

OFFICE OF THE CITY CLERK
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**CITY OF OAKLAND
SUPPLEMENTAL AGENDA REPORT**

TO: Office of the City/Agency Administrator
ATTN: Deborah A. Edgerly
FROM: Finance and Management Agency
DATE: July 11, 2006

RE: **A Report to Update the City Council on the Performance of the City of Oakland's Existing Interest Rate Swaps**

SUMMARY

At the June 13, 2006 meeting of the Finance and Management Committee ("Committee") the Committee requested an informational report to update the City Council ("Council") on the performance of the City of Oakland's ("City") existing interest rate swaps. The City currently has two interest rate swap agreements associated with the following outstanding bond issuances:

- (1) Oakland Joint Powers Financing Authority ("Oakland JPFA") Lease Revenue Refunding Bonds, 2004 Series A-1 and A-2 ("2004 Bonds").
- (2) Oakland JPFA Refunding Revenue Bonds, 2005 Series A-1 and A-2 ("2005 Bonds").

FISCAL IMPACTS

This is an informational report. There is no fiscal impact.

BACKGROUND

Definitions

Traditional Fixed Rate Debt: Debt obligations in which the interest rate on the bonds remains unchanged, or "fixed", throughout the life of the debt. Currently, traditional fixed interest rate debt represents 62.15%¹ (or approximately \$700 million) of the City's total outstanding direct debt.

Traditional Variable Rate Debt: Debt obligations in which the interest rate on the bonds changes, or "varies", depending on market conditions. The variable rates on the bonds are determined on the appropriate reset date (e.g., daily, weekly, monthly, etc.). Currently, 17.61%¹ (or approximately \$198 million) of the City's total outstanding direct debt is comprised of

¹ Includes the \$21 million issuance of the City of Oakland General Obligation Bonds (Series 2006, Measure G), which is expected to close on June 28, 2006.

traditional variable rate debt; this includes the City's 50% obligation towards the Oakland-Alameda County Coliseum Authority's ("OACCA") outstanding lease revenue bonds.

Interest Rate Swap: An interest rate swap is a written contract, or agreement, entered into by the issuer and a counterparty (or counterparties) in connection with the issuance of debt obligations to provide for an exchange, or "swap", of payments based upon fixed and/or variable interest rates. Under an interest rate swap, a traditional fixed rate bond can be "synthetically" structured such that the net result is a variable rate transaction. Similarly, a traditional variable rate bond can be "synthetically" structured such that the net result is a fixed rate transaction. Currently, 20.24%¹ of the City's outstanding direct debt obligation is comprised of bonds with associated interest rate swap agreements.

Background on City's Outstanding Variable Rate Bonds

There are clear benefits to issuing traditional fixed rate bonds. Of note, traditional fixed rate debt provides budgetary certainty, no ongoing fees, as well as the opportunity to lock in rates at the time of issuance. However, there are distinct disadvantages in issuing traditional fixed rate bonds – the most obvious being the constraints in the ability to refinance or refund the debt. Unless the bonds are being "advance" refunded, meaning that bonds are called prior to the call date, traditional fixed rate bonds typically can not be refinanced without paying a hefty penalty within the first 10 years of issuance. As a result, if the issuer issues traditional fixed rate debt during a high interest rate period, for example, the issuer is "locked-in" at those high coupon rates for the first 10 years.

Therefore, traditional variable rate debt can be an important tool in managing the City's debt program. While there are disadvantages, such as interest rate risk and ongoing fees, traditional variable rate debt, when issued prudently, can be beneficial for the following reasons:

- (1) ***Lowers the cost of borrowing.*** Tax-exempt variable rates have historically outperformed tax-exempt fixed rates. Since January 1987, the spread between traditional fixed rate bonds and traditional variable rate bonds has been 2.43%², meaning that on average, the coupon on traditional fixed rate debt has been 2.43% higher than variable rate debt.
- (2) ***Hedges against interest rate risk during a high interest rate environment.*** Traditional variable rate debt allows the issuer to instantly capture the benefits of lower interest rates if the market changes.
- (3) ***Provides restructuring flexibility.*** Traditional variable rate debt can be restructured at the issuer's discretion for various financial reasons as variable rate debt instruments are continually callable.
- (4) ***Allows access to a wider investor base.***

² Reflects market conditions as of June 16, 2006, based upon the 20-Bond Buyer Index General Obligation (BBI GO), which is the benchmark for long-term fixed rate general obligation bonds, and the Bond Market Association (BMA) Index, which is the benchmark for variable rate bonds. Since January 1987, BBI GO has averaged 5.88% and the BMA Index has averaged 3.45%.

The City currently has approximately \$198 million of traditional variable rate bonds outstanding, comprising 17.61% of the City's overall direct debt portfolio. The following comprise the traditional variable rate portion of the City's direct debt portfolio:

- (1) Civic Improvement Corporation Variable Rate Demand Certificates of Participation ("COPs"), Series 1985;
- (2) Oakland JPFA Special Refunding Revenue Bonds, 2005 Series B;
- (3) OACCA Variable Rate Lease Revenue Bonds, Series 1996; and
- (4) OACCA Variable Rate Lease Revenue Bonds, Series 2000.

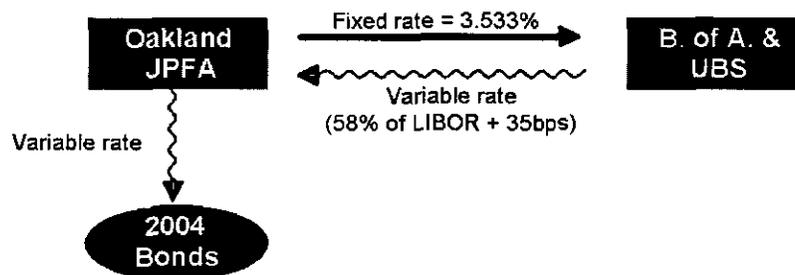
It is important to note that the City is well within the appropriate level of variable rate debt as deemed by the rating agencies based on the City's financial strength and composition of assets.

Background on City's Outstanding Interest Rate Swaps

Interest rate swaps often are entered into to realize overall lower debt service, receive upfront cash, and/or maximize financing flexibility. The City currently has two interest rate swaps outstanding as follows:

- (1) Synthetic Fixed Rate Swap tied to 2004 Bonds
- (2) Synthetic Fixed Rate Swap tied to 2005 Bonds

Synthetic Fixed Rate Swap tied to 2004 Bonds: On June 10, 2004, the City issued its 2004 Bonds as traditional variable rate debt (auction rate securities) and simultaneously entered into a synthetic fixed rate swap agreement ("2004 Swap") with Bank of America and UBS AG (the "Counterparties"). Under this swap agreement, the City agreed to pay the Counterparties a fixed interest rate of 3.533% and in exchange, receive a variable rate based on 58% of the 1-month London InterBank Offered Rate Index ("LIBOR") plus 35 basis points ("bps"). The diagram below illustrates the structure of the 2004 Swap:

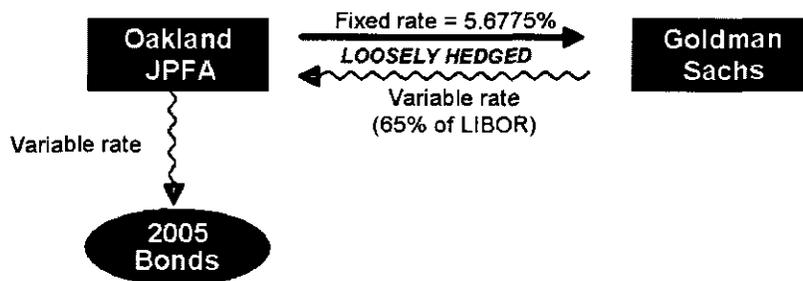


The net effect of this transaction is that the two variable rate legs will cancel each other out, leaving the City with a net fixed rate exposure of 3.533% on the 2004 Bonds.

Synthetic Fixed Rate Swap tied to 2005 Bonds: On December 1, 1988, the City issued \$209.84 million in Special Refunding Revenue Bonds, 1988 Series A ("1988 Bonds"). The 1988 Bonds had been issued with high interest rates (coupons ranged from 6.50% to 7.60%) and were not

“callable”, meaning that the 1988 Bonds could not be defeased, until 1998. As a result, on January 9, 1997, the City entered into a forward-starting synthetic fixed rate swap agreement (“1998 Swap”) with Goldman Sachs (“Goldman”) in order to realize upfront savings on the 1988 Bonds. Under this agreement, Goldman agreed to pay the City \$15 million almost 1.5 years *prior* to the call date of the 1988 Bonds, and in exchange, the City agreed to defease the 1988 Bonds with new bonds in 1998 (when the 1988 Bonds were callable). In effect, in exchange for receiving \$15 million upfront in January 1997, the City was bound to enter into a synthetic fixed rate swap on the issuance of Oakland Joint Powers Authority Lease Revenue Bonds, 1998 Series A-1 and A-2 (“1998 Bonds”). Under this agreement, the City agreed to pay Goldman a fixed interest rate of 5.6775%, and in exchange, receive a variable rate based on the Bond Market Association (“BMA”) Index³. In April 2000, the City restructured the variable rate index from the BMA Index to 65% of the LIBOR⁴; the City received an upfront payment of \$5.58 million from Goldman for this restructuring.

On June 21, 2005, the City refunded the 1998 Bonds with the 2005 Bonds (previously defined as the Oakland JPFA Refunding Revenue Bonds, 2005 Series A-1 and A-2). However, given the market conditions at the time, the City did not terminate the existing swap agreement on the 1998 Bonds. As a result, the 2005 Bonds, also issued as traditional variable rate bonds (auction rate securities), are loosely hedged by the swap agreement originally entered into with the issuance of the 1998 Bonds. The following diagram illustrates the current swap structure:



As with the 2004 Bonds, the net effect of this transaction is that the two variable rate legs will cancel each other out, leaving the City with a net fixed rate exposure of approximately 5.6775% on the 2005 Bonds.

KEY ISSUES AND IMPACTS

Council asked Staff to examine the “value” of the City’s two outstanding swap agreements and we will answer the following questions for both synthetic fixed rate swap agreements tied to the 2004 Bonds and 2005 Bonds:

- (1) Would the City have been “better off” issuing traditional fixed rate bonds?
- (2) What is the current termination value of the existing swap agreement?

³ The BMA Index is an industry benchmark for floating-rate tax-exempt bonds.

⁴ Historically, the BMA Index has performed at 65% of LIBOR.

2004 Swap

(1) Would the City have been better off issuing the 2004 Bonds as traditional fixed rate bonds?

No, the City would not have been better off issuing the 2004 Bonds as traditional fixed rate bonds versus the current structure as synthetic fixed rate bonds as illustrated in the table below:

Type of Financing	Average Coupon/ All-in Cost ⁵	Total Net Debt Service	Debt Service “Savings”
Traditional Fixed Rate	4.68% <i>(estimated)</i>	\$186,631,431	--
Synthetic Fixed Rate	4.03% ⁵	\$176,920,168	\$9,711,245

As shown in the table above, by entering into a swap agreement on the 2004 Bonds, the City conservatively saves nearly \$10 million in comparison to a traditional fixed rate structure.

(2) What is the current termination value of the existing swap agreement?

As of June 9, 2006, the 2004 Swap had a “mark-to-market” or “termination” value of approximately \$400,000 against the City’s favor, meaning that had the City chosen to terminate the 2004 Swap on that date, the City would have been obligated to pay the Counterparties \$400,000. It is important to note that the “termination value” (i.e. mark-to-market value) is based on the market conditions of that date and is a very temporary number, directly subject to market volatility. Should short-term interest rates increase, as they are expected to, the City could potentially terminate the 2004 Swap at a much lower value, and even “receive” moneys for terminating.

However, should the City hold the 2004 Swap to maturity, and not terminate the swap, the debt service payments on the swap will be what they are akin to any traditional fixed rate debt. As a result, relative to a traditional fixed rate transaction, the City would be better off by nearly \$10 million as shown in the previous table by having issued these bonds through synthetic fixed rate structure.

2005 Swap

(1) Would the City have been better off issuing the original 1998 Bonds as traditional fixed rate bonds?

The analysis for the 2005 Swap is very complex. Had the City issued the 1998 Bonds as traditional fixed rate bonds, instead of the synthetic fixed rate structure, it will not have been eligible for a restructuring in 2005. As the Council is aware, the 1998 Bonds were refinanced with the 2005 Bonds in order to allocate additional monies into the City’s General Fund. Therefore, assuming that the City had issued the 1998 Bonds as traditional fixed rate bonds

⁵ All-in cost includes on-going support costs of 25bps plus conservative estimate of any trading differential in the variable rate legs of 25bps.

and there were no subsequent refinancing of these bonds, the City would *not have been better off* issuing the original 1998 Bonds as traditional fixed rate bonds versus the current synthetic fixed rate structure. The reasons are as follows:

- A. The City received **\$15 million** in January 1997 for entering into a forward-starting interest rate swap agreement.
- B. The City received **\$5.58 million** in April 2000 for changing the underlying variable rate received from Goldman from the BMA Index to 65% of LIBOR.
- C. On a cashflow basis, had the 1998 Bonds been issued as traditional fixed rate bonds, it will not have been eligible for the restructuring in 2005. As a result, in terms of debt service payments, the City will have paid approximately **\$10 million** more in debt service by issuing traditional fixed rate bonds versus the current synthetic fixed rate structure.

(2) What is the current termination value of the existing swap agreement?

As of June 9, 2006, the swap associated with the 2005 Bonds had a negative mark-to-market value of approximately \$15.15 million, meaning that had the City chosen to terminate this agreement on that date, the City would have been obligated to pay Goldman \$15.15 million. However, it is important to note that should short-term interest rates increase as expected, the City could potentially terminate this agreement at a much lower value, and even “receive” moneys for terminating.

Even if the City chose to terminate this agreement and make the estimated \$15.15 million payment to Goldman, the City would have extracted over \$5 million of value from entering into this swap transaction given the sizable upfront monies we have already received (*i.e.*, \$15 million in January 1997 and \$5.58 million in April 2000).

However, should the City hold this swap to maturity, the City will be able to extract the full value of \$20.58 million in upfront monies. In addition, the City would capture over \$10 million in lower debt service versus traditional fixed rate bonds. If held to maturity, the net effect will be that the City will have benefited by over \$30.58 million by having issued synthetic fixed rate bonds versus traditional fixed rate bonds.

SUSTAINABLE OPPORTUNITIES

There are no sustainability opportunities associated with this report.

DISABILITY AND SENIOR CITIZEN ACCESS

There is no impact to disability or senior citizen access following actions under this report.

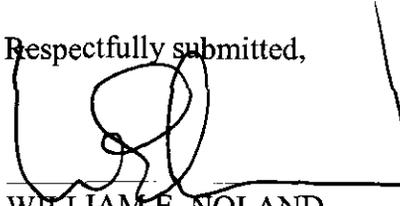
RECOMMENDATIONS AND RATIONALE

Staff recommends Council’s acceptance of this informational report.

ACTIONS REQUESTED OF THE CITY COUNCIL AND THE GOVERNING BOARD

Staff requests Council's acceptance of this informational report.

Respectfully submitted,



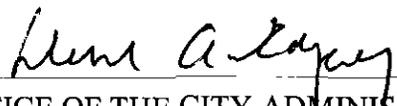
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APPROVED AND FORWARDED TO THE
FINANCE AND MANAGEMENT COMMITTEE


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