and/or low short-term rates
- Long-term transactional costs of refunding
- Bond size increases to finance Termination payment
- Removes any opportunity to lower termination cost (if future rates increase) by refunding in current market

Recommendation

- Refund outstanding VRDOs with Assured Guaranty fixed rate bonds
- Terminate Citigroup Swap
- Fund the swap termination payment with the proceeds of the Series 2008 Electric System bond issue

Justification:

- Due to credit market problems, liquidity is a serious challenge and we could not secure a LOC to allow continued VRDO mode
- Eliminates future Swap Termination risk for the System
- Terminating now permits a tax-exempt financing. Any future Termination financing would be taxable
- Establishes a steady, predictable debt service obligation for the System; eliminates additional swap payments


Series 2008 Electric System
Bond Structure & Transaction Costs

Summary of Proposed Financing

- Proposed financing
  - Not-to-exceed $65 million Electric Revenue Certificates of Participation (COPS)
  - Refund the outstanding 2002A COPs in early August, 2008
  - Finance swap termination payment of approximately $9.2 million
- Estimated borrowing costs
  - Interest rates for 2008 COPs will be set on day of pricing
  - Borrowing cost estimated at 5.25% as of May 2008
  - Estimated reserves and issuance costs
    - Cash Reserve $5.0 million, Bond Insurance $2.7 million
    - Underwriter $345,000-382,500
    - Bond Counsel $110,000
    - Financial Advisor $70,000
    - Other costs including rating agency review, printing etc. $77,500

Estimated Sources & Uses

Par Amount	$64,300,000
Refunding of 2002A COPs	46,760,000
Swap termination payment	9,200,000
Reserve fund	5,000,000
Bond insurance	2,700,000
All other costs of issuance	640,000
Total uses	$64,300,000

Analysis of Bond Insurance Bid

- Bond Insurance Bids
  - Solicited bids from FSA and Assured Guaranty
  - FSA declined to bid
  - Assured Guaranty bid of 245 basis points (2.45%) times debt service
- Economic Value of Assured Guaranty Insurance
  - COPs sold at "AAA" interest rates instead of "BBB+/BBB" rates
    - Compared alternatives based on market rates as of May 14, 2008
  - Total debt service savings
    - ~$4 million to maturity; ~$1.8 million to 10-year par call date
  - "Net present value" of debt service savings
    - ~$2.4 million to maturity, ~$1.4 million to 10-year par call date

Proposed Schedule and Next Steps

• May 21st	Council direction on proposed structure
• Late May	Engage financing team to begin document preparation
• Throughout June	Draft legal documents and preliminary official statement
• Mid-June	Notice to trustee and investors on refunding (45 day notice requirement)
• July 2nd	Agenda deadline for July 16th Council date
• July 16th	Council consideration of bond financing documents
• July 17th	Distribute preliminary official statement (POS)
• July 23rd	Price Refunding Bonds
• August 6th	Close Refunding / Defease outstanding 2002A Variable Rate COPs

Questions?