



COMPASS

Deal in the Spotlight

Oakland Unified School District Leads the Way in Implementing Federal Economic Stimulus Funds

The Oakland Unified School District (OUSD) teamed with KNN Public Finance to become one of the first California issuers of new debt financing tools developed by the federal government to stimulate the economy. On July 29, 2009, OUSD sold \$26,320,000 in Qualified School Construction Bonds, \$70,795,000 in Build America Bonds, in addition to \$87,885,000 in tax-exempt General Obligation Bonds. The negotiated sale of \$185 million total par amount successfully closed on August 12th. The funds will be used for a District-wide modernization program to upgrade existing classrooms and add new learning space.

Background on Federal Economic Stimulus Funds

The American Recovery & Reinvestment Act of 2009 recognized an opportunity to stimulate the economy through government construction programs (the "shovel-ready" projects that received so much media attention). Unfortunately, there were constraints for public agencies who sought to implement the construction programs. One was access to investors. In the economic turmoil, many institutional investors had vanished from the market and the remaining investors were looking for highly-rated bonds only.

In order to provide incentives for public agencies to issue debt and to expand the bond buyer pool, the federal government developed a number of different financing tools. Qualified School Construction Bonds (QSCBs) provide purchasers with federal tax credits in lieu of interest payments, which significantly reduces an issuer's cost of borrowing. For a school district, this results in an almost interest-free bond. Build American Bonds (BABs) provide a public agency with a direct federal subsidy payment that results in lower net borrowing costs than the issuance of tax-exempt bonds.

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News and Notes

KNN Schools Finance Conference

KNN Public Finance sponsored its 15th Annual Schools Finance Conference on September 25, 2009 in San Francisco. As always, attendees were drawn to this event by the interesting topics and the opportunity to network with colleagues from around the state.

This year's presentations included:

- 2010 Election Climate – Is There One?
- Life Today as a Municipal Investor
- A New Meaning to Negotiation
- The Media and School District Communication

If you were unable to attend the conference but would like more information on any of these topics, please contact your KNN financial advisor at 510-839-8200.

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Deal in the Spotlight continued...

Steep Learning Curve for District's Finance Team

KNN was intimately involved in the legal structure, investor education, and financial pricing of all three bonds in OUSD's \$185 million transaction. Because OUSD is one of the 100 largest school districts in the nation, identified by a federal poverty index, the District received a direct allocation of the \$11 billion in QSCBs authorized for 2009. Additionally, OUSD decided to take advantage of the BABs program to achieve lower net costs for its taxpayer base. The District sought to obtain these funds to meet construction project timelines for its ongoing modernization program; therefore, the District's finance team and KNN swiftly gained the knowledge necessary to execute the new bonds.

Additional "firsts" for this transaction included:

- These were the first QSCBs and BABs issued in Alameda County.
- This was the first negotiated transaction for OUSD.
- Collecting the federal subsidy for the BABs and properly setting aside tax collections into a sinking fund for the QSCBs are new to the District and the County and will require new and ongoing administrative responsibilities.

The sale was further complicated by the District's low underlying rating ("BBB+" from Standard & Poor's and "Baa1" from Moody's), which could not be augmented by cost-prohibitive bond insurance. Therefore, KNN supported OUSD by outreach to potential investors to develop investor interest in the offering. In May, KNN issued a request for proposals for underwriters and conducted an extensive selection process for the underwriting team. Due to the negotiated nature of this transaction, the interaction with the underwriters and investors was much more direct than OUSD was accustomed to. Over the course of three months, KNN helped provide detailed information to the legal team, the underwriters and the potential investors to ensure investors were comfortable with the credit and would participate in the bond sale.

Results

KNN assisted OUSD in issuing \$185 million in school modernization bonds at a much lower cost to taxpayers. By using QSCBs and BABs, OUSD saved the taxpayers of Oakland over \$19 million in interest costs. While the new

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News and Notes continued...

Presentation on New Debt Financing Tools



KNN Vice President **Ruth Alahydoian** made a presentation this summer to assist public agencies in understanding the new debt financing tools available to the municipal market through federal economic stimulus programs.

School Bonds: Qualified Zone Academy Bonds and School Construction Tax Credit Bonds

[The American Recovery and Reinvestment Act of 2009: Financing Opportunities for California's Public Agencies](#)

Presented with a Panel of Experts

California Debt and Investment Advisory Commission (CDIAC) and California Infrastructure and Economic Development Bank (I-Bank)

June 19, 2009

Deal in the Spotlight continued...

federal financing tools were more complex, KNN succeeded in completing the transaction with a similar turnaround time as required for regular GO bonds.

The QSCBs and BABs are regarded as novel, exciting bond types by underwriters who enjoy the opportunity to explain a municipal bond deal to inexperienced investors. A lesson learned from the OUSD transaction is that BABs and QSCBs entail negotiated sales and more legal documentation and

post-sale requirements than standard GO bonds. A financial advisor is critical to ensuring the deal is structured to provide significant, long-term financial benefits to the public agency and its taxpayers.

KNN Vice President Ruth Alahydoian was assisted on this transaction by Vice President Dan Cox, Assistant Vice President Janice Peters, and Senior Associate Makiko Sato.

Public Finance Best Practices

Financial Management

By David Brodsky, Managing Director

In these articles, we rely on the experience of our financial advisors and, perhaps most importantly, the practices of various clients.

There can be no more ironic timing to discuss Best Practices in Financial Management than in the trough of a major recession. Strong financial management boils down to a few principles, one of which is spending less than you bring in. As local governments continuously scramble to rebalance budgets in the face of bad economic news and assault from the State, the watchword is survival, not excellence.

Although this may not be the year for making progress towards meeting long-term goals, it is a good time to take stock of the inevitable consequences of economic and natural cycles, and to consolidate recent experience. While we know of no agency that was fully prepared for recent economic events, without a doubt, those that had strong financial management practices in place have managed with less disruption of public service, severe impact on their own employees, and execution of budgetary actions from which it will take years to recover.

Best Practices in Financial Management can be summarized by three basic guideposts:

1. Take a long view of your operations.

Multi-year capital planning, budget forecasting and the like are fundamentally a fulfillment of the Oracle at Delphi's aphorism: "Know thyself." The more you understand the drivers of your operation, the more you identify the variables that will govern your destiny, the better you can plan for the future and for the vicissitudes that time will bring.

2. Set aside money out of current revenues for future uses.

Some of these future needs will be likely uses (such as capital replacement or recurring economic cycles) and some will be extraordinary (such as a natural disaster). Government agencies and their constituencies will always have more needs than resources, but only through long-range financial discipline can you assure your ability to meet at least your core responsibilities at all times.

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3. Articulate your principles in written policy.

Written policies are no guarantee of good practice. Some policies are heavy on restating the obvious. Sometimes policies set goals that are rarely or inconsistently met by a particular agency. For example, we know several agencies that do not maintain their stated target fund balance or fail to apply one-time revenues exclusively to one-time expenses. Best practice is to have policies presented to and approved by the legislative body and reported on at least once a year, where adherence to the policy can be confirmed. Many include such reports as part of their budget documents, which accomplishes several goals: it ensures the institutionalization of the practice, allows for integration of such policy decisions with specific budget actions, and makes the policy and practice highly visible to decision makers and the public.

Impact of Financial Management on Ratings

Three years ago, Standard & Poor's introduced a formal financial management assessment as part of its rating process. In doing so, the rating agency formalized what had long been acknowledged by credit analysts and other observers of municipal practices: those agencies that have an institutionalized practice of financial planning tend to have more consistent results. While financial results are paramount, agencies that have formalized policies and practices have a much higher probability of achieving those results.

Standard & Poor's (S&P) evaluates established and ongoing management practices and policies in the following seven areas, which it considers most likely to affect credit quality. Following the category of management practice in S&P's assessment (indicated in bold) are a few of our thoughts on best practices in those areas.

- 1. Revenue and expenditure assumptions.** Rating agencies will always favor "conservative assumptions," which increase the chances of actual results

outperforming a budget. Among the features of "best practice" is clearly articulating key assumptions in budgets and other documents, and drilling down so that those assumptions are aligned with the facts and circumstances of the specific agency, both historic and projected.

- 2. Budget amendments and updates.** The only thing certain about any plan (including a budget) is that reality will be different. Periodic review and adjustment reduces surprises, and makes the inevitable adjustments less traumatic. At minimum, budgets should be reviewed at least once mid-year, and best practice is to have more frequent reviews. This best practice has been legislated for school districts in California, as they are required under the Education Code to produce two interim financial status reports, in addition to their annual budget.

- 3. Long-term financial planning.** While multi-year financial plans are prepared by a minority of agencies, we are seeing more and more of our clients produce financial plans covering anywhere from two to ten years. Such exercises can often reveal the points of financial pressure; it is not uncommon for them to reveal structural imbalance in years beyond the current budget, where expenditure growth outstrips reasonable revenue assumptions. Credit analysts and other informed observers of government practice recognize that long-term forecasts are invaluable tools in helping agencies make the hard decisions early that are required to narrow those gaps, so they can be closed in budget balancing. The first step to any recovery is acknowledging the problem.

- 4. Long-term capital planning.** Because most debt is issued for capital projects, debt and capital improvements are inexorably linked. Capital improvement plans that are realistic and balance debt with revenue ("pay-as-you-go") provide transparency

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Public Finance Best Practices continued...

to future debt expectations, and demonstrate affordability and compliance with existing debt covenants.

5. **Investment management policies.** Following the Orange County bankruptcy filing, state law was changed to require all cities and counties to adopt investment policies. School districts, who by law invest most of their resources with their county, are exempt. However, adoption of a simple policy will still be well received, at least by S&P. Unfortunately, investment policies can also provide the best examples of hollow clichés; all policies place the preservation of capital above all other principles, yet a number of agencies chasing yield were drawn to structured investment vehicles and commercial paper that failed during the recent financial crisis. Among other things, this recent experience is a reminder that investments should not overly rely on ratings.
6. **Debt management policies.** We have seen such policies range from the most simple to long documents including such details as the contents of the request for proposal for procurement of consultants. In our view, the marks of a strong policy are ones that go beyond the basic truisms, and deal with more difficult decisions such as meaningful limits on the amount and type of indebtedness. There are several good model policies available (usually from other agencies), but the provisions of these templates should be carefully considered and adapted so they are appropriate to your agency.
7. **Reserve and liquidity policies.** For cities, counties and school districts, the level of unreserved fund balance is the single most important rating factor under your control; it serves as a form of "warning light" on the credit dashboard. Reserves ensure flexibility in decision making, the ability to respond to unforeseen events, and the ability to manage month-to-month variation in cash flows and year-to-year variation in revenues. Not only do reserves suggest resilience to unforeseen events, they also demonstrate a prior practice of financial discipline in generating the balance and good budget practices.

Many agencies ask "What is the right amount of reserves?" and often look to the rating agencies for an answer. Unfortunately, there is no single answer. Rating agencies can report what the

While S&P has formalized its review of financial management, it is an important factor in both Moody's and Fitch ratings as well. In 2002, Fitch published an article describing its "12 Habits of Highly Successful Finance Officers," which provides a similar checklist worth considering in developing your own practices.

- Fund balance reserve policy/working capital reserves
- Multiyear financial forecasting
- Monthly or quarterly financial reporting and monitoring
- Contingency planning policies
- Policies regarding nonrecurring revenue
- Debt affordability reviews and policies
- Superior debt disclosure practices
- Pay-as-you go capital funding policies
- Rapid debt retirement policies (greater than 65% in 10 years)
- Five-year capital improvement plan integrating operating costs of new facilities
- Financial reporting awards
- Budgeting awards

If you would like further information on any of the topics mentioned above, please contact your KNN financial advisor at 510-839-8200.

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median is for other agencies and even tell you the median by rating level. But, frankly, they don't know what the proper level is; all they know is that more is better. Each government agency must look at its own operations to determine the appropriate level of comfort. Some of the questions you can ask yourself are:

- Historically, what has been the largest drop in revenues you have experienced due to economic or other factors?
- Have you had a practice of unplanned expenditures that might reoccur? These can include costs that might be included under the rubric of "risk management" (such as major claims or natural disasters).

- Have you adequately set aside money for future, known expenditures, such as replacement of aging infrastructure, equipment and computer systems? Many entities address these reserves within internal service funds.

In many ways, the expectations of the credit markets give issuers additional incentive to take the long view; bond investors have thirty-year horizons, well beyond the four-year cycles of local elections. But in truth, the interests of the bond investor and the local constituent really are not in conflict, because the long-term stability of an organization benefits both types of stakeholders. Many financial managers have learned to use the rating agencies and credit markets as allies in building a local consensus around the value of financial discipline.

MSRB Issues Request for Comments Regarding Priority of Orders in Primary Offerings

The Municipal Securities Rulemaking Board (MSRB) is considering a rule change that it hopes will curb "flipping" and that could save issuers millions of dollars in interest each year. A growing chorus of municipal market participants suggests that the practice of "flipping" has recently become rampant. Flipping occurs when bonds are sold to selected buyers during the order period and then shortly thereafter reappear for sale at higher prices and lower yields in the secondary market, in spite of unfilled customer orders during the primary offering period. In these situations, bonds appear to be mispriced at issuance. As a result, issuers incur additional costs as bonds are issued at lower prices and higher interest rates than may be warranted based on subsequent market pricing.

One of KNN's foremost goals is to ensure integrity and accountability in the financing process. Central in each

client engagement is a thorough pricing analysis based upon a myriad of factors. In a negotiated sale, the underwriter selection process is multi-faceted and typically includes a rigorous RFP process, detailed interviews, and evaluation of each firm's recent sales. Further, underwriters are held accountable during the pricing process through referencing pricing from comparable offerings, secondary market trades, and other relevant market intelligence. Moreover, KNN has always been committed to "competitive sales", where appropriate, as a means of providing an objective, transparent, quantifiable pricing solution in order to capture the lowest possible financing rates for our clients.

While there are always a number of avenues to achieve a best-case solution, ultimately KNN's mission is to provide unbiased guidance to secure low interest rates and minimize costs of issuance. This most recent proposal by the MSRB illustrates the challenges the issuer faces in obtaining the best pricing for its bonds, especially in the course of a negotiated sale, and the importance of employing an objective third-party who is regularly in the market, and has the tools and experience necessary to monitor and judge the market.

Federal Stimulus Package: A Guide to the Acronyms

The Federal Stimulus Package offers a great many opportunities for public agencies to finance projects at reduced costs for their constituents. KNN Public Finance professionals are experienced in the execution of these programs and can help your organization to include the new financing tools as part of your overall bond program. Below are brief descriptions of programs that have been introduced or re-emphasized in the past nine months.

ARRA = American Recovery & Reinvestment Act of 2009

According to Recovery.gov, "The purpose of the Recovery Act is to create and save jobs, jumpstart our economy, and build the foundation for long-term economic growth. The Act includes measures to modernize the nation's infrastructure, enhance America's energy independence, expand educational opportunities, increase access to health care, provide tax relief, and protect those in greatest need."

BAB = Build America Bonds

The Department of the Treasury describes these new bonds as "taxable bonds issued by state and local governments, giving them access to the conventional corporate debt markets. At the election of the state and local governments, the Treasury Department will make a direct payment to the state or local governmental issuer in an amount equal to 35 percent of the interest payment on the Build America Bonds. As a result of this federal subsidy payment, state and local governments will have lower net borrowing costs and be able to reach more sources of borrowing than with more traditional tax-exempt or tax credit bonds."

QSCB = Qualified School Construction Bonds

Purchasers of these bonds receive Federal tax credits in lieu of interest payments which significantly reduce an issuer's cost of borrowing. For a school district, this results in an almost interest-free bond. The proceeds from these bonds must be spent on construction, rehabilitation, or repair of a school facility, equipment, or on the purchase of a site for a school facility. ARRA has authorized \$11 billion for 2009 and an additional \$11 billion in QSCBs for 2010. KNN serves as the financial advisor to Oakland

Unified School District, one of just six districts to issue QSCBs nationally as of August 2009.

OZAB = Qualified Zone Academy Bonds

The precursor to the QSCB, a OZAB is a useful bond option for any public school in a federally-designated empowerment zone or enterprise community. Proceeds from these bonds may only be used on rehabilitation or repair of existing school facilities or for equipment, course materials, and teacher training for existing schools. Additionally, the project must receive a matching grant from a local business partner for 10% of the project costs and the project must be associated with a school that promotes college and/or workforce preparedness.

RZEDB = Recovery Zone Economic Development Bonds

RZEDBs are issued as taxable governmental bonds that provide: (1) issuers with a direct federal subsidy of 45% of interest, or (2) bondholders with a tax credit of 45% of interest. Proceeds for RZEDBs must be used in a designated "recovery zone" for a "qualified economic development purpose," which includes expenditures for public infrastructure, facilities, job training, or educational programs, amongst others. Cities and counties are therefore able to borrow at interest rates that are more favorable than even traditional tax-exempt bonds.

RZFB = Recovery Zone Facility Bonds

RZFBs are issued as tax-exempt private activity bonds (not governmental projects) that must be used for "recovery zone property," which is further defined in the Act. Permitted RZFB borrowers include counties, cities and for-profit private companies. These securities allow them to borrow at tax-exempt interest rates for the purpose of economic development. Such bonds would be issued as conduit bonds through a governmental issuer and are also subject to a volume limitation.

As your financial advisor, KNN has developed elaborate models for our clients' bond programs to help them comprehend the big picture impacts of issuing new bonds. Our objective is to keep your entire capital planning program intact. We seek the opportunity to work with you to evaluate the options available and find the best way to fit one of the ARRA bonds into your existing debt program. **Call one of our experienced financial advisors today at 510-839-8200.**

Meet Our Professionals



Janice Peters

Assistant Vice President

Janice joined the firm in 2005. She currently serves county, city and school district issuers. Janice's experience includes structuring General Obligation Bonds, Certificates of Participation, Lease Revenue Bonds, and Tax and Revenue Anticipation Notes (TRANS). She also performs quantitative analysis in the context of evaluating debt affordability and refunding opportunities.

Janice has worked with large, complex California issuers such as the Los Angeles Unified School District and Oakland Unified School District, and has participated in the San Diego School District TRAN program, which included 15 districts in one issuance. Most recently, she assisted with the \$95.41 million Kern County Certificates of Participation and \$34.27 million City and County of San Francisco Lease Revenue Bonds. She also helped the McKinleyville Union School District in their first bond sale ever with the issuance of \$7 million of General Obligation Bonds.

Prior to KNN, Janice served as an Equity Research Associate for Salomon Smith Barney, performing economic, financial and operational analyses for the metals and mining industry on projects in North America, South America, Africa, Asia, and Australia. In addition, she worked at Prudential Securities doing equity research for the capital equipment industry.

Janice earned her B.A. in Business/Economics from the University of California, Santa Barbara. Janice enjoys traveling the world, running, hiking, and relaxing in the great outdoors.



Cindy Gallardo

Administrative Assistant

Cindy joined KNN Public Finance in 2007. Her voice is the first one that callers hear when they contact the firm. She also engages in a wide variety of administrative activities, including ordering office supplies and maintaining the firm's filing system. She makes travel arrangements, compiles expense reports, and creates invoices for each transaction the firm completes.

Cindy was born and lived in the Philippines for 17 years before coming to the United States. She is fluent in Tagalog. She enjoys spending time with her family, especially with her son and her three beautiful nieces. She loves music: listening to alternative modern rock, singing karaoke, learning to play the acoustic guitar, and playing the piano. She is currently into social networking and loves reconnecting with old friends.

Prior to joining the firm, Cindy served as an administrative assistant for a variety of East Bay companies for 16 years and attended Chabot College.

2009 Second Quarter Transactions

Issuer	Type/Purpose	Sale Date	Par Value
City of Fresno	2009 LRB, (Police and Fire Master Lease Projects)	4/2/09	\$43,385,000.00
Kern County	2009 COP, Series A	4/7/09	95,410,000.00
California Board of Public Works	LRB 2009 Series A, B, C, D	4/8/09	435,145,000.00
Tracy Unified School District	School Facilities Improvement District #3 Bonds, Election of 2008, Series 2009	4/21/09	12,000,000.00
California Board of Public Works	LRB 2009 Series E, F	4/22/09	206,830,000.00
California State University	Northridge Corp. Student Union Food Service Renovation CP	5/5/09	2,459,000.00
City of Oakland	Tax Allocation Bonds, Series 2009T (Federally Taxable) (Central District Project)	5/6/09	38,755,000.00
Santa Clara County	GOB (Election of 2008), 2009 Series A	5/11/09	350,000,000.00
Pittsburg Unified School District	2009 GOB, Election of 2006, Series B	5/12/09	35,000,000.00
Bellevue Union Elementary School District	GO Bonds, Election of 2008, Series A	5/14/09	6,500,000.00
California State University	San Bernardino Health Center CP	5/20/09	6,006,000.00
Berkeley Unified School District	2009 GOB	5/26/09	17,774,222.00
City of Santa Barbara	2009 Airport Revenue Bonds	5/27/09	47,270,000.00
Oak Grove School District	2009 Ref GOB	5/27/09	8,390,000.00
Oak Grove School District	GOB Election of 2008, Series A (CABs)	5/27/09	19,999,922.80
Oak Grove School District	GOB Election of 2008, Series A (CIBs)	5/27/09	10,000,000.00
California State University	Fullerton Parking Structure #4, Phase 1 CP	6/4/09	14,530,000.00
Susanville School District	GOB Election of 2008, Series 2009 (CIBs)	6/9/09	4,240,000.00
Susanville School District	GOB Election of 2008, Series 2009 (CABs)	6/9/09	259,904.55
Orange County	2009-2010 TRAN	6/10/09	150,000,000.00
City of San Jose	2009 GOB	6/16/09	9,000,000.00
City of Los Angeles	Judgment Obligation Bonds, Series 2009-A	6/23/09	20,600,000.00
Fresno County	2009-10 TRAN	6/23/09	95,000,000.00
Albany Unified School District	2009 Ref GOB	6/25/09	7,290,000.00
Albany Unified School District	GOB, Election of 2008, Series A	6/25/09	10,000,000.00
Total Par			\$1,645,844,049.35



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