

Fundamentals of Tax-Exempt Financing

Key Roles

Underwriter

- Reviews credit-worthiness of transaction
- Structures financing and recommends best time to enter market
- Oversees preparation of disclosure document
- Purchases obligations from Issuer and resells to investors

Bond Counsel

- Primary purpose is to issue opinion expressing that interest is tax-exempt
- Ensures compliance with state and federal law
- Helps structure financing

Trustee/Fiscal Agent

- Banking institution which handles administrative functions and pays principal and interest to investors
- In some instances, holds and disburses proceeds of the obligations

Rating Agency

- If involved, reviews underlying credit of transaction
- Assigns rating to obligations, which affects interest costs

Credit Enhancer

- Highly rated entity
- Risk Transference (e.g. lends its credit profile to the transaction in exchange for premium)
- Insures the payment of debt service

Key Terms

Bond

The evidence of debt

Creates securities whereby an issuer agrees, by written contract, to pay a fixed *principal* sum on a specified *date* (maturity date) and at a specified *rate* of interest.

Pay-as-you-go:

A phrase that means that capital projects are being financed from current operating revenues or taxes rather than by borrowing.

Leverage\N\

- 1: an inducing or compelling force
- 2: EFFECTIVENESS, POWER
- 3: the advantage gained by the use of a tool which provides benefit disproportionate to the energy or resources expended.

Why Do Public Agencies Use Tax-Exempt Financing?

To benefit from their tax-exempt status

- Preserve their cash reserves for other purposes or projects; ensure orderly expenditure of reserves
- Leverage financial assets, i.e. financing more capital projects than expenditure of cash reserves or current receipts would support.
- Avoid “phased” financing approach often dictated by pay-as-you-go alternative
- Debt/equity management, e.g. retention of equity implies financial flexibility & safeguards against financial exposure and uncertain events.
- Guarantees control over project since 100% funding is provided up-front.
- Asset/liability management, i.e. matching of short-term assets with short-term liabilities & long-term assets with long-term liabilities. Ideal match applies the receipt of a long term revenue source (e.g. assessments or rates and charges) against a long-term liability (e.g. debt service).
- Place burden of costs on all beneficiaries of improvements, not just current users

Financing vs. “Pay-as-you-go”

- Financing is more expensive
- Financing provides greater flexibility
 - *Ability to adjust repayment schedule*
 - *Easier to undertake large projects*
 - *Ability to adapt to changing needs*
 - *Minimize risk of construction cost increases*

General Obligation (G.O.) Bonds

- Most secure obligation
- Requires 2/3rds vote of electorate
- Used only to acquire or improve real property
- Secured by unlimited ad valorem property tax

Advantages of G.O. Bonds

- *Lowest interest cost*
- *Provides previously unavailable source of revenues (won't detract from other sources available to issuer)*
- *No debt service reserve fund requirement*

Disadvantages of G.O. Bonds

- *Schedule - usually 6 to 9 months*
- *Difficulty in obtaining 2/3rds vote*
- *Limitations on use of proceeds*
- *Non-flexible formula for levy - uniform percentage of assessed value*

Assessment Bonds

- Secured by Special Assessment Levied on Property
- Property must receive special benefit from project
- Assessment levied in proportion to benefit received
- Not a Tax
- Generally used to finance infrastructure (e.g. roads, parks, sewer, h2o, streets and lights, drainage, other utilities)
- Requires Prop. 218 attention

Mello-Roos Bonds

- Secured by special tax annually levied by issuer
- No requirement of establishing special benefit to property
- No gross lien on property
- Greater flexibility in structuring and phasing projects, spread of tax over different types of property
- Generally used to finance certain services (e.g. fire, police, library, and recreational services)

Certificates of Participation (“COP’s”)

- Financing based on power of District to lease or purchase property
 - *No voter approval required*
 - *Need to review enabling legislation for appropriate powers*
- Used to finance capital facilities
- Governing board approval only
- Well recognized in tax-exempt market
- Facilitates legal and debt service structuring
- Easily marketed - competitive rates

Lease-based COPs

- Subject of the lease is either facility to be built or acquired, or an existing facility
- District leases facility or property to another entity (e.g. CSDA Finance Corporation), which leases completed project back to District
- Lease payments assigned to trustee, which issues certificates evidencing right to share in such payments
- Annual payments must equal fair rental value
- Annual payments are made from general fund and other legally available funds of District
- Payments abated if project not available for use (e.g. damaged by fire)

Lease-based COPs: Advantages

- *No voter approval*
- *Quick time schedule*
- *Flexible structure*
- *Finance wide variety of capital improvements (e.g. pipelines, buildings, reservoirs)*
- *Generally available to all Districts*
- *Generally not subject to acceleration*

Lease-based COPs: Disadvantages

- *Facility is security for financing and subject to encumbrance*
- *Abatement risk usually requires rental interruption insurance*
- *Requires capitalized interest until project completed*

Revenue-based COPs

- *Used to finance facilities related to revenue producing enterprises (e.g. water or sewer systems)*
- *Repayment limited to specific enterprise revenues*

Revenue-based COPs: Advantages

- *No lien on non-enterprise revenues*
- *Secured by rates and charges of enterprise*
- *Generally considered very secure credit*
- *Used for a wide variety of facilities*
- *Generally viewed as a revenue bond without the necessity of a vote*
- *No capitalized interest required*

Revenue-based COPs: Disadvantages

- *District obligated to raise rates and charges if revenue is insufficient*
- *No abatement*
- *Requires coverage factor of 1.10x – 1.25x*
- *Limitations on issuance of additional debt*
- *Not available to certain agencies because of debt limits in enabling legislation*

General Considerations

- *Source of debt repayment*
 - *Existing users*
 - *Rates, charges, fees*
 - *Future users*
 - *connection fees, hook-up fees, assessments*
 - *Mix of existing & future users*
 - *all rates, charges, fees, connections and hook-up fees*
 - *Direct beneficiaries*
 - *All properties*
 - *Property Taxes*

- *Debt Capacity (i.e. ability to assume annual debt service obligation)*
 - *Context & perspective (i.e. consider the future plans of the District)*
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