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MEMORANDUM

TO: James Preston, Finance Officer
City of Rapid City, South Dakota

FROM: Barry W. Fick
Senior Vice President

DATE: February 9, 2010

SUBJECT: Investment of Water Bond Proceeds

The City of Rapid City sold Water Revenue Bonds in December 2009 for the purpose of constructing improvements to the Water System operated by the City. The bonds were very well received in the market and have favorable interest rates. The bonds included funding for construction costs, interest payments during construction, a debt service reserve fund and issue costs.

You have asked us to review the investment rates on the funds invested and compare them to market rates in effect at the time the investment bids were taken.

To invest the funds, the City used a competitive bid process to solicit bids from qualified providers for the investment of the Water Bond proceeds. The competitive bid insures that safety of the principal is maintained consistent with earning the best rates available in the market at that time.

The investment environment in place throughout 2008, 2009 and into 2010 is characterized by very low interest rates for short term investments. This is the result of the United States Government lowering short term borrowing rates to historic lows to help the United States recover from the economic recession. Low interest rates are beneficial for borrowers, but they result in low returns for investors.

The interest rate that the City of Rapid City received for the funds in the construction fund and the capitalized interest fund is 0.448% on an annualized basis. This is a 100 percent guaranteed rate, with US Government investments pledged for repayment if the provider fails to repay the funds when requested.

In comparison to the rate to be received by the City, US Government securities for a similar investment time period are paying a rate of 0.304% percent or lower. This is a lower rate than the City will receive for a substantially similar type of security and investment. The interest rate bid on the construction fund and capitalized interest fund is generally higher than the City could obtain by investing in other allowable investments. The City's investment is "fully flexible" which means the City has the ability to make periodic withdrawals of any amount that relates to the project cost, without loss of interest. There is no penalty if the funds are withdrawn sooner than projected.

Based on these comparisons, the investment rate that the City will receive is beneficial for the type of investment and the City is protected for return of the principal invested from the construction fund and the capitalized interest fund.

The City also has competitively bid the investment of the debt service reserve fund. The debt service reserve fund is a sum of money that provides security for bondholders if the City is ever unable to make timely debt service payments on the 2009 Water Bonds. At the final maturity of the Water Bonds, the debt service reserve funds are available for the City to use in the Water System. The investment return on the debt service reserve fund was bid with 2 options. The first option is for a "full term" reserve, which invests the debt service reserve until the final maturity. The second option was for a "term certain" reserve, which means the debt service reserve is invested for a specific time period, much like a person invests in a Certificate of Deposit.

The bids submitted for the debt service reserve resulted in the selection of the term certain option. The bids submitted for the full term were low as a result of current economic conditions and not selected by the City. The bids for the term certain were favorable in view of the market and the strong security provided for the principal protection of the debt service reserve.

The best bid for the term certain debt service reserve was 1.913%. That is ¼% higher than the other two bids received on the debt service reserve. The bid is higher than the City could realize by investing in a bank deposit account. The bid is approximately ½% lower than a US Treasury of a similar maturity. However, the City has the right to withdraw the funds from the debt service reserve at any time to pay debt service if needed and the value of the debt service reserve investment doesn't change as market rates change, removing a risk from the City.

In the current investment market, the term certain option is beneficial for the City since it provides the opportunity to reinvest the debt service reserve fund in the future at then current interest rates. At the expiration of the initial investment period for the debt service reserve fund, the City will re-bid the investment at what are expected to be higher interest rates.

The City's use of a competitive bidding process to invest the funds from the Series 2009 Water Revenue Bonds has produced investment returns that are strong in the current market and provide the City with the flexibility to take advantage of higher future interest rates. The security of the principal invested is assured by the use of US Government securities as collateral for the investment, assuring the City of a full return of the amount invested. In addition, the value of the debt service reserve is guaranteed to remain at par, removing valuation risk from the City. These factors, combined with the favorable interest rates received on the investments, place the Water Revenue Bond funds in a secure position and earn a strong market return.