Long Term Financing Options

CDIAC Municipal Debt Essentials

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SECTION I

Considerations for Issuing Debt

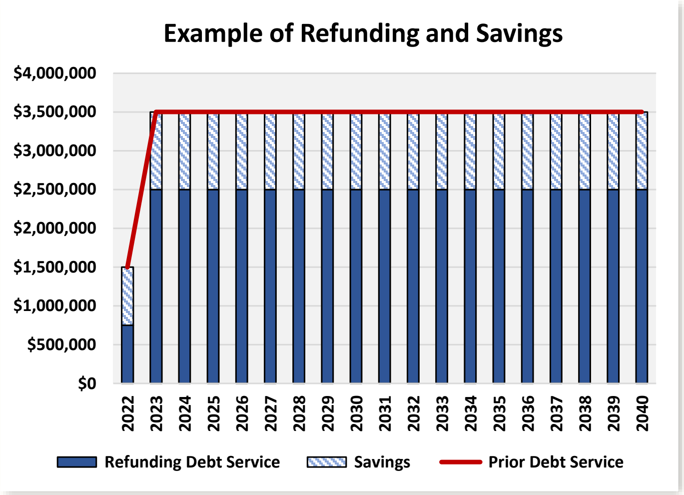
Funding Infrastructure in California

- **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 and future users pay
  - Can accelerate phased projects, capture cost savings
  - Preserves cash reserves for other things

Key Considerations for Issuing Bonds

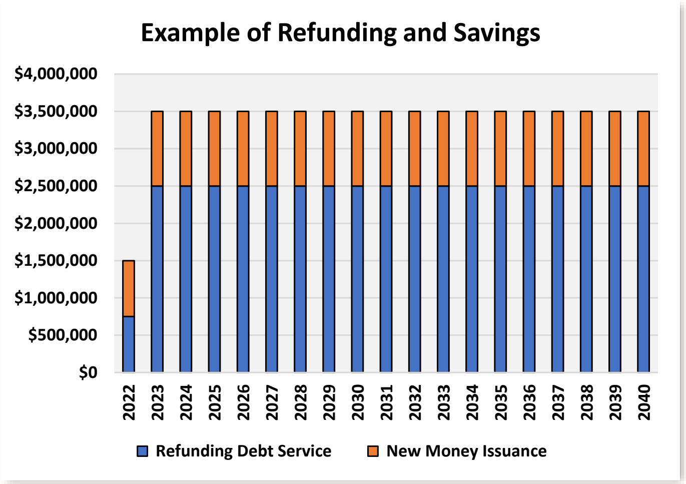
- **Issuer's Objectives**
  - What projects are planned? When are funds needed?
  - What revenues are available - or could be raised - to repay debt?
  - How much payment flexibility does the issuer need?
- **Legal and Other Constraints**
  - Which debt instruments is the issuer legally authorized to utilize?
  - Of the available debt instruments, which best accomplishes the issuer's goals and can be implemented on the issuer's timing?
  - What approvals are required (e.g. governing body or electorate)?
  - Are there any other political 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?
  - Which debt option provides the best balance of cost and flexibility?

•Annual "revenue stream" of $3.5 million



•Refunding frees up revenues for either savings or new debt

New debt can be issued to fill to revenue stream



SECTION II

Financing Tools

Debt Repayment Revenues

Historical Taxes	
Ad Valorem Real Property Taxes	An issuer's portion of the 1% general fund property tax levy on assessed value (AV) may be used as a source of repayment for tax and revenue anticipation notes (TRANs) and leases, including certificates of participation (COPs).
Taxes Requiring Approval of Voters	
Ad Valorem Real Property Taxes Securing Debt Obligations	An issuer may seek voter approval for tax levy on AV above the 1% CA Constitutional limit. For most issuers, requires approval by 2/3 of voters; school districts and community college districts (subject to certain requirements), requires approval by 55% of voters.
General Taxes	Tax levy levied by a city or county for a general purpose. New, extended or increased general taxes require approval by a 2/3 vote of the taxing entity's governing board members and a majority of voters. May be used as a source of repayment for general fund obligations such as TRANs and leases.
Special Taxes	Special tax levy (including parcel tax) for a specific purpose or by special districts. Levies generally require approval by a majority of the taxing entity's governing board and 2/3 of voters. Typically used as a source of repayment for Mello-Roos bonds or sales tax revenue bonds.

Debt Repayment Revenues (cont.)

<u>Charges Requiring Approval Under Procedural Requirements</u>	
Assessments	Levy of charges on real property assessed in proportion to a special benefit, with burden of proof on the levying public agency. Procedural requirements for assessments include public hearings and approval by majority vote of governing board members and property owners. Typically used as a source of repayment for assessment bonds.
Fees & Charges	Typically used as a source of repayment for enterprise revenue bonds, including water, wastewater and solid waste utility revenue bonds. Two-part analysis: 1) Fee or charge does not exceed governmental entity's <u>reasonable costs</u> to provide the benefit, privilege or service AND that costs allocated to a particular payor bear a fair and <u>reasonable relationship</u> to the burden on the local government or the benefit that the payor receives from the governmental entity. 2) If "Property-Related Fee or Charge" then additional requirements apply under Article XIID of the CA Constitution.

Limits on Municipal Borrowing: California Constitutional Debt Limit

- Article XVI, Section 18: No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of 2/3 of the voters of the public entity voting at an election to be held for that purpose.
- Exceptions:
  - *Current fiscal year exception* – typically applied to TRANs and revenue anticipation notes (RANs)
  - *Annual appropriation exception* – not commonly used given the Lease exception
  - *Lease exception* – public agency only has to make payments if it has use of the leased facility that year; typically applied to lease revenue bonds or COPs
  - *Special fund exception* – repayment source is solely a special fund of the agency and no reliance on the general fund, and there must be a nexus between the purpose of the debt and the special fund from which the debt is payable; typically used in water, wastewater, solid waste, and toll revenue bonds.
  - *Contingent obligation exception* – no payment obligation in any fiscal year unless the other party is providing benefits or services; commonly applied to service contracts, interest rate swaps, and other financial products.
  - *Obligation imposed by law exception* – payment of a liability must be mandated by law; commonly applied to judgment bonds and pension obligation bonds.

Limits on Municipal Borrowing: Federal Tax Law Constraints

- Under Internal Revenue Code, interest on bonds issued by a state or local government is generally excluded from gross income for federal income tax purposes.
  - This means that investors in tax-exempt bonds will not pay federal income tax on the interest they receive as a bondholder. As a result, investors will purchase the bonds at a lower interest rate than if the interest on the bonds were taxable.
- Additional Requirements:
  - Bonds must finance capital expenditures or cash flow working capital borrowings.
  - Bond must not be an issue of private activity bonds unless *qualified private activity bonds.*
  - Bonds must not be "arbitrage bonds" –Issuer cannot borrow at a lower federally tax-exempt interest rate and invest the proceeds at a higher rate.
- When federal tax law requirements cannot be met, taxable bonds are an alternative.
- California Constitution provides that interest on bonds issued by the State or a local government in the State is exempt from taxes on income.

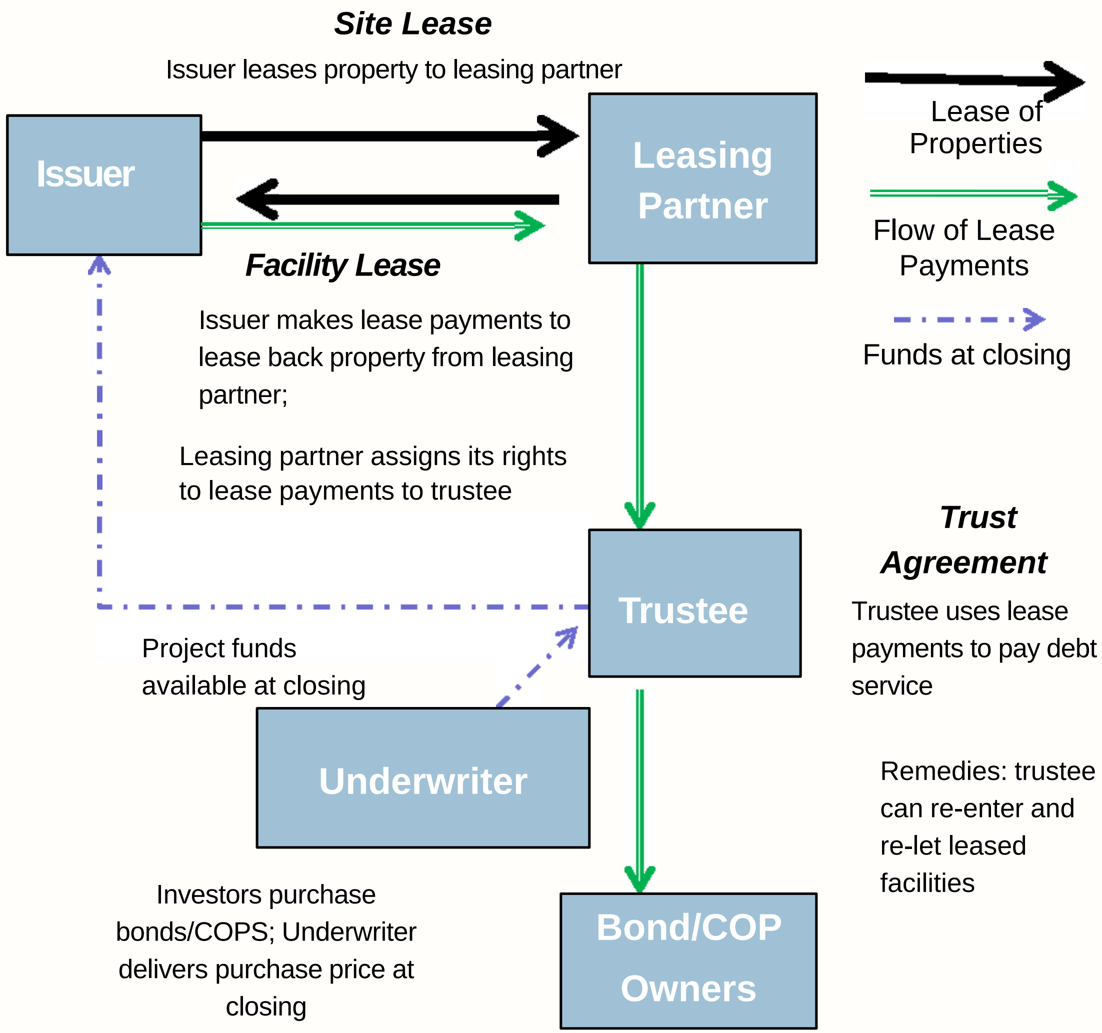
General Fund Borrowings

General Fund Lease Financings

- **Lease Financing**
  - Uses lease-leaseback structure with nonprofit corp. or JPA as leasing partner
  - Issuer covenants to appropriate annual lease payments from legally available funds
  - Viewed as a general fund credit
  - May be structured as lease revenue bonds or COPs
  - Not subject to CA 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)

Lease-Leaseback Structure

1. Issuer leases an essential asset to a nonprofit corp. or JPA as leasing partner
2. Issuer then subleases asset back, and agrees to make lease payments for use of property
3. Lease payments serve as debt service on bonds or COPs
4. Requires issuer have beneficial use and occupancy of leased asset (or abatement of lease payments)
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
  - Value and "essentiality" of leased assets

- **Capacity Constraints**
  - Requires available, unencumbered assets for lease
  - Value of leased asset must equal borrowing
  - New project funded by bonds can be leased but requires either capitalized interest or asset transfer

General Fund Lease Credits

- General credit 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

General Obligation Bonds

General Obligation Bonds

- **Overview – PROPOSITION 46**
  - Available to cities, counties, school districts, community college districts, and some special districts
  - Proceeds of bonds can only be used for the acquisition or improvement of real property
  - Property tax levy on AV in an amount sufficient to cover debt service on the bonds
  - Requires a 2/3 voter approval
  - Voters approve total bond authorization and use of proceeds, not tax rate or annual payment
- **Overview – PROPOSITION 39**
  - Available to school districts and CCDs ONLY
  - Proceeds of bonds can be used for construction, reconstruction, rehabilitation, or replacement of school facilities, including the furnishing and equipping of school facilities, or the acquisition or lease of real property for school facilities
  - Requires 55% voter approval
  - Requires a list of the specific school facilities projects to be funded
  - Requires a certification that the board has evaluated safety, class size reduction, and information technology needs in developing that list
  - Requires annual, independent financial and performance audits
  - Requires formation of citizens' oversight committee, with the authority to audit and review the bond program and advise the public

General Obligation Bonds (cont.)

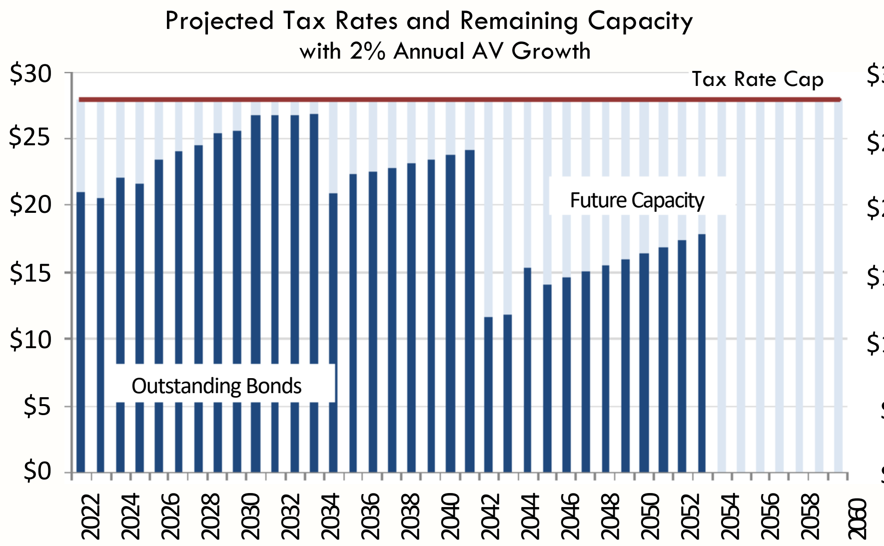
- **Advantages**
  - Broad-based tax support for public improvements
  - Lowest interest cost due to *ad valorem* security and unlimited tax pledge
  - Generates new revenue source to repay debt; no support from general fund
  - Wide investor acceptance
- **Disadvantages**
  - Time, expense and uncertain outcome of election
  - Property tax increase
  - Many financing terms dictated by statute
- **When Used?**
  - Typically for projects with broad political support – varies by community

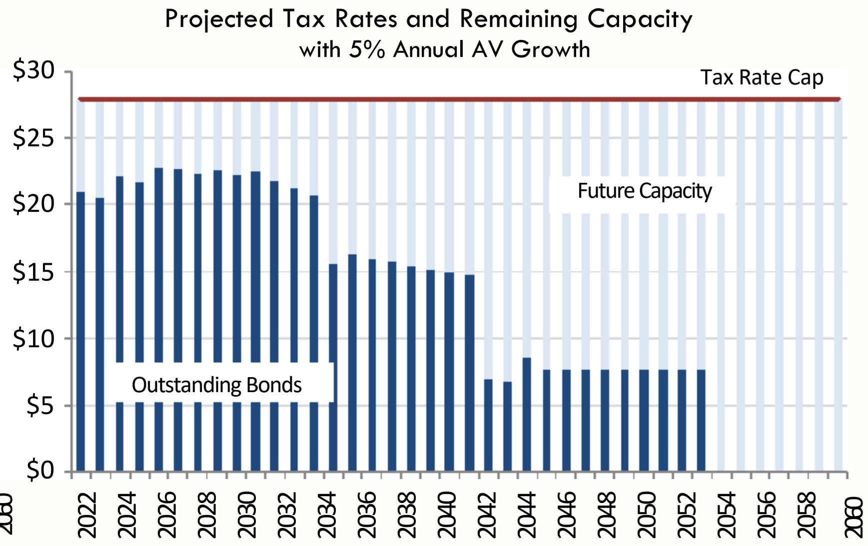
General Obligation Debt Considerations

- Statutory debt limits
  - Varies by type of issuers: 1.25% of assessed value for counties, elementary or high school districts; 2.50% for unified school districts and CCDs; 3.75% for general law cities
- Maximum authorized principal based on voter approval
- Assessed property values and target tax rates
  - Growth trends and forecast
  - Tax base diversity
  - Level or descending tax rate
- Tax rate limitations
  - Unlimited tax - levy of *ad valorem* property taxes (through the county treasurer) at the rate necessary to repay the principal and interest due on the bonds
  - Many general obligation bond issuers – except school districts – set the levy rate (e.g., counties and cities) by adopting a resolution annually
- Debt structure
  - Level or escalating debt service
  - Repayment term and principal amortization
  - Current interest or capital appreciation 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 Assessed Valuation.

Land Secured Bonds

Land Secured Finance Overview

- **Basic premise**
  - Public agency sponsors creation of special district - Property owners agree to put lien on property to fund certain facilities
- **Bond financing**
  - Bonds generate up-front funds for capital projects
  - Repaid with special taxes or assessments levied annually on property tax bill
  - Issuer may foreclose on delinquent parcels
  - In the event of a foreclosure, land value serves as ultimate collateral securing repayment
- **Advantages**
  - New revenue stream created for projects
  - No payment obligation for public agency
- **Disadvantages**
  - Requires formation of district, which takes time
  - Development projects can be risky in early stages
  - Assessment spreads vulnerable to legal challenge

Two Types of Districts

Community Facilities District

Mello-Roos Act

2/3rds approval

Flexible tax spread

⇒ Most frequently used option

Assessment District

1915 Act

50+% support

Proportional allocation of "special benefit"

⇒ Burden of proof on issuer results in potential litigation risk

Land Secured Finance Overview

- **Bond capacity constraints**
  - Eligible public facilities identified
  - Land value relative to debt
    - Minimum 3-to-1 value-to-debt standard – Tax burden on end-user
    - All-in effective tax of 2% for residential
- **Considerations**
  - Issuer goals and policies
  - Developer may post letter of credit
  - Capitalized interest up to 2 years
  - Phased bond issuances
    - Land use entitlements and development momentum at issuance
    - Ability to refinance debt at lower rates once development is complete

Land Secured Credits

- ***Issuer:*** reputation and experience
- ***Local Economy:*** real estate cycle, sales activity
- ***Property:*** location, attractiveness, environmental condition, value
- ***Strength of the Developer(s):*** financial resources, equity invested, development experience
- ***Development Plan:*** entitlements, development schedule, approvals, absorption schedule, product mix
- ***Product Demand:*** demographics of competing projects
- ***Tax Levy:*** burden on property, debt service coverage, value-to-lien
- ***Legal Structure and Covenants:*** foreclosure provisions, reserve fund, type of debt

Comparison of Land-Secured Districts

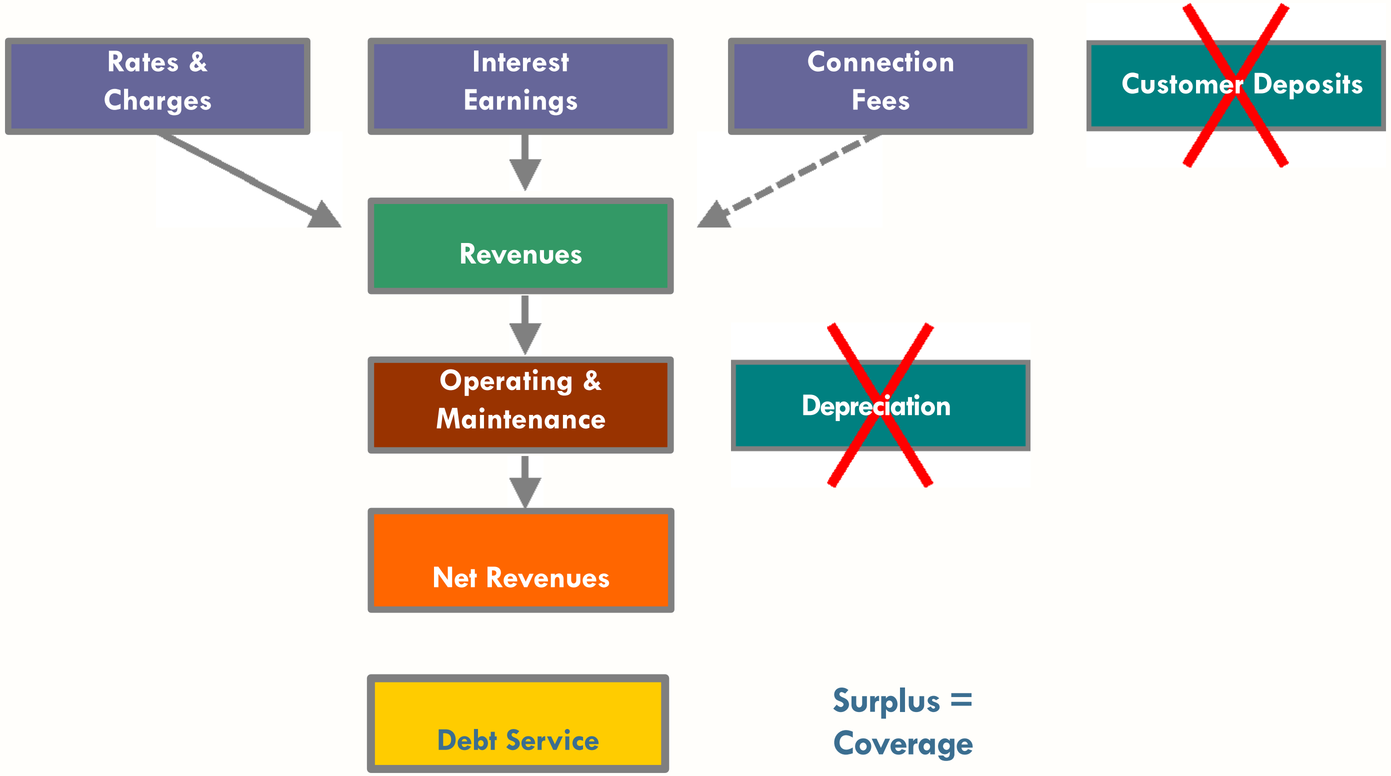
	Community Facilities District (CFD)	Assessment District (AD)
Statute	Mello-Roos Act of 1982	1915 Act/1913 Act
Security	Annual special tax on property tax roll	Annual assessment levied on property tax roll
Vote	2/3rds vote of property owners (Election)	Less than 50% Majority Protest (Protest Hearing)
Scope	Capital projects with "specific capital projects and maintenance benefits" only	Direct and special benefit improvements, no general public benefit
Spread of Lien	"Reasonable" spread of costs in special tax formula Dynamic payment obligation, can change as development proceeds	Spread must be proportional based on benefit Fixed payment obligation

Revenue Bonds

Enterprise Revenue Bond Overview

- **Overview**
  - Specific revenue stream pledged to bonds, often for a separate enterprise fund or separate agency supported by user fees
  - Enterprise can consist of an entire revenue-generating system or a single revenue-generating facility
  - Not subject to CA constitutional debt limit under special fund exception
- **Enterprise Revenue Pledge**
  - Used by a variety of issuers, including 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); no security interest in physical assets of enterprise
  - ***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

Enterprise Revenue Based Pledge



Capital project costs paid after debt service

Enterprise 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
  - Construction risk
  - Value and useful life of asset
  - Reserve fund
  - Capitalized Interest
- Financial Data
  - Stability and consistency
  - Debt service coverage
  - Liquidity
  - Collections history

Sales Tax Revenue Bonds

- **Overview**
  - Sales tax revenue bonds are payable from and secured by revenues from the imposition of a sales and use tax, or a transactions and use tax, on retail transactions within the issuer's boundaries
  - Sales tax revenues are collected by the California Department of Tax and Fee Administration (CDTFA) and remitted to issuer
- **Advantages**
  - Broad-based tax support for public improvements
  - Generates new revenue source to repay debt; no support from general fund
  - Wide investor acceptance
- **Disadvantages**
  - Time, expense and uncertain outcome of election
  - Voter authorization of sales tax required: general tax (majority voter approval) v. special tax (2/3 voter approval)
  - Sales tax increase
- **When Used?**
  - Only public agencies with the statutory authority to impose a sales tax may issue sales tax revenue bonds
  - Although cities and counties may impose sales taxes and issue sales tax revenue bonds, most sales tax revenue bonds are issued by transportation authorities.
  - Typically for projects with broad political support – varies by community

Direct Lending

Private Placement Alternative to Public Bond Sale

- **Overview**
  - A privately negotiated extension of credit from a commercial lender – or institutional investor - that does its own (regulated) diligence before making the loan
  - Sophisticated investor assesses credit on its own without the need for a separate disclosure document in most instances
- **Considerations**
  - Interest rates can be higher or lower than available in public markets
  - Benefits may include limited documentation, quick completion time and lower costs of issuance
    - May eliminate need for bond ratings, Official Statement, and/or debt service reserve fund – Issuer may take on additional risks, such as tax risk
  - Investor credit parameters and purchasing interests vary
    - Term may be limited to 10 years or shorter, but some lenders willing to go longer
    - Less interest in transactions paid from general fund appropriation
    - Sometimes large par amounts are not conducive to private placements

SECTION III

Policy Considerations

Questions to Ask Before Issuing Bonds

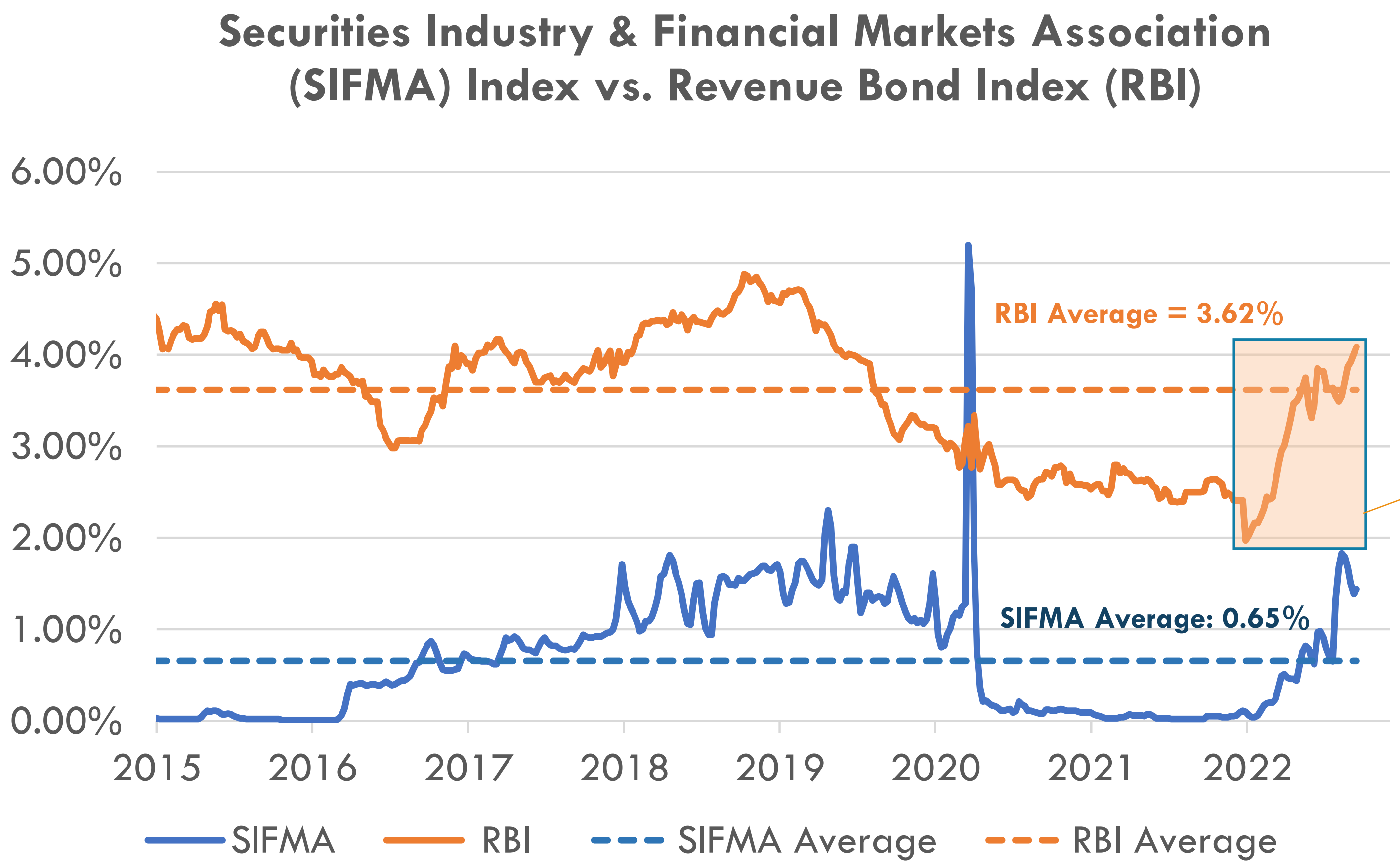
- **Can you afford the debt?**
  - Adequate revenues?
  - Adequate reserves?
  - Adequate coverage?
  - What could go wrong?
- **Who's helping you?**
  - Get good advice from respected professionals
- **Is disclosure adequate?**
  - Official Statement ("OS") is the issuer's document
  - Have you told investors everything they need to know in the OS?
  - Have you kept up with continuing disclosure obligations?

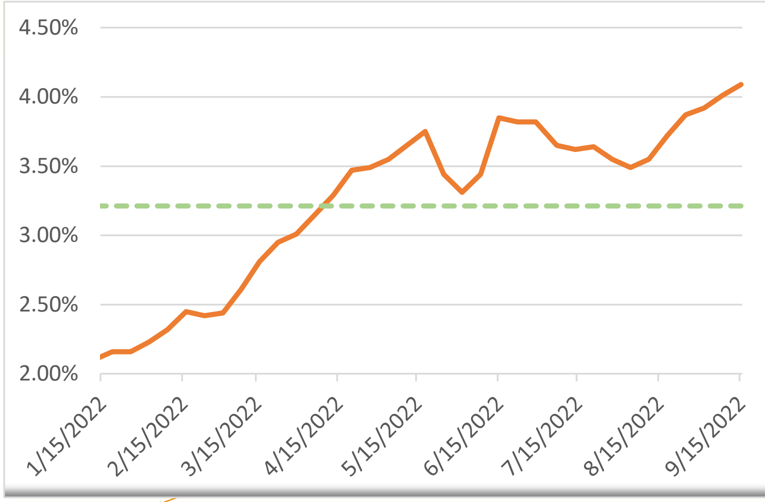
Securities Exchange Act of 1934
Rule 10b-5:

"It shall be unlawful for any person…

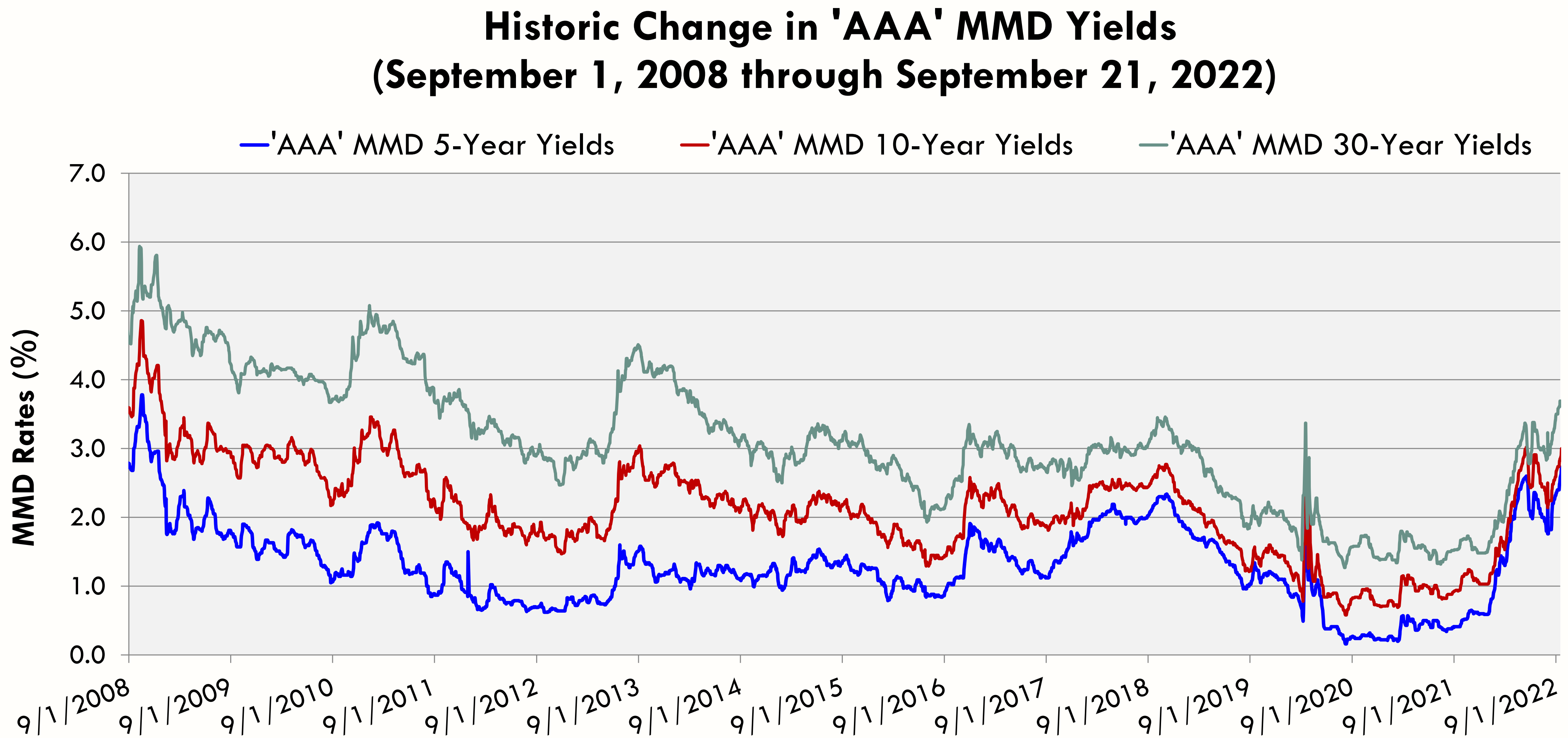
a. to employ any device, scheme or artifice to defraud,
b. to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. . ."

Current Bond Market Conditions





AAA MMD Rate History



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