## CITY COUNCIL REPORT

## GENERAL INFORMATION

TO: Mayor and City Council  PACKET DATE: May 5, 2016

FROM: Ed Zuercher
City Manager

SUBJECT: SPORTS FACILITIES SPECIAL REVENUE FUND

This report provides the City Council with information on the Sports Facilities Special Revenue Fund, also known as the Arena Fund.

THE ISSUE

Several councilmembers have asked questions about the use of the Fund. Attached to this report is a memo from the Chief Financial Officer describing the Sports Facilities Special Revenue Fund.

If you have further questions, please let me know.

RECOMMENDATION

This report is for information only.

**Attachment A – Use of Sports Facilities Special Revenue Fund Memo**
**Attachment B – Letter from Bond Counsel**
**Attachment C – Fiscal Year 2015-16 SFF Forecast**
**Attachment D – Letter from Financial Advisor**

Attachment A

**City of Phoenix**

**To:** Ed Zuercher
City Manager

**Date:** May 2, 2016

**From:** Denise Olson
Chief Financial Officer

**Subject:** USE OF THE SPORTS FACILITIES SPECIAL REVENUE FUND

This report provides information on the Sports Facilities Special Revenue Fund (the "SFF", often referred to as the "Arena Fund").

**Summary**

The SFF was established in 1989 upon City Council authorization. Revenues flowing into the fund annually are derived through certain excise taxes charged on hotel and rental cars (the "Sports Facilities Tax"). Sports Facilities Taxes are one component of the City's total excise tax or sales tax collections.
The SFF was created with the main purpose of funding the original construction and subsequent maintenance and repair of the downtown Phoenix sports arena known today as Talking Stick Resort Arena (the "Arena"). The SFF was also intended to broadly promote tourism and sporting events in the downtown Phoenix corridor, including costs for security, convention marketing and administration.

Although the SFF was created for a specific purpose and is legally pledged to the excise tax bondholders, there are no restrictions on the City Council appropriating SFF monies that remain, after making debt service payments, for any other lawful purposes. Currently, a large portion of the SFF monies are committed to bondholders for the Arena, City owned hotel (the "Hotel"), the Translational Genomics Research Institute building (the "TGEN") and Ak-Chin Pavilion. The SFF also funds about $2 million in operating costs for security and downtown staffing that would otherwise be paid from the general fund. Further, it provides $500,000 annually to tourism-related support.

Until the Hotel and TGEN buildings have been disposed of through sale or lease with financial guarantees, staff strongly recommends that the current SFF fund balance and annual cashflow remain in the SFF until the fund balance reaches at least a level of $40 million. This level of funding is anticipated to be achieved in fiscal year 2019. A $40 million SFF fund balance will provide a necessary backstop in the event that a negative financial event occurs for either of these properties through substantial vacancy or other operating disruptions.

There are other long-term reasons to preserve the SFF balance such as legal restrictions, contractual obligations, excise tax credit ratings, future needs and contingency planning.

## Legal and Contractual Obligations from the SFF

### Pledge and Security to Bondholders

In the big picture of City debt and revenue, the SFF is a part of the entire monies pledged to cover bonded debt service. The City has made a pledge to senior lien, junior lien and subordinated lien bondholders of all excise, transaction, privilege, business and franchise taxes, state shared sales and income taxes, and receipts from licenses and permits, which the City presently or in the future imposes or receives from other entities and which are not earmarked by the contributor for a contrary or inconsistent purpose (the "Excise Taxes"). Please refer to **Attachment B – Letter from Bond Counsel** for detailed information regarding the Excise Tax pledge and the Sports Facilities Tax component.

The following table shows principal outstanding on all Excise Tax obligations, by priority:

**Total Citywide**
**Excise Tax Obligations[1]**
**As of March 1, 2016**

| Type of Lien | Amount Outstanding |
|---|---|
| Senior Lien | $ 222,860,000 |
| Junior Lien | - |
| Subordinated Lien[2] | 826,195,000 |
| Total Excise Tax Debt | $1,049,055,000 |

[1] The SFF is one component of the revenues pledged to the entirety of the City's Excise Tax obligations.
[2] Includes $305,940,000 principal outstanding on the Hotel Loan.

### Contractual Obligation

In August 2015, the City and the Downtown Phoenix Hotel Corporation (the "DPHC") successfully completed the refinancing of the DPHC bonds that were originally issued to construct the Hotel. The refinancing (the "Hotel Loan") resulted in an immediate reduction in debt outstanding of $23.78 million, or 7.2%, and reduced scheduled debt service by approximately $110 million over the next ten years. The Hotel Loan is secured by a subordinated pledge of the City's Excise Taxes and are on parity with the City of Phoenix Civic Improvement Corporation Subordinated Excise Tax Revenue Bonds. The debt service payments on the Hotel Loan will be made from Hotel revenues.

The objective of the refinancing was twofold: (1) protect and preserve the City's SFF, which was legally pledged under the original bonds if Hotel revenues were insufficient to make debt service payments; and (2) provide an exit strategy for the asset as soon as practically possible. The City, DPHC and its consulting team have worked diligently toward achieving these objectives. The following table shows how the SFF balance dropped from $41.2 million to $18.3 million over the previous three years due to Hotel revenues being insufficient to cover debt service payments on the original bonds.

**Sports Facilities Fund Balance**
(in '000s)

| 2011-12 Actual | 2012-13 Actual | 2013-14 Actual | 2014-15 Actual | 2015-16 Projected |
|---|---|---|---|---|
| $41,171 | $31,715 | $23,911 | $18,261 | $25,208 |

Starting in FY 2015-16 due to the refinancing, Hotel revenues are anticipated to be sufficient to cover future debt service payments. However, the City is contractually obligated to budget the Hotel Loan payments from the SFF. The following table shows the actual debt service payments on the original bonds from FY 2011-12 through FY 2014-15, and the anticipated debt service payments on the Hotel Loan from FY 2015-16 through FY 2024-25.

**Hotel Debt Service Payments**
(in '000s)

| Fiscal Year | Debt Service |
|---|---|
| 2011-12 | $21,977 |
| 2012-13 | 22,069 |
| 2013-14 | 22,160 |
| 2014-15 | 22,257 |
| 2015-16 | 9,326* |
| 2016-17 | 8,583 |
| 2017-18 | 8,512 |
| 2018-19 | 8,512 |
| 2019-20 | 8,536 |
| 2020-21 | 15,186 |
| 2021-22 | 15,190 |
| 2022-23 | 15,235 |
| 2023-24 | 15,149 |
| 2024-25 | 15,192 |

* Includes partial debt service payment from the original Hotel bonds through the call date of August 12, 2015 and debt service on the Hotel Loan.

Beginning in FY 2025-26, if the Hotel is not sold, the debt service payments significantly increase to approximately $25.5 million per year for 20 years. This increase in debt service if the Hotel is not sold is another reason preserving SFF fund balance is so critical.

## Excise Tax Credit Rating

The City seeks to obtain and maintain the highest possible credit ratings for all categories of short- and long-term debt. The rating represents a relative measure of risk to bondholders that reflects an issuer's willingness and ability to repay scheduled interest and principal payments on time and in full. Higher credit ratings mean lower borrowing costs to the City.

The City's Excise Tax credit ratings are some of the highest ratings issued. The City's Excise Tax credit rating are as follows:

**Excise Tax Credit Ratings**

| | Moody's | S&P |
|---|---|---|
| Senior Lien Excise Tax Revenue | Aa2 | AAA |
| Junior Lien Excise Tax Revenue | Aa3 | AA+ |
| Subordinated Excise Tax Revenue | Aa3 | AA+ |

These high credit ratings mean that the City has market access to issue debt at extremely low interest rates. In fact, some of the top buyers of municipal debt are long-term repetitive investors in the City's bonds. As such, the City takes numerous precautions to ensure all quantitative factors are carefully balanced in order to maintain the credit ratings.

As mentioned previously, the Sports Facilities Taxes are a component of the broader Excise Tax pledge. This means when rating agencies and investors analyze the Excise Tax credit, the SFF is included. Any reduction to the SFF balance is reflected in the pledged revenues used to calculate coverage on the Excise Tax bonds. Coverage is one of the primary quantitative factors in a credit rating. Over the past three years, rating agencies have expressed concerns over the use of the SFF balance. The Hotel refinancing eliminated the large draws on the SFF balance. In addition, the City has communicated its expectations to rating analysts that the SFF will grow at a modest pace thereby further alleviating any concerns.

The important take-away from a rating perspective is that dollars spent from the SFF will impact the broader Excise Tax credit. In other words, taking money from the SFF has the same effect on the City's credit rating as taking money from the general fund.

## Future Commitments and Contingency Planning

Looking forward, the City anticipates small growth in the Sports Facilities Taxes, which will lead to an increase in fund balance. Refer to **Attachment C – Fiscal Year 2015-16 SFF Forecast** for detail.

Not only is this positive from a rating agency perspective, but it allows the City an opportunity to grow this fund over time in order to ensure monies are available for existing obligation and to be able to utilize it when needs are critical. Obligations in areas such as debt service payments for the Hotel, Arena and TGen facilities, downtown security, Greater Phoenix Convention and Visitors Bureau and miscellaneous other administrative costs would have to be paid out of the general fund if adequate revenues are not available in the SFF. By allowing time to grow the fund balance, the City will have opportunities in the future to use it for major projects or initiatives without jeopardizing the credit rating of the Excise Tax bonds or risking the general fund resources.

The City and the Phoenix Suns have had preliminary discussions regarding the condition of the current Arena and potential for a new arena (the "Arena Project"). One consideration is to use the SFF to pay for the City's contribution to a potential Arena Project as the City would most likely leverage its highly rated Excise Tax credit to secure financing. By using the SFF for such a project, the City preserves general funds for essential operational needs. The Finance Department, in conjunction with its Financial Advisor (Frasca & Associates, LLC) has done analysis on the debt capacity of the SFF. Debt capacity is the amount that could be financed and paid out of the SFF. In the short-term, the SFF cannot provide any capacity to pay for an Arena Project as there is already debt service being paid out of the SFF for the current Arena and fund balance has been substantially depleted over the past three years. However, there is approximately $175 million of bond capacity in future years, as the old debt service matures and fund balance increases. The capacity varies depending on actual Sports Facilities Tax collections, when the debt is issued, how long the debt amortizes and if the City sells the Hotel and TGEN buildings. This analysis assumes the Sports Facilities Taxes continue to grow at a modest rate and there are no additional material draws on the SFF monies.

The City Council has authority to use the SFF balance after making debt service payments on all Excise Tax obligations. The Finance Department recommends preservation of the SFF monies for all the reasons listed above. In addition, building a strong SFF balance will further protect against any downside situations such as a recession, political or economic changes, laws and regulations that prohibit or restrict Sports Facilities Taxes and large market fluctuations that impact the hotel or rental car industries.

The information in this memo is further supported in a letter by Frasca & Associates LLC attached herein as **Attachment D – Letter from Financial Advisor**.

Attachment B

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May 2, 2016

**VIA FIRST CLASS MAIL & EMAIL**

Denise Olson
Chief Financial Officer
City of Phoenix.
251 West Washington Street, 9th Floor
Phoenix, AZ 85003

**Re: Amounts in the Sports Facilities Fund as General Excise Tax Funds of the City**

Dear Denise:

As the City's Bond Counsel on Excise Tax financings, we have been asked to comment whether there is any different treatment of, or restrictions on, Excise Taxes of the City deposited into the City's Sports Facilities Fund from other Excise Taxes of the City.

The City has issued or incurred bond and other obligations which are secured by a pledge of the City's Excise Taxes. For this purpose "Excise Taxes" consist of all excise, transaction, privilege, business and franchise taxes, state-shared sales and income taxes, and receipts from licenses and permits, which the City presently or in the future imposes or receives from other entities and which are not earmarked by the contributor for a contrary or inconsistent purpose. The pledge of Excise Taxes is intentionally very broad which accounts for the high credit ratings assigned to these bonds and obligations.

In 1989, the Mayor and Council increased the Excise Tax rate on certain activities in the City, generally referred to as "Sports Facilities Taxes." Sports Facilities Taxes are one component of the City's total Excise Tax or Sales Tax collections and include (1) an incremental one percent tax levied on the gross income from the business activity of any hotel or motel engaging within the City in the business of charging for lodging and/or lodging space furnished to any person who, for a period of not more than thirty consecutive days, obtains lodging or lodging space in any hotel or motel, and (2) an incremental two percent tax levied on the gross income from the business activity of any person engaging in the business of leasing, licensing for use, or renting any motor vehicle with a gross vehicle weight of less than twelve thousand pounds for a term of not more than thirty-one calendar days.

We understand that the City has been depositing Sports Facilities Tax collections into the internally designated "Sports Facilities Fund" and used the money for various downtown-related projects and expenses. However, the amounts deposited into the Sports Facilities Fund retain their status as "Excise Taxes" for all purposes, do not represent a new or different source of funds, are pledged for the payment of all of the City's Excise Tax obligations and can be used for any other purpose for which other Excise Taxes can be legally applied.

I hope this is helpful to the City. Please contact me if you would like to discuss in more detail.

Sincerely,

Timothy E. Pickrell

TEP:wa

## Sports Facilities Special Revenue Fund

| | 2015-16 Projected |
|---|---|
| **Beginning Fund Balance** | 18,261,000 |
| | |
| **Revenues and Other Sources** | |
| Excise Tax - Hotels (1) | 7,579,000 |
| Excise Tax - Vehicle Rentals (1) | 9,100,000 |
| Interest Earnings | 150,000 |
| Interest on Arena $5MM Loan | 111,000 |
| Transfer from Sheraton Hotel for Loan Payment | 7,564,000 |
| Transfer from Capital Project Fund (2) | 3,583,000 |
| **Total Revenues and Other Sources** | 28,087,000 |
| | |
| **Expenditures, Encumbrances and Other Uses** | |
| Current Operating | |
| General Government (Staff & Administrative) (3) | 448,000 |
| Public Safety (Downtown Security) | 1,294,000 |
| Community Enrichment (GPCVB) | 500,000 |
| Arena Analysis (4) | 350,000 |
| Community Development (Downtown Partnership Assessment) | 150,000 |
| Debt Service | 10,834,000 |
| Debt Service - Hotel | 7,564,000 |
| **Total Expenditures, Encumbrances and Other Uses** | 21,140,000 |
| | |
| **Net Change in Fund Balance** | 6,947,000 |
| | |
| **Ending Fund Balance** | 25,208,000 |

(1) The City has pledged certain excise tax collections to make lease payments sufficient to pay principal and interest on City of Phoenix Civic Improvement Corporation bonds and the Hotel Loan. Sports Facilities tax revenues are one component of the City's pledged excise taxes for bond holders. This pledge gives priority to senior, junior, subordinated, and junior subordinated bond holders to all excise tax collections. The Hotel Loan is on parity with the subordinated bonds.

(2) In FY2008-09, the General Fund borrowed $10,000,000 from unrestricted reserves in order to establish a required Retiree Rate Stabilization Trust. The borrowing is to be repaid with interest through transfers to the Sports Facilities Tax Fund of about $1,025,000 annually from the General Fund over a 15 year period ending in FY2023-24.
Approximately $2,558,000 of this amount reflects reimbursement from the Sports Facilities Capital Fund for Convention Center garage repairs.

(3) Includes Convention Center, Community & Economic Development and Finance administrative costs, central service cost allocations and fiscal agent fees related to outstanding bonds.

(4) Includes financial advisory fees, engineering consultant fees and sporting facilities consultant fees related to research on the obsolescence of the current basketball arena and the feasibility and affordability of a new arena.

**Detailed Breakout of Debt Service Expenditures**

| | 2015-16 Projected | Payoff Date |
|---|---|---|
| **Debt Service:** | | |
| Talking Stick Resort Arena (formerly US Airways Center) | $ 4,382,000 | 7/1/2022 |
| Ak-Chin Pavilion (formerly Cricket Pavilion) | 269,000 | 7/1/2016 |
| Filmore Land (Biomedical Campus) | 842,000 | 7/1/2035 |
| T-GEN/IGC (Biomedical Campus) | 3,059,000 | 7/1/2035 |
| Phoenix Union High School (Biomedical Campus) | 520,000 | 7/1/2035 |
| Hotel Bonds (Original Bond Indenture) | 1,762,000 | 8/12/2015 |
| | $ 10,834,000 | |

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| | |
|---|---|
| To: | Denise Olson<br>Kathleen Gitkin |
| From: | Frasca & Associates, LLC |
| Subject: | **Sports Facility Special Revenue Fund** |
| Date: | May 2, 2016 |

Frasca & Associates, as a Financial Advisor to the City, has evaluated the impacts of any potential additional withdrawals from the Sport Facility Fund ("SFF") balance.

**Credit Implications.** Significant near-term draws from the Sports Facility Fund may impact the ratings for the City's Excise Tax Revenue Bonds (senior lien ratings of Aa2/AAA). While the Excise Tax ratings are primarily based upon the level of debt service coverage (i.e., the ratio of excise tax revenues to debt service), reduced fund balances limit the City's financial flexibility. Further, any pressure on the Excise Tax ratings could pressure the ratings, particularly Moody's, on the City's General Obligation debt.

**Current Obligations of the Sport Facility Revenues.** In recent years, the City utilized some of the balances in the SFF to fund a portion of the debt service related to the hotel. In 2015, the City refunded and restructured the hotel debt to eliminate the draw on the SFF. This restructuring has reduced the need to use Sport Facility Revenues to fund hotel debt service payments and has allowed for the balance in the SFF to increase in 2016. Currently, staff is exploring and evaluating strategies for the hotel. If the City retains ownership of the hotel, SFF balances may be needed to supplemental hotel net revenues in the future as principal on the hotel loan begins to amortize in 2021. If the hotel is sold or leased, amounts from the SFF balance may be needed to defease a portion of the hotel loan or to fund other transition costs.

**Potential Future Projects.** The balances in the SFF may be needed for the future City projects, including a potential new arena. Prudently growing the balance in the SFF increases the capacity to fund future projects from the dedicated Sport Facility excise taxes. Balances in the SFF are necessary to bridge "pinch points" in the dedicated Sport Facility excise tax cash flows to be able to fit additional debt service for new projects.

Frasca & Associates has prepared an initial financial model to evaluate alternative funding strategies for the potential new arena. In each scenario, we have assumed no additional draws on the SFF balances. Any such SFF draws would negatively impact the City's ability to fund a new arena.