

County of Santa Clara
Finance Agency

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September 17, 2012

Redevelopment Successor Agency of the City of Sunnyvale
650 W. Olive Avenue
Sunnyvale, CA 94088

City of Sunnyvale Oversight Board
659 W. Olive Avenue
Sunnyvale CA 94088

Department of Finance – Attention Robert Scott
915 L Street
Sacramento CA 95814

Subject: Objection to Sunnyvale Successor Agency third ROPS

In our Notice of Objection dated August 28, 2012, objection was made to line 4 of the subject ROPS. Please find enclosed our position paper as to why the subject City Loan does not qualify as an exemption under Health and Safety Code Section 34171 (d) (2).

While the transaction appears at first to be a little layered, the exhibits A and B help unravel the complexity and ultimately this matter is very straight forward. Please contact our AB X1-26 Audit Manager John Guthrie at 408-299-5246 (or John.guthrie@fin.sccgov.org) if you have any questions.

Respectfully submitted,

Vinod Sharma
Director Finance Agency
Santa Clara County

cc: Grace Leung
Brice McQueen
Kathy Berry

RDA Loan from the City of Sunnyvale per 1977 Reimbursement Contract

Question:

Does the Loan from the City of Sunnyvale to its RDA pursuant to the 1977 Reimbursement Contract Qualify as an "Enforceable Obligation" under Health and Safety Code Section 34171(d)(2)?

Answer:

Based upon a detailed review of the transaction, it does not.

Background:

On May 1, 1977 the City and the RDA entered into a lease for a parking facility to be constructed (project lease) and, based on this lease, the RDA sold \$11.2 million Series A Parking Lease Revenue Bonds. Simultaneously, the Sunnyvale RDA entered a Reimbursement Contract with the City to provide reimbursement to the City for amounts paid out by the City to the RDA for rental payments made under the project lease and for all "contributions" (including future contributions) made by the City to the Agency. At the time, the City also transferred assets to the Agency without consideration.

On May 1, 1978 the City sold property to the Agency for \$1,360,673, which was recorded as the first amount due under the Reimbursement Contract and, that same day, the RDA sold \$11.1 million of Series B Parking Lease Revenue Bonds. Debt service of \$1.73 million annually commenced on the two series in 1980, and City rent payments paid under the project lease were recorded as loan additions due to the City under the Reimbursement Contract.

The Reimbursement Contract calls for an interest rate of 8% and the City has provided a spreadsheet showing all loan additions, interest accruals and repayments by the Agency. On that schedule, it should be noted that in 2009 the City made a contribution to the Agency, which was listed as a project payment of \$6.8 million. According to the City, this contribution has since been paid off. The current outstanding balance of the Reimbursement Contract is \$26.8 million and it is listed on the ROPS as \$ 41.6 million, which includes estimated additional interest at 8% until 2018 when it is estimated to be paid off.

Health and Safety (H&S) Code sections 34171 and 34178(a) state that City-RDA agreements are not enforceable obligations. The Reimbursement Contract is a City-RDA agreement, and hence may not be currently enforced as a matter of law. However, the legislation provides a specific vehicle for reinstating such loans, by allowing their restoration by the oversight board if the successor agency receives a "finding of completion" from the State Department of Finance. All such loans, however, must be recomputed at Local Agency Investment Fund (LAIF) interest rates from inception. Our calculations indicate that reducing interest from the 8% rate per the agreement to LAIF rates would decrease the current loan balance from \$26.8 million to \$220,684. In other words, at LAIF rates the loan would be near the point of being paid off.

Lease Obligation Bond Structure:

Exhibit A shows the basic lease obligation bond structure that the City and RDA used to sell the bonds. Specifically, (1) the City entered a parking facilities lease with the RDA promising to pay up \$2 million dollars a year in rent payments for the use of a (to be developed) parking facility. Based upon this pledge (2) the RDA sold \$11.2 million of Series A lease obligation bonds and (3) used the proceeds to (4) construct the facility. One year later a second Series B for \$11.1 million was also issued for the facility which was also covered under the parking facility lease. In 1980 the facility was completed and (5) annual lease payments commenced from the City to the RDA of \$1.73 million, which (6) the RDA used to make debt payments to the bond holders.

This describes the complete transaction as it was used for the issuance of debt and as it was disclosed in the Series A Official Statement.

Exhibit B shows the previously described basic transaction plus the addition of a separate agreement between the City and the RDA: the (7) Reimbursement Contract (*i.e.*, the agreement at issue here). Under this agreement each lease payment made by the City to the RDA under the parking facility lease would simultaneously (8) be added to the balance due on an escalating City loan to the RDA. Additionally this agreement provided for (9) the inclusion of other future “contributions” to be added to the loan balance and also included an 8% interest rate on the unpaid balance. The RDA was to pay the loan off from (10) excess tax increments after payment of senior bond debt and ongoing project costs.

Discussion:

City of Sunnyvale and its consultants Goldfarb and Lipman have stated to the Oversight Board that the City loan is an exception to the general rule under H&S Code section 34171(d)(2) that contracts between the redevelopment agency city that created it do not constitute “enforceable obligations.” This section states that written agreements may be exempt from this exclusion if they were “entered into (A) at the time of issuance . . . of indebtedness obligations, and (B) solely for the purpose of securing or repaying those debt obligations”

This H&S code section provides a very narrow window for exceptions and is clearly intended to protect lease obligation financing between two agencies under existing rental agreements. The purpose here is to protect debt holders from any interruption of debt payments. To qualify for this exception, both of the requirements (A) and (B) must be met. We will examine each in turn.

The first question is whether this Reimbursement Contract meets the requirements of subsection (A) as having been entered into *at the time* of debt issuance of indebtedness obligations. Since the agreement was entered into the same day as the first debt issuance, it arguably could meet this requirement with respect to the Series A Parking Lease Revenue Bonds. But it would not meet the requirements for any of the other transactions covered by this agreement.

On the second element—whether the loan was entered into “solely for the purpose of securing or repaying those debt obligations”—the Reimbursement Contract fails on several levels.

Specifically:

1. As described above under Lease Obligation Bond Structure, the Reimbursement Contract is independent of the actual issuance of debt and had no role in securing or repaying the two debt issues. Instead, the Reimbursement Contract's sole purpose was to provide for the eventual return of rental payments and contributions from future excess tax increments to the City. As this purpose was solely to protect the City's interest, it may have been necessary in order to obtain City Council approval for the financing, but it had no role in securing or repaying the actual debt issuances themselves. In fact, it was the project lease that was the key vehicle for securing and repaying the debt obligations but the project lease did not nor could not result in an RDA debt to the City. Instead, the project lease created an obligation of the City to the RDA. This can be clearly seen by comparing Exhibits A and B.

Further proof of this can be found in the official statements for the debt issues. The Series A Official Statement describes the project lease agreement in detail (as would be expected in such an arrangement) but does not even mention the repayment contract. One year later, the Series B Official Statement again describes the project lease agreement as the basis of the security and only casually mentions the Reimbursement Contract. Specifically it stated that:

Pursuant to a reimbursement agreement between the Agency and the City any surplus tax increment revenues received by the Agency (in excess of debt service requirements on outstanding 1977 Bonds) may be applied (but are not pledged) to city lease payments for application of debt service on the debt described herein.

What investors were told here was that surplus tax increments could be applied to city lease payments. No investor would have relied on this non-pledge as securing or paying either debt issuance. The City was already responsible for the lease payments via the lease.

2. The Reimbursement Contract itself was not intended to be used solely for securing or repaying debt issuances since it includes the provision for repayment of past and future "contributions" related to the subject project. Records show that over the three and a half decades, it was used as a utility vehicle for several different loan transactions between the City and RDA, including the original loan balance from the sale of land of \$1.36 million and the \$6.8 million project payment mentioned above and the add-on of the Series B Parking Lease Revenue Bonds a year later.

What is particularly interesting to note is that the City accounts for all components in their loan spreadsheet and uses a Last-in-First-Out (LIFO) approach in paying off the various components of debt under the Reimbursement Contract. Since 1977 the \$1.36 million from the original land sale is still on the books and will be the last item paid off. At 8% interest, the balance for the property sale has increased to over \$18.9 million. This represents the majority of the remaining loan balance (approximately 70%), and it has nothing to do with securing the two debt issuances.

3. While the 8% interest rate was not an excessive interest rate when the Reimbursement Contract was first entered, for the last two decades the interest rate has become out of alignment with appropriate rates of interest and has increased the loan balance far beyond a reasonable level. These rates neither reflect the City's pool investment rate nor any underlying debt interest rate. These facts alone would argue against the idea that such loan agreements were entered into or used solely for the purpose of paying or securing bond debt.

The required recalculation of city loans to the LAIF rate from origination was adopted in AB 1484 to approximate a reasonable rate that such city loans would have earned had the money stayed in city treasuries. The fact that a LAIF adjustment will result in a \$26.6 million write down shows how out of alignment the 8% has become over the three and a half decades of this loan's existence.

City of Sunnyvale 1977 Parking Lease Obligation Bonds

Exhibit A

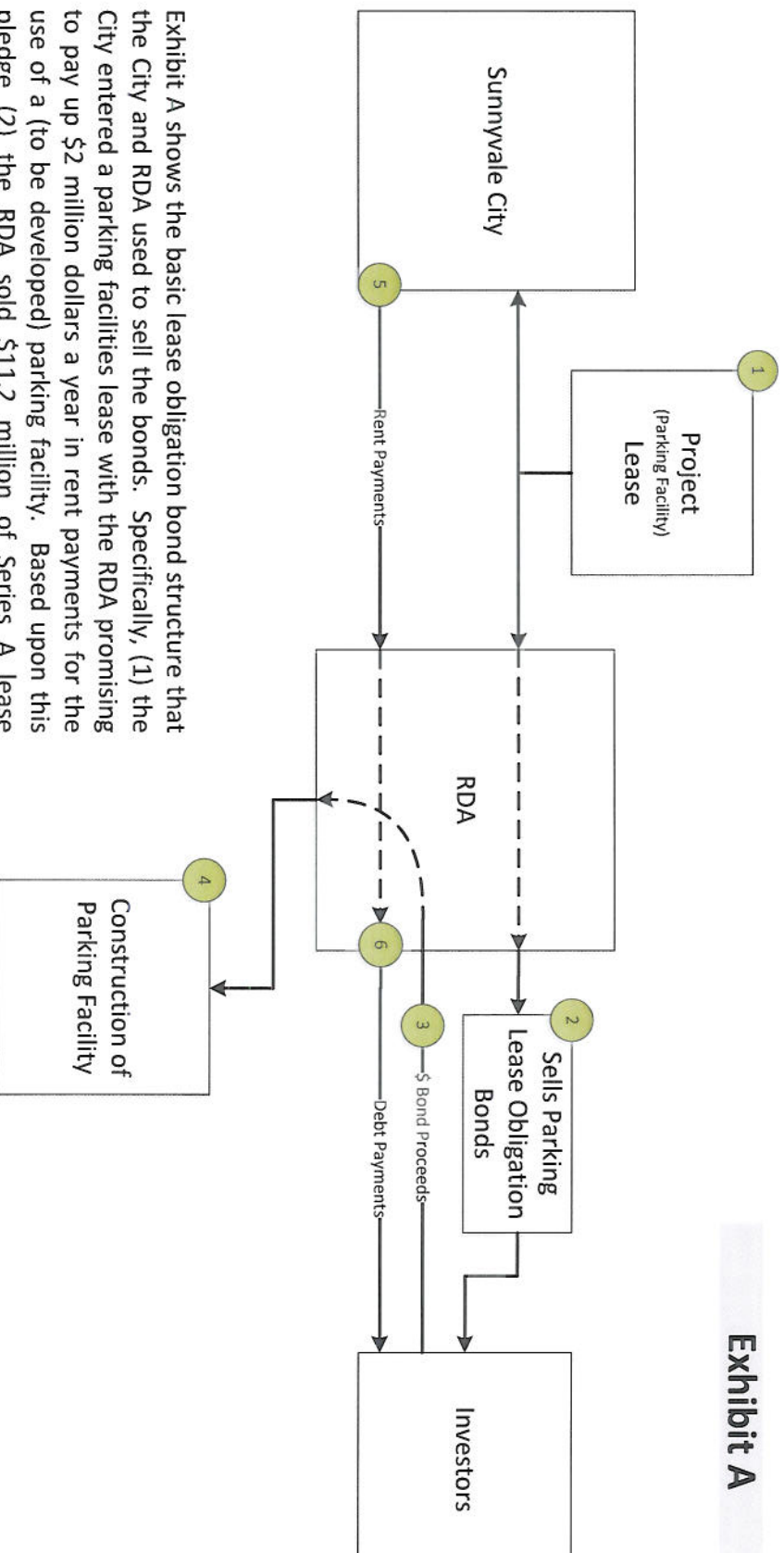


Exhibit A shows the basic lease obligation bond structure that the City and RDA used to sell the bonds. Specifically, (1) the City entered a parking facilities lease with the RDA promising to pay up \$2 million dollars a year in rent payments for the use of a (to be developed) parking facility. Based upon this pledge (2) the RDA sold \$11.2 million of Series A lease obligation bonds and (3) used the proceeds to (4) construct the facility. One year later a second Series B for \$11.1 million was also issued for the facility which was also covered under the parking facility lease. In 1980 the facility was completed and (5) annual lease payments commenced from the City to the RDA of \$1.73 million, which (6) the RDA used to make debt payments to the bond holders.

City of Sunnyvale 1977 Parking Lease Obligation Bonds Plus: City Loan to RDA

Exhibit B

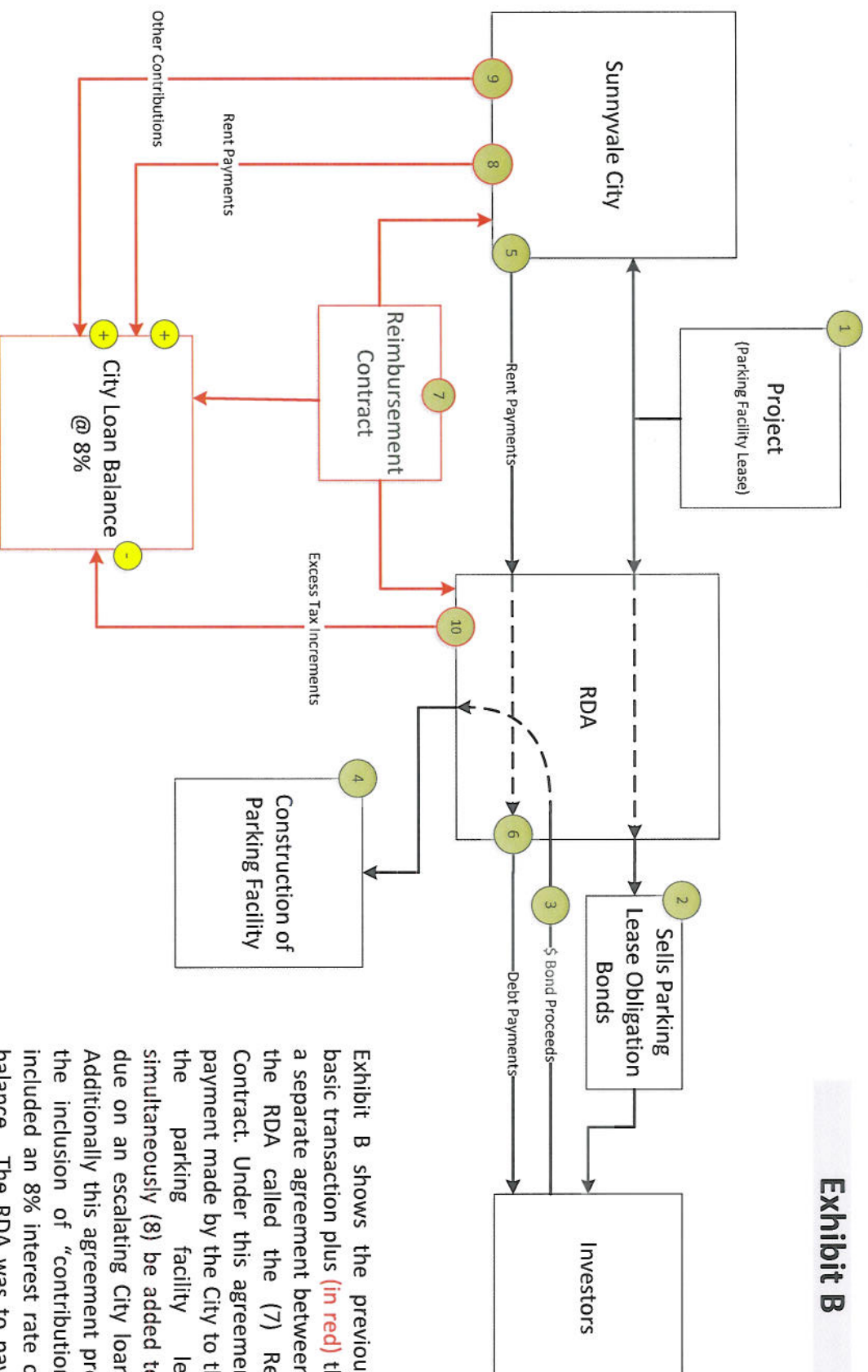


Exhibit B shows the previously described basic transaction plus (in red) the addition of a separate agreement between the City and the RDA called the (7) Reimbursement Contract. Under this agreement each lease payment made by the City to the RDA under the parking facility lease would simultaneously (8) be added to the balance due on an escalating City loan to the RDA. Additionally this agreement provided for (9) the inclusion of "contributions" and also included an 8% interest rate on the unpaid balance. The RDA was to pay the loan off from (10) excess tax increments after payment of senior bond debt and ongoing project costs.