EXTENSION OF AN IRREVOCABLE DIRECT PAY LETTER OF CREDIT (“LOC”) AND REIMBURSEMENT AGREEMENT WITH UNION BANK OF CALIFORNIA (“THE BANK”) FOR THE $55,000,000 STOCKTON PUBLIC FINANCING AUTHORITY VARIABLE RATE DEMAND WATER REVENUE BONDS, SERIES 2010A (DELTA WATER SUPPLY PROJECT) (THE “2010A BONDS”)

RECOMMENDATION

Adopt Resolutions of the City of Stockton and the Stockton Public Financing Authority authorizing the City Manager, or authorized designee, to apply for and enter into an extension of the Irrevocable Direct Pay Letter of Credit (“LOC”) with Union Bank of California (“Bank”) issued in conjunction with a Reimbursement Agreement for the $55,000,000 Stockton Public Financing Authority Variable Rate Demand Bonds Series 2010A. The LOC is set to expire on October 18, 2013. The resolutions would allow an initial 60-day extension, and future additional extensions as needed of the LOC subject to Bank approval, until the 2010A Bond conversion transaction is completed.

Summary

City Council and Stockton Public Financing Authority Resolutions were approved on August 13, 2013 authorizing the conversion of the 2010A Bonds from a variable rate of interest to a fixed rate of interest (Resolutions No. 2013-08-13-1501/1502) and approved all documents and directed certain actions in connection therewith. Simultaneously with the remarketing of the 2010A Bonds, staff also began negotiations with the Bank for the extension of the LOC as presented in August 13, 2013 staff report in the event the remarketing could not be consummated on or before the expiration of the LOC on October 18, 2013. This was contemplated in the event staff needed to return to City Council with an alternative in the event the remarketing was not completed as planned due to change in market conditions or market sensitivity. Should the LOC expire prior to the fixed rate conversion being completed, the 2010A Bonds in the amount of $55.0 million would become immediately due and payable by the water fund. The water fund does not have sufficient liquidity to honor this demand as outlined in the August 13, 2013 staff report.

To mitigate this risk, staff has obtained an offer from the Bank to provide the City with an extension of the LOC to allow additional time to complete the remarketing of the 2010A Bonds. The Bank has offered to grant periodic extensions contingent on the City continuing with the fixed rate remarketing which will eliminate the Bank’s LOC when completed. The City has received a written offer from the Bank to extend the existing LOC for 60-days to provide additional time to facilitate the remarketing of the conversion of the variable rate bonds to a fixed rate. The Bank’s new parent company, Mitsubishi Bank of Japan has decided they no longer wish to renew the LOC for the long-term, but are committed to assist us until we complete the remarketing to a fixed rate.

The resolutions will authorize the City Manager, or his designee, to apply for and enter into extensions of the letter of credit until the remarketing of the 2010A Bond transaction is completed.
The first of these extensions will be for a period of 60-days.

DISCUSSION

Background

The City Council, acting in the capacity of the Stockton Public Financing Authority previously issued $55.0 million of Variable Rate Demand Water Revenue Bonds, Series 2010A (Delta Water Supply Project) (the “2010A Bonds”) pursuant to an indenture, dated as of October 1, 2010 (the “Indenture”). An indenture is the agreement that specifies the terms of the bond issuance. The indenture is by and between the Authority and Wells Fargo Bank, National Association, as trustee (the “Trustee”), to provide funds to the City for the acquisition, construction, installation and improvement of its Delta Water Supply Project. Included in the Indenture, issued in connection with the debt was a provision that allows for the City to convert the outstanding variable rate debt to a fixed rate. This would be accomplished by remarketing the bonds to investors at fixed rates and using the funds to pay off the current variable rate investors.

When the 2010A Bonds were issued, the City also entered into a LOC issued by the Bank under a Reimbursement Agreement. The maximum amount available under the current LOC to support the Bonds is $55,958,357. A LOC is a commitment by the Bank to honor demands for payment of a debt upon certain conditions and/or the occurrence of certain events specified under the terms of the Reimbursement Agreement. A LOC is often used as credit enhancement for the Bonds and also provides liquidity. The bonds are variable rate and are bought and sold weekly. Each week the interest rate paid on the bonds is based on the then market interest rates. When the bonds are remarketed (sold and purchased by new investors), those proceeds are used to pay the prior investors for their investment. If any portions of the bonds are not purchased when remarketed, the Trustee can make a demand on the LOC which provides the funding to purchase the bonds.

The LOC is set to expire on October 18, 2013. Should the LOC expire prior to the conversion to fixed rate being completed, the 2010A Bonds in the amount of $55.0 million would become immediately due and payable by the water fund. The water fund does not have sufficient liquidity to honor this demand as outlined in the August 13, 2013 staff report.

Present Situation

City Council and Stockton Public Financing Authority Resolutions approved on August 13, 2013 authorized the conversion of the 2010A Bonds from a variable rate of interest to a fixed rate of interest (Resolutions No. 2013-08-13-1501/1502) and approved all documents and directed the City Manager to take certain actions in connection with the remarketing agreement. Staff’s recommendation for the fixed rate conversion was to mitigate risks to the City’s water fund such as the potential for acceleration of the $55.0 million of 2010A Variable Rate Demand Water Revenue Bonds, the renewal risk associated with the LOC, and the variable interest rate risks. We are working on consummating that remarketing to a fixed rate.

Concurrently, the City’s Financial Advisor, Del Rio Advisors LLC, began talks with the Bank on its offer to extend the LOC made last year. The original proposal was for the Bank to grant a renewal for a period of up to 3-years in exchange for the City paying down the bonds in $5.0 million increments.
for each year of extension or up to $15.0 million. The Bank’s parent company Mitsubishi Bank of Japan has recently shifted course and no longer wishes to offer a long-term renewal. In exchange, the Bank is willing to grant extensions as long as the City continues to move toward the fixed rate remarketing as approved by Council. The first 60-day extension should provide adequate time to complete the transaction.

In addition, since the meeting of August 13, 2013, City staff and the Financing Team has met with all three bond rating agencies, an important step in remarketing the bonds. As expected, these meetings resulted in obtaining rating upgrades on the 2010A Bonds from Fitch Ratings (“Fitch”) from BB+ to BBB and Standard & Poor’s Corporation (“S&P”) from BB+ to A-. This S&P rating upgrade is rather dramatic. This has the effect of upgrading our rating by four levels. The City anticipates possible similar action by Moody’s Investors Service (“Moody’s”) and should have a notice of this action before the expiration of the LOC. These rating upgrades are extremely important to investors as it helps to move the credit quality of the underlying 2010A Bonds from a non-investment grade to investment grade. This should improve the required interest rate.

Though it is still anticipated that the conversion and remarketing to fixed rate bonds may be completed prior to the original expiration date of the LOC, the additional extension of time will mitigate any short term acceleration concerns and give the City time to go to the financial markets with the remarketing.

FINANCIAL SUMMARY

There is no additional fee to enter into the extension agreements with Union Bank. There is no financial impact as a result of the adoption of the resolutions extending the current LOC for a period of 60-days.

Attachment A - Application for Union Bank Letter of Credit 60-Day Extension