

# California Debt and Investment Advisory Commission Review of Federal Stimulus Programs

Presentation to Contra Costa County School Districts

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# A Brief History of CA School Facilities Finance

- California school facilities finance entered into something of a golden age during the first half of this decade.

Period	Local Bonds	State Bonds
<b>Pre-Prop 13</b> California's Golden Age	Locally approved general obligation bonds required 2/3 vote .	State school building aid for developing school districts.
<b>From Prop 13 to Prop 46</b> Tax Results	Ban on locally approved general obligation bonds lifted by statewide initiative in 1987.	State school bond elections held in alternate years (generally in amounts in the hundreds of millions).
<b>The late 1980s and early 1990s</b> Testing the Waters	Local school bonds attempted by a relatively small percentage of school districts, in relatively small amounts, and with relatively low pass rates (around 40%).	State school facility bonds grew in size and in frequency amounts began to exceed \$1 billion).
<b>The mid to late 1990s</b> Building Momentum	Public support for schools (and school taxes) increased. The number of school districts seeking authorization more than doubled and the passage rate increased from less than 40% to more than 60%.	State school facility bonds increased in size and in percent support.
<b>Prop 39 to date</b> A Golden Age for School Facilities	More school districts placed larger and larger bond measures on the ballot with the passage rate exceeding 80%.	School facility bonds (still held in alternate years through 2006) grew to exceed \$10 billion per measure.

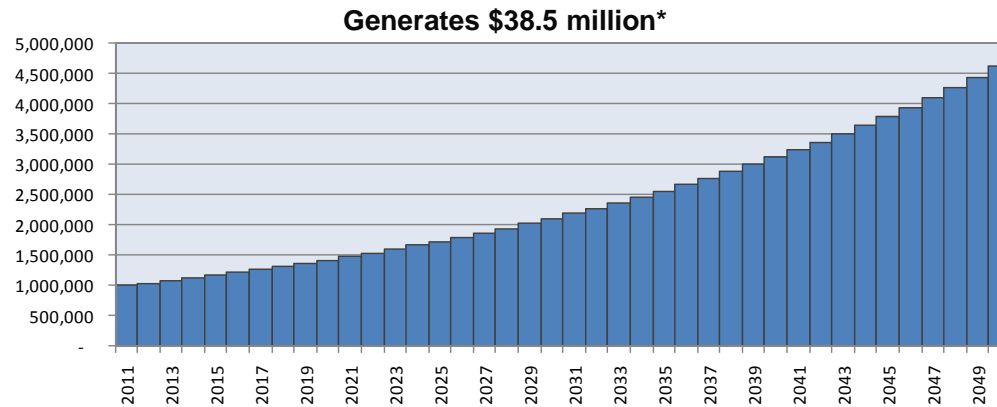
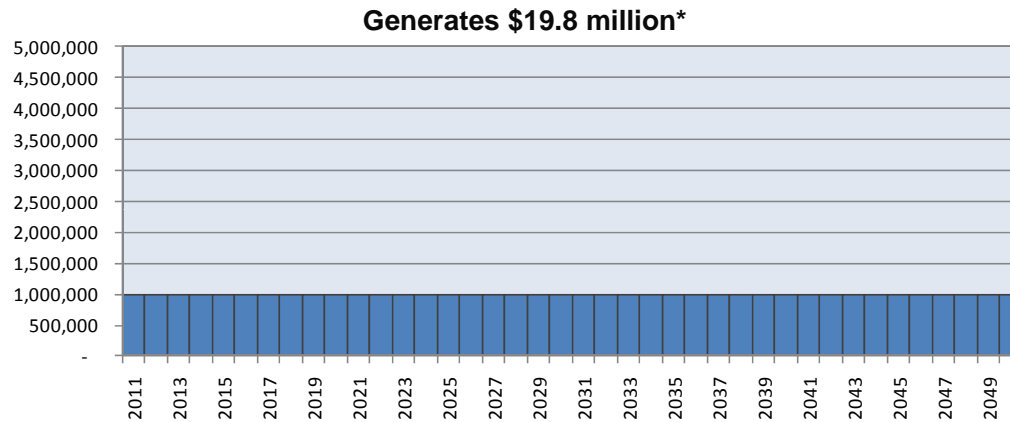
# The Boom Times

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- During this most recent boom, many school districts sought to make up for lost time with regard to facility projects.
  - Some projected that the approval of Prop 39 would usher in a period of an increased number of relatively small bond measures being placed on the ballot with more frequency and less intense campaigning.
  - In many ways, the impact was just the opposite – bond issues increased in size with tax rate impacts frequently at the statutory maximum.
  - Many larger school districts sought multiple authorizations over relatively short periods of time.
  - Many smaller districts sought their first authorization of the post-Prop 13 era.

# Deferred Debt Service

- Deferred debt service programs allowed school districts to accomplish more projects today while depending on future tax base growth to mitigate annual tax rate impact.



\*Hypothetical Scenario.



# Economic Downturn

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- Because of the recent economic downturn, many of these deferred debt service programs have become constrained.
  - For the first year in recent history, state-wide assessed values decreased in tax year 2009-10. County-wide, assessed values decreased by more than 7%, with eleven out of eighteen school districts in the County experiencing declining AVs.
  - When AVs decline, current year tax rates increase as do future revenue projections based on the target tax rate.
  - Under such circumstances, bond programs are challenged to squeeze existing and planned debt service obligations into a reduced revenue constraint.
  - Because so many existing programs are built on relatively aggressive assumptions, the solutions often include slowing the pace of bond issuance.

# Economic Stimulus

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- In developing its economic stimulus package, the federal government sought to avoid potential delays to municipal projects.
  - The stimulus bill included a broad array of tax cuts, benefit extensions, and domestic spending designed to mitigate the impact of the economic downturn.
  - Various spending provisions and incentive programs were developed so that “shovel ready” projects could move forward without delay.
  - Among the incentive programs relevant to local public agencies were the Build America Bond program and the Qualified School Construction Bond Program.

# Build America Bonds

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- Build America Bonds are taxable municipal bonds that carry special tax credits or federal subsidies for either the issuer or the bondholder.
  - BABs can be issued by any public agency choosing to do so through December 2010.
  - Public agencies issuing BABs will pay interest at relatively high rates because investors buying the bonds will have to pay taxes on the interest they receive over time.
  - However, the program is designed to reduce costs in two ways: (1) by having a federal paying a federal subsidy to the public agency and (2) by expanding the buyer base for municipal bonds.
  - The program has been largely successful, with \$64 billion in BABs issued in 2009 (more than 20% of the market).
  - An extension of the BAB program has been proposed, though with a reduction in the subsidy rate (from 35% to 28%).

# BABs Financial Analysis

- In general, an issuer would choose to issue BABs in cases where doing so creates an economic benefit under the desired structure.

	Tax-Exempt Bonds	Build America Bonds (BABs)	Difference
Benchmark Yield:	25-year MMD	30-year Treasury	N/A
Benchmark Yield Level on Feb 2, 2010:	4.09%	4.57%	N/A
Estimated Spread to Benchmark: <sup>(a)</sup>	+0.80%	+2.00%	N/A
Gross Yield:	4.89%	6.57%	N/A
Federal Subsidy	N/A	35% of Interest Cost	N/A
Yield Net of Federal Subsidy:	4.89%	4.27%	0.62%
Par Amount:	\$25,000,000	\$25,000,000	N/A
Total Interest Cost: <sup>(b)</sup>	\$30,562,500	\$26,590,625	\$3,871,875
Present Value (PV) Savings for BABs <sup>(c)</sup> (over tax-exempt bonds):	N/A	N/A	\$2,419,470

(a) Assumes AA-rated California school district bond.

(b) Assumes one 25-year maturity.

(c) Assumes 4% discount rate.

# BAB Limitations

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- At the same time, there are a number of reasons that an issuer might choose not to issue BABs.
  - The benefit is not so large that you would choose to pursue a project that you would otherwise forego or to debt finance a project on which you would otherwise expend cash.
  - The BAB market has been operating most efficiently for larger issues and for longer maturities (though this seems to be changing).
  - BABs typically cost more to issue and are often structured with less flexibility with regard to future restructuring.
  - Certain administrative and risk factors make BABs less attractive than traditional tax-exempts.
  - BAB structures which involve the use of the interest subsidy to pay for anything other than interest on the issued bonds should receive careful independent party legal review.

# Qualified School Construction Bonds

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- Qualified school construction bonds carry special tax credits intended to allow borrowers to achieve a 0% interest rate.
  - QSCBs can be issued only by public agencies receiving special authorization to do so.
  - \$22 billion in QSCB authority was approved by Congress for 2009 and 2010, including \$8.8 billion for “100 large local educational agencies” and \$1.6 billion to be distributed by the State of California over these two years.
  - Investors purchasing QSCBs will receive tax credits from the federal government based on a rate established by the federal government on the date of purchase.
  - Although this tax credit rate was originally intended to be sufficient to allow public agencies to borrow at 0% interest, such has not been the case in practice and issuers commonly pay a “supplemental coupon” to investors.
  - Questions surrounding an investors ability to strip and sell tax credits has reduced the market for these bonds.

# QSCB Financial Analysis

- QSCBs are extremely likely to produce an economic benefit provided that they can be made to fit within the desired structure.

	Tax-Exempt Bonds <sup>(a)</sup>	QSCBs with 0% Supplemental Coupon	QSCBs with 1% Supplemental Coupon	QSCBs with 2% Supplemental Coupon	QSCBs with 3% Supplemental Coupon
Par Amount:	\$25,000,000	\$25,000,000	\$25,000,000	\$25,000,000	\$25,000,000
Structure: <sup>(b)</sup>	Level	Level	Level	Level	Level
Final Maturity:	8/1/2025	8/1/2025	8/1/2025	8/1/2025	8/1/2025
Interest Cost:	\$7,809,092	\$0	\$2,046,150	\$4,184,000	\$6,412,500
Total Future Value (FV) Savings	N/A	-\$7,809,092	-\$5,762,942	-\$3,625,092	-\$1,396,592
Present Value (PV) Savings <sup>(c)</sup> (over tax-exempt bonds):	N/A	-\$5,785,500	-\$4,270,426	-\$2,685,830	-\$1,034,803
Approximate Annual Debt Service Due:	\$2,185,000	\$1,670,000	\$1,805,000	\$1,945,000	\$2,095,000

(a) Based on recently priced bonds.

(b) Assumes no costs.

(c) Based on 4% PV Rate.

# QSCB Limitations

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- Despite their clear economic advantage, there are a number of reasons that an issuer might choose to forego the opportunity.
  - Although there is a clear economic benefit to their use, QSCBs do not represent “free money.”
  - For COPs, the fifteen year limitation on maturity can make annual payments on a general fund supported COP higher than on a longer term non-subsidized financing.
  - For GOBs, the fifteen year limitation on maturity can also create difficulties in fitting in with existing debt structures.
  - For BANs, the issuer takes advantage of only a small percentage of the subsidy.
  - Legal issues complicate more aggressive structures.
  - Only five of the eleven large school districts in California allocated direct authority for 2009 issued QSCBs.

# Common QSCB Structures

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- QSCBs can be structured in a variety of ways in order to accommodate various financing objectives.
  - The BAN structure fits well with the expressed purpose of the program, but does not take full economic benefit of the federal subsidy. For school districts at or near their bonding capacity, the BAN structure creates some degree of risk.
  - Bullet maturities for COPs or GOBs maximize the economic benefit of the subsidy, but can produce difficult structuring issue if part of a larger program.
  - Bullet maturities for COPs can also be used as an interim financing vehicle, and can be especially effective in funding solar energy projects.
  - Structures which involve the sale of QSCBs to third-party JPAs at non-market rates should be receive careful independent party legal review.

# Other Bonds

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- Additional bond structures created (or extended) under the federal stimulus act are less likely to apply to California school districts.
  - New Clean Renewable Energy Bonds are tax credit bonds that can be issued for renewable energy projects by any issuer who receives an allocation from the treasury.
  - (New) Qualified Zone Academy Bonds are tax credit bonds that can be issued for certain purposes by qualified issuers meeting certain conditions.
  - California school districts are not qualified to issue Recovery Zone Economic Development Bonds, Recovery Zone Facility Bonds, or Qualified Energy Conservation Bonds.

# Other Provisions

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- The federal stimulus act contained other provisions intended to improve the marketability of municipal bonds.
  - Expanded bank qualified limit to \$30 million.
  - Eliminated tax-exempt interest as a preference item for purpose of the Alternative Minimum Tax.
  - Reduced restrictions on bank ownership of tax-exempt bonds.

# Where They Work

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- The stimulus bonds work best when they are used to reduce the cost of previously planned financings.
  - School districts planning for a regularly scheduled bond issuance should review whether issuing bonds as BABs will reduce costs.
  - School districts planning on bond issuance toward the end of calendar 2010 or in early 2011 should consider how changes in the BAB legislation might impact the economics of the planned financing.
  - School districts with active bond programs should analyze how having QSCB authority might create economic benefit and should strongly consider applying for QSCB allocations.
  - School districts planning on funding a major capital project without GOB proceeds should also analyze the potential benefit of using QSCBs and strongly consider applying for allocations.
  - School districts considering a major capital project (including solar projects) should review the potential benefit of the various stimulus related vehicles.
  - Stimulus bonds work less well when there is no existing financing plan or when the existing financing plan must undergo significant adjustments in order to accommodate the limitations of the financing vehicle.

