

**CITY OF SAN ANTONIO
PUBLIC UTILITIES OFFICE
CITY COUNCIL AGENDA MEMORANDUM**

TIME CERTAIN
ITEM NO. 4
1:30PM

TO: Mayor and City Council

FROM: Ben Gorzell Jr., Director, Public Utilities Office

SUBJECT: An Ordinance Authorizing the Issuance of \$160,000,000 City of San Antonio, Texas Electric and Gas Systems Junior Lien Revenue Bonds, Series 2004 and Authorizing the Delegation of Authority to Issue and Set Pricing of the Bonds to the Designated Financial Officers, defined as either the CEO or the CFO, of City Public Service.

DATE: November 4, 2004

SUMMARY AND RECOMMENDATION

This Ordinance authorizes the issuance of \$160,000,000 City of San Antonio, Texas Electric and Gas Systems Junior Lien Revenue Bonds, Series 2004, issued as Variable Rate Demand Obligation Bonds ("VRDOs"), to fund the purchase of an additional 12% ownership interest in the South Texas Project ("STP") equal to 300 megawatts of additional nuclear generation capacity. This Ordinance will authorize the delegation of authority by the San Antonio City Council to issue and set pricing of the bonds to the Designated Financial Officers of City Public Service through a "Q" Authorization. The Ordinance will also authorize other matters incident and relating to the issuance, through the execution of: a Paying Agent/Registrar Agreement; a Remarketing Agreement; a Purchase Contract; and, a Standby Bond Purchase Agreement.

It is recommended that City Council approve this Ordinance.

BACKGROUND INFORMATION

On March 1, 2004, American Electric Power ("AEP") notified City Public Service ("CPS") of its intention to sell its 25.2% ownership interest in STP to Cameco Corporation. On May 26, 2004, the CPS Board of Trustees passed a resolution to exercise its "Right of First Refusal" and directed CPS' management to proceed with the purchase of a minimum additional 12% share of STP subject to regulatory approval which included City Council's approval of a base rate adjustment. Finally, on September 30, 2004, the San Antonio City Council approved a new rate ordinance, Ordinance No. 99823, which adjusted the electric base rate fuel recovery from 1.600¢ per kWh to 1.416¢ per kWh for all retail classes. The base rate fuel recovery change will enable CPS to pay for increased operations and maintenance expenses and the additional debt service required to fund the purchase of the additional 12% ownership interest in STP.

CPS' financing program includes a corporate objective of maintaining a 20% gross variable rate and 80% fixed rate debt structure. The issuance of an additional \$160 million in variable rate debt increases the gross variable rate percentage to 25%. CPS maintains short-term investments, which mitigates risks associated with variable rate debt. As the variable rate of interest costs rise, so should CPS' earnings on short-term investments, which provides a hedge against rising interest rates. CPS can earn returns on short-term investments that offset the variable rate interest being paid on these bonds.

Historically, average variable interest rates have been lower than average fixed interest rates because the risk to the lender has been lower. This allows CPS, the issuer, to save on interest costs because CPS

assumes the risk of rising interest rates. Although these bonds are a long-term investment, interest rates will reset at the end of the chosen term, initially for either a one-year or two-year term, and investors must tender their bonds for remarketing at the reset date.

The purchase of variable rate bonds at the reset date offers CPS flexibility that is not present in long-term fixed interest rate bonds. Long-term fixed rate bonds are generally not callable for the first ten years after issuance. The variable rate bonds are also multi-modal meaning that at the reset date they can be converted to different modes such as daily, weekly, commercial paper, auction, term (with different rate periods), or fixed, which also contributes to the flexibility of the variable rate bonds.

The issuance of variable rate debt requires the assistance of key parties performing essential tasks. The paying agent makes principal and interest payments to the bondholders on behalf of the issuer. A remarketing agent resets interest rates on the bonds and "remarks" the bonds to the bondholders or buyers. The purchase contract establishes the terms and conditions that dictate the behavior of the parties involved. Finally, a liquidity bank, which is set in place by a standby bond purchase agreement, is required to purchase the bonds as insurance in the event there are no purchasers available. Having a liquidity facility in place helps insulate CPS from any unforeseen cash demands.

In addition, VRDOs differ from fixed rate bonds in that City Council approval is given prior to pricing and bond proceeds are received shortly after pricing. In a fixed interest rate issue, City Council approval is given after pricing, and bond proceeds are then received approximately 30-days thereafter. Therefore, CPS requests from City Council delegation of authority to be provided to CPS' Designated Financial Officer through approval of a "Q" Authorization. A "Q" Authorization, as permitted by Chapter 1371 of the Texas Government Code allows CPS' Designated Financial Officer to issue and set pricing on the City's \$160 million Electric and Gas Systems Junior Lien Revenue Bonds, Series 2004. This authorization allows the adoption of the ordinance authorizing the issuance of the bonds without stating the interest rate or sale price in the ordinance. The interest rate and sale price will be formally set upon the execution of the Pricing Certificate. This approach is recommended to allow CPS to take advantage of market conditions. Similar authority was provided to CPS during the Series 2003 variable rate bond transaction in May 2003.

On May 1, 2003, City Council adopted Ordinance No. 97564, which authorized the issuance of \$250,000,000 City of San Antonio, Texas Electric and Gas Systems Junior Lien Revenue Bonds, Series 2003. Along with the current \$250 million in VRDOs outstanding, CPS has an additional \$350 million in outstanding Tax Exempt Commercial Paper ("TECP"). CPS is authorized to issue up to \$450 million of TECP, however, issuance of any additional TECP is not currently planned.

POLICY ANALYSIS

This transaction is consistent with the CPS debt plan and on-going review of financings.

FISCAL IMPACT

On September 30, 2004, Ordinance No. 99823 authorized the electric base rate fuel recovery adjustment. The rate adjustment includes annual recovery of debt service of \$8.174 million related to the acquisition of the 12% additional nuclear generation capacity in STP. The annual recovery of debt service was based on the assumption that fixed rate debt would be issued at 5.11%. CPS uses a cash flow modeling tool in its financial planning process. The cash flow model helps CPS determine what base rate adjustments, if any, are needed to cover projected operation, maintenance, debt service, working capital and construction

needs. For the financial planning process it is necessary to incorporate fixed rates in the model in order to ensure that CPS' Electric and Gas Systems will have the necessary funding in the event that interest rates begin to rise.

The issuance of the \$160 million in variable rate, long-term bonds, allows CPS to take advantage of the current market's lower cost of borrowing. Based on the current market, it is expected that variable rate debt can be initially issued at approximately 2.0%, or an estimated \$3.2 million in annual interest costs. CPS will then use the difference between the actual interest incurred and the \$8.174 million forecasted to pay down principal on the VRDOs. This method allows CPS to reduce the amount of outstanding principal sooner and helps reduce the amount of interest cost, which would otherwise be incurred.

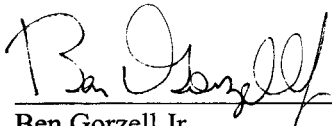
COORDINATION

This action has been coordinated with the CPS Board of Trustees, CPS Staff, the City Attorney's Office, and CPS' co-financial advisors and co-bond counsel.

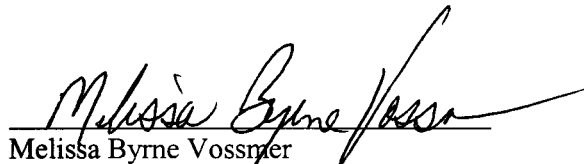
SUPPLEMENTAL COMMENTS

A working group comprised of City Public Service staff; Remarketing Agent: Morgan Stanley & Co. Incorporated; Paying Agent: Wachovia Bank, National Association; Standby Bond Purchase Agreement (liquidity provider): BNP Paribas; Co-Financial Advisors: First Southwest Company and Estrada Hinojosa & Company; Co-Bond Counsel: Fulbright & Jaworski L.L.P. and Escamilla & Poneck, Inc.; Issuer's Outside Counsel: Cox Smith Matthews Incorporated; and Morgan Stanley's Underwriter's Counsel: Andrews Kurth LLP was assembled to work on this bond issue.

The disclosure requirements of the City's Ethics Ordinance are not applicable.

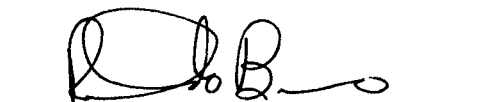


Ben Gorzell Jr.
Director of Public Utilities Office



Melissa Byrne Vossmer
Assistant City Manager

Approved:



J. Rolando Bono
Interim City Manager