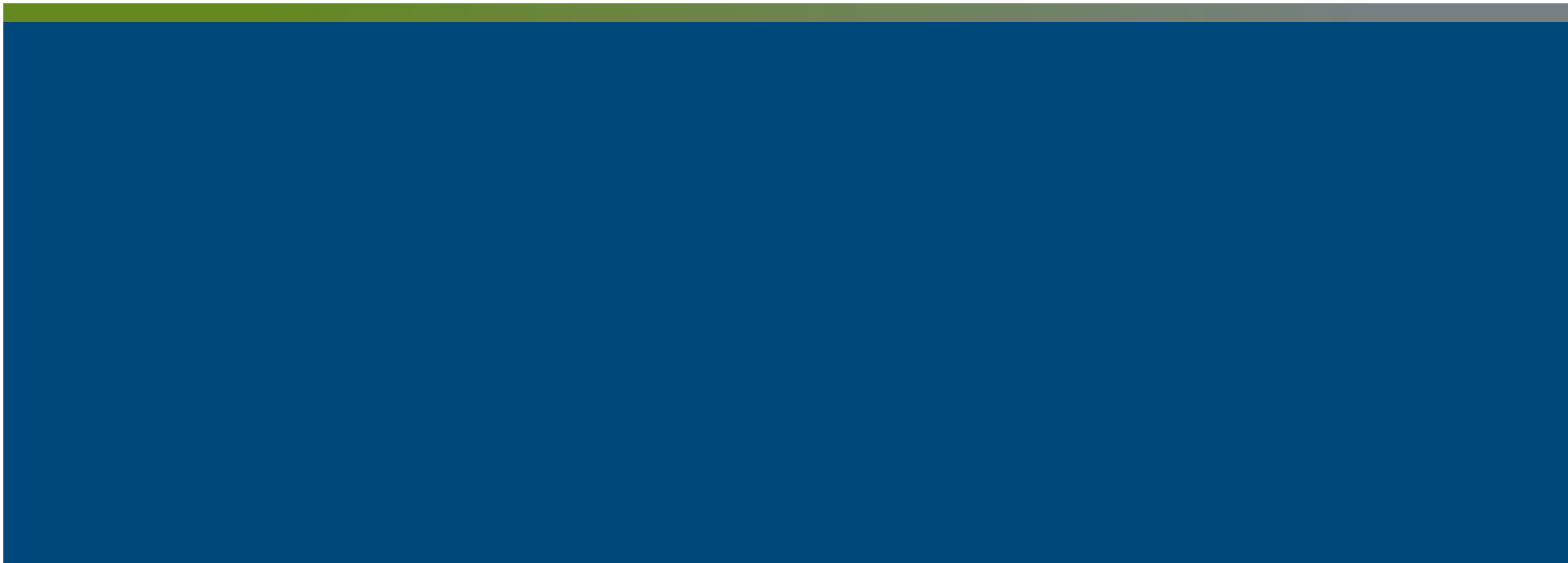




Public Finance Tools to Fund Infrastructure

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Introductions

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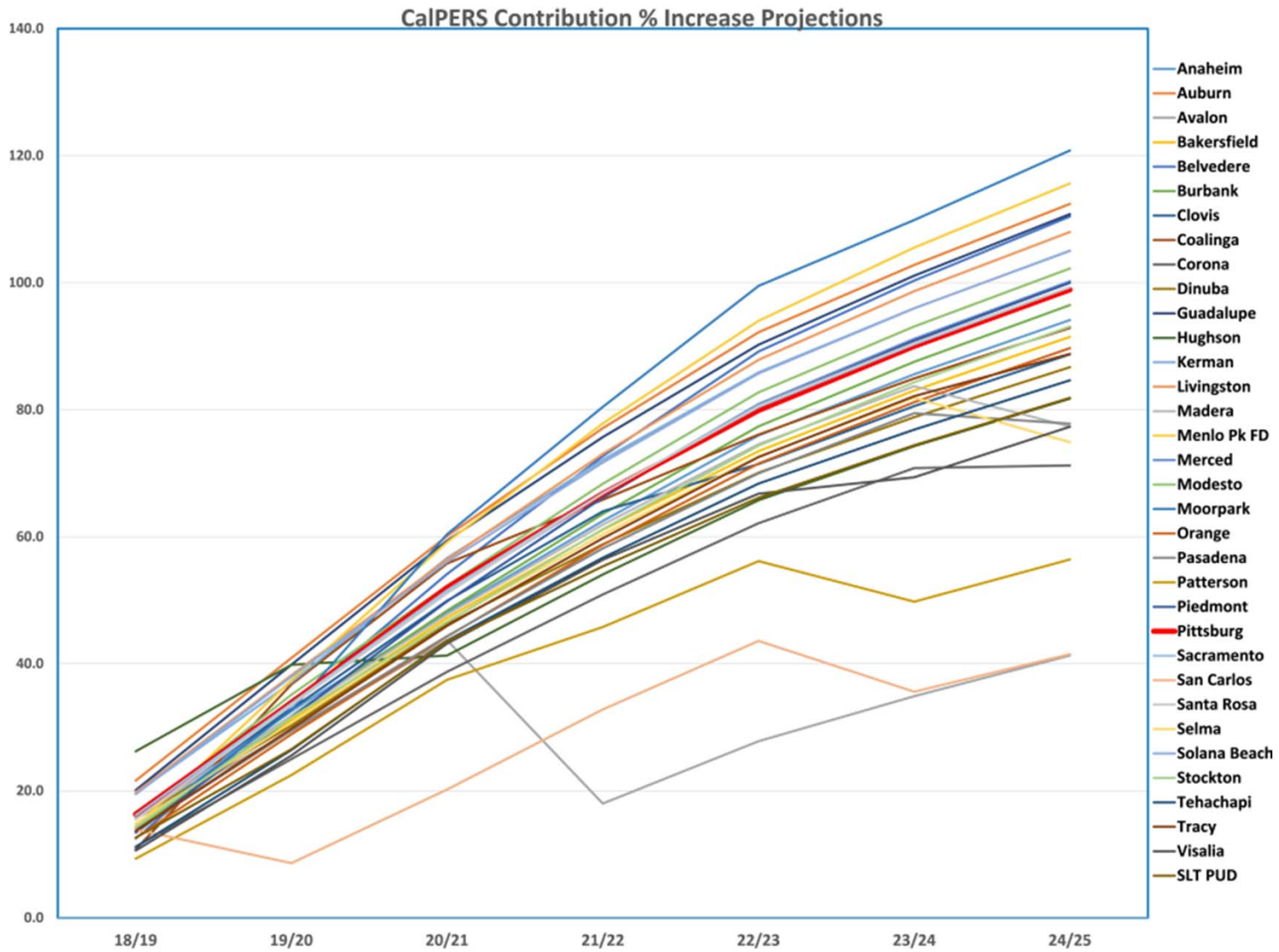
Internal Borrowing

- **Public agencies can loan from the General Fund to other funds as the only real unrestricted fund**
- **Enterprise funds cannot loan to the General Fund**
 - No authority under the debt limit
 - Raises Proposition 218 issues
 - Water and sewer funds are specific examples of this during the “great recession”

Long Range Financial Planning

- **CalPERS costs are skyrocketing**
 - Expected to double between now and 2022 to 2024
 - Expected to improve slowly after this period
 - Only assumes current 7.50% down to 7.00% but will increase significantly with additional change to a lower actuarial rate
 - The actuarial rate almost does not matter since really depends on actual returns which have been less than stellar because of:
 - Lack of investment vehicles
 - More conservative investment policies
- **Already starting to see pension and OPEB costs pinching out services and funding for capital projects**
- **Agencies needs to do a minimum 10 year financial forecast of the “General Fund and friends” to plan for cost increases and to pick up changes over the entire plan period**

Long Range Financial Planning



Economics of Municipal Finance

- The yield curve varies for different credits. Lower rated credits have higher yields; they pay higher interest rates in order to compensate investors for greater risk
- Standard & Poor's, Fitch and Moody's Investor Service are the three primary rating agencies and have the following rating categories:

	Standard & Poor's / Fitch	Moody's	
	AAA	Aaa	Investment Grade
	AA	Aa	
	A	A	
	BBB	Baa	
	BB	Ba	

- The rating agencies rate each municipality's underlying credit. While many factors affect this underlying rating, the structural balance between expenditures and revenues is significant, together with overall debt burden and management

Municipal Advisor

- **Works as the advocate for the municipal issuer by recommending the structure, timing and terms of a municipal offering**
 - Municipal advisors must make certain disclosures including: specific tasks to be completed, total compensation, term of the engagement, disciplinary actions and conflicts of interest
 - Underwriter's must disclose "arms-length" nature of their relationship

Municipal Advisor (continued)

- **Municipal Advisors are regulated by the Securities and Exchange Commission “SEC” and the Municipal Securities Rulemaking Board “MSRB”**
 - Rule G-42: establishes a fiduciary duty:
 - Duty of care: the municipal advisor possesses a degree of knowledge and expertise; makes reasonable inquiry as to the facts and has a reasonable basis for any advice
 - Duty of loyalty: the municipal advisor must deal honestly and with the utmost good faith and act in the best interests of the client without regard to the interests of the municipal advisor
 - Rule G-3: establishes that the municipal advisor must take and pass the Series 50 Municipal Advisor Representative Examination
 - Rules G-2 and A-12: Requires registration of the individual and the firm with both the SEC and the MSRB
 - Rules G-8 and G-9: rules for the preservation of books and records
 - Rule G-37: limits political contributions
 - Rule G-20: governs gifts, gratuities and non-cash compensation

Sale of Tax-Exempt Debt – Direct Placement

- **Direct placement: the sale of an obligation to a direct lender, generally a commercial bank that operates in the municipal space**
 - Placement Agent: a broker-dealer that acts as intermediary placing the obligation with a direct lender
 - Under SEC guidance, unless an offering is considered a loan, a broker-dealer is required to offer the securities in a direct placement
 - *Placement Agent Fee*: The broker-dealer is compensated by payment of a fixed fee amount which is negotiated in advance of the placement

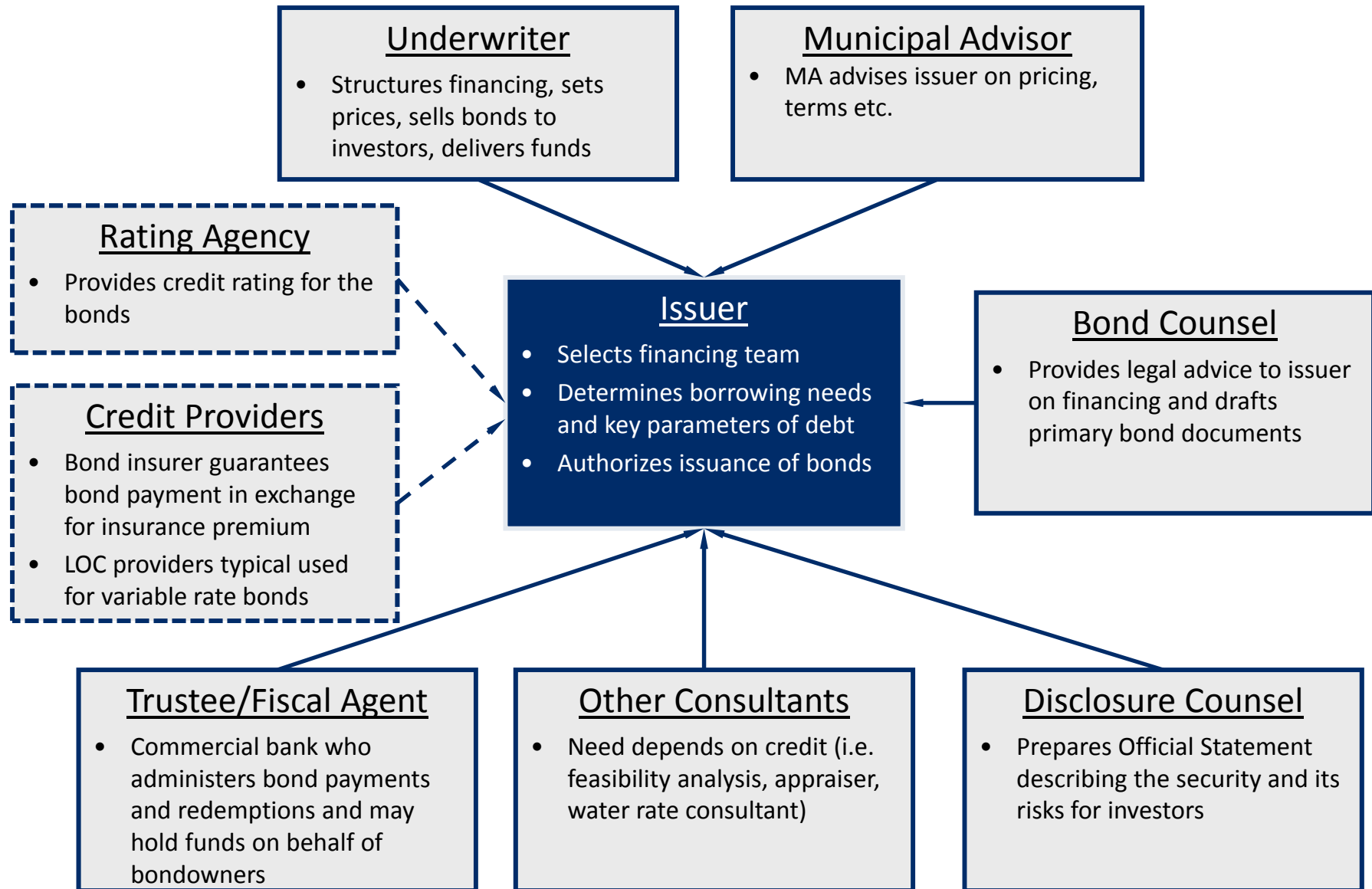
Sale of Tax-Exempt Debt – Public Offering

- **A Public offering is the marketing of bonds to retail and institutional investors**
 - Underwriter: an investment banking firm that purchases “underwrites” any unsold balances at the end of the public sale period
 - *Negotiated sale*: the issuer selects an underwriter in advance of the sale of bonds to help structure and pre-market its bonds
 - *Competitive sale*: the issuer determines the basic bond structure and asks firms to submit bids with the winning bid being the underwriter or syndicate with the lowest “true interest cost”
 - *Underwriter’s Discount*: the compensation an issuer pays to the underwriter and is generally paid as a percentage of the issue size
 - The gross spread is agreed to prior to the date of sale and reflects both the size of the issue and market factors

Components of the Gross Spread

Component	Recipient	Description
Management Fee	Senior Manager	For structuring and/or coordination of deal
Underwriting Risk	Senior & Co-Managers	Compensation for underwriting risk (if any)
Takedown	Senior, Co-managers & Selling Group	Basically a commission for selling the bonds
Expenses	Senior Manager	Reimbursement for issuance related expenses

Participants in the Municipal Market



Bond Insurance

- Issuers sometimes employ various forms of credit enhancement to improve the credit rating for their issue and thus reduce the overall cost of borrowing
- **Bond Insurance**
 - an “unconditional and irrevocable guaranty that the insurance company will pay all principal and interest” on the debt obligations for the life of the debt
 - An insured issue receives the rating of the insuring company, since it is the insurance company that is providing the ultimate security for the bonds. In return, the bond insurance provider receives a fee paid on the closing date that is non-refundable even if the bonds are subsequently refunded.
 - Today, insurance is most common in conjunction with a debt service reserve policy

Bond Insurer	Ratings (Moody's / S&P / Fitch)
Assured Guaranty Municipal 	A2 / AA / --
Build America Mutual 	-- / AA / --

Financing Process

- **Timing depends on complexity of project & certainty of financing plan**
 - Simple, straightforward financing can be completed in 3 months
 - Most financings are completed within 4 to 6 months
 - Infrequent issuers may need more time for analysis & board approvals
 - Bond or revenue elections require long lead time

<u>Financing Plan</u> (Month 1)	<u>Preparing Bond Sale</u> (Month 2)	<u>Pricing/Closing</u> (Month 3)	<u>Post-Closing</u> (Thereafter)
<ul style="list-style-type: none">• Engage financing team• Clarify project list• Analyze financing options	<ul style="list-style-type: none">• Draft legal documents• Draft investor disclosure (Official Statement)• Seek credit rating• Secure Council/Board financing approvals	<ul style="list-style-type: none">• Notice of Sale to Underwriters, Market bonds to investors or Bid indications• Set interest rates• Deliver funds	<ul style="list-style-type: none">• Make timely payments• Provide ongoing disclosure• Keep good records• Refinance when appropriate

Debt Limit in the California Constitution

- **Article XVI, Section 18 of the State Constitution (“the Debt Limit”)**
 - California cities, counties, and school districts can only borrow with 2/3rds vote of the electorate with three (3) exceptions:
 - Offner-Dean Lease Exception (Leases)
 - Special Fund Doctrine (water and sewer)
 - Obligations Imposed by Law (pension bonds and judgments)
 - Public agencies can borrow from pooled cash to fund operations during the fiscal year but must repay by the end of the fiscal year or create illegal indebtedness
 - Special districts are not subject to the Debt Limit

Federal Tax Law

- **In order to maintain tax-exemption at the federal level, municipal issuers have to comply with certain extremely complex federal rules and regulations. A few are summarized below:**
- **Arbitrage**
 - Federal law prohibits an issuer from earning positive arbitrage on the funds it raises through a tax-exempt offering. Arbitrage is the difference between a municipality's cost of funds and the earnings it receives from those funds. For example, they borrow at a tax-exempt rate of 3% and turn around and invest those funds at a rate of 5%, earning a 2% return on the money they borrowed. According to federal law, any funds earned in excess of the arbitrage yield (the tax defined overall cost of funds for an offering) must be rebated to the federal government
- **Private Activity**
 - The federal government also places restrictions on tax-exempt issuance for private purposes (i.e. sports facilities, etc.). There are a variety of rules and criteria that must be met in order to finance private activity bonds on a tax-exempt basis, primarily relating to (a) agreements for exclusive use of a bond-financed facility by a private business, and (b) management contracts
- **Spending Rules**
 - There are federal limitations on how quickly a municipality expends the funds raised. Essentially, the federal government requires that issuers expend funds within a certain time-frame in order to maintain tax-exemption. General rule is to spend 85% within 3 years and 100% by year 5

Financing Options for California Public Agencies

- **Public agencies are looking at available financing mechanisms to finance long term capital needs which include:**
 - General Obligation Bonds
 - Lease Financings
 - Land Secured Bonds (Assessment / Special Tax)
 - Infrastructure Financing Districts
 - Sales Taxes and Parcel Taxes
 - Revenue Bonds
 - Obligations Imposed by Law

General Obligation Bonds

- **The most conventional form of municipal financing**
- **Annual tax levied on property tax roll in proportion to total assessed property values**
- **Requires a 2/3rds voter approval**
 - Voters approve total bond authorization and use of proceeds, not tax rate or annual payment
 - School districts can issue with 55% approval, subject to additional accountability measures
- **Tax rate is calculated each year around July and based on annual debt service divided by total assessed value for that fiscal year**

Note

Level debt service causes declining tax rate per \$100,000 of assessed value and escalating debt service can create an essentially level tax rate each year per \$100,000 of assessed value

General Obligation Bonds: Advantages and Disadvantages

- **Advantages**

- Broad-based support for public improvements
- Highest rating and lowest interest cost due to ad valorem security and unlimited tax pledge
- Generates new revenue source to repay debt
- No reserve fund: IRS does not allow, and investors do not require, as this is the most secure form of municipal debt
- Taxes based off of assessed value, not market value
- No annual administration as debt service collected by the County and sent directly to the Trustee to pay investors

- **Disadvantages**

- Time, expense and uncertain outcome of the election
- Property tax increase
- Adjacent homes may have different annual taxes depending on when property was purchased
- Cannot fund equipment, maintenance or other projects not defined as capital improvements (except for school districts)

General Fund Lease Financings

- **Uses lease-leaseback structure with third-party entity generally a joint powers authority “JPA” of the local agency aka public financing authority “PFA”**
 - Lease an asset to the PFA and lease it back with payments equivalent to debt service on the bonds
 - Issuer covenants to appropriate annual lease payments from General Fund
 - Lease subject to abatement if no longer have “use and occupancy” of the asset
 - Lease cannot be accelerated
 - Lease payments must equal “fair rental value”
- **May be structured as lease revenue bonds or “certificates of participation” (“COPs”)**
- **Not subject to constitutional debt limits per Offner-Dean Lease Exception**

General Fund Lease Financings: Advantages and Disadvantages

- **Advantage**
 - No voter approval required
- **Disadvantage**
 - Requires unencumbered leasable assets
 - Lease term cannot exceed useful life of the improvements
 - Increases General Fund debt burden
- **Other Considerations**
 - Total interest cost based on underlying rating of the General Fund
 - Value of leased assets must exceed amount of the borrowing
 - New project funded by bonds can be leased asset but requires either capitalized interest or asset transfer
 - Investors consider the value and essentiality of the leased assets

Sales Taxes and Parcel Taxes

- **Sales Tax**

- Requires legislative approval to authorize the direct issuance of sales tax revenue bonds. Otherwise, must use lease financing to secure the financing and use sales tax as the internal source of repayment.
 - Special Tax: requires 2/3rds voter approval
 - General Tax: requires 50% +1 simple majority approval

- **Parcel Tax**

- The parcel tax is considered a special tax requiring 2/3rds voter approval. No legislative authority for the direct issuance of bonds secured only by a voter approved parcel tax. May use lease financing to secure the financing and use the parcel tax as the internal source of repayment
- Note: A parcel tax must be the same amount per parcel unless voted on for police and fire service where you can charge different amounts for residential, industrial and commercial

Land Secured Bonds (Assessment/Special Taxes)

- Public agency sponsors creation of special district
- Property owners agree to put lien or special taxes on their property tax bill
- Security interest is ultimately the property and not the individual
- Sole remedy is judicial foreclosure and ultimate tax sale if delinquencies not cured



Land Secured Bonds: Advantages and Disadvantages

- **Advantages**

- New revenue stream created for projects
- No payment obligation for public agency

- **Disadvantages**

- Increases tax rates on property owner tax bills
- Requires vote of the electorate (registered voters or landowners)
- Difficult to defend against legal challenge

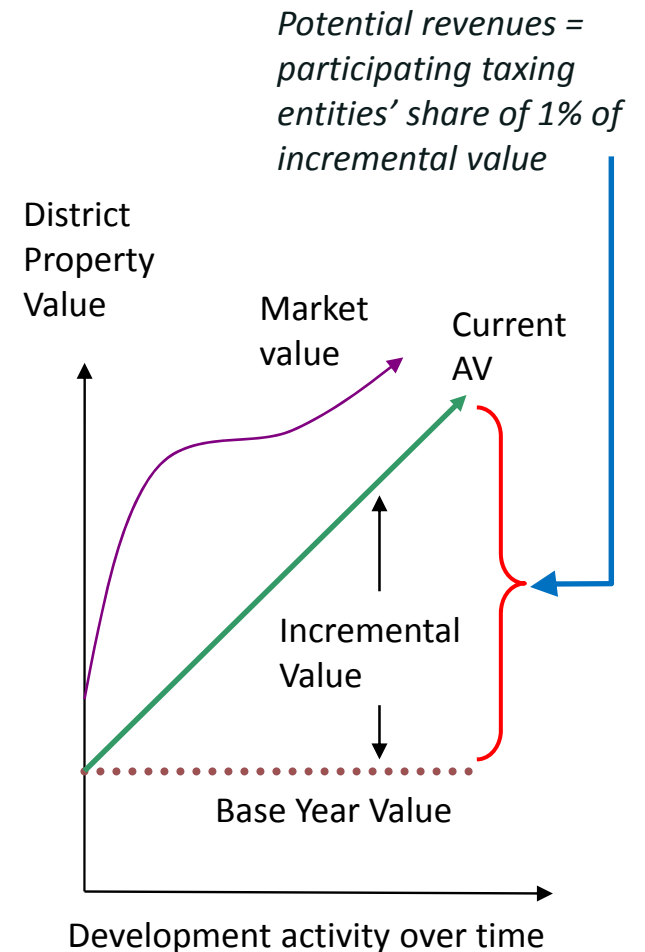
Comparison of Land Secured Districts

Item	Recipient	Description
Statute	Mello Roos	1915 Act / 1913 Act
Security	Annual special tax on property tax roll	Annual assessment on property tax roll
Vote	2/3rds vote*	50%+ weighted by assessment
Scope	Capital projects and maintenance	Capital projects and maintenance with “special benefit” only
Tax Spread	“Reasonable” spread of costs	Spread must be proportional based on special benefit
Lien on Land	Dynamic, can change as development proceeds	Fixed assessment lien

* By electorate if 12 or more registered voters; otherwise, by landowners weighted by acreage

Infrastructure Financing Districts

- **Conceptually similar to RDAs**
- **IFDs can receive/securitize a portion of incremental tax growth within a district**
- **Statutory authority since 1990; limited use thus far and no bonds issued to date**
 - Recent SB 628 “Enhanced IFDs” expands powers lowers voter approval
- **Revenue Stream**
 - Limited to share of base 1% property tax revenues of city, county or special district that opts in
 - Excludes amounts due to schools
 - No revenue until growth occurs
- **Most Likely Applicability**
 - Generally used in combination with other tools, like a CFD
 - Issuers with a large share of 1% property tax rate



Revenue Bonds (Water, Sewer)

- **No voter approval since user charges approved by Proposition 218 process**
- **Size of borrowing is based on available revenue stream**
- **Net Revenue Pledge (Gross Revenue Less O&M)**
- **Bonds generally subject to certain covenants:**
 - Rate Covenant: requires certain minimum debt service coverage
 - Additional Bonds Test “ABT”: limits the issuance of additional obligations with claims from the same available revenue
- **Security is ability to raise rates and charges to maintain debt service coverage under Proposition 218 process**

Obligations Imposed by Law (POBs and JOBs)

- **No voter approval since issuer either moves to validate the issuance through the courts or loses a judgment in the courts requiring a payment**
- **Pension Bonds**
 - Money is deposited from the taxable issuance into the pension fund
 - If pension fund returns more than the bond rate, then the issuer can realize budgetary savings
 - If return falls short, bond rate is locked and unfunded liability continues to climb “timing is everything”
 - Prior issues had a promise to pay but, since the Stockton and San Bernardino impairment of POBs in bankruptcy, the market now requires lease structure with security interest in a leased asset
 - Requires judicial validation (court action)

Summary

General Obligation Bonds	Lease Revenue Bonds	Land Secured Bonds	Infrastructure Financing District	Revenue Bonds (Water / Sewer)	Obligations Imposed by Law
Property Tax Surcharge	Annual Budget and Appropriation and "Promise to Pay"	Special Tax or Assessment Levied on the Property Tax Bill	Issuers Property Tax Share	Net Revenue Pledge	Annual Budget and Appropriation and "Promise to Pay"
County required to levy surcharge, unlimited as to rate or amount	Secured by Issuer's General Fund	Land Value Through Foreclosure	Incremental Tax Revenue Over Base Year	Ability to Raise Rates and Charges under Proposition 218	Secured by Issuers General Fund and Leased Asset
2/3rds Voter Threshold	Approved by Legislative Body	Property Owner Consent or Vote (Assessment 50%+1 or Special Tax 2/3rds)	Original IFD 2/3rds, IRFD 2/3rds, EIFD None (55% for Bonds)	Approved by Legislative Body after Rate Adoption	Approved by Legislative Body after Validation