

Date: March 10, 2008

Committee Meeting Date: March 20, 2008

Board Meeting Date: April 3, 2008

**BOARD MEMORANDUM**

**ACTION ITEM**

**TO:** Administration and Finance Committee  
Santa Clara Valley Transportation Authority  
Board of Directors

**THROUGH:** Michael T. Burns  
General Manager

**FROM:** Joseph T. Smith  
Chief Financial Officer

**SUBJECT:** Variable Rate Debt Refinancing or Restructuring

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**Policy-Related Action: Yes**

**Government Code Section 84308 Applies: Yes**

**RECOMMENDATION:**

Adopt a resolution authorizing the General Manager or his designee to agree to the terms of and execute documents relating to a negotiated sale, up to \$201 million of Sales Tax Revenue Refunding Bonds, 2008 Series A (2008 A Bonds) to refund \$199 million aggregate principal amount of VTA's 1985 Equipment Trust Certificates and 2005 Sales Tax Revenue Refunding Bonds and to pay the costs of issuance; and, further authorize the General Manager or his designee to amend existing liquidity agreements for 1985 Equipment Trust Certificates and 2005 Sales Tax Revenue Refunding Bonds, and/or convert the 2005 Sales Tax Revenue Refunding Bonds to a one-year term mode, as alternative courses of action.

**BACKGROUND:**

In recent years, state and local governments, nonprofit corporations, and other issuers have insured nearly half of new municipal bond issues with bond insurance. Bond insurance enabled these bond issues, for the most part, to be rated at the highest possible levels and provided comfort to investors that they would receive full payment of the bonds they purchased. For this added protection, investors were willing to accept lower interest rates which, in turn, translated to lower borrowing costs for issuers. Virtually all of VTA's outstanding debt (99%) is insured through Ambac (86%), FSA (11%), or MBIA (2%).

One year ago, there were seven municipal bond insurers with "Aaa/AAA/AAA" ratings from Moody's, Standard & Poor's and Fitch, respectively. Only two bond insurers (FSA and Assured Guaranty) currently retain such ratings without threat of downgrade. The other five insurers

(Ambac, CIFG, FGIC, MBIA and XL Capital) have been downgraded below “AAA” by one or more of the rating agencies or are being reviewed for potential downgrades. The reason for this situation is that many of the bond insurers, including Ambac, have strayed from providing insurance only for municipal bonds into providing guarantees on the debt service of structured obligations secured by sub-prime mortgage loans.

While bond insurance initially “enhanced” the credits of public agencies and broadened the market for their bonds, downgrades of these bond insurers have thrown the variable rate bond market into unprecedented turmoil. Both auction rate bonds and variable rate demand bonds<sup>1</sup> have been affected. Even the most prominent issuers nationwide are being penalized with higher interest rates to attract investors to purchase insured bonds. In many instances, investors have refused to purchase such bonds at any interest rate, even though the underlying municipal credits are fundamentally sound.

In addition to investor concern over bond insurer risks, there are increasing concerns that banks, which have guaranteed, under liquidity agreements, to purchase variable rate demand bonds in the event of failed remarketings, could terminate such liquidity agreements in the event of insurer downgrades and insolvency.

VTA currently has \$314.9 million of bonds outstanding that are secured by the 1976 ½ cent sales tax. Of these bonds outstanding, four separate bond issues, with an aggregate amount outstanding of \$271.6 million, were issued in variable rate demand bond form. These include:

- 1985 Equipment Trust Certificates (1985 ETCs), \$29.2 million outstanding
- 1998 Sales Tax Revenue Bonds (1998 Bonds), \$40.0 million outstanding
- 2000 Sales Tax Revenue Bonds (2000 Bonds), \$32.7 million outstanding
- 2005 Sales Tax Revenue Bonds (2005 Bonds), \$169.7 million outstanding

The 1998 and 2000 Sales Tax Revenue Bonds, insured by FSA, have not experienced a significant impact due to current market conditions. These bonds were issued through the California Transit Finance Authority; therefore, if action becomes necessary for these bonds, it will be requested under separate board action.

By contrast, the remaining two issues, the 1985 ETCs and the 2005 Bonds, are currently at greatest risk for higher interest costs resulting from current market conditions--as they are insured by Ambac.

VTA has been particularly impacted by recent events in the municipal market through higher interest rates and liquidity fees associated with Ambac-insured 2005 Bonds. The fiscal year to date<sup>2</sup> average “all-in” rate<sup>3</sup> for the 2005 Bonds has been 3.42%. However, by the end of

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<sup>1</sup> The difference between auction rate bonds and variable rate demand bonds is that in the auction rate market, when auctions fail to generate enough buyers, existing investors are stuck holding investments they cannot sell. With variable rate demand bonds, if the bonds are not remarketed, they are purchased by the bank that has agreed to buy them pursuant to an agreement between VTA and the bank.

<sup>2</sup> As of February 29, 2008

<sup>3</sup> Includes annual remarketing fees, liquidity fees, and swap payments to/from swap counterparties.

February, this rate had increased to 6.02%. This compares to the average all-in rate of 3.35% for the 2005 Bonds during the prior fiscal year.

Additionally, as of March 11, 2008, one of VTA's remarketing agents has been unable to remarket \$3.7 million of 2005 Bonds. The unremarketed bonds have been purchased by Depfa Bank PLC, pursuant to a standby bond purchase agreement with VTA, which was executed when the 2005 Bonds were originally issued. The interest rate that VTA is obligated to pay Depfa for this \$3.7 million of bonds is 6.0%. If these bonds are not remarketed or refunded within 90 days, that rate will increase to 7.5%, and VTA will have to accelerate repayment from a final maturity of 2026 to 2018. Furthermore, if Ambac becomes insolvent Depfa has the right to terminate our agreement and would no longer be required to purchase our bonds. In this instance if an additional failed remarketing occurred prior to the engagement of a replacement bank; VTA would be obligated to purchase the bonds from the investor(s).

## **DISCUSSION:**

**2005 Bonds.** The recommended course of action is to issue *uninsured* variable rate refunding bonds (2008 Bonds), secured by VTA's 1976 ½ cent sales tax and a liquidity agreement with a highly rated bank (the "Liquidity Bank") with a short-term rating of at least VMIG-1/A-1 from Moody's and Standard & Poor's. The proceeds of the 2008 Bonds would be used to retire the 2005 Bonds and pay the cost of issue. Staff anticipates that the 2008 Bonds would have long-term ratings of AAA/Aa3/AA- from Standard & Poor's, Moody's and Fitch, respectively—consistent with other existing long-term bonds which are also secured by VTA's 1976 ½ cent sales tax. The short-term rating on the 2008 Bonds would be based on the Liquidity Bank's short-term rating. The existing variable-to-fixed interest rate swap agreements, currently associated with the 2005 Bonds, would remain in place.

The structure and terms of the 2008 Bonds would remain substantially the same as the current structure with the exception that the 2008 Bonds would be uninsured and the liquidity agreement would contain termination provisions based on VTA downgrades or insolvency. Additionally, the liquidity agreement would more than likely be valid for a period of 364 days to 5 years (versus the current liquidity agreement which had a 10 year term).

By refunding the 2005 Bonds and eliminating the current Ambac "penalty rates," being required from investors, interest rates should decline by 2.0% or more from current levels. However, based on current indications, the annual fees associated with liquidity and remarketing are anticipated to be greater than those negotiated in 2005—which were 0.21%, annually. Staff anticipates that annual liquidity and remarketing fees in the current market for the 2005 Bonds could be as high as 0.50%, annually. Given these levels the projected annual "all-in rate" would be approximately 0.36% lower than the SIFMA<sup>4</sup> rate, which is reset weekly, plus an additional .50% for liquidity and remarketing fees and an additional amount for swap payments made under the swaps. For the week of March 10, 2008, VTA's "all-in" rate<sup>5</sup> for VTA would have been

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<sup>4</sup> Index of short term rates reflecting activity in the variable rate market. Rate on 3/10/08 was 2.96%.

<sup>5</sup> Includes interest to bondholders, liquidity and remarketing fees, and swap payments made to/from swap counterparties.

3.98%, compared to FY 2007 actual all-in rate of 3.35% for the 2005 Bonds. This represents approximately \$1.1 million of increased debt service per year.

**1985 ETCs.** The interest rate increases with the 1985 ETCs, to date, have not impacted VTA's all-in borrowing costs, as under the variable-to-fixed interest rate swap associated with this transaction (executed in 1998), VTA receives a variable rate equal to the rate paid to bondholders (Bond Rate) on the 1985 ETCs. Based on this, staff currently recommends taking a "wait and see" tactic for these bonds. However, authority is being requested to amend existing liquidity agreements (to remove bond insurer related termination provisions) with VTA's standby bank as well as the ability to issue variable rate refunding bonds (similar to that described above for the 2005 Bonds) to refund the 1985 ETCs, if necessary.

Either of these actions would only be undertaken if the current remarketing agent experiences increased difficulty in remarketing the 1985 ETCs and has need to draw on the liquidity bank. In that circumstance, VTA would no longer receive the variable interest rate equivalent to the Bond Rate (pursuant to the existing swap agreement), but rather a significantly lower rate – resulting in increased interest expense for VTA (similar to that currently being experienced with the 2005 Bonds). For the week of March 10, 2008, VTA's "all-in" rate for the 1985 ETCs (had they been refunded with variable rate bonds) would have been 4.86% as compared to the current "all-in" rate of 4.59% (due to higher liquidity fees in the current market), which would represent an increase of approximately \$78,840 per year in debt service for these bonds.

### ***Alternative Course of Action***

In the current market, VTA may be unable to successfully obtain liquidity agreements with one or more banks, which would be necessary to complete a variable rate refunding.

If this were to occur, VTA's alternative course of action for the 2005 Bonds is to amend existing liquidity agreements to remove insurer related termination provisions or to convert from weekly variable rate demand bonds to bonds with a term of one year and an interest rate that would be fixed for that period. Under this type of structure, based on current interest rates, VTA's "all-in rate" is expected to be between 3.7% and 4.2%<sup>6</sup>. The expected outcome is to reduce VTA's near term exposure to unusually high weekly interest rate resets. This strategy would be temporary in nature. At the end of the one year term, if market conditions have improved or returned to some level of "normalcy" VTA would remarket the 2005 Bonds into a weekly mode (or other mode determined at that time). If market conditions do not improve, VTA may need to implement another temporary approach or try to refinance such obligations – in each case, incurring additional issuance costs.

### ***Manner of Sale***

For a negotiated sale, staff recommends using one or more underwriting firms from the pool of underwriters and broker-dealers that serve as remarketing agents and broker-dealers for existing variable rate and auction rate bonds. These firms were initially selected through a competitive process. The firms include Banc of America Securities, Citigroup Global Markets, Inc., Goldman

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<sup>6</sup> Includes annual liquidity fees and swap payments made to/from swap counterparties.

Sachs & Co., Lehman Brothers Inc. and Morgan Stanley. In addition, VTA would include J.P. Morgan, which has managed prior debt issued in support of the Measure A Program.

### ***Financing Team***

Staff issued task orders to VTA's financial advisor (Ross Financial) and one firm in VTA's bond counsel pool (Orrick, Herrington & Sutcliffe LLP) to act as Bond & Disclosure Counsel.

### **Documentation**

The resolution recommended for approval by the Board of Directors describes the parameters for converting or sale of any potential bond issuances; as well as, the transaction documents being approved by the Board of Directors. Documents which are required in connection with the options described above include:

- Supplemental Indenture(s)
- Disclosure Documents(s)
- Purchase Contract(s)
- Liquidity Agreement(s) and Supplemental Liquidity Agreements
- Remarketing Agreement(s)
- Continuing Disclosure Certificate(s)

A description of each of these documents is included in Attachment A. Substantially completed draft documents are attached to the Resolution as exhibits.

### **ALTERNATIVES:**

The Board could choose to do nothing; however, if current interest rates continue, debt service would increase by approximately \$5.3 million per year for the 1985 ETCs and 2005 Bonds as compared to FY 2007.

### **FISCAL IMPACT:**

Estimated fees for the issuance of variable rate refunding bonds is \$875,000 and would be paid from bond proceeds. These costs include bond counsel, financial advisory, underwriting, rating, trustee and other miscellaneous fees. If a variable rate refunding is accomplished on both the 1985 ETCs and 2005 Bonds, the anticipated increase in annual debt service would be approximately \$1.2 million.

In lieu of refunding, fees associated with a one year temporary fix would be approximately \$815,000, and would be absorbed within the adopted FY 2008 VTA Transit Budget.

Prepared by: Kimberly Koenig, Fiscal Resources Manager, Department of Finance

### **Listing of Consultants**

<b><u>Contractor Firm &amp; Location</u></b>	<b><u>Contractor Role</u></b>	<b><u>Contact Name/Phone</u></b>
Banc of America Securities LLC Public Finance Group 600 Montgomery Street, 18 <sup>th</sup> Floor	Broker-Dealer	Scott Nagelson (415) 953-7314
Citigroup Global Markets Inc One Sansome Street, 28 <sup>th</sup> Floor San Francisco, CA 94104	Underwriter/Broker-Dealer	Michael Gomez (415) 951-1615
Goldman Sachs & Co. 555 California Street, 45 <sup>th</sup> Floor San Francisco, CA 94104	Underwriter/Broker-Dealer	Eric Zampol (415) 393-7514
J.P. Morgan 560 Mission Street, Suite 2130 San Francisco, CA 94105	Underwriter/Broker-Dealer	Dan Feitelberg (415) 315-5957
Lehman Brothers 555 California Street, 30 <sup>th</sup> Floor San Francisco, CA 94104	Underwriter	John McCray-Goldsmith (415) 274-5374
Morgan Stanley 555 California Street, Suite 2130 San Francisco, CA 94104	Underwriter/Broker-Dealer	John Sheldon (415) 576-2083

**Supplemental Indenture.** This document supplements the related existing master bond indenture entered into by VTA in connection with prior issues of variable rate bonds and establishes the terms and provisions of restructured existing bonds and new debt issuances (including BANs and Refunding Bonds). Each supplemental indenture, together with the related master bond indenture, is a legal contract between VTA and our Trustee that establishes the responsibilities of VTA and the rights of bondholders. Each master bond indenture defines the security, flow of funds, bond covenants, and other provisions provided by VTA for the protection of investors. A draft supplemental indenture, which is required for the issuance of the BANs, is attached to the Resolution as Exhibit A. If Refunding Bonds are issued, the supplemental indentures would be substantially identical to that for the BANs, except that provisions relating to variable rate demand bonds would be incorporated.

**Disclosure Document(s).** A disclosure document, which may take the form of an Official Statement, a remarketing memorandum or an information statement, will be required in connection with the remarketing of existing bonds being converted from one interest rate mode to another; the amendment of liquidity agreements and the offering of BANs or Refunding Bonds. The disclosure document functions as the municipal market's version of the "prospectus" or "offering circular" used in corporate markets. The disclosure document discloses pertinent information about VTA and the terms and provisions of the BANs, Refunding Bonds, or converted debt (as the case may be), a description of the debt, its purpose, security for repayment of the debt and the risks inherent in owning the bonds. It also contains a discussion of legal matters relevant to the debt, such as the tax status of interest income earned by investors, specifically, if interest income is tax-exempt for federal and state purposes. A draft disclosure document in the form of an Official Statement is included as Exhibit B and in the form of an Information Statement is included in Exhibit C to the resolution. In the case of BANs, the final disclosure document will incorporate final pricing terms known only after the sale, including coupon interest rates, yields, prices and final principal amortization schedule (if applicable). The disclosure concerning VTA in each final disclosure document will be substantially the same as the disclosure include in the draft Official Statement attached to the Resolution.

**Purchase Contract.** This document, which is utilized in a negotiated sale, is a contract between VTA and the senior managing underwriter. It sets forth the price to be paid for the BANs or Refunding Bonds and all closing conditions, including required legal opinions and certifications. A draft of the bond purchase contract is attached to the Resolution as Exhibit D.

**Liquidity Agreement(s).** This document is a contract between VTA and a selected bank or other financial institution, referred to as a liquidity provider. A liquidity agreement, which may be in the form of standby bond purchase agreement or a letter of credit, sets forth the terms under which the bank will agree to purchase the bonds in the event the remarketing agent is unable to place them with investors. Staff may elect to pursue amending existing liquidity agreements with respect to the 1985 ETCs and 2005 Bonds to remove or modify bond insurer related termination provisions. If this option is selected, amendments to existing liquidity agreements would be executed. A draft of the liquidity agreement is attached to the Resolution as Exhibit E. If VTA issues Refunding Bonds, it will need to enter into a new liquidity agreement or, if the use of a direct pay letter of credit structure is used, a letter of credit and reimbursement agreement.

**Remarketing Agreement.** A remarketing agreement is a contract between VTA and one or more remarketing agents who agree to remarket VTA's variable rate demand bonds. A remarketing agreement may need to be executed in connection with the conversion of the 2005 Bonds or if VTA issues Refunding Bonds. Additionally, Staff would like the flexibility to replace existing underwriters or hire additional underwriters, as necessary. A draft is attached to the Resolution as Exhibit F.

**Continuing Disclosure Certificate(s).** This is an agreement to provide certain financial information and other data to the market on a continuing basis. In addition, the continuing disclosure certificate lists certain events, which, if determined material by VTA, must be disclosed to the market place. Information to be disclosed includes VTA's audited financial reports and updated information relative to sales tax revenue collections. A continuing disclosure certificate would be executed for the BANs or if the existing bonds are converted to a term rate mode. A draft continuing disclosure certificate is attached to the Resolution as Exhibit [G].