Financing Options: Which type of Debt is Best for your Project, Part 1

CDIAC Municipal Debt Essentials

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Considerations for Issuing Debt

Funding Infrastructure in California

Three basic options for funding capital projects

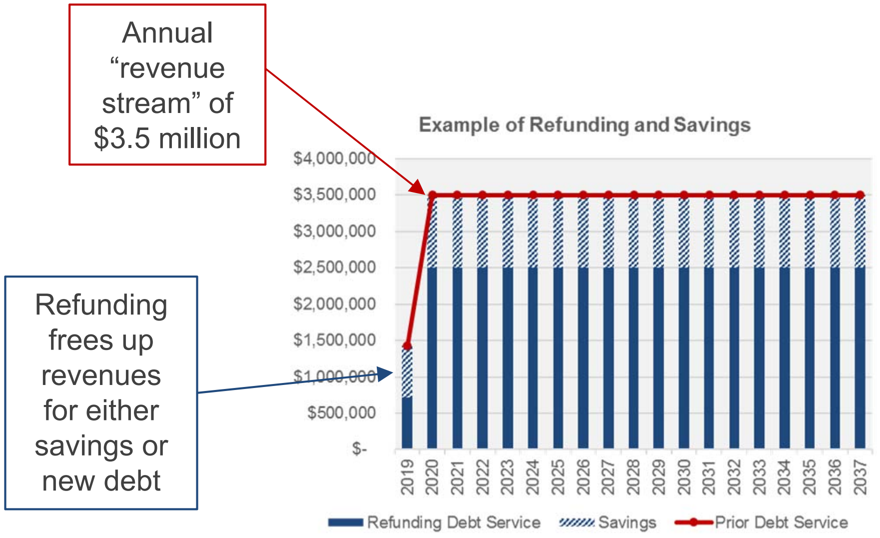
- **Pay As You Go: Utilize reserves or ongoing revenues**
  - Requires ample cash reserves and manageable capital program
  - Policy objectives may favor

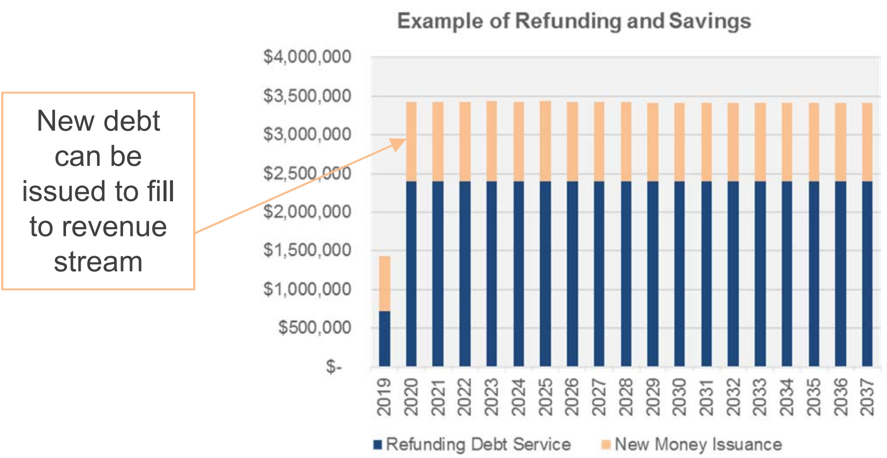
- **Beg: Secure state or federal grants or low-interest loans**
  - Requires available funding on attractive terms
  - Timing delays and program restrictions can offset subsidy

- **Borrow: Issue debt**
  - Spreads cost over useful life of asset, current <u>and</u> future users pay
  - Can accelerate phased projects, capture cost savings
  - Preserves cash reserves for other things

Key Considerations for Issuing Bonds

- **Issuer's Objectives**
  - What kind of projects are planned? When are funds needed?
  - What revenues are available - or could be raised - to repay debt?
  - How much payment flexibility does the issuer need?
- **Legal and Policy Constraints**
  - What kind of debt can be issued?
  - What kind of approvals by legislative body or electorate are required?
  - Are there any other policy constraints to consider?
- **Financing Options**
  - How much debt can revenue support? How strong is the credit?
  - Is any other debt outstanding? Any parity debt requirements? Can existing debt be refinanced?
  - What debt option provides the best balance of cost and flexibility?





SECTION II

Financing Tools

Debt Repayment Revenues

- **Typical Revenue Sources**
  - General Fund Revenues (property tax, general obligation tax override, sales tax, utility user tax, hotel occupancy tax)
  - Parcel tax, special tax or assessment
  - Charges for service, development-related impact or connection fees
  - Intergovernmental revenue

- ***New taxes*** **require approval by voters**
  - "General purpose" tax = simple majority approval (50+%)
  - "Special purpose" tax = super-majority approval required (67%)

- ***New fees*** **must be tied to "cost of service"**
  - Must establish nexus between charge and service
  - Proposition 26 expanded the definition of what constitutes a "tax" versus a "fee", excludes special benefit, governmental service or product, licenses and permits, fines and penalties, local governmental property, property development, Proposition 218

- **Rate increases are subject to Proposition 218**
  - Advance notice and public hearing with no majority protest

Limits on Municipal Borrowing

- **California Constitutional Debt limit**
  - No cities, counties or school districts can enter into debt exceeding annual revenue without a 2/3rds voter approval
  - Exceptions
    - Long term leases not long term "debt" if subject to annual appropriation and other structuring restrictions
    - Special "enterprise" funds, such as water or sewer enterprise
    - "Obligation imposed by law", such as pension liability and judgments

- **Federal Tax Law Limitations**
  - Projects must have general public purpose to qualify for tax-exemption
  - Certain uses – student loans, industrial development, housing – must compete for state private activity volume cap allocations (CDLAC in California)
  - Arbitrage restrictions – no "printing press"
  - Taxable bonds are an alternative

Basic Bond Financing Tools

General Obligation	Lease Revenue	Enterprise Revenue
Simplest Bond security type “Full faith and credit” of issuer Secured by property taxes – and in rare cases, issuer’s general fund	General fund appropriations for lease payments Requires a leased asset Subject to abatement	Net enterprise revenue pledge Rate covenant to charge sufficient rates Limitation on additional debt
2/3rds vote threshold 55% for some school GO bonds	Approved by legislative body	Approved by legislative body

General Obligation Bonds

General Obligation Bonds

- **Overview**
  - Annual tax levied on property tax roll in proportion to total assessed property values
  - Requires a 2/3rds voter approval, 55% approval for school G.O. bonds approved pursuant to Proposition 39 of November 2000
  - Voters approve total bond authorization and use of proceeds, not tax rate or annual payment
- **Advantages**
  - Broad-based tax support for public improvements
  - Lowest interest cost due to ad valorem security and unlimited tax pledge
  - Generates new revenue source to repay debt
  - Wide investor acceptance
- **Disadvantages**
  - Time, expense and uncertain outcome of election
  - Property tax increase
  - Many financing terms dictated by statute
- **When Used?**
  - Typically for projects with broad political support – varies by community

General Obligation Debt Considerations

- **Considerations**
  - Equity: Who votes? Who benefits? Who pays?
  - Election: timing, politics, competing items
- **Capacity Constraints**
  - Statutory debt limits
    - Varies by type of issuers, i.e. 1.25% of assessed value for counties, elementary or high school districts vs. 3.75% for general law cities
  - Maximum authorized principal
    - Voter approved
  - Assessed property values and target tax rates
    - Growth trends and forecast
    - Tax base diversity
    - Level or descending tax rate
  - Debt structure
    - Level or escalating debt service
    - Repayment term and principal amortization
    - Current interest or capital appreciation bonds

General Obligation Credits

- Economic and demographic
  - Size and strength of local economy
  - Wealth levels
  - Diversity of tax base
- Management
- Financial measures
  - Liquidity
  - Budgetary performance
  - Budgetary flexibility
- Debt and contingent liabilities
- Institutional framework
  - Statewide legal context

G.O. Bond Variations for Education

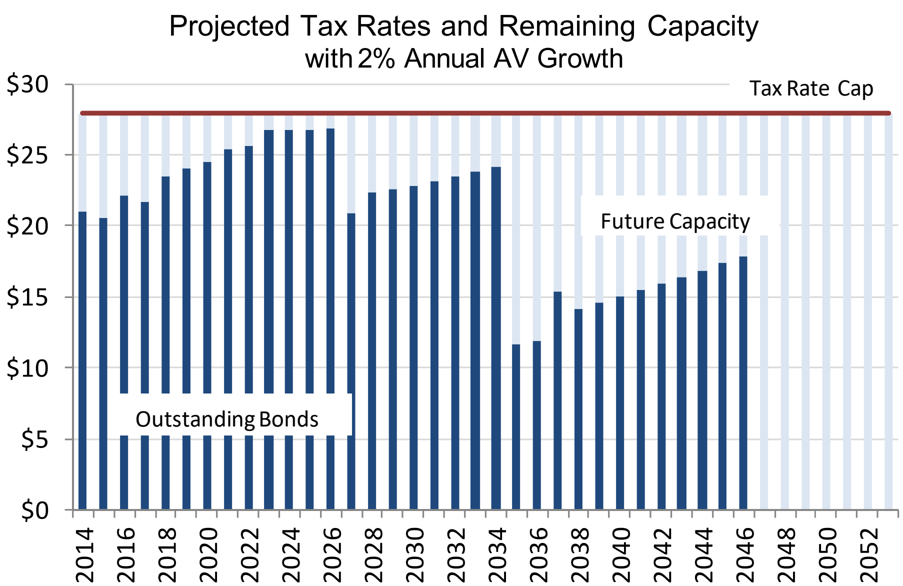
- **Proposition 39 Overview**
  - Approved by voters in November 2000 and effective January 1, 2001
  - Provided an alternative lower voter approval of 55% for school GO bonds
  - Limits on total tax rate
    - Community college districts: $25 per $100,000 of AV
    - Elementary and high school districts: $30 per $100,000 of AV
    - Unified school districts: $60 per $100,000 of AV
  - Limits on election dates
  - Citizen's Oversight Committee required
  - Equipment allowed as eligible cost

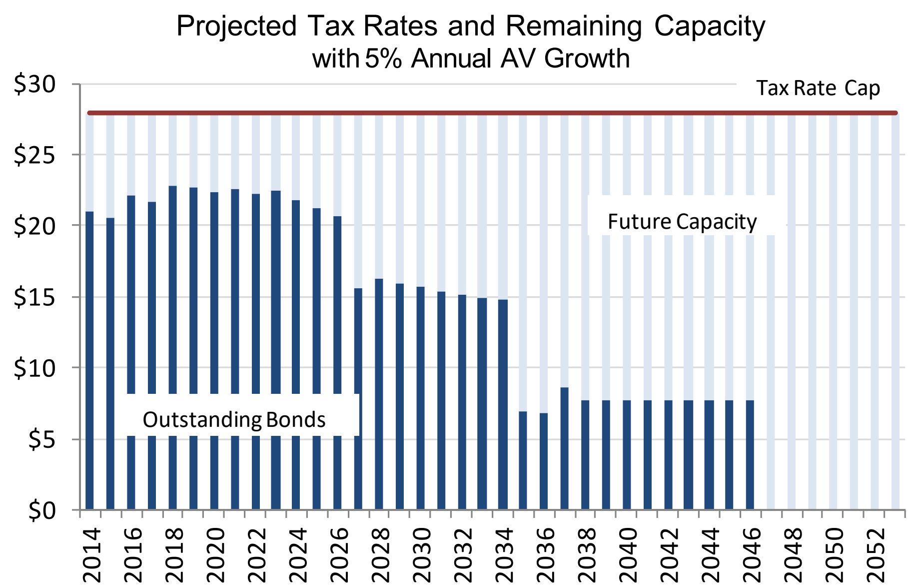
- **School Facilities Improvement Districts**
  - Enables tailored geographic boundary for certain GO bonds

AV Growth, Tax Rate Caps and GO Bond Capacity

- **Tax Rate based on Outstanding debt service ÷ District assessed valuation**
  - Requires projection of future assessed value trends
  - AV growth rate > expectations => lower than forecast tax rate
  - AV growth rate < expectations => higher than forecast tax rate

- **Tax Rate Limits**
  - Constraint on bond capacity and sensitive to future growth estimates





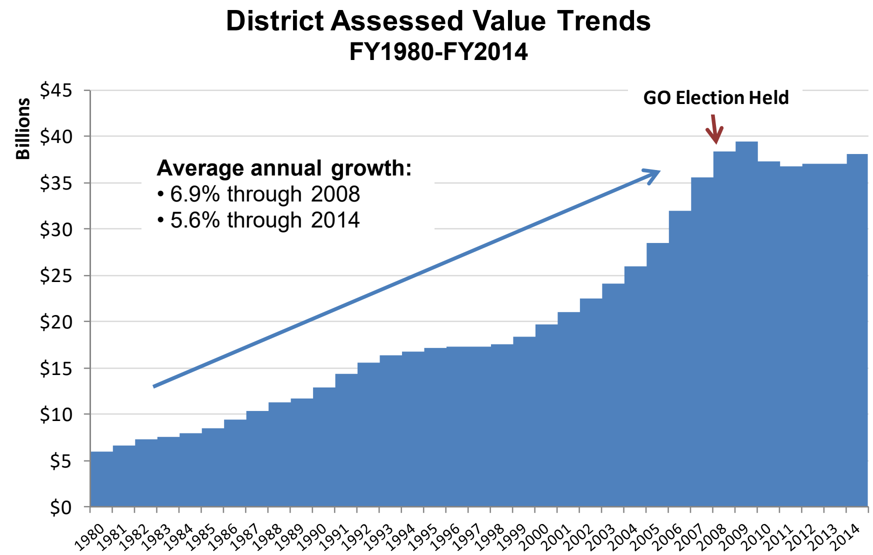
* Tax Rates presented per $100,000 of AV

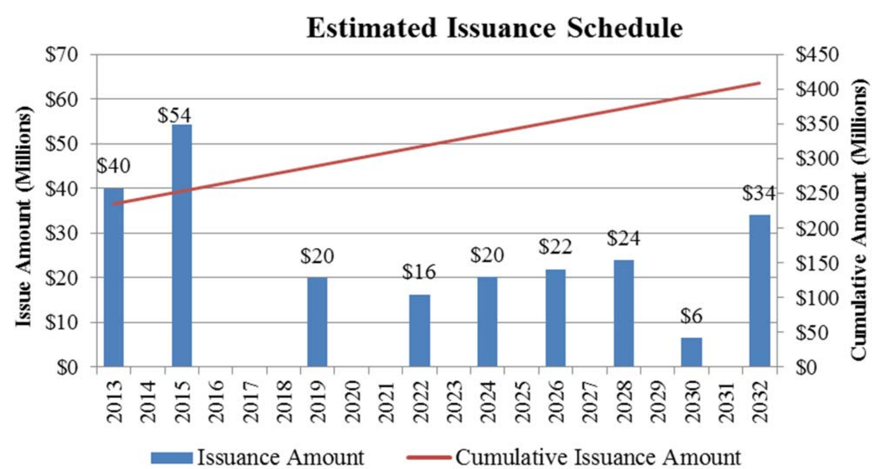
New Legislative Limits on School District Bonds

- **Recent legislation, AB 182, limits use of CABs by school districts**
  - Effective January 1, 2014
- **Final maturity of CABs shortened from 40 years to 25 years**
  - No change in 40 year final maturity for school current interest bonds
- **Debt repayment ratio limit**
  - Caps the ratio of GO bond debt payments to principal at 4-to-1 per series
- **Optional redemption**
  - Requires that issuers can refinance CABs no later than 10 years after initial issuance
- **Maximum interest rate reduced from 12% to 8%**
- **Board resolution**
  - Requires a district's Board to acknowledge intent to issue CABs, compare costs of issuing CABs to current interest bonds, and provide reasons for using CABs
- **Exemption**
  - Allows a school district who issued Bond Anticipation Notes (BANs) prior to 12/31/13 to seek a one-time waiver from the debt repayment ratio limit, optional redemption requirement and Board resolution for the BAN take-out

Illustrative High School District Example

- **~$400 million of Prop. 39 GO bonds**
  - Authorized by voters in 2008
  - 56.65% voter approval
- **Original assumptions**
  - Tax rate of $27.90 per $100,000 of AV
  - Phased issuances over 8 years
  - $40 million annually, with larger final sale
  - Use of both CIBs and CABs
- **Actual bond issuances**
  - $60 million in April 2009
  - $80 million in August 2010
  - $40 million in May 2011
- **Expected future issuances**
  - Affected by AV growth and AB182
  - Smaller, more frequent issuances over a longer time horizon





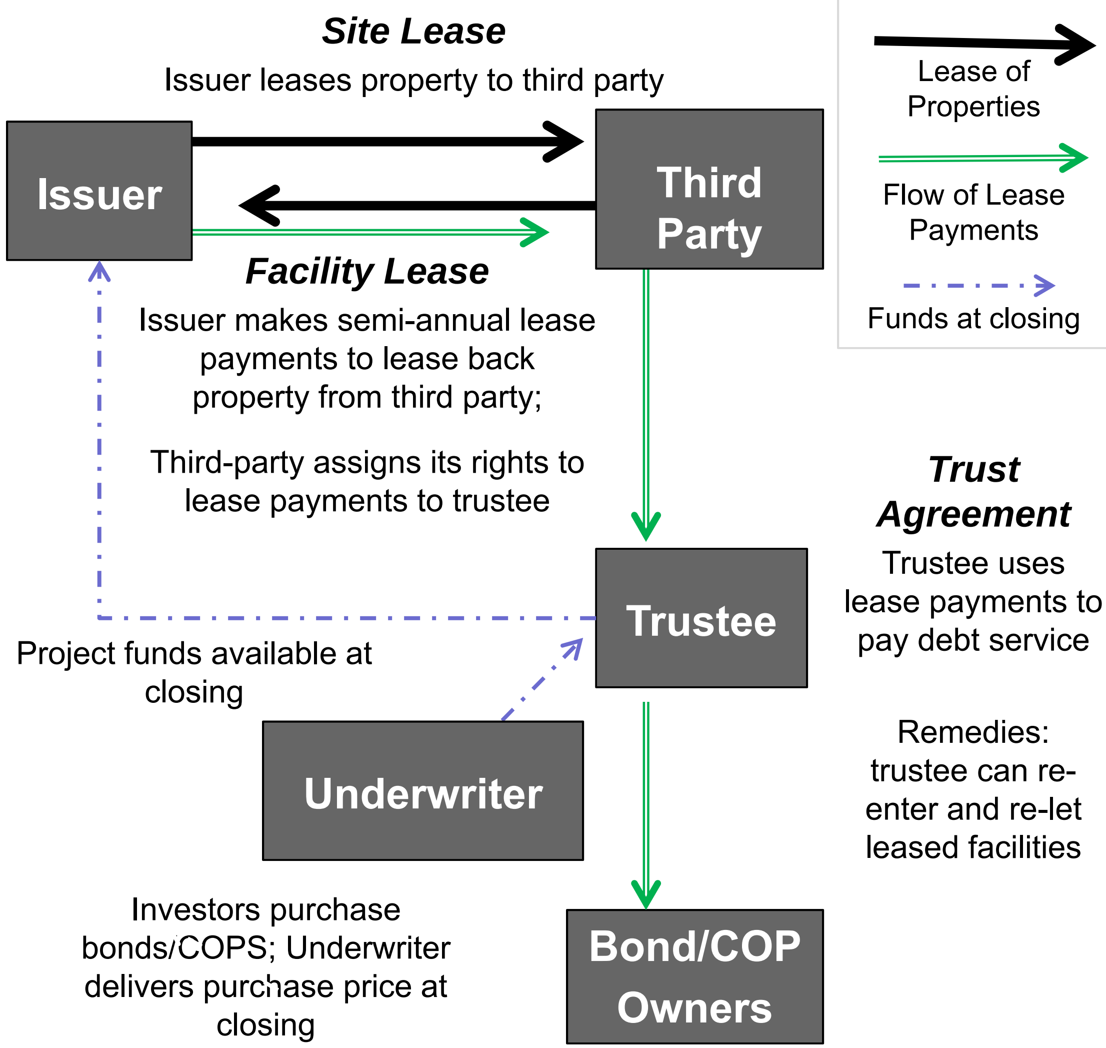
General Fund Borrowings

General Fund Lease Financings

- **Lease Financing**
  - Uses lease-leaseback structure with third-party entity
  - Issuer covenants to appropriate annual lease payments from general fund
  - May be structured as lease revenue bonds or “certificates of participation” (“COPs”)
  - Not subject to constitutional debt limits per lease exception
- **Advantages**
  - No voter approval required
- **Disadvantages**
  - Requires unencumbered leasable assets
  - Debt payments compete with other general fund priorities
- **When Used?**
  - When bond financing is unavailable or undesirable
  - For projects of general community benefit that produce no revenue of their own
  - To indirectly leverage a general fund revenue stream (i.e. sales tax increase)
  - To provide “credit enhancement” for less credit-worthy borrowing for desired “risk-sharing”

Lease-Leaseback Structure

1. Issuer leases an asset to a third party for nominal amount (~$1)
2. Issuer then "rents" asset back, with value amortized over time
3. Lease payments for "rental" used to pay debt service
4. Requires issuer "use and occupancy" of leased asset
5. Trustee can re-enter and re-let asset if issuer doesn't make payments



General Fund Lease Considerations

- **Considerations**
  - Nature of general fund revenues
    - Type and diversity
  - Current and historic revenue trends
  - General fund debt burden
  - Pension and health care liabilities
  - Value and "essentiality" of leased assets
- **Capacity Constraints**
  - Requires available assets for lease
  - Value of leased asset must exceed borrowing
  - New project funded by bonds can be leased but requires either capitalized interest or asset transfer

General Fund Lease Credits

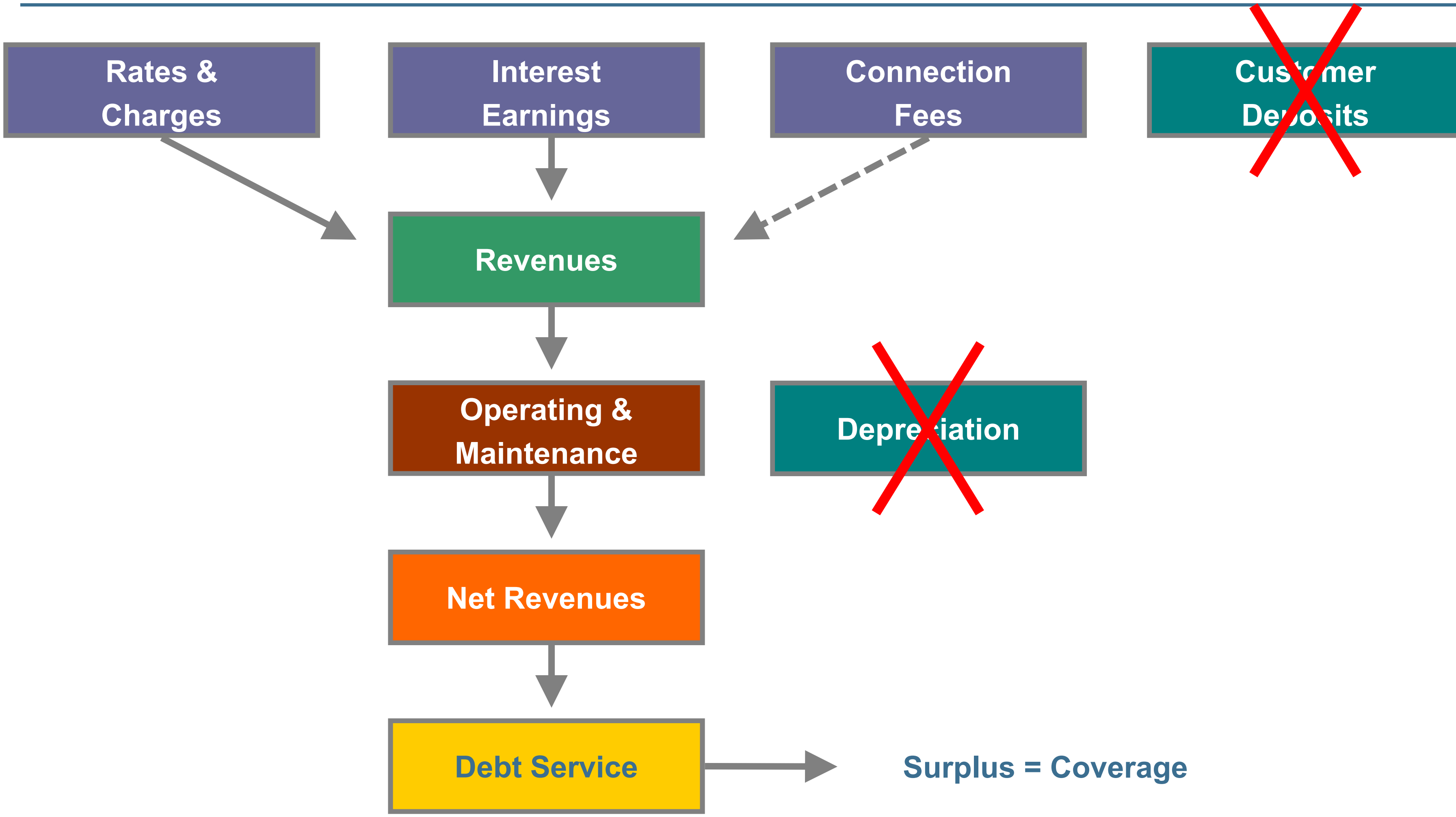
- General obligation factors
  - Economic and demographic
  - Management
  - Liquidity
  - Budget performance
  - Budget flexibility
  - Debt and contingent liabilities
  - Institutional framework
- Essentiality and Project Risk
  - Nature of pledged asset
  - Seismic considerations
  - Insurance coverage
- Security Features
  - Construction risk
  - Value and useful life of asset
  - Reserve fund
  - Capitalized Interest

Revenue Bonds

Revenue Bond Overview

- **Basic Premise**
  - Specific revenue stream pledged to bonds, often for a separate enterprise fund or separate agency supported by user fees
- **Enterprise Revenue Pledge**
  - Used by electric, water or sewer utilities, airports, ports, bridges, parking garages, stadiums or convention centers
  - ***Net Revenue Pledge***: all fees and charges of enterprise after payment of operations and maintenance (excluding depreciation)
  - ***Rate Covenant***: issuer commits to charge rates sufficient to pay debt service with a coverage cushion; may require rate increases in future with Proposition 218 process
  - ***Additional Bonds Test***: limits subsequent financings secured by same revenues
- **Limited Revenue Pledge**
  - Used for sales tax or certain other revenue streams (service charges, tolls, connection fees, admission fees, rents) – with statutory authorization
  - Voter approval required
  - ***Debt service coverage*** relative to volatility of revenues
  - Flow of funds, reserve funds and issuer liquidity

Enterprise Revenue Based Pledge



Capital project costs paid after debt service

Revenue Bond Considerations

- **Credit considerations**
  - Breadth and depth of revenue base
  - Stability and predictability of revenues
  - Essentiality of service, elasticity of demand
  - Ability to raise rates as necessary
  - Local economic factors
  - Liquidity
- **Capacity constraints**
  - Current and projected revenues and expenses
  - Current or planned rate increases
  - Cash flow for capital, reserves
  - Debt service coverage cushion
  - Other outstanding debt and parity debt limits

Enterprise Credit Criteria

- Customer Profile
  - Customer mix and concentration
  - Current and future demand
- Operational Factors
  - Management ability
  - Capacity and condition of assets
  - Regulatory compliance
- Rate Criteria
  - Rate-setting process
  - Affordability of rates
  - Price elasticity of rates
- Financial Data
  - Stability and consistency
  - Debt service coverage
  - Liquidity
  - Collections history

SECTION III

Policy Considerations

Questions to Ask Before Issuing Bonds

- **Can you afford the debt?**
  - Adequate revenues?
  - Adequate reserves?
  - Adequate coverage cushion?
  - What could go wrong?

- **Who's helping you?**
  - Get good advice from respected professionals

- **Is disclosure adequate?**
  - Official Statement ("OS") is the issuer's document
  - Have you told investors everything they need to know in the OS?
  - Have you kept up with continuing disclosure obligations?

Securities Exchange Act of 1934 Rule 10b-5:

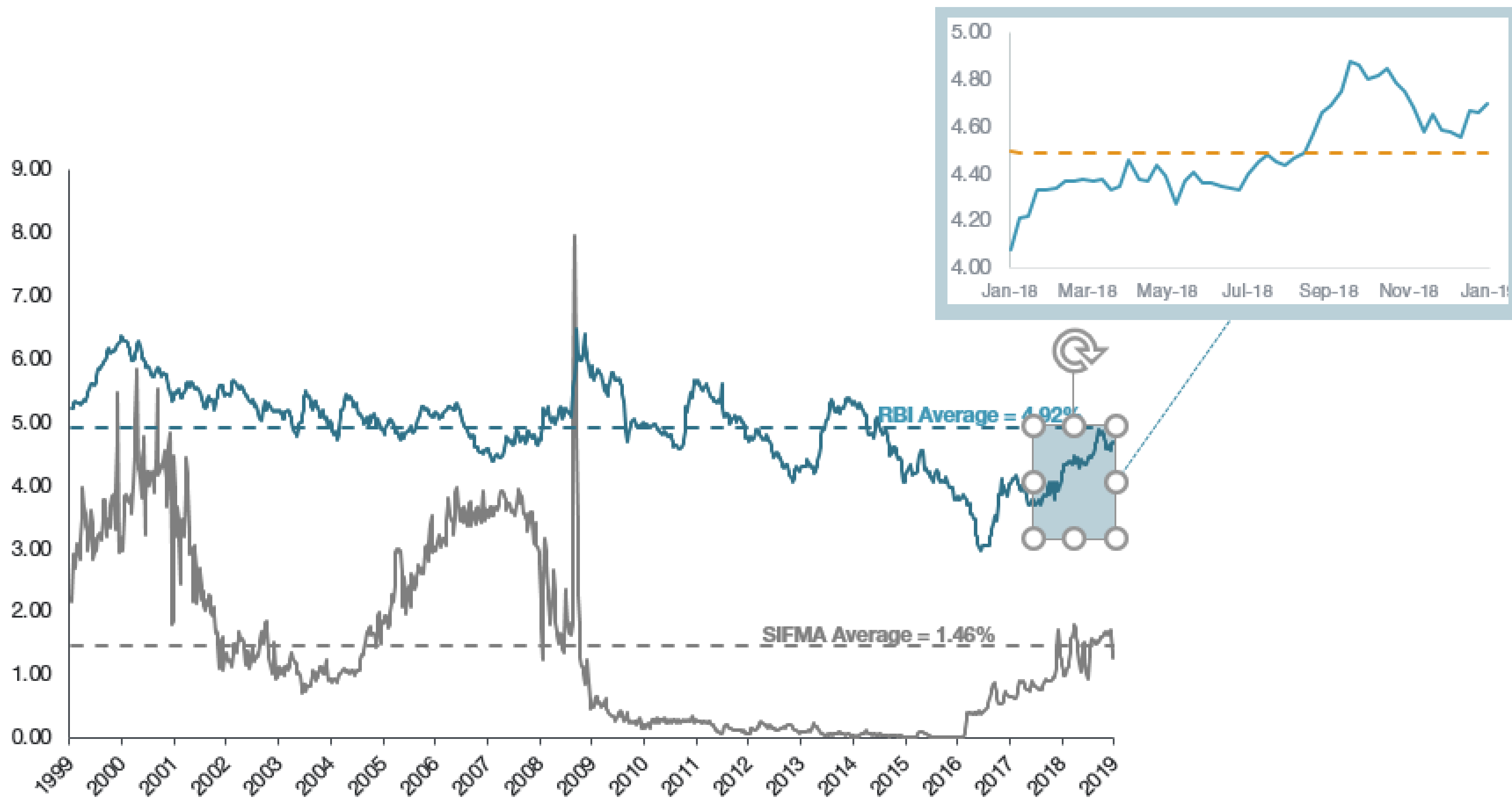
"It shall be unlawful for any person. . .

(a) to employ any device, scheme or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. . ."

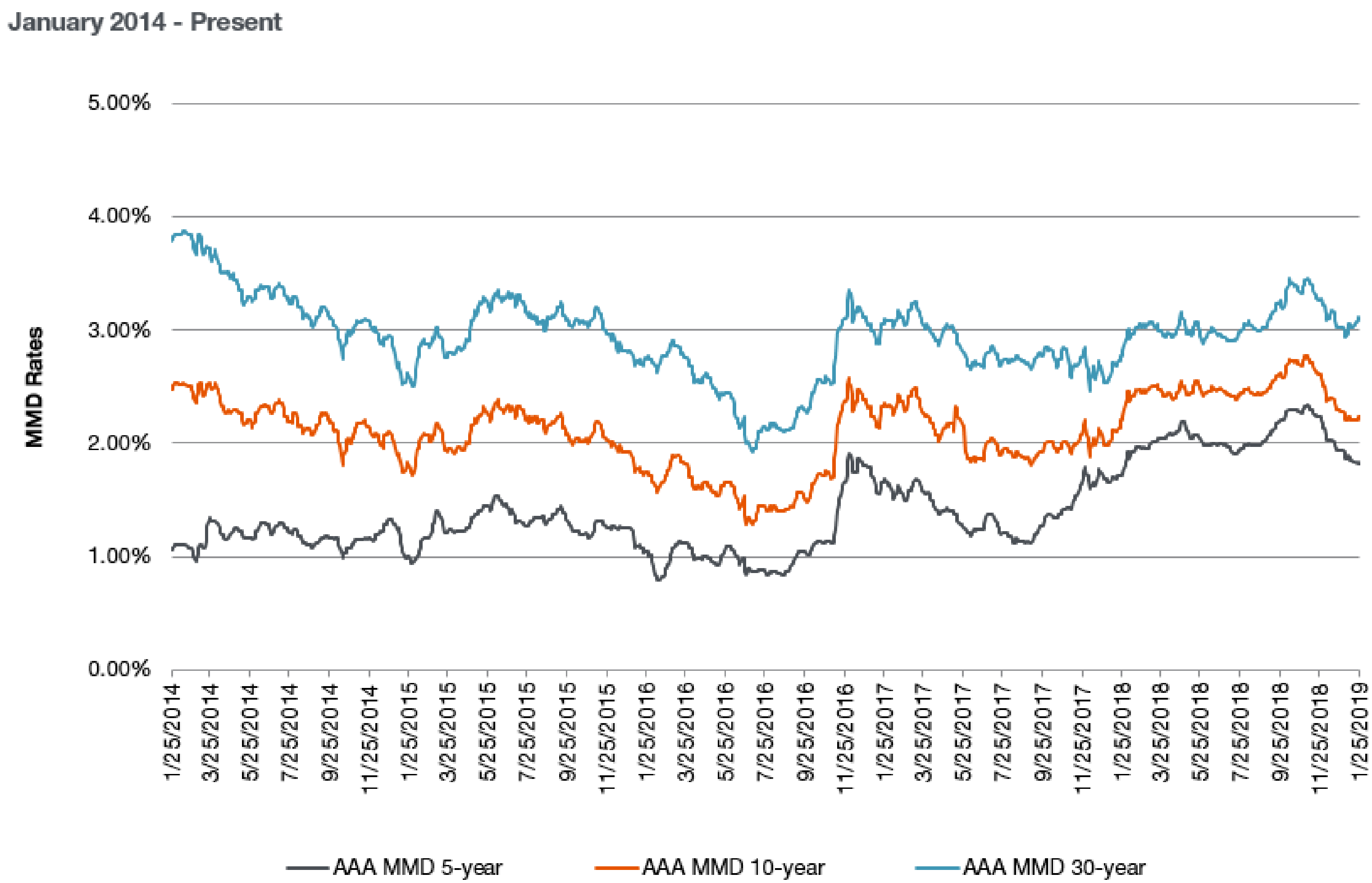
Current Bond Market Conditions

Securities Industry & Financial Markets Association (SIFMA) Index vs. Revenue Bond Index (RBI)



Source: SIFMA

AAA MMD Rate History



Source: Municipal Market Data

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