



Santa Clara Valley Water District

File No.: 21-1311

Agenda Date: 1/11/2022
Item No.: 3.3.

BOARD AGENDA MEMORANDUM

SUBJECT:

Receive the Financing Plan for Water Utility System and Safe, Clean Water and Natural Flood Protection Program Capital Projects, and Authorize the Payment of the Series 2006B Water Utility System Refunding Revenue Bonds.

RECOMMENDATION:

- A. Receive the financing plan for Water Utility System and Safe, Clean Water and Natural Flood Protection Program capital project costs;
- B. Authorize the payment of the Series 2006B Water Utility System Refunding Revenue Bonds from proceeds of short term debt obligations; and
- C. Authorize the Chief Executive Officer and the Chief Financial Officer, or their designees, to take all actions necessary to effectuate the payment of the Series 2006B Water Utility System Refunding Revenue Bonds.

SUMMARY:

As part of the Fiscal Year (FY) 2021-22 adopted operating budget, Santa Clara Valley Water District (Valley Water) planned for the issuance of debt to finance capital improvements in the amount of \$159 million for the Water Utility enterprise and \$100 million for the Safe, Clean Water and Natural Flood Protection (SCW) program. The actual timing and issuance amounts of the debt obligations will be determined depending on capital spending progress. Valley Water's strategy is to finance capital spending on a just-in-time basis through the issuance of interim short-term debt and the subsequent sale of more permanent long-term debt to refund the short-term debt. The sale of long-term debt to investors in the municipal market involves the participation of bond underwriting firms and includes different methods of sale. Board Governance Policies dictate limitations on banks that Valley Water may do business with, including bond underwriting firms.

In order to help mitigate the pressure to increase water rates, staff recommends Board approval to refund all outstanding Series 2006B Water Utility System Refunding Revenue Bonds (2006B Bonds) with short-term debt. Paying off all of the 2006B Bonds would terminate the Senior Master Resolution for Water Utility debt obligations which have antiquated and restrictive debt covenants. An example of one restrictive covenant is that the Senior Master Resolution prohibits the use of reserves in calculating debt service coverage. By repaying all of the 2006B Bonds, any remaining Water Utility debt obligations will be governed solely by the Parity Master Resolution which has more modern and

flexible covenants, such as allowing Valley Water to use much of its reserve funds to count towards debt service coverage requirements when planning for future water rates. The redemption provisions of the 2006B Bonds, of which \$16.5 million is currently outstanding, require a “make-whole” redemption payment estimated to be \$3.9 million. Along with the outstanding amount of the 2006 Bonds, the additional one-time “make whole” cost would be paid for initially by short-term debt and then later refunded by long-term debt. Potential interest rate savings projected in FY 2022-23 by repaying the 2006B Bonds with short-term commercial paper (CP) certificates is estimated to be \$670,000. Additionally, depending on interest rates at the time of issuing the long-term debt, some or potentially all of the “make-whole” cost may be offset by lower interest rates. Despite the initial redemption costs, the increased flexibility afforded in setting water rates would be beneficial to Valley Water.

Staff will return to the Board at a later date for authorization to issue long-term debt and approve the necessary financing documents for the water utility system and SCW program.

Water Utility and SCW Financing Plan

WIFIA Loan

Finance and project staff are working on applications and compliance requirements for Environmental Protection Agency (EPA)-administered Water Infrastructure Finance and Innovation Act (WIFIA) loans for the Pacheco Reservoir Expansion Project and various SCW parcel tax-funded projects, with applications expected to be completed in spring 2022. After submission of the loan applications, negotiations with the EPA will be an ongoing effort until execution of the loans, which is anticipated to be by fall/winter 2022, subject to the Board’s approval of the loan documents. Additionally, it is expected that a WIFIA loan letter of interest will be submitted for the Anderson Dam Retrofit Project after the release of the next annual notice of WIFIA funding availability, which is anticipated in spring 2022.

Debt Issuance

Valley Water’s financing needs are met initially by the issuance of short-term, variable rate CP certificates through the established CP program which has \$150 million of capacity. As the capacity to issue CP certificates is used up, long-term, fixed rate debt is issued to repay/refinance outstanding CP, and also provide new debt proceeds as needed. In addition to the CP program, Valley Water has a \$170 million revolving line of credit that could also be utilized to provide interim financing prior to the issuance of long-term debt.

Staff closely monitors capital spending and funding needs to strategically plan for the optimal time to undertake the District-wide effort required to draft the preliminary official statement (i.e., the primary securities offering document to potential investors, also known as bond disclosure) and subsequently issue the associated long-term debt. Timing is also impacted by other ongoing efforts. The timing of long-term debt issuance will be determined when capital expenditures reach a minimum of \$100 million for each debt issuance. This minimum amount is considered an optimal amount to market Valley Water bonds and achieve low financing costs and economies of scale for costs of issuance

which is estimated at \$300,000-\$400,000 per issuance.

It is currently forecasted that staff will begin the effort to issue long-term debt for water utility and SCW capital project costs (not funded by WIFIA loans or grant proceeds) on or after summer 2022 and complete the transaction by winter 2022 or spring 2023. Staff will return to the Board for approval of the actions and financing documents necessary to issue the debt.

Underwriting Firms

The issuance of long-term debt/bonds by Valley Water involves the participation of investment banking firms that act as underwriters in a multi-faceted financial transaction. Underwriters purchase bonds from issuers such as Valley Water with the intent to resell the bonds to investors. A single underwriter or a group of underwriters can be used for each debt issuance transaction.

There are two types of underwriting deals:

1. **Negotiated Sale** - In a negotiated sale, one underwriter (or a group of underwriters) negotiates directly with the issuer to determine the coupons (i.e., interest rates) and yields at which the new issue will be sold. These levels are designed to minimize the cost to the issuer while still being desirable enough for investors to buy the bonds.
2. **Competitive Sale** - In a competitive sale, numerous underwriters (or groups of underwriters) submit bids to the issuer recommending the coupons and yields at which they can sell the new bond issue. The underwriter (or group) that proposes the lowest cost to the issuer is awarded the deal and is then responsible for selling the new bonds to investors.

In a negotiated sale, the issuer will customarily select a lead manager (senior managing underwriter), and any co-managers if an underwriting team/syndicate is created, early in the process. The senior managing underwriter, along with an issuer's municipal advisor and bond counsel, will contribute to the preparation of the preliminary official statement and may help the issuer determine what is to be financed, the method of financing, and the financing structure. Negotiated sales, often used for complex or unusual debt financings, provide for flexibility in changing the sale date to respond to market conditions, permit direct input from bond investors, and allow for a substantial amount of preselling of the debt, including sales to smaller retail investors, all in an effort to obtain the best possible financing terms.

Bonds sold in a competitive sale are relatively standard in design and security because underwriters have not been independently involved in the design of the financing structure and only have available to them the official statement and other readily accessible information concerning the issuer. Although competitive sales may limit the flexibility of an issuer to dramatically change the amount of the sale, offer multiple interest rates per maturity, provide priority to retail investors, or engage targeted underwriting firms, a properly conducted competitive sale gives an issuer reasonable comfort that on the date of sale, given the financial structure chosen, the issuer has received the best possible bid for its bonds.

For the next issuances of bonds, staff is planning on using (1) a competitive sale to finance water utility system improvements and (2) a negotiated sale to finance SCW improvements. Valley Water has been issuing water utility system debt for many years and the water rate revenues supporting its repayment are typical of water utility issuers and are understood by investors. For this reason, a competitive sale may be a good option to ensure low cost of financing. In contrast, Valley Water has never issued long-term debt secured by the SCW special parcel tax, so the SCW capital projects and the security mechanism will be new to investors. For this reason, a negotiated sale may be a good option to allow for more interactions with potential investors to generate demand for the bonds and drive down financing costs.

Valley Water Underwriter Pool

The Valley Water Board of Directors' Executive Limitation (EL) 4.7.7 established certain boundaries on banking firms that Valley Water can utilize to meet its needs. EL 4.7.7 states that Valley Water shall not do business with banks that do not have an Environmental, Social, and Governance (ESG) rating from at least one professional ESG research company of at least average/medium (or its equivalent). Banking firms and credit unions located within the nine Bay Area counties with total assets below \$10 billion are exempt from this limitation. As ESG research companies update their ratings, investment banks may become eligible or ineligible to underwrite Valley Water debt pursuant to the limitation.

Staff has applied the following criteria, all of which must be met, for determining eligible senior managing and co-managing underwriters for future bonds issued on a negotiated basis:

Senior/Co- Manager Eligibility Criteria

1. In California State Treasurer's Office (STO) underwriter pool as eligible for appointments on all state bond sales¹
2. Not headquartered in states subject to California State Assembly Bill 1887 travel prohibition regarding discrimination against lesbian, gay, bisexual, and transgender people²
3. Total assets greater than \$50 million (to ensure sufficient capital to underwrite bonds as needed)
4. Has offices located in California
5. Complies with (or is exempt from) EL 4.7.7 ESG rating requirement as of date of underwriter selection or notice of sale of debt

Small Business Co-Manager Eligibility Criteria

1. In STO underwriter pool as eligible for appointments on all state bond sales¹
2. Headquartered in California
3. Member of STO Small Business Enterprise (SBE) Program³
4. Meets EL 4.7.7 total asset size exemption from ESG rating requirement

Application of the above criteria provides for a number of experienced and diverse underwriting firms that will be able to help Valley Water realize the lowest possible cost of capital on its debt financings.

Underwriting firms currently eligible under the criteria are outlined below. If the STO updates its underwriter pool, or if specific firms obtain enhanced ESG rating or otherwise meet the criteria outlined above, Valley Water may update the list of eligible underwriting firms as appropriate.

Senior/Co- Manager

Barclays Capital	Morgan Stanley & Co.
BNY Mellon Capital Markets	Piper Sandler & Co.
BofA Securities	RBC Capital Markets
Citigroup Global Markets	Siebert Williams Shank & Co. (M,W)
Goldman Sachs & Co.	U.S. Bancorp Investments
J.P. Morgan Securities	UBS Financial Services
Jefferies	

Small Business Co-Manager

Alamo Capital (S,W)	Mischler Financial Group (S,V)
Backstrom McCarley Berry & Co. (S,M)	Prager & Co. (S)
Caldwell Sutter Capital (S)	Wulff, Hansen & Co. (S)
Great Pacific Securities (S)	

Note: *M = minority owned, S = member of STO’s Small Business Enterprise Program (see footnote 3), V = veteran owned, W = women owned.*

Competitive sales of bonds are generally advertised to attain bids from as many underwriters as possible and don’t necessarily limit bids to underwriters in an issuer’s negotiated underwriter pool. However, issuers such as the state of California do limit bidders on some of its competitive sales to firms in the STO’s pre-qualified underwriter pool. Valley Water may likewise limit bidders on its competitive sales to firms in Valley Water’s underwriter pool.

Repayment of 2006B Water Utility Bonds

In conjunction with the aforementioned financing plan, staff is proposing to redeem all of the outstanding 2006B Bonds with short term debt as a mechanism to limit water rate increases. Currently, the outstanding principal amount of the bonds is \$16.5 million, and the bonds mature on June 1, 2035. The 2006B Bonds include a “make-whole” redemption provision that is currently, subject to changing market conditions, estimated to cost \$3.9 million. The redemption payment allows Valley Water to repay outstanding bonds prior to final maturity, and ensures investors are protected from losses in interest income due to the earlier redemption date. The actual redemption payment amount will be calculated on the redemption date, pending the then market conditions. Along with the outstanding principal, the additional one-time “make whole” cost would be paid for initially by short-term debt and then later refunded with long-term debt. Depending on interest rates at

the time of issuing the long-term debt, some, or potentially all of the “make-whole” cost may be offset by lower interest rates. Additionally, the interest cost for interim short-term debt such as CP is anticipated to be much lower than the interest cost for the 2006B Bonds should they remain outstanding. CP interest rates for the week of November 29 to December 3, 2021 ranged from 0.09-0.14% and have averaged 0.07% for 2021. Assuming a higher average CP interest rate for FY 2022-23 of 1.00% in comparison to the actual 5.312% interest rate on the outstanding bonds, interest cost savings in FY 2022-23 to be realized by repaying the 2006B Bonds with CP is estimated to be \$670,000.

Footnotes

- ¹ See <https://www.treasurer.ca.gov/bonds/pools/underwriter.asp>. The STO requires firms to have numerous qualifications, and to certify as to compliance with various state laws and prohibitions, at all times to be eligible to underwrite periodic state bond issues.
- ² See <https://oag.ca.gov/ab1887>.
- ³ Defined by STO as an independently owned and operated business with average annual gross receipts of \$38.5 million or less for the three most recent years.

ENVIRONMENTAL JUSTICE IMPACT:

There are no Environmental Justice impacts associated with this item.

FINANCIAL IMPACT:

Repayment of outstanding 2006B Bonds principal is \$16.5 million prior to June 1, 2022. Subject to changing market conditions, the current estimate for the “make-whole” cost of \$3,919,387 (based on interest rates as of November 29, 2021) required to pay off outstanding 2006B Bonds on June 1, 2022, would be incurred and would be funded, along with the outstanding principal, from the proceeds of short-term debt. The FY 2021-22 budget is sufficient to cover debt service on all debt issued during FY 2021-22. Staff will return to the Board for approval of the actions and financing documents necessary to issue long-term debt to refund outstanding CP certificates and possibly provide new project funds for future capital costs. At such time a detailed estimate of all related financing costs will be presented.

CEQA:

The recommended action does not constitute a project under California Environmental Quality Act (CEQA) because it does not have a potential for resulting in direct or reasonably foreseeable indirect physical change in the environment, as outlined in the State CEQA Guidelines, Section 15060(c)(2).

ATTACHMENTS:

None.

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