FORM GEN. 160

CITY OF LOS ANGELES
INTER-DEPARTMENTAL CORRESPONDENCE

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Date: May 30, 2014

To: The Council

From: Miguel A. Santana, City Administrative Officer Miguel A. Santana

Subject: **2014-15 SPECIAL STUDY - NO SMALL FEES REPORT RELEASED BY FIX LA COALITION AND WASTEWATER SYSTEM SWAPS**

On March 25, 2014, the Fix LA Coalition released a report entitled "No Small Fees: LA Spends More on Wall Street than Our Streets." The report reviews the amount of money spent on bond issuance costs, remarketing fees, letters of credit, bank service fees, investment fees and other financial transaction fees for the City's General Fund and Wastewater System bond programs, the City's three proprietary departments (Departments of Airports (LAWA), Harbor, and Water and Power (DWP)), and the City's three employee pensions systems (the Los Angeles City Employees' Retirement System (LACERS), the Fire and Police Pension System (LAFPP) and the Department of Water and Power Pension System). Given the City Administrative Officer's (CAO) role with respect to the management of the City's debt, it is important that this Office provide some clarifications and additional context to the important issues raised in the Fix LA Coalition's report.

This report provides information on the Council-controlled debt programs managed by the CAO, including information on the Wastewater System's swaps. In addition, the City Council during its consideration of the 2014-15 Proposed Budget requested City Attorney to provide a written opinion on the swap issue and terminating swap agreements in light of the new Dodd-Frank rules.

As part of the 2014-15 Proposed Budget deliberations, the City Council also requested additional information and reports from LACERS, LAFPP, the Department of Water and Power Pension System, DWP, LAWA, the Harbor Department, and the Office of Finance regarding issues and costs described in the Fix LA Report which pertain to their department operations. While this report does not address these items, this Office will follow-up with the appropriate departments to ensure timely responses are provided to the committee. In addition, the CAO was instructed to provide a report back to the Budget and Finance Committee regarding the fees associated with the Tax and Revenue Anticipation Notes financing over the last several years. Please see Attachment 1 for this report.

This report is for informational purposes only.

Why Issue Debt?

The City of Los Angeles, like every other local, state, and federal governments, is limited in its ability and resources to finance every program, project, and need on a cash-only basis. One of the primary reasons for a debt program is for the financing of capital projects that tend to be some of the most costly expenditures. The reason that the municipal sector debt finances capital projects is to spread the cost over the life of that project at the lowest possible cost. Obviously, paying cash with no interest is always the best possible mechanism. This decision, however, has to be weighed against all other taxpayer priorities and limited revenues. For example, paying for the construction of a building with cash one year will limit the cash available to pay for non-capital programs and services. Additionally, since buildings typically last 30 to 50 years, spreading the cost of the building over time ensures that the taxpayers of today do not have to pay for the entire use of the building when it will also be used by future generations. Thus, while debt-financing projects increases their cost due to interest, debt-financing projects leave cash available for services and spreads the cost of projects to multiple generations of taxpayers that will derive a benefit from the project.

Nevertheless, due to the cost associated with issuing debt, the decision to issue debt is one that should be considered only after weighing the costs and benefits to the City. The City's Debt Management Policies were established in 1994 and then updated in April 2005 to facilitate the decision making process. These Policies provide a framework for issuing debt, for the amount of debt the City can issue, for the procedures for issuing debt, and for the management of debt. By conforming to its policies, the City ensures that the best practices for issuing and managing debt are followed. All three credit rating agencies have complimented the City on its policies as best practice. The City's Debt Management Policies are detailed in Attachment 2.

Fix LA Report "Fees and Payments Wall Street Collected from LA (2012-13)" page 4

As a very large city both in population and square miles, the City's debt burden is moderate compared to other cities at 4.8 percent of General Fund revenue, according to Standard and Poors' Rating Service. However, even with such a low debt burden, fees are unavoidable for debt issuers. The City pays fees for financial transactions but does so at the lowest possible cost. Moreover, when paying fees, the City does so in the context of achieving net savings from the financial transactions as a whole.

The Fix LA report states that "Wall Street banks collected $204 million from the City of Los Angeles last year, while services to ordinary residents were slashed." For Fiscal Year 2012-13, this Office identified a much more limited amount detailed below related to the CAO-managed debt program. Furthermore, the amounts included in the Fix LA report did not reflect the net savings achieved by the City as a result of the financial transactions. For example, although in Fiscal Year 2012-13 there was a one-time cost to refund debt attributable to Council-controlled departments of $3.5 million, the net result saved the City $142.8 million over 20 years.

Below is a discussion on the "Fees and Payments Wall Street Collected from LA (2012-13)" table on page 4 for the costs only associated with debt managed by the CAO. The categories are from the table.

- **"$12.9 million in bond issuance costs"**: Of this amount, $3.5 million is attributable to Council-controlled departments, specifically, a one-time cost to refund debt. As previously mentioned, although there was a one-time cost to refunding this debt of $3.5 million, the net result saved the City $142.8 million over 20 years. This means that the City will pay less in interest cost for the infrastructure built on behalf of the taxpayers.

- **"$18.9 million, $1.0 million in remarketing fees and $17.9 million in letter of credit fees"**: The CAO-managed debt programs' costs for letters of credit (LOC) and remarketing fees were $2.9 million for MICLA Commercial Paper (actual fees $3.2 million) and $1.3 million for Wastewater System Commercial Paper. Currently, Commercial Paper is the lowest cost of financing, as demonstrated in the scenarios in Attachment 3.

- **"$4.8 million in annual interest rate swap payments"**: This fee is for the Wastewater System swaps and is correct. In addition, $8.13 million was paid to bondholders for the variable rate bonds, for a total payment of $12.9 million in debt service. Without the swap to lower the debt service cost, a fixed-rate bond transaction would have cost $15.1 million in debt service.

The remainder of the $204 million in fees is attributable to the three proprietary departments, the three pension systems or the Office of Finance.

<u>Debt to Preserve the City's Credit Strength and Budget Flexibility</u>

As part of the CAO's ongoing responsibility to manage the City's debt programs, the CAO actively monitors the City's debt portfolio to preserve the City's credit strength and budget flexibility. For every transaction, the CAO reviews the long-term implications, including borrowing costs, interest rate trends, debt capacity, credit enhancement, and opportunities to refund outstanding bonds. The remainder of this section highlights the CAO's debt management program over the last several years.

Table 1 shows the amount of savings from refundings (refinancing) of debt over the last five years with associated costs, and the costs in letters of credit for commercial paper compared to issuing long-term bonds.

Table 1
CITY OF LOS ANGELES REFUNDING BOND SAVINGS SINCE 2009-10
Debt Service Savings over the Life of the Bonds

	2009-10	2010-11	2011-12	2012-13	2013-14[2]	Total
GENERAL FUND - MICLA[1]	$ -	$ 1,097,938	$ 14,892,427	$ -	$ 5,400,000	$ 21,390,365
GENERAL OBLIGATION BONDS	-	-	19,769,737	-	-	$ 19,769,737
LANDSCAPE & LIGHTING DISTRICT (PROP K) BONDS	-	-	-	-	2,200,000	$ 2,200,000
SOLID WASTE RESOURCES REVENUE BONDS	3,463,598	-		18,553,349	-	$ 22,016,947
ST LIGHTING ASSESSMENT DIRECT PURCHASE BONDS	-	-	-	-	2,850,223	$ 2,850,223
WASTEWATER REVENUE BONDS		10,904,194	77,182,101	124,246,582		$ 212,332,877
Total:	$ 3,463,598	$ 12,002,132	$ 111,844,265	$ 142,799,931	$ 10,450,223	$ 280,560,149

Actual Savings (as of 5/30/2014):	$ 272,960,149
2013-14 Estimated Savings:	$ 7,600,000
Total:	$ 280,560,149
General Fund Savings:	$ 21,390,365
Special Fund Savings:	$ 259,169,784
Total:	$ 280,560,149

[1] Municipal Improvement Corporation of Los Angeles
[2] 2013-14 MICLA and Prop K savings are estimates only. Actual savings will be realized upon successful refunding transaction.

Refunding Bond Transactions: In addition to issuing bonds for its capital needs, the City issues refunding bonds to achieve interest savings. In accordance with the City's Debt Management Policy, the CAO monitors on an ongoing basis potential savings available by refunding the outstanding debt of the City. All costs and benefits of any refunding will be taken into account. Over the last five years, the City has captured $272.96 million in savings over the life of the bonds as shown in Table 1 above at a cost of $10.3 million. Additionally, the City is currently working on two refunding transactions with expected net savings of $7.6 million over the life of the bonds.

Municipal Improvement Corporation of Los Angeles Commercial Paper Program: The Mayor and Council approved the Municipal Improvement Corporation of Los Angeles Commercial Paper Program (MICLA CP Program) for the purpose of financing the acquisition and improvements of various capital assets, including equipment and real property. CP is short-term debt that can only be outstanding for 270 days or less. The MICLA CP Program gives the City tremendous flexibility in financing its capital program, including quicker implementation and reduced borrowing costs. The City's liquidity position is an important factor to investors and rating agencies in assessing the City's ability to pay its short-term obligations. To reduce the risk to investors and maintain high credit ratings, the MICLA CP Program is supported by letters of credit to provide liquidity. Attachment 3 is an illustration showing the savings achieved by utilizing a CP program. This illustration compares two financing scenarios: 1) issue fixed rate long-term bonds to fully fund the capital projects needs of $200 million at the start of construction with interest capitalized during construction period and 2) issue CP of $50 million in project expenditures every six months with a $200 million refinancing of CP into long-term bonds.

Tax and Revenue Anticipation Notes: The City issues Tax and Revenue Anticipation Notes (TRAN) to pay its annual contributions for its two retirement systems and for cash flow management purposes. The City experiences a short-term cash flow deficit during the first half of the fiscal year due to the timing of receiving certain taxes and revenues from the State. The City may borrow internally from special funds and/or the Reserve Fund, access the capital markets, or a combination of both. Each year, the City compares borrowing internally at the Investment Pool Rate versus borrowing from the capital markets through the issuance of TRAN to ensure the City uses the most cost effective financing approach. Furthermore, the City receives a discount from the two retirement systems for making the annual contribution payments in full by July 15. The discount is the difference between paying the full annual contributions by July 15 and making bi-weekly contribution payments throughout the fiscal year. Table 2 below shows the true interest cost (TIC) of each TRAN issuance versus the City's Investment Pool Rate and the net savings achieved by taking advantage of the discount over the last five years.

Table 2
TRAN Historical Information

Fiscal Year	Par Amount	Investment Pool Rate	TIC	Discount	Net Savings*
2009-10	$1,038,200,000	2.91%	0.51%	$23,936,422	$19,647,106
2010-11	$1,164,630,000	2.35%	0.79%	$26,254,673	$18,105,617
2011-12	$1,204,665,000	2.35%	0.32%	$31,759,843	$27,824,436
2012-13	$1,256,290,000	1.27%	0.26%	$30,329,358	$27,246,959
2013-14	$1,324,550,000	1.06%	0.21%	$33,138,243	$30,296,772

* Represents savings achieved from paying the full annual pension contributions by July 15 through the issuance of TRAN vs. making payments on a bi-weekly basis with no borrowing.

<u>Fix LA Report "Need for a Full Accounting of Wall Street Fees" page 5</u>

The City conducts a competitive process to select the most qualified firms to assist in the issuance of bonds. The competitive process requires firms to submit proposals demonstrating their experience, qualifications and proposed fees. When seeking financial products such as letters of credit, the City again conducts a competitive process to gather information such as proposed fees and terms. The City further negotiates with the selected banks to obtain the lowest fees and various provisions in the best interest of the City including termination provisions. All of these fees are part of public documents as required by the Securities and Exchange Commission. These fees are available on EMMA, the Electronic Municipal Market Access platform created by the Municipal Securities Regulation Board. In addition, the CAO prepares final transcripts with all the financing documents for every bond transaction. An original copy is available from the City Clerk, as part of the Council File.

Benchmarking to Other Municipal Issuers: When we benchmarked ourselves against other cities, the City is comparable or better in the management of its debt issuances. Each time the CAO issues bonds, a Post Issuance Analysis is prepared that includes how our bonds fared compared to other agencies. Attachment 4 shows how the City's issuances compared in pricing with other agencies that went to market at the same time period, with the same type of bond and with similar ratings.

Credit Ratings: We also use ratings to compare ourselves to other municipal issuers. Although there are many factors that go into a rating, such as management practices and the economy, the City compares well to other large cities. Attachment 5 shows the City's General Obligation debt rating compared to the 10 largest US cities and the 10 largest California cities.

Nevertheless, while the CAO's management of the City's debt program may be efficient and effective, there is room for improvement. During 2014-15, the CAO plans to update the Debt Management Policies to ensure that the City is meeting best practices, implement a debt management data base to better track all costs associated with debt and renegotiate letters of credit for the Wastewater System by leveraging the cost information from the three proprietary departments and the City Treasurer.

Fix LA Report "Leveraging LA's $100 Billion in Economic Clout to Reduce Fees" page 6

Besides this Office, there are three proprietary departments that issue debt under their own credit ratings: LAWA, Harbor and DWP. When negotiating fees and terms, the CAO exchanges information with the three proprietary departments about terms and fees associated with letters of credit, such as utilization and remarketing. In addition, we sit on each other's Selection Panels for attorneys, advisors and underwriters so we are aware of the fees associated with these consultants.

The Fix LA Report speaks to combining or consolidating certain financial products to leverage better rates. Since the market considers the four of us as different entities and we receive different ratings, we cannot combine our financial products. The most effective leveraging of our portfolios within the law is the ongoing exchange of information we undertake on a regular basis.

Fix LA Report "Renegotiate Bad Deals that Cost Taxpayers Millions a Year" page 6

The Fix LA report states that "The City of Los Angeles is locked into a swap deal through 2028 that could cost the taxpayers an additional $65.8 million.[7] New York Mellon won't let the city out of the toxic deal unless it pays $24.7 million in penalties to terminate the swap.[8] The city already paid New York Mellon $26.1 million in 2012 to terminate part of another swap[9] that was costing the city an additional $2.5 million per year.[10]"

Based on our analysis, we confirmed that the swap transaction generated approximately $21.7 million in savings to date, and we do not recommend terminating the swap.

Every financial transaction has risks. When we analyze those risks, it is difficult to compare to what could happen due to changing market conditions. In 2006, the CAO prepared a report on this financing and explained the risks of variable rate bonds hedged with swaps, including a termination payment. We recommended the swap due to the savings that could be generated as compared to a fixed-rate bond. The Mayor and Council approved this deal in March, 2006 (C.F. 06-0319).

In 2006, the City saw an opportunity to refund Wastewater System revenue bonds. When this Office analyzed the best mechanism to save the most money, the analysis supported executing a transaction consisting of variable rate bonds (VRDBs) (insured with municipal bond insurance) hedged by a LIBOR-based (London International Borrowing Overnight Rate) swap to a fixed rate. The swap amount was $315 million and a variable rate deal for $316.8 million. The City pays the swap counterparty 3.34% in interest with 64.1% of LIBOR subtracted out. If the variable interest cost is less than 64.1% of LIBOR, the City benefits. If the variable rate is more, it adds to the cost. If we had refunded into a fixed rate deal then the net savings to taxpayers would have been $8 million over the life of the bonds. By doing a swap and a variable rate deal, the estimated net savings were $35 million over the life of the bonds. The CAO released a RFP for the letters of credit to back the VRDB and a

RFP for the swaps. Also, municipal bond insurance was bought because the bonds were then AAA, which provided a lower interest rate with additional savings.

In 2008, the municipal market was in crisis as AAA municipal bond insurers were downgraded, also resulting in the downgrade of the City's Wastewater System revenue bonds, including the variable rate bonds associated with the swap. The City refunded this debt in 2008 due to the financial crisis and the lack of interested buyers willing to buy bonds insured by the municipal bond insurers that had been downgraded.

In 2012, the City took advantage of a market opportunity to refund a portion of the 2008 bonds and terminate the corresponding portion of the swap due to the ability to achieve savings, and reduce the remaining swap amount to $151 million. In this transaction, the City replaced the first 12 years of swapped variable rate bonds with lower cost fixed rate bonds (at a 1.887% interest rate) and used the savings ($26.1 million) between the fixed rate on the refunding bonds (1.887%) and the fixed swap rate (3.34%) to terminate about half the swap for net savings of $500,000. The cost of the swap termination, $26.1 million, was part of the gross savings. In addition to allowing the City to achieve savings, this transaction also reduced the amount of LOCs required by $160 million.

The City has paid $104 million in debt service on the 2006 bond refunding transaction as follows: $46.8 million to swap providers, and $57.2 million to bondholders and in related expenses (i.e. liquidity) on the variable rate bonds. If the City had issued fixed rate bonds in 2006 instead of the swap transaction, the fixed rate would have been approximately 4.3% and debt service to bondholders through May 1, 2014 would have been $125.8 million. The swap and variable rate bonds combined have saved the City $21.7 million through May 1, 2014. Currently, the VRDB is less than the 64.1% so the City is making payments to the swap counterparties. Ideally, the swap counterparties would be sending payments to the City. Even with the payment, the City is still paying less than a fixed rate bond refunding rate. See Table 3 below.

Table 3
Wastewater System - Swap Transaction

Original Swap Amount	$	315,820,000
City Pays		3.34%
City Receives		64.1% of LIBOR
Terminated Amount[1]	$	164,735,000
Revised Swap Amount[2]	$	151,085,000
Total Gross Costs of Swap[3]	$	104,098,101
Debt Service of Fixed Rate Scenario[4]	$	125,801,292
Total Savings of Swap	$	21,703,191

[1] Terminated portion of swap as part of Series 2013A refunding
[2] Remaining swap contract amounts after partial termination
[3] Includes swap payments, liquidity costs, variable rate interest payments through May 1, 2014
[4] Estimated Total Interest Cost of 4.3% for fixed rate deal based on comparable transaction

<u>Fix LA Report "Take Legal Action to Recoup Losses from Bank Fraud" page 7</u>

In 2013, it was discovered that banks had manipulated the LIBOR by stating that interest rate reported by the banks was lower than it actually was. This reduced the amount of savings that Wastewater System swaps produced. It is very difficult, however, to determine the actual impact of this manipulation because it is impossible to calculate with certainty what the actual LIBOR rate should have been absent the manipulation. Nevertheless, this Office will provide whatever assistance is required by the City Attorney should the City decide to take legal action.

FISCAL IMPACT STATEMENT

There is no fiscal impact resulting from this report. This report is for informational purposes only.

MAS:NRB:09140220

Attachments

Attachment 1: Tax and Revenue Anticipation Notes – Report Back on Fees Paid
Attachment 2: City's Debt Management Policies
Attachment 3: Illustration – MICLA CP Program Savings Analysis
Attachment 4: Five-Year History of Comparable Bond Transactions for MICLA
Attachment 5: Ratings of Top 10 Most Populated U.S. and California Cities