

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: Measure A Variable Rate Debt Refinancing or Restructuring

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 \$260 million of Measure A Sales Tax Revenue Refunding Bonds or Notes, 2008 Series A (Measure A 2008 A Bonds) to refund \$236 million aggregate principal amount of Measure A 2006 Series A-D Sales Tax Revenue Bonds and to pay the costs of issuance.

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 bonds¹ 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.

VTA currently has \$356 million of bonds outstanding that are secured by the 2000 Measure A ½ cent sales tax. These bonds consist of 2006 Series A-D 2000 Measure A Sales Tax Revenue Bonds (2006 Bonds) and 2007 Series A Measure A Sales Tax Revenue Refunding Bonds (2007 Bonds). For the 2006 Bonds, VTA has been significantly impacted by recent events in the municipal market through higher interest rates on these Ambac-insured bonds (which have \$236 million of principal outstanding). The fiscal year to date² average “all-in” rate³ for the 2006 Bonds has been 4.40%. However, by the end of February, this rate had increased to 7.62% (and actually had reached a high of 9.76%). This compares to the average all-in rate of 3.67% for the 2006 Bonds during the prior fiscal year.

DISCUSSION:

The recommended course of action is to issue *uninsured* variable rate refunding bonds (2008 Measure A Bonds), secured by the 2000 Measure A 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 Measure A Bonds would be used to retire the 2006 Bonds and pay the cost of issue. Staff anticipates that the long-term credit rating of the 2008 Measure A Bonds would be rated AA+/Aa3 from Standard & Poor’s and Moody’s, respectively—consistent with the Measure A ratings on the 2007 Bonds, which are also secured by the 2000 Measure A sales tax. The current long-term ratings are based on the fact that a debt service reserve fund (funded with a surety bond through Ambac) is included with existing Measure A debt obligations. However, the proposed refunding bonds would not include a surety bond; therefore, it may become necessary to cash fund a debt service reserve fund in an amount up to \$23 million—in order to maintain the current level of long-term credit ratings. 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 2006 Bonds, would remain in place.

The 2008 Measure A Bonds would be weekly uninsured variable rate demand bonds. As variable rate demand bonds, interest rates would be reset weekly by remarketing agents, based on market

¹ 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.

² As of February 29, 2008

³ Includes annual remarketing fees, liquidity fees, and swap payments.

demand. VTA would engage the services of a standby bank in case of a failed remarketing (which occurs when supply exceeds demand). The terms of 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.

By refunding the 2006 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 market conditions, the annual fees associated with liquidity and remarketing are anticipated to be as high as 1.00%, annually (versus prior broker-dealer fees for 2006 Bonds of 0.25%). Staff would aggressively pursue better rates. Given these levels the projected annual “all-in rate” would be approximately 0.36% lower than the SIFMA⁴ rate, which is reset weekly, plus an additional 1.00% 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” rate⁵ would have been 4.92%, compared to FY 2007 actual all-in rate of 3.67% for the 2006 Bonds. This represents approximately \$3.0 million of increased debt service per year.

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 2006 Bonds is to convert from 7-day auction rate securities to 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 4.4% and 5.0%⁶. The expected outcome is to reduce VTA’s near term exposure to unusually high weekly interest rate resets. 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 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

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

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

⁶ Includes interest to bondholders and swap payments made to/from swap counterparties.

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 \$9.3 million per year for Measure A Bonds as compared to FY 2007, based on all-in rates at the end of February.

FISCAL IMPACT:

Estimated fees for the issuance of variable rate refunding bonds is \$965,000 and would be paid from bond proceeds. These costs include bond counsel, financial advisory, underwriting, rating, trustee and other miscellaneous fees. Debt service is anticipated to increase by approximately \$3.0 million.

In lieu of refunding, fees associated with a one year temporary fix would be approximately \$950,000, and would be absorbed within the adopted FY 2008 Measure A Budget.

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

Listing of Consultants

<u>Contractor Firm & Location</u>	<u>Contractor Role</u>	<u>Contact Name/Phone</u>
Banc of America Securities LLC Public Finance Group 600 Montgomery Street, 18 th Floor	Broker-Dealer	Scott Nagelson (415) 953-7314
Citigroup Global Markets Inc One Sansome Street, 28 th Floor San Francisco, CA 94104	Underwriter/Broker-Dealer	Michael Gomez (415) 951-1615
Goldman Sachs & Co. 555 California Street, 45 th 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 th 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].