



Public Finance Perspectives

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**Now that's
A Bright
Idea**

Managing Your Debt

Considering debt restructuring and method of sale

The need to restructure debt can come about in many different ways. One cause is a sudden drop-off of in the real estate market. During a real estate boom school districts must keep up with the enrollment growth that is associated with new housing. To fund the new schools, districts can levy special taxes, but more commonly, they receive developer fees. Developer fees are not paid upfront though; the fees are paid as homes are constructed.

In order to fund new school construction costs, school districts will often issue Certificates of Participation (COPs) that are secured by the general fund. This debt is structured so that payments can be made by the projected developer fee revenues. If, however, the booming real estate market busts, developer fees stop coming in then school districts are forced to use other general fund contributions to make COP debt service payments. This is, of course, problematic.

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Solar Possibilities

Alternatives to high energy costs

As energy prices continue to rise, school districts face the problem of ever increasing energy bills. But there may be a solution. Recently the idea of school districts using solar power as an alternative energy source caught our interest.

After looking into this possibility a little deeper, we discovered two possible ways for districts to make use of solar power. The first is to enter into a Power Purchase Agreement (PPA) with a solar power company. In a PPA, the company aids in the design and facilitates the installation of the solar array at the district's site. The initial cost may be higher, but repairs, maintenance, and operation is all managed by the solar company, and yearly cost can be locked in at a fixed rate.

The other option is that the district may own a solar power system. Ownership requires tax-exempt financing through a capital lease, with the district making fixed payments over a period of time. Although the price would be cheaper than entering into a PPA, the maintenance and operation of the system lies directly with the district.

In either case, there are several things to consider about the financing of a solar powered energy system:

- the initial cost of installing the system,
- projected repair and maintenance costs,
- annual payments that repay the debt financing,
- the projected rise in energy costs over the life of the debt financing.

If solar energy seems like an alternative to higher energy costs that your district would like to pursue, obtain financial advice on whether solar energy is a cost efficient possibility and request a financial analysis to determine what type of energy deal may be the most efficient, as well as how it may be financed.



"In an unstable market, such as we are currently experiencing, an issuer cannot be too hasty when deciding on the method of sale."



News Flash! Redevelopment Problems

A few mistakes you may have overlooked

The path that redevelopment pass-through payments travel is very complex. But for such an important area of government as redeveloping blighted areas, there seems to be, although they are accidental, too many mistakes made throughout the process.

The State Controller's Office has recently revealed the findings of a study that showed an inordinate amount of accounting mistakes being made by Redevelopment Agencies (RDAs) across the state. Within the complex calculations, there are principally two areas where mistakes are made. The first one is within the calculation for redevelopment pass-through payments themselves. The second is the way in which the redevelopment pass-through payments are distributed to the district.

These mistakes have not only cost the state millions of dollars, but some areas have not received their full share of the redevelopment payments as well. Lawmakers have decided that these mistakes can no longer be tolerated. Currently they are working on amending a bill (SB 360) that would give the responsibility of making RDA pass-through calculations to the county auditors instead of leaving it with the over 400 different RDAs.

If your district has experienced inconsistencies with redevelopment pass-through payments, or lack thereof, Capitol PFG can assist in recalculating what the district is entitled to based on your district's redevelopment formula.

The Present Problems Continued from page 1

Recently, Western Placer Unified School District had a challenging financial need with five outstanding COPs, totaling \$128 million, and only a \$50 million general fund budget. Additionally, all of the District's COPs had variable interest rates, which exposed the District to market and interest risk.

Western Placer USD was one of the fastest growing districts in the state and relied on Mello-Roos taxes and developer fees to fund their rapid expansion. But, when the flow of developer fees slowed, their projected debt obligation quickly became larger than their revenue projections. In order to minimize the impact on the District's general fund, Western Placer USD looked to restructure their debt and meet four objectives:

- (1) refinance the COPs into long-term fixed rates;
- (2) maximize affordability from repayment revenue sources other than the general fund;
- (3) structure a responsible financing plan that will allow for repayment;
- (4) allow for transparent and thoughtful transactions.

The trouble with variable rate debt

Variable rates often seem like a good idea because of the low interest rate that the issuer pays in the short run. However, as the economy changes, so does the rate. It is very possible that the issuer will end up paying more money and at a higher rate than if they had locked in at a fixed rate in the first place. So, despite the lure of immediate low rates, a variable rate for long

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FYI

Financial advisors that are associated with investment banks are usually more bond market oriented and may not necessarily be creating financial solutions from the perspective of the school district.

Have you heard the news?

Capitol PFG competitively sold the first TRAN of year! Santa Clara Unified School District received seven bids for their \$13 million dollar TRAN. Bank of America won the bid with a low true interest cost of 1.6511%.

The Present Problems: continued

term financing may not be the best choice for school districts. Moreover, the credit crunch has caused many traditional letter of credit providers to be unwilling or unable to continue to provide letters of credit (LOC).

Variable rate debt relies on LOCs to provide investors with certainty that there will be a market to resell the debt when the interest rate is reset (usually every 7 or 30 days). In the event of a credit rating downgrade of a LOC bank or the unwillingness of a bank's renewal of an existing LOC, the market for variable rate debt can evaporate, which may cause a variable interest rate to hit the default interest rate, which can be as high as 12%!

Why competitive sales may not yield the best results

The municipal initial public offering market is creating additional challenges for bond issuers. Many financial advisors will tell you that a competitive sale will produce the best results when selling municipal debt. In a stable market, this is often the case. But in an unstable market, such as we are currently experiencing, an issuer cannot be too hasty when deciding on the method of sale.

Competitive sales typically give the issuer the best possible pricing because, true to their name, investment banks are competing to buy the debt. By submitting interest rates for which the investment banks are willing to buy the debt, not only can the issuer decide between many different options, but the interest rates offered are lower due to competition.

But in a non-competitive market, a negotiated sale may be a better choice. Just as an auction with only one or two buyers will not yield much profit, a competitive sale with only one or two bids will likely not produce the best result.

In the current unstable market, there are fewer banks willing to commit capital to buy municipal bonds without first obtaining commitments from bond investors. Investment banks are opportunistic, and will submit expensive interest rates when they suspect a new debt offering will receive only 1 or 2 bids. In a negotiated sale, the issuer and investment bank negotiate over pricing, which includes the interest rate, underwriter's discount, and expenses. Bond pricing can be tricky as only financial advisors who are experienced with evaluating the pricing process will have the knowledge and experience necessary in order to evaluate whether the District received the best possible pricing.

Despite the market's current state, it is still possible to secure three or more bids in a competitive sale. But unless you are absolutely positive that your sale will produce at least three bids, our advice is to think about a negotiated sale and retain an experienced financial advisor to structure the debt and manage the pricing process. If done correctly, your financial advisor and underwriter should be able to work amicably together.

Western Placer USD's Approach

In order to achieve the best results for Western Placer USD on their debt restructuring, Capitol PFG recommended a negotiated sale. Even a negotiated sale can host a little bit of competition, though. Instead of simply appointing an underwriter, Capitol PFG solicited proposals from five underwriting firms, including bids for the underwriting discount (the fee charged for underwriting services). This helped to reduce the cost impact on the school district. But, when considering different investment banks, the financial advisor cannot simply look at the proposed underwriter's discounts. There are several other factors that must be taken into

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Other criteria revised in 2001 included:

- Lease and appropriation
- School and other state enhancement programs
- Special tax
- State revolving funds
- Liquidity
- Bond anticipation notes

Restructuring the Debt Concluded

consideration, including interest rates and the original issue discount (an additional fee that goes to original investors).

An experienced financial advisor should be able to evaluate the different factors associated with pricing, and manage the sale in a way that ensures a financing that represents the issuers best interest. After interviewing several investment banks, Western Placer USD decided that M.L. Stern would best suit the District's needs. However, even after deciding on M.L. Stern as the investment banking firm to buy the bonds, getting the best deal possible is still no easy task.

Securing bond insurance in a market where there are only two bond insurers, compared to the seven it once boasted, is a challenge. The lack of competition between bond insurers allows them to only insure those bonds that they decide are very low risk and can generate good compensation. Cost Effective bond insurance was available because Western Placer was able to receive a credit rating upgrade from Standard & Poor's.

The sale, which took place on June 5, yielded a positive outcome for the District. Western Placer was able to sell their restructured COP with a 40 year term and a **true interest cost** of approximately **5%**.

Upward Trends in Credit Ratings

Upgrading your rating in a poor market

Of course everyone wants their credit rating to be upgraded. The appeal comes from the fact that with a higher rating, issuers will be able to get better borrowing rates and cheaper bond insurance. Some people may think however, that because of the economy and the bond market's current condition, it would be very hard, if not impossible, to attain a credit rating upgrade. This is simply not the case.

Since 2001, Standard & Poor's has revamped their credit rating system. Their new approach has allowed many organizations, especially public entities, to receive credit rating upgrades despite the current economic slow-down. S&P concluded that many governments would have the capabilities to attain a higher rating, specifically if the public entity had sound management practices.

In the time since that change, there have been approximately three times as many upgrades as downgrades. And in the last six months, we have seen an accelerated trend of upgrades. Within the last several weeks, a number of our clients have received credit rating upgrades including Western Placer Unified School District, Auburn Union School District, and Dry Creek Joint Elementary School District.

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