California Debt and Investment Advisory Commission

Debt Basics – Session 2

Long-Term Debt Financing Options
and
Understanding Best Practices

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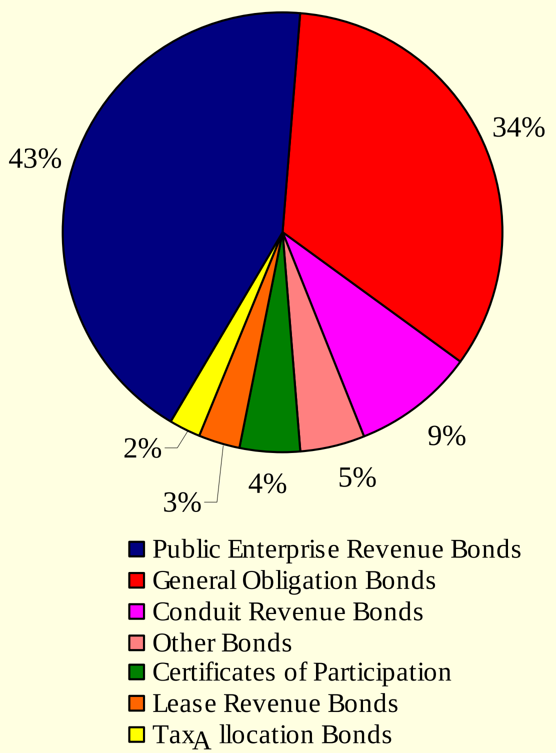
What is Long-Term "Debt"

- Article XVI, Section 18 of the California Constitution prohibits cities (including chartered cities), counties and school districts from borrowing an amount in a given year that exceeds "…. the income and revenue provided for such year" unless approval is obtained from at least 2/3 of the voters*
  - This is what is meant by the term "subject to the Constitutional bonded debt limitation"
- A broader definition of "debt" is any arrangement where an agency receives funding today and promises to pay it back over time, with interest
  - Some forms of debt financing fall under the Constitutional bonded debt limitation
  - Others fall under exemptions from the Constitutional bonded debt limitation

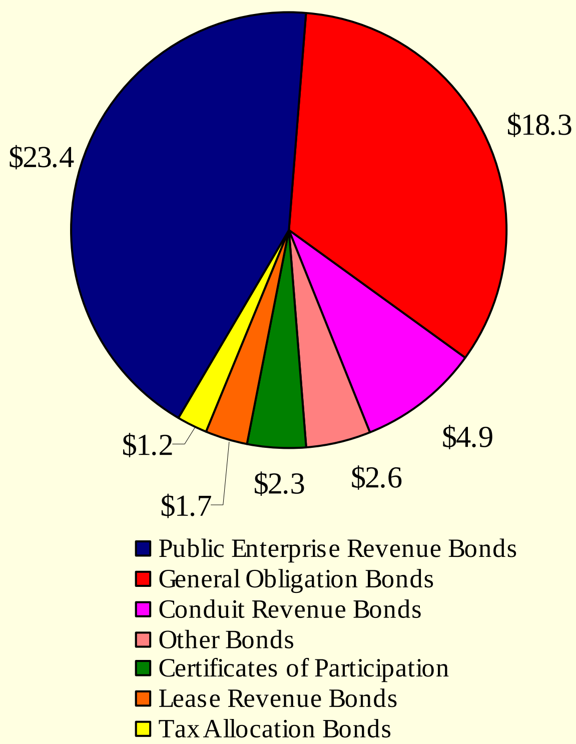
* The minimum requirement is 55% voter approval in the case of school and community college district general obligation bonds issued pursuant to Proposition 39.

California Long-Term Debt Issuance in 2010

Percentage Distribution of California Long-Term Financing by Type (January through November 2010)



Dollar Volume Distribution of California Long-Term Financing by Type (January through November 2010) ($ Billions)



Debt Types and Topics to be Presented

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Part I

General Obligation Bonds

Minimum Voter Approval Percentages; Security

Agency Requesting General Obligation Bond Authorization	Minimum Voter Approval Requirement per Authorization	Security for the Bonds
State of California	50%	Pledge of full faith and credit of the State's general fund to pay debt service
City, County and School and Community College District (traditional, Prop. 46)	66 2/3	Pledge to levy unlimited *ad valorem* property taxes to pay debt service
School and Community College Districts (Prop. 39)	55%	New revenue stream of *ad valorem* property taxes is levied and held by the home County solely for bond debt service; the *ad valorem* property taxes are never held by the issuing agency

Statutory Debt Limitations on Outstanding Bonds

Issuer Type	Statutory Debt Limitation: Percentage of Assessed Valuation of Taxable Property
General Law Cities	15%, but is actually 3.75% under Article XIII(a), Section 1(a) that requires taxable property to be assessed at full cash value rather than ¼ of that value
Counties	5%, but is actually 1.25% under Article XIII(a), Section 1(a) that requires taxable property to be assessed at full cash value rather than ¼ of that value; 3.75% for water conservation, flood control and certain road projects
Unified School Districts*	2.5%
Community College Districts*	2.5%
Union School Districts*	1.25%

* School and community college districts can apply to the California Department of Education for an Education Code debt limit waiver.

Use of Proceeds

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Issuer Type	Use of Proceeds
State	■ Matching funds for K-14 construction projects ■ University buildings ■ Housing projects ■ Roads, mass transit, parks, water projects and more
Cities	■ Convention halls ■ Hospitals ■ Parks, airports, infrastructure, flood control and more
Counties	■ Highways, toll bridges ■ Airports ■ Seismic safety, redevelopment projects and more
Schools and Community Colleges	■ New school construction, including land acquisition ■ Modernization projects and equipment, buses and furnishings ■ Refunding of outstanding COPs or other debt ■ Prop. 39 bonds proceeds must be spent only on projects on the "Project List" approved by voters

Seven Step Process for Local Bond Measures

1) Determine project needs (Master Plan)
2) Select professional consultants to assist in preparing for the election
   - Pollster
   - Political strategist
   - Financial advisor (quantitative modeling of bond issuance and tax rate projections)
   - Bond counsel
3) Submit ballot measure and conduct the election pursuant to Elections Code
4) Prepare for issuance of bonds, including Board approval and selection of financing team
5) Conduct credit presentation for rating agencies
6) Sell and close the bond issue
7) Implement the Master Plan/projects

Management of Tax Rates is Important

$$\text{Tax Rate} = \frac{\text{Annual Debt Service}}{\text{Net Assessed Valuation that year}}$$

- Tax rate is affected by
  - Timing and size of Bond series
  - Interest rates and maturity dates of each Bond series
  - Growth – or decline – in the assessed valuation base
- Other agencies may also be issuing g.o. debt, so total tax rate will reflect "overlapping" debt
  - Special taxes and fees are additional (parcel taxes, special assessments)
- Tax rates are not relevant on State g. o. bonds, as the security pledge is full faith and credit of State's General Fund
- Local agencies need to make ongoing projections of tax rates and attempt to manage them
  - Keep promises made to voters on the estimated cost of the Bonds (Tax Rate Statement)

Tax Rate Limitations

- Unlimited *ad valorem* property tax for Proposition 46 elections
  - Issuer may still be wise to manage the tax rate
- For Proposition 39 elections, school and community college districts have the following tax rate caps:
  - $25 per $100,000 AV (community college districts)
  - $30 per $100,000 AV (elementary and high school districts)
  - $60 per $100,000 AV (unified school districts)
- Tax rate cap applies to each separate authorization
  - Issuer must represent it expects to remain below the cap over the life of the bonds, but
  - Actual tax rate can exceed the cap

Issuance Authority

- General obligation bonds may be issued under the:
  1) Education Code, in the case of school and community college districts (25 year maximum maturity), or
  2) Government Code (40 year maximum maturity)
- Ed Code G.O.s require the assistance of the home County Board of Supervisors

Part II

Certificates of Participation

Certificates of Participation

- "Financing Vehicle of Choice in California"

What's in a Name …

- Certificates of Participation (COPs)
- Lease Revenue Bonds
- Municipal Lease
- Master Lease

What Makes a Lease ?

- Lease Agreement
  - 2 parties
- Involves a Leasable Asset or Assets
  - No operating capital leases
- Subject to one of the following:
  - Abatement
  - Annual budgeting and appropriation
  - Installment purchase

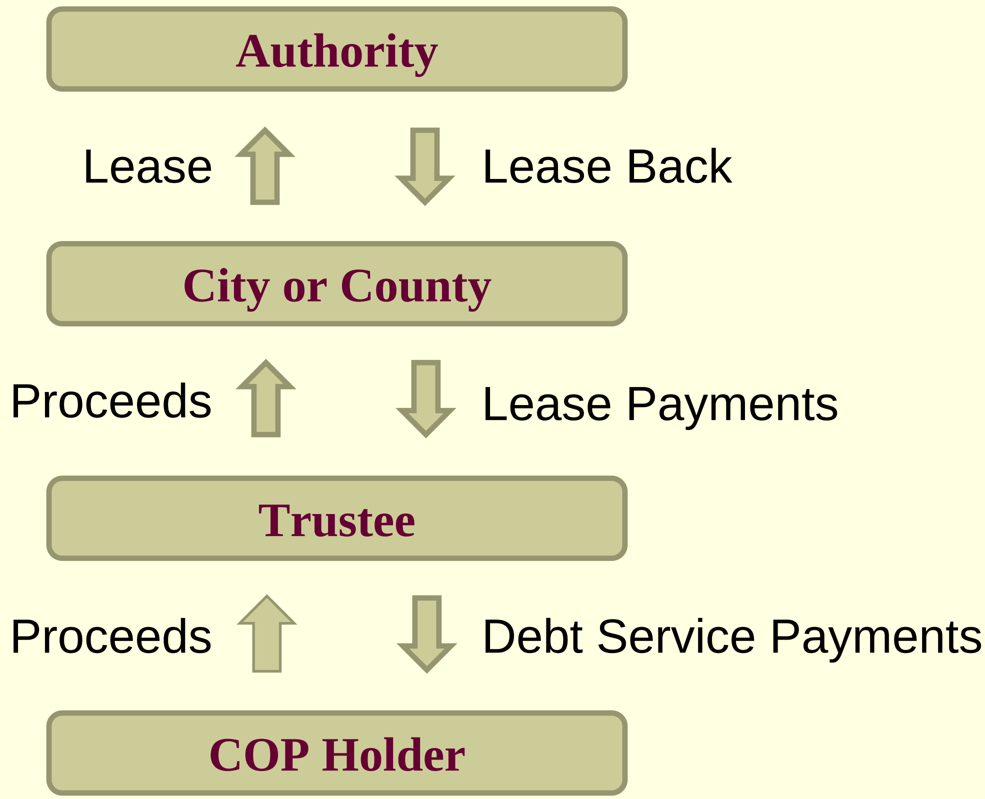
It is the Lease Structure that Avoids Voter Approval Requirements of GO Bonds

- COPs do not involve tax increases.

The Lease Outs – Important Considerations

- Abatement
  - Insurance
  - Asset transfer – avoids capitalized interest
- Budgeting and appropriations
  - Covenant to appropriate

Structure


Authority
Lease
Lease Back
City or County
Proceeds
Lease Payments
Trustee
Proceeds
Debt Service Payments
COP Holder

Credit Considerations

- Essentiality
- Ability to pay
- Seismic concerns
- Abatement risks

What do I Need to Know About COPs ?

- They are not a weird, risky deal; they are the typical way capital projects are financed.
- Only finance essential, capital assets with COPs.
- Do not exceed the useful life of the project in amortizing the debt.
- Avoid capitalized interest if possible.

Part III

Enterprise Bonds & Revenue Bonds

Revenue and Sales Tax Bonds

- Most common type of debt for enterprise entities, utilities and transportation.
- California self-help counties lead the nation in sales tax bonds.
- Enterprise bonds refer to debt-secured by a municipal “enterprise” such as
  - parking fees
  - water
  - convention centers
  - sewers
  - electricity
  - gas
  - toll roads
  - tidelands
  - ports
  - etc.

How They Work (Sales Tax)

BOE Collects Tax

↓

Trustee

↓

P and I

↓

Reserve Replacement

↓

Released to Agency

- Enterprise agencies must first fund operations.

Important Considerations

- Rate covenants / rate setting ability
- Debt service coverage – gross and net
- Additional bonds tests
- Revenue base trends
- Competitive facilities

Part IV

Mello-Roos Bonds

Mello Roos Bonds

- Henry Mello and Mike Roos
- Assessment Bonds
- Voted by property owner
- Often used by developers to fund public improvements

Mello Roos Credit Considerations

- Lien-to-value ratio
- Development risk
- Market absorption rate
- Property owner diversity
- Total tax burden

Part V

Tax Allocation Bonds

Tax Allocation Bonds (TABs)

- California law allows redevelopment agencies (RDAs) to develop plans to remedy economic "blight" in "project areas"
  - Revitalize communities
  - Provide resources for low-income housing
- RDAs issue TABs to fund revitalization projects
  - Security for the TABs is the incremental property tax generated when the AV in the project area rises due to development ("tax increment")
  - "Fiscal Report" covering the project area is a key credit component (AV changes, AV appeals, top taxpayers, volatility ratios)
- State has recently taken property taxes from redevelopment to deal with State deficits
  - Prop 22 was passed in November 2010 to stop State grabs
- But Governor's sweeping proposal to restore State budget balance includes the elimination of RDAs and transfer of affected property taxes to local government

Part VI

Forms of Long-Term Debt

Forms of Long-Term Debt

- Vanilla fixed-rate bonds
- Unhedged floating rate bonds
  - Variable Rate Demand Bonds (VRDBs)
  - Auction rate bonds
  - Floating rate notes
- Swapped floating rate debt
- Build America Bonds
- Tax Credit Bonds

Part VII

Marketability of Bonds and COPs

Marketability of Bonds and COPs

- "Marketability" is a function of:
  - Investor appetite for particular bond structures (demand)
  - Volume of issuance (supply)
  - Credit ratings of particular issuers and particular bond structures
  - Liquidity in the market
    - Dealer inventories
    - Secondary market trading
    - Investor portfolios and cash flows
    - Market tone
      - Crises can "close" the market, as happened when Lehman Brothers went bankrupt in September 2008
    - Generally, the municipal market functions smoothly through an interconnected network of broker-dealers and investors

Credit Ratings Delineate Market Segments

	Credit Ratings			
	Strongest	Moody's	Standard & Poor's	Fitch
Investment Grade	↓	Aaa	AAA	AAA
		Aa	AA	AA
		A	A	A
		Baa	BBB	BBB
Non-Investment Grade	↑	Ba	BB	BB
		B	B	B
		Caa	CCC	CCC
		Ca	CC	CC
		C	C	C
	Weakest	C	D	D

Part VIII

Best Practices for Bonds and COPs

Best Practices

- Per Government Finance Officers Association (GFOA) “best practices” for debt management, local agencies should establish a Debt Management Policy that lays out key control factors
  - ✓ Debt capacity limits and associated bond issuance schedules
  - ✓ Tax rate thresholds and performance, if relevant
  - ✓ Conservative assessed valuation history and projections, if relevant
  - ✓ Selection of method of sale and financing team
  - ✓ Funding for both routine and long-term maintenance of bond-funded facilities
    - ✓ Reserves for replacement of equipment and facility repairs
  - ✓ Maximum term of bonds to be tied to useful life of project
  - ✓ Establishing refunding criteria and savings targets

Best Practices (cont'd)

- Disclosure and disclosure obligations
  - ✓ Follow the National Federation of Municipal Analysts (NFMA) "Recommended Best Practices in Disclosure for General Obligation and Tax Supported Debt" (separate papers on Revenue Bonds and Tax Allocation Bonds)
  - ✓ Timely file the required Annual Report
- Use resources on EMMA (Electronic Municipal Market Access website)
  - ✓ Official Statements
  - ✓ Annual financial reports and material event notices
  - ✓ Real-time trade pricing and yields
  - ✓ Interest rates for variable rate bonds
  - ✓ Education materials
  - ✓ Municipal market statistics