

Agenda Report

FEBRUARY 14, 2000

TO: City Council
THROUGH: Finance Committee
FROM: Cynthia J. Kurtz, City Manager
SUBJECT: APPROVAL OF A RESOLUTION OF THE CITY COUNCIL
ESTABLISHING COMPETITIVE BIDDING PROCEDURES FOR,
APPROVING THE PUBLICATION OF NOTICE OF AND
AUTHORIZING THE DISTRIBUTION OF A REQUEST FOR AN
INTEREST RATE SWAP, APPROVING THE FORM OF AN
INTEREST RATE SWAP AGREEMENT, AUTHORIZING THE ENTRY
INTO ONE OR MORE INTEREST RATE SWAP TRANSACTIONS
AND CERTAIN ACTIONS RELATING THERETO

RECOMMENDATION

It is recommended that the City Council approve a Resolution establishing competitive bidding procedures for, approve the Publication of Notice of and authorize the distribution of a Request for an Interest Rate SWAP and approve the Form of an Interest Rate Swap Agreement, authorize the entry into one or more Interest Rate Swap transactions and certain actions relating thereto.

Background

In August 1998, the City accomplished a very successful financing for the Department of Water and Power. The 1998 Bonds were issued with a par amount of \$70,635,000 and took advantage of historic low interest rates to lock-in a true interest cost of 4.79%. Proceeds of the 1998 Bonds were utilized to refund and restructure all of the Department's prior Electric Revenue Bond obligations, and additionally provided funding for certain capital improvements to the Department's electric distribution system. Issuance of the 1998 Bonds also facilitated adoption of a new modernized financing legal framework which will assist the City's electric system in remaining competitive.

Prior to bringing the 1998 financing to market, the City evaluated the potential benefits of issuing the 1998 Bonds with a variable rate of interest rather than at a fixed cost to maturity. Potential benefits of variable rate debt include a lower expected cost of funds and

increased financial flexibility. Additionally, variable rate debt would serve as a hedge to the DWP's invested reserve balances, reducing potential volatility in the system's net interest earnings. Two factors lead to staff decision to recommend proceeding, however, with the issuance of fixed rate debt. First, Charter restrictions limited the Utility's ability to issue variable rate debt. In addition, legislative changes being considered in Washington in early 1998 posed a potential risk to the City's ability to keep variable rate debt outstanding on a tax-exempt basis if the City opened its electric system to competition. These concerns, combined with a very attractive interest rate environment, lead to the City's decision to sell long-term fixed rate bonds.

Interest rate movements in 1999 now favor a type of transaction called "synthetic variable rate debt", or more specifically, a "fixed-to-floating" interest rate exchange agreement or "swap". This type of interest rate exchange agreement offers the electric system the interest rate benefits (and risks) of variable rate debt. Currently, Pasadena Light and Power Fund has no direct variable rate debt on its balance sheet, and only limited amounts of variable rate debt through its joint power obligations.

Discussion

Usually the advantages of variable rate debt are achieved by financing capital improvements with variable rate bonds, or by utilizing variable rate debt to refinance outstanding fixed rate bonds. As previously noted, Charter restrictions and tax law uncertainties deterred the City from issuing variable rate bonds in 1998. Staff is now recommending that the City Council approve the entering into a swap agreement(s) which will allow the City to benefit from a variable rate obligation without exposure to these potential tax law risks.

Rating agencies typically feel it is prudent for a public agency like Pasadena Electric Utility to have up to 15 to 20 percent of its total outstanding (direct and JPA) debt in variable rate obligations, including variable rate bond and swaps. In computing this percentage, the rating agencies typically will net cash reserves against total variable rate obligations, so that only "unhedged" variable rate debt (i.e. that portion of variable rate debt which is not offset by a comparable amount of reserve funds) is utilized in determining an agency's fixed/variable debt mix.

The attached resolution will enable Pasadena to issue requests for bids and enter into agreements if certain target levels are achieved. Because of the nature of variable interest rates, there is no guarantee as to annual interest costs while the agreements are in place, and estimated annual cashflow savings may change depending upon actual variable interest rates experienced over time. If variable rates move significantly upwards, swap transactions can result in an increase in debt service costs from present levels. If this happens, future actions can be taken by the City to mitigate the impact.

In general, a swap is an agreement between parties to exchange interest rates paid on an agreed upon notional amount. For example, Pasadena would enter into an agreement with a counterparty (typically a commercial or investment bank). Under this agreement, the

counterparty will pay the City a fixed interest rate on the agreed upon notional amount, and the City agrees to pay the counterparty a variable rate on the same agreed upon amount. The difference in interest rates between the fixed interest rate determined at the time the contract is signed, and the variable interest rate, which is determined by a published index on a monthly basis, determines the relative payments of the parties.

The following actions are required to implement the swap agreement:

- Council approval of the attached Resolution
- Finalize exchange agreement terms
- Review with credit rating agencies and adjust terms as necessary
- Prepare and issue bid requests
- Determine winning bids
- Execution of swap agreement by Director of Finance

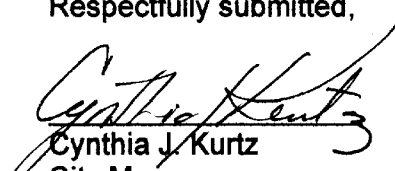
The notional amount of the interest rate exchange agreements will be finalized after further discussions with the rating agencies. The resolution sets the maximum amount of the notional amount; the actual amount may be reduced. The terms and conditions of the agreement will be finalized, within the framework established by the resolution, and reviewed by the Director of Finance prior to execution of the agreement.

Additional information is attached to this Agenda Report which describe the features of a swap agreement in greater detail.

Fiscal Impact


Utilizing the rating agencies' hedged variable rate debt analysis, and considering Pasadena's share of SCPPA and IPA assets and liabilities, the entire \$70 million of 1998 Bonds may be swapped to a variable rate, while unhedged variable rate debt would only reach 15%. At current market levels, this additional variable rate debt would result in an annual debt service savings for the Light and Power Fund of over \$1.3 million.

Respectfully submitted,



Cynthia J. Kurtz
City Manager

Approved:



Jay M. Goldstone
Director of Finance