CITY OF HOUSTON

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To: Budget and Fiscal Affairs Committee **From:** Finance Working Group

Cc: **Date:** May 1, 2012

Subject: Combined Utility System Variable Rate Demand Bonds Series 2004B-1 Conversion

Finance Working Group Recommendation

- Terminate the existing letter of credit
- Convert the structure from variable rate demand bonds to SIFMA Index Floaters
- Split the $225 million into two tranches

See Attachment 2 for the list of the Finance Working Group (FWG).

Background

The Combined Utility System's liquidity needs consist of a $700 million commercial paper program, almost $800 million of variable rate demand bonds, and $250 million of SIFMA Index Floaters (see Table 1).

The Variable Rate Demand Bonds Series 2004B-1 is $225 million with liquidity provided by Bank of America and an expiration date on the letter of credit of December 16, 2013. Variable rate demand bonds are remarketed on a weekly basis, which requires an associated letter of credit or stand-by bond purchase agreement for the potential event that the bonds are unable to be remarketed. If the credit-worthiness of the bank providing the letter of credit decreases, then investors may be less willing to purchase the underlying bonds, thus driving their interest rate up.

On February 15th, Moody's Rating Agency announced a review of 17 banks and securities firms with global capital markets operations and published a special comment on the challenges facing each bank. Included in this review is a potential downgrade of Bank of America. The market has reacted to this potential downgrade by charging higher interest rates for variable rate debt backed by Bank of America, including the Series 2004B-1 bonds.

Recommendation Rationale

- Terminate the existing letter of credit.
    - The current contract allows the City to terminate without penalty and doing so may allow the City to avoid the potential costs associated with a downgrade of the liquidity provider.
    - If the current trading differential continues, it will cost CUS an additional $225,000 annually.
- Convert the structure from variable rate demand bonds to SIFMA Index Floaters. This structure involves selling the bonds to investors for a period of time that is typically inside of 5 years and the interest expense is pegged to an index plus a fixed spread.
    - Maintain a variable rate structure.
        - Short-term interest rates are low and the variable rate exposure of CUS is below the City's maximum policy target of 20%.
    - Use SIFMA Index Floaters as the alternative to variable rate demand bonds.
        - The investors hold the bonds until maturity, so the bonds no longer need to be remarketed on a weekly basis, which requires a letter of credit. Eliminating the need for a letter of credit reduces the City's exposure to the financial health of the associated bank. The FWG determined that the benefits of the reduction in bank risk significantly outweighed the small estimated cost difference ($55k).
        - See Attachment 1 for an analysis of the cost differences between variable rate demand bonds and SIFMA Index Floaters.
        - The FWG issued a Request for Proposals for either the replacement of the existing letter of credit or for an alternative structure. Only two proposals were received for replacement of the existing letter of credit, while around fifteen proposals were received for an Index Floater. Based on this response, the availability of letters of credit from a highly rating bank is a concern.
- Split the $225 million into two tranches; a $125 million 3-year Index Floater and a $100 million 5-year Index Floater.
    - Staggered maturities reduce the remarketing risk at the end of the term.

Table 1: CUS Liquidity Summary

Liquidity Type	Series	Size ($ millions)	Bank	Expiration	Requires Bank Letter of Credit
Commercial Paper	B-1	250	JPMorgan Chase	12/16/2013	Y
	B-2	75	Wells Fargo	12/14/2012	
	B-3	75	Bank of Tokyo-Mitsubishi	1/20/2015	
	B-4	100	Barclay's	7/15/2013	
	B-5	100	BBVA	5/27/2015	
	B-6	100	Citibank	7/15/2013	
	Total	**700**			
Variable Rate Demand Bonds	2004B-1	225	Bank of America	12/16/2013	Y
	2004B-2	100	State Street	4/5/2013	
	2004B-3	75	Sumitomo	4/3/2015	
	2004B-4	75	JPMorgan Chase	4/6/2013	
	2004B-5	100	Lloyd's	4/6/2013	
	2004B-6	78.33	Sumitomo	4/3/2015	
	2008D-1	132.01	JPMorgan Chase	12/31/2012	
	Total	**785.34**			
	Subtotal	**1,485.34**			
SIFMA Index Floater	2010 B-1	200	RBC	3/22/2013	N
	2010 B-2	49.08	RBC	3/23/2013	
	Total	**249.08**			
	TOTAL	**1,734.42**	**18.5%**	*	
Total Outstanding Debt		**5,966.92**			

* The percentage of variable rate exposure includes $902 million of hedged debt and $70.4 million of commercial paper. The calculation does not include the entire $700 million commercial paper program.

Attachment 1: Cost Comparison

SUMMARY: Under the best case scenario, where it is assumed that the rating of the bank providing the letter of credit does NOT impact interest rates (i.e. the variable index spread below is zero), a 3-year Index Floater costs approximately $55,000 more than maintaining the current variable rate structure with an alternate bank. Anything less than the best case scenario will result in a decrease of the cost difference.

Costs (% of par)	VRDB	3-yr Index Floater
Interest (Assumes SIFMA)	0.25%	0.25%
LOC Fee	0.53%	N/A
Remarketing Fee	0.05%	N/A
Fixed Index Spread	N/A	0.53%
Variable Index Spread *	0.00%	N/A
	0.83%	0.78%
2004B-1 Par Amount	225,000,000	225,000,000
Estimated Annual Cost	1,856,250	1,755,000
One-Time Cost of Issuance:		
Legal Fees	60,000	250,000
Underwriter's Discount		279,000
	60,000	529,000
Annualized	20,000	176,333
Total Estimated Annual Cost	1,876,250	1,931,333
Difference		55,083

ASSUMPTIONS:

- The Finance Working Group issued a Request for Proposals for either the replacement of the existing letter of credit or for an alternative structure. The costs quoted above are based on the results of these proposals.
- The Variable Index Spread is assumed to be zero, which is only true for the highest rated banks. This is the spread that would increase without limit should the associated bank be downgraded.
- Legal fees are estimated based on similar previous transactions.
- The entire $225 million is estimated based on a 3-year Index Floater even though $100 million will be structured as a 5-year Index Floater. This is done because no proposals were received for a 5-year letter of credit against which a 5-year Index Floater could be compared. This assumption increases the costs associated with the Index Floater because the higher one-time costs of issuance are annualized over a shorter period of time.

Attachment 2: Finance Working Group

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