CDIAC CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

MUNICIPAL DEBT ESSENTIALS
Day 2: : PLANNING A BOND SALE
Debt Policy and Plan of Finance

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Metro

What We Will Cover

- Capital planning
- Debt policies
- Debt capacity
- The plan of finance
- Practice (after the break)

Capital Planning

Why Capital Planning Matters

- The budgetary pressures of the operating budget compete with capital investment
  - It is always easy to defer an investment until next year
  - But time is cruel to physical assets, and the problems don't get better on their own
- Capital budgeting and planning is the poor step-child of the operating budget
  - But a bigger picture of infrastructure needs is a pre-requisite for the meaningful deployment of debt and debt capacity
  - Encourages a longer view of resource allocation
- The GFOA (and common sense) recommends that local governments establish a system for assessing their capital assets and then appropriately plan and budget for capital maintenance and replacement needs
  - "A properly prepared capital plan is essential to the future financial health of an organization and continued delivery of services to citizens and businesses."
  - Little "how to" literature on the topic

Elements of a Capital Plan

- A capital improvement plan or capital improvement program (both often referred to as a “CIP”) is usually a short- to medium-range plan, usually four to ten years, that
  - Identifies capital projects, equipment purchases and, sometimes, information system needs
  - Provides a planning schedule
  - Identifies options for financing the plan.
- Finance officers usually work with user departments, engineers and project managers to establish priorities
- To create a sustainable capital plan, the finance officer and other participants in the capital planning process need to consider, , all within a given planning timeframe:
  - All capital needs as a whole
  - Assess fiscal capacity
  - Plan for debt issuance
  - Understand impact on reserves and operating budgets

Elements of a Typical CIP

- Establishing a capital planning committee with bylaws or ground rules
- A listing of the capital projects or equipment to be purchased
- Justification for the project
  - Safety
  - Legal mandate
  - Economic development
  - Quality of life
- Projects ranked in order of priority
- A schedule for anticipated acquisition, design and construction
- The plan for financing the projects
  - Balance current resources (pay-go) with future resources (debt)
  - General resources and dedicated revenues sources
  - In practice, projects that have dedicated resources (such as enterprise revenues and special taxes) tend to get funded first
- A superior plan accounts not only for initial planning and construction costs but also maintenance and future replacement needs

References

- The GFOA has published several "best practices" on the subject, most of them big picture and aspirational, but short on details

  http://www.gfoa.org/best-practices

- Massachusetts Department of Revenue's Capital Improvement Planning Guide https://www.mass.gov/files/documents/2016/08/ov/cipguidefinal.pdf?_ga=2.139011451.954248830.1546569655-965011553.1546569655

The MTA Capital Plan

- The MTA's mandate involves substantial capital investment
  - Construction of a major rail and busway network and roadway improvements
  - Responsible for funding acquisition and construction, maintenance and substantial operations of both bus and rail systems
  - Now has a total of 2% in local sales taxes dedicated to its mission
  - Two sales taxes have specific voter-approved projects, which identify costs and timing
  - Devotes significant internal resources to capital planning and management
- The 2014 Short Range Financial Forecast, Updated in 2018
  - Ten-year action plan that guides programs and projects through 2028
  - Drives immediate planning and funding
  - Advances long-term goals identified in the Long Range Transportation Plan
- Long Range Transportation Plan (LRTP), last adopted in 2009 and updated in 2017
  - A 40-year vision for addressing growth and traffic in Los Angeles County
  - Recent activities supporting update include
    - Orientation and Content Module Framework (April 2018)
    - Public Participation Framework (November 2017)
    - Financial Forecast Update (October 2017)

Debt Policies

Purpose of Debt Policy

- Creates tools to reconcile capital needs with available resources
- Establishes some basic parameters and principals
  - When, why and how debt can be issued
  - Amount, type, issuance process, management of the debt portfolio
  - Promotes objectivity in the decision-making process
- Educates stakeholders
  - Explains the what, why and how of the process to non-finance staff, elected officials and the public
  - Provides an opportunity to discuss policy elements
  - Increases transparency to stakeholders

Why Policies Can be Powerful

- Guiding principles are a place to start
  - Policies help make difficult decisions easier by establishing values and priorities before they are placed under stress by adverse circumstances
  - Policies provide a place to record lessons for future generations
  - Not every life lesson needs to be learned from experience
  - All modern cultures maintain a written scripture of inherited wisdom
- Board approved policies provide protection against political expediency
- Regulators, rating agencies and other second-guessers love written policies
  - "Demonstrates" sound financial management to rating agencies and investors

> *"Good judgement is the result of experience and experience the result of bad judgement"*
>
> --Mark Twain

SB 1029 added Section 8855 to the Government Code

- Amends current law that requires "the issuer of any proposed debt issue of state or local government shall, no later than 30 days prior to the sale of any debt issue, submit a report…." to include:
  - "a certification by the issuer that it has adopted local debt policies concerning the use of debt and that the contemplated debt issuance is consistent with those local debt policies."
- A local debt policy shall include all of the following:

  (A) The purposes for which the debt proceeds may be used.

  (B) The types of debt that may be issued.

  (C) The relationship of the debt to, and integration with, the issuer's capital improvement program or budget, if applicable.

  (D) Policy goals related to the issuer's planning goals and objectives.

  (E) The internal control procedures that the issuer has implemented, or will implement, to ensure that the proceeds of the proposed debt issuance will be directed to the intended use.

What Should be Included in Debt Policy?

- Debt objectives
- Debt instruments
- Debt capacity
- Debt structure
- Debt issuance process
- Debt Management
  - Refunding
  - Tax covenants
  - Disclosure covenants
  - Other covenants
- Resources
  - http://www.gfoa.org/debt-management-policy
  - http://www.treasurer.ca.gov/cdiac/publications/policy.pdf

Debt Objectives

- How will the agency determine whether to issue debt?
  - Integration of capital planning and debt financing activities
  - Funding options, including debt, evaluated on case-by-case basis
- Type of debt authorized and the authorization process
- Striking the balance
  - Current resources (pay-as-you-go) vs. future resources (debt)
  - Current users vs. future users (generational equity)
  - Investment vs. deferral
- Limits on indebtedness
  - Imposed by State and/or federal law
  - Affordability constraints
  - Limits imposed by parity debt covenants

What Type of Debt Should be Covered by Policy?

- Direct debt
  - General Obligation Bonds
  - Appropriation debt (e.g., lease revenue obligations)
- Revenue Debt
- Variations on the theme
  - Long-term and short-term
  - Fixed-rate and variable-rate
  - Publicly offered and privately placed
- Other debt to consider
  - Conduit Debt
  - State and Federal subsidized borrowing programs
  - Interfund Borrowing

Debt Structure

- Term
  - Should not exceed useful life of asset
  - More rapid amortization creates future capacity
- Repayment pattern
  - Level debt service
  - Escalating debt service
  - Wrapping around existing debt
- Deferral of principal
  - Capitalized interest until completion of project
  - Capital appreciation bonds
- Redemption features
- Coupon structures
- Variable vs. fixed interest rates

Debt Issuance Process

- Criteria for determining the method of sale
  - Credit rating or "story bonds"
  - Volatility of market
  - Frequency of issuances
  - Social policies (small businesses)
  - Public offering v. private placement
- Selection of professional team
- Credit ratings
  - When is a rating necessary?
  - Which rating agencies?
- Credit enhancement –
  - Municipal bond insurance
  - Letters of credit
  - Collateral pledges (reserves)
- Disclosure – preparing an OS

Debt Management

- Who is responsible for ongoing responsibilities related to debt?
- Monitoring refunding opportunities
- Tax compliance
  - Private use
  - Arbitrage rebate
  - Timely expenditure of proceeds
  - Other risks
- Disclosure compliance
  - Annual disclosure
  - Material events
  - Maintaining communications with credit agencies and investors
- Covenant compliance
  - Insurance
  - Filings
  - Keeping records
- Investment of bond proceeds

Refunding

- A refunding "uses up" a valuable asset, your call option
- Refundings usually undertaken for savings, but can also be used to restructure debt or change legal covenants
- Issuers typically use a Present Value Savings minimum of between 3% and 5% of refunded par
  - Measured on a maturity-by-maturity or aggregate basis
  - But much higher savings are often obtained, especially if the issuer exercises patience
- Elimination of tax-exempt advance refundings simplifies decision making, but there are still alternative "advance" techniques such as forward delivery and taxable refunding

Metro's Debt Policy

- First adopted in 1998
- Reviewed annually or when needed
- Comprehensive
- Available www.metrobonds.net

Metro Debt Policy Table of Contents

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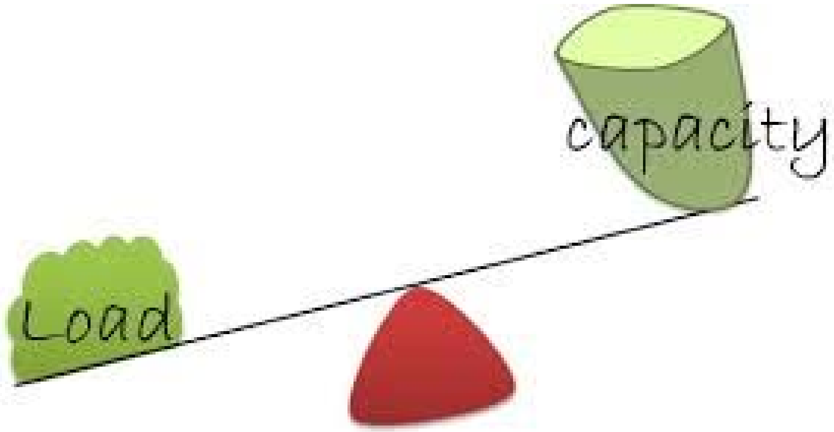
Debt Capacity



Sources of Restrictions

- Restrictions imposed by law
- Restrictions imposed by contract
- Restrictions influenced by rating agency and investor reaction
- Restrictions imposed by affordability and fiscal discipline

Restrictions Imposed by Law

- The State Constitution limits "indebtedness"
  - "Indebtedness" (paid out of property taxes requires 2/3 vote; schools can issue with 55% approval)
  - Statutory restrictions on the amount of debt as a percent of assessed valuation
  - Proposition 39 school debt (with 55% approval) also has restrictions on expected debt service tax rates
- Various court decisions have carved out key exceptions for leases, revenue bonds paid out of "special funds," and obligations imposed by law
- More significant than the restrictions on debt are the restrictions on the revenues that can be raised to repay debt
  - Proposition 13 (1978) limited property taxes and instituted the need for voters to approve special taxes
  - Proposition 218 (1996) closed judicially-defined exceptions to Prop 13, requiring votes for all taxes, and restricted fees and assessments
  - Proposition 26 (2010) further tightened the rules requiring voter approval

Restrictions Imposed by Contract

- Many indentures impose limits on additional “parity” debt: the Additional Bonds Test (ABT)
  - Typically, limited restrictions on subordinate lien obligations
- Established based on feedback from rating agencies, bond insurers, investors
  - Can effect rating and insurance premium
  - 1.25 coverage of debt service by “net revenues” (after payment of operating and maintenance expenses) is common for revenue bonds

Rating Agency Data

- Rating agencies (Moody's, Standard & Poor's, Fitch and Kroll) publish information
  - How they evaluate debt factors into their ratings
  - What are the medians for various ratios at different rating levels
- Can be helpful in understanding the landscape, but should not be overvalued
  - Rating agency job is to assign ratings, not prescribe best practice
  - Credit is only one factor in making a public policy decision
  - Arguably, the key stakeholders are local, not third-party investors

S&P

Debt & Contingent Liabilities (10% of Indicative Rating)

Total Governmental Funds Debt Service as % of Total Governmental Funds Expenditures	Net Direct Debt as % of Total Governmental Funds Revenue				
	< 30	30 to 60	60 to 120	120 to 180	≥ 180
< 8	1	2	3	4	5
8 to 15	2	3	4	4	5
15 to 25	3	4	5	5	5
25 to 35	4	4	5	5	5
≥ 35	4	5	5	5	5

Moody's

Factor 4: Debt/Pensions (20%)

	Aaa	Aa	A	Baa	Ba	B & Below	Weight
Net Direct Debt / Full Value	< 0.75%	0.75% ≤ n < 1.75%	1.75% ≤ n < 4%	4% ≤ n < 10%	10% ≤ n < 15.%	> 15%	5%
Net Direct Debt / Operating Revenues	< 0.33x	0.33x ≤ n < 0.67x	0.67x ≤ n < 3x	3x ≤ n < 5x	5x ≤ n < 7x	> 7x	5%

Key Credit Ratings Medians

- Have the advantage of *appearing* objective
- Rating agencies tend to focus on "classic" debt factors
  - Direct debt per capita
  - Direct debt as a % of assessed valuation
  - Direct debt as a % of revenues
  - Debt service as a % of revenues
  - Rate of amortization
  - Overlapping debt
  - Coverage of revenue debt
- The amount of debt is becoming a less significant rating factor
  - For S&P, debt and contingent liabilities (including pension) account for only 10% of rating
  - For Moody's 10% of rating is for debt, another 10% for pension liabilities
- Agencies recognize that pension debt typically overshadows external borrowing

Restrictions Imposed by Affordability and Fiscal Disciple

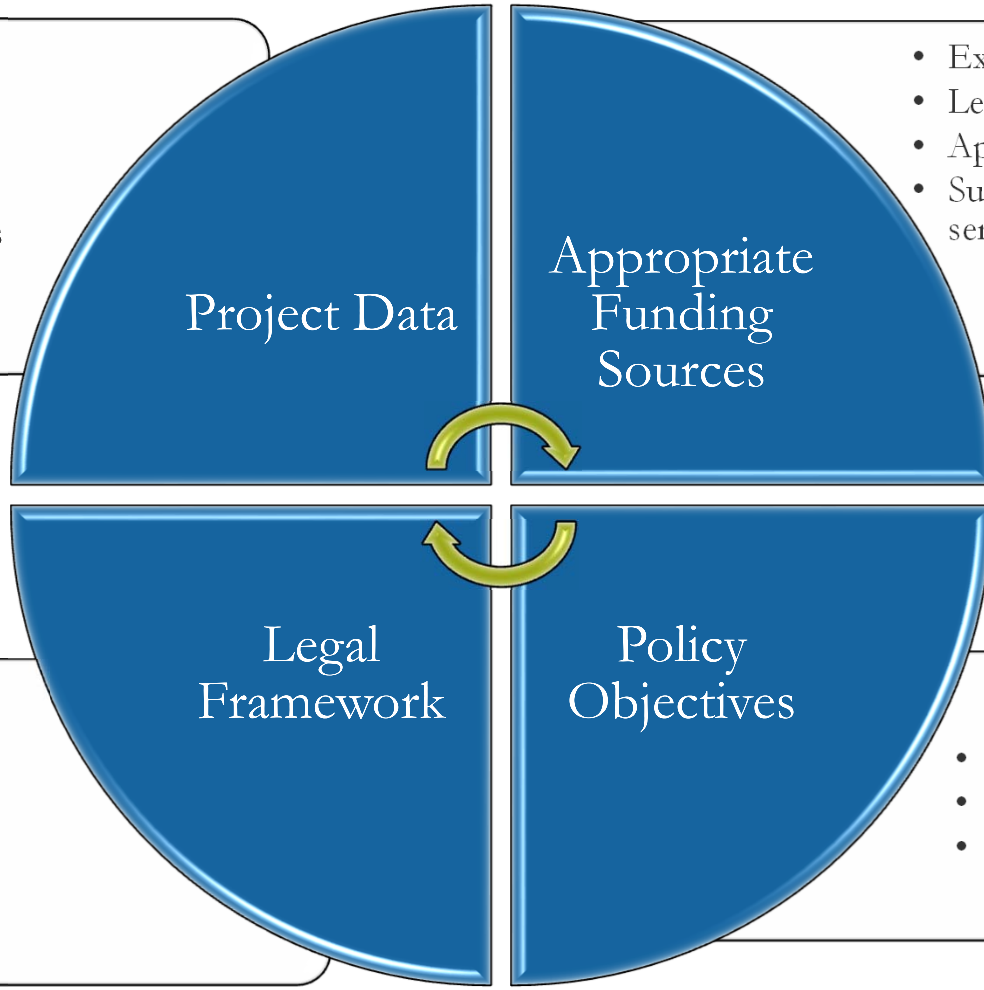
- This is the hard stuff
  - Very little external guidance
  - But it is really an agency's own sense of capacity that matters most
- Appropriation debt (lease revenue certificates of participation and bonds) is probably the most important for defining limits
  - Definition of "capacity" varies widely by agencies
  - 6% of the General Fund might be a rule of thumb
  - But a custom-designed target is best
- Voter approved debt (usually GO bonds)
  - Measured by rating agencies as % of AV
  - Local agencies usually more focused on the property tax override levy
- Total debt
  - Some agencies combine voter-approved and appropriation debt
  - Overlapping debt of other agencies is virtually impossible to control, but it may be a factor in ratings

Plan of Finance

Components of a Financing Plan

- Priority
- Cost Data
- O&M
- Ripeness: Ready to spend
- Environmental Approvals
- Contract Status

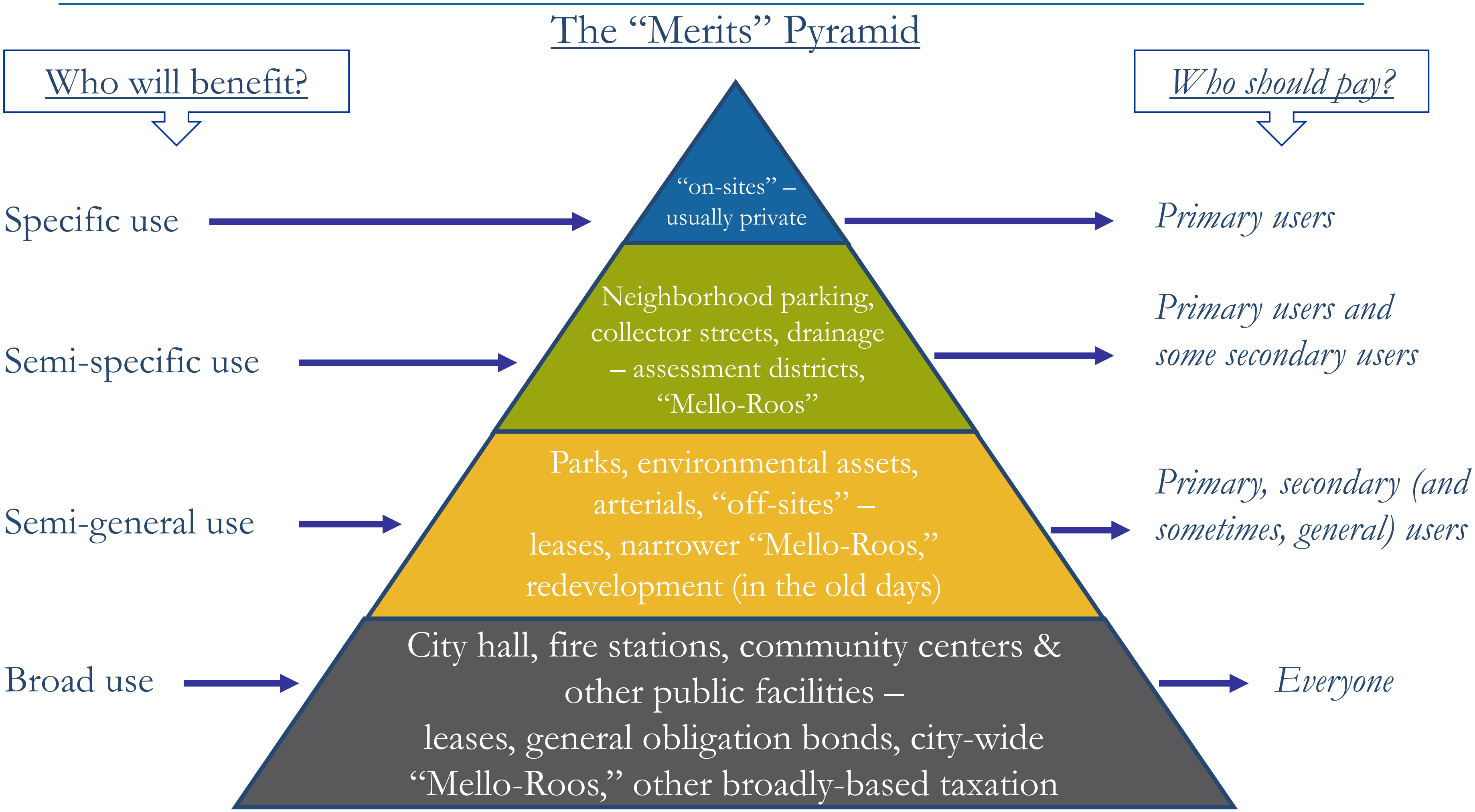
- Existing or new
- Legally available
- Appropriate to purpose
- Sufficient to absorb debt service



- State allows for securing some form of 'debt'
- Tax law allows for tax-exempt borrowing
- Compatible with prior commitments (e.g., Additional Bonds Test)

- Capital plan priorities
- Pay-go or debt
- Affordability

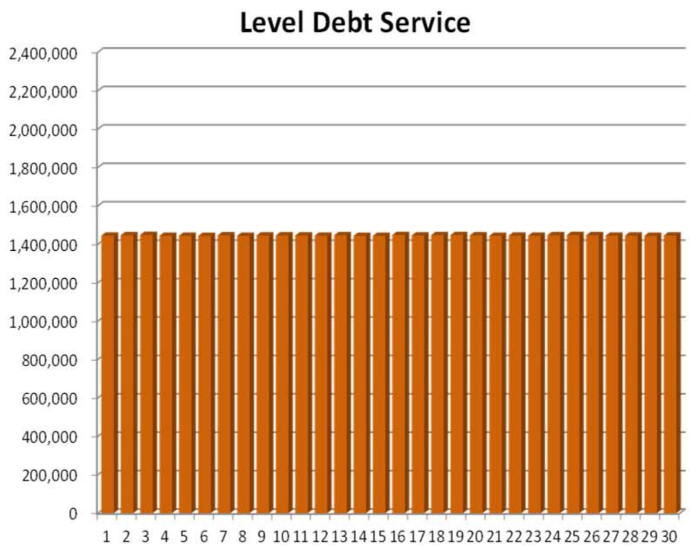
Aligning Benefits with Repayment Burdens

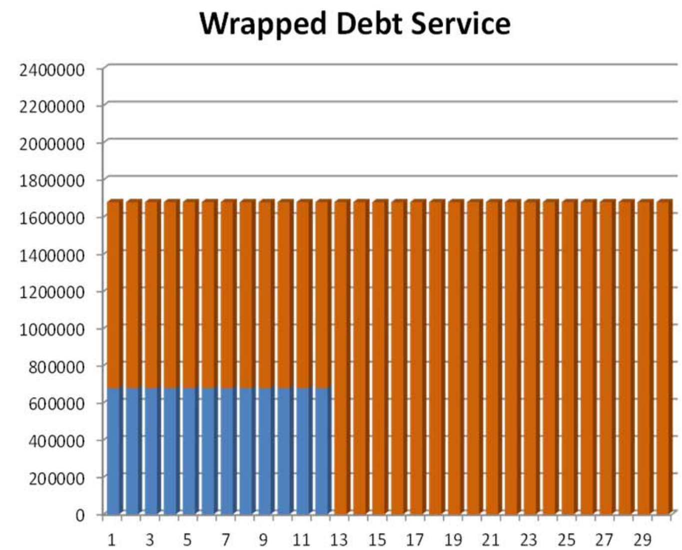


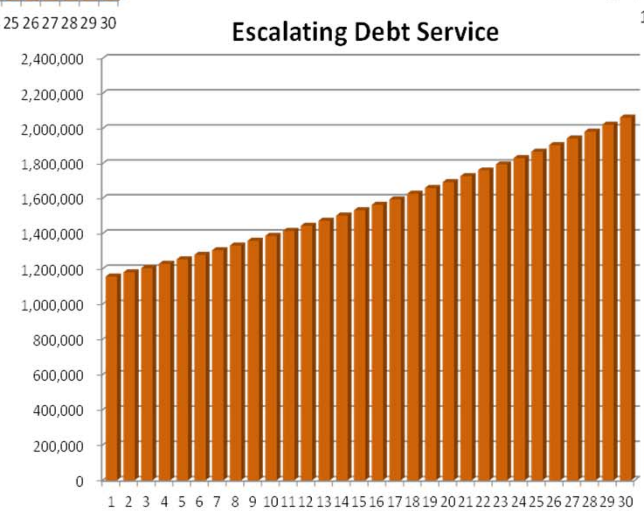
Revenue Sources Determine Type of Bond

< Higher Grade			Types of Bonds		Lower Grade>
	General Obligation	**Enterprise Revenue**	**Lease Revenue (Certificates of Participation)**	**Special Tax**	**Special Assessment**
Revenue Pledge	Secured by property taxes	Net revenue of a specified enterprise, such as water, sewer, solid waste, or parking	Lease payments for use of government asset; paid from general fund	Lien on property; bonds paid from tax levied in addition to normal 1% ad valorem tax	Lien on property; bonds paid from annual assessment on property that benefits
Vote?	2/3rds vote threshold; schools may be 55%	No public vote required	No public vote required	2/3rds vote of property owners by acreage or of registered voters	50% + 1 vote of assessees, weighted by amount of assessment

Repayment Terms: Level, Escalating or Wrapped







Group Exercise: Creating the Project Plan

The Problem

- City X has fallen behind on its street maintenance program
- The City is committed to accelerating street repair by spending $100 million in the next five years

Develop a Plan of Finance

- Identify the various beneficiaries of the street improvement project
- Identify at least three potential revenues sources to finance street improvements
- Consider the appropriate balance of pay-go and debt for this project
  - What were the goals that lead to this conclusion
- Identify the kinds of debt instruments that can leverage the identified revenues
- From these building blocks, describe a plan of finance for the street improvements
- Identify the conditions, challenges and obstacles to implement this plan of finance

MSRB Rule G-42 Disclosures

MSRB Rule G-42: Disclosure of Conflicts of Interest and Legal or Disciplinary Events

Pursuant to Municipal Securities Rulemaking Board ("MSRB") Rule G-42, on Duties of Non-Solicitor Municipal Advisors, Municipal Advisors are required to make certain written disclosures to clients which include, amongst other things, Conflicts of Interest and any Legal or Disciplinary events of KNN Public Finance, LLC ("KNN Public Finance") and its associated persons.

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KNN Public Finance represents that in connection with the issuance of municipal securities, KNN Public Finance may receive compensation from an Issuer or Obligated Person for services rendered, which compensation is contingent upon the successful closing of a transaction and/or is based on the size of a transaction. Consistent with the requirements of MSRB Rule G-42, KNN Public Finance hereby discloses that such contingent and/or transactional compensation may present a potential conflict of interest regarding KNN Public Finance's ability to provide unbiased advice to enter into such transaction. This conflict of interest will not impair KNN Public Finance's ability to render unbiased and competent advice or to fulfill its fiduciary duty to the Issuer.

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KNN Public Finance, LLC, has never been subject to any legal, disciplinary or regulatory actions nor was it ever subject to any legal, disciplinary or regulatory actions previously, when it was a division of Zions First National Bank or Zions Public Finance, Inc.

A regulatory action disclosure has been made on Form MA-I for one of KNN Public Finance municipal advisory personnel relating to a 1998 U.S. Securities and Exchange Commission ("SEC") order that was filed while the municipal advisor was employed with a prior firm, (not KNN Public Finance). The details of which are available in Item 9; C(1), C(2), C(4), C(5) and the corresponding regulatory action DRP section on Form MA and Item 6C; (1), (2), (4), (5) and the corresponding regulatory action DRP section on Form MA-I. Issuers may electronically access KNN Public Finance's most recent Form MA and each most recent Form MA-I filed with the Commission at the following website: www.sec.gov/edgar/searchedgar/companysearch.html.

The SEC permits certain items of information required on Form MA and Form MA-I to be provided by reference to such required information already filed on a regulatory system (e.g., FINRA CRD). The above noted regulatory action has been referenced on both Form MA and MA-I due to the information already filed on FINRA's CRD system and is publicly accessible through BrokerCheck at http://brokercheck.finra.org. For purposes of accessing such BrokerCheck information, the Municipal Advisor's CRD number is 4457537.