School Services of California INC.

The FISCAL REPORT an informational update

BOND FINANCING - A FUNDING ALTERNATIVE

by Lori Raineri

Since the passage of Proposition 13 in 1979, school districts in California have had to rely on the state to fund school construction through the State School Building Lease Purchase Program, a program funded primarily by state bond issues. In recognition of the need for school districts to address their problems on a local level, much legislation has been passed in the aftermath of Proposition 13 that provides school districts with the authority and the methods to issue their own bonds. School districts may now issue general obligation bonds, lease revenue bonds, certificates of participation, Mello-Roos bonds, and notes.

School districts should explore bond financing options with respect to all capital projects and equipment purchases. Not only does bond financing offer an **additional** source of funds but, for many school districts, it is a **better** alternative. School districts may issue "tax-exempt bonds," meaning that the interest on their bonds is exempt from federal and state income taxes. The capital marketplace reflects the advantage of tax-exempt income by placing a lower yield on tax-exempt bonds than on other types of investments. This means that the tax-exempt bond market may be the least expensive source of funds for a school district.

TYPES OF DEBT INSTRUMENTS

GENERAL OBLIGATION BONDS

A general obligation bond issue is a debt which is secured by the full faith and credit of the issuer and its taxing power. General obligation bonds are the most traditional form of municipal debt and generally carry a relatively low interest cost. Proposition 13 eliminated general obligation bonds as a financing vehicle in California. However, Proposition 46, adopted in June, 1986, permits the issuance of general obligation debt with a 2/3 voter approval. Since general obligation bonds are supported by tax revenues, a district must have sufficient debt service coverage from current tax revenues or increase taxes accordingly. The election process addresses these issues while preserving local control. The Education Code imposes a limitation on the amount of general obligation debt which can be issued by a school district. A unified school district can issue bonds equal to 2.5% of the assessed valuation of the taxable property within the district; other school districts can issue up to 1.25% of the assessed valuation.

April 24, 1987

LEASE REVENUE BONDS

Lease revenue bonds are a limited obligation of the issuer. The issuer pledges the revenue due under a lease to bondholders. The Education Code provides for the financing of school facilities through lease revenue bonds issued by a nonprofit corporation. A school district must have a construction site for the proposed facilities. A nonprofit public benefit corporation is formed for the purpose of constructing the required buildings on the site and leasing the buildings to the school district. The nonprofit public benefit corporation may issue lease revenue bonds to raise funds for construction, and the bonds will be secured by the lease payments to be made by the school district.

CERTIFICATES OF PARTICIPATION (COPs)

A certificate of participation is a negotiable security sold in the municipal market similar to a municipal bond. Each certificate represents a proportionate share in lease payments (interest and principal) from a municipal entity, such as a school district. In many respects, certificates of participation are similar to lease revenue bonds; however, because Proposition 13 restricted the ability of local governments to issue bonds, certificates of participation became widely used as a method of avoiding some of these restrictions. Certificates of participation are generally the most efficient method of lease-purchase financing due to the tax-exemption and the demand among municipal investors for this type of security. Certificates of participation are used for efficient lease-purchases of equipment, as well as a method of capital project financing. Essentially, certificates of participation allow school districts to access the capital markets for funding without the restraints imposed on bond financing and the ability to raise revenues imposed by Proposition 13.

MELLO-ROOS BONDS

Mello-Roos bonds are one of the most recent developments in school finance. The Mello-Roos Community Facilities Act of 1982 enables school districts, through the establishment of a Community Facilities District, to issue bonds to finance new school construction and to repay the bonds through a special Community Facilities District tax levy. School districts can establish a Community Facilities District, which encompasses the area to be served by proposed school facilities. The Community Facilities District has bonding and taxing authority so that it can issue bonds to finance new school facilities or services, and the bonds will be repaid by a special tax levied by the Community Facilities District. In a Mello-Roos bond financing, users of financed facilities pay for those facilities through the payment of a special tax. The special tax levy must be approved by a vote of 2/3 of the eligible voters. However, if less than 12 registered voters reside within the proposed Community Facilities District, the vote shall be by the landowners of the proposed Community Facilities District with each landowner having one vote per acre. This lends itself to establishing Community Facilities Districts in developing or rehabilitating areas. For example, a community may have a proposed single-family home development which may require a new elementary school to serve the new families moving into the community. The development area may be established as a Community Facilities District during development, by a vote of the developer/landowner, to provide financing for the new elementary school. When the development is completed and the homes are sold, the new homeowners will repay the bonds through payment of the special tax. Hence, the residents of the community who actually benefit from the new school pay for it, relieving the entire school district community from having to bear the cost of growth in other areas of the district.

SHORT TERM NOTES

Many school districts are already familiar with short-term tax-exempt financing through the issuance of notes. Short-term financing is used to cover a cash shortfall created by uneven matching of revenue collections and required disbursements. School districts may finance such cash flow deficits with tax and revenue anticipation notes (TANs and TRANs) which would be secured by any taxes, income, revenues, cash receipts or other moneys of the district received in a single fiscal year.

SOME CAUTIONS TO CONSIDER

Because of the fixed costs involved in issuing bonds, it is often not feasible for school districts to issue debt in amounts less than $1 million. Furthermore, the larger the debt issue the larger the relative savings on the costs of bond issuance. Therefore, pooled financing can be very effective for small school districts. A pooled financing is one where several school districts join together to issue bonds, making the total bond size large enough to realize an economy of scale. Attorneys, consultants, trustees, and investment bankers have minimum levels of compensation which may not be supportable in a $500,000 bond issue. However, for a transaction in the $100 million range, most members of the financing team would be willing to take a lower per bond fee due to the bond volume. Furthermore, as a pool issuer does more transactions and develops name recognition among investors, new issues will be well-received in the marketplace. This may produce a lower interest rate than the issue of an individual school district, due to the district's inability to attract as much market attention.

It is important for school districts to tread carefully when issuing bonds. The structuring of a bond issue is not a simple task and involves a large cast of characters--including a bond underwriter, a bond counsel, and occasionally a financial advisor. A poorly structured bond issue could cost a school district over a million dollars during a 25 or 30 year bond term. Furthermore, many school districts have never done a bond issue and need to educate themselves about bond financing to avoid a poorly designed bond issue. Therefore, while bond financing is an exciting alternative, it is a course of action which will impact a school district for years, and should be carefully examined.

Lori Raineri is Vice President of Cranston Securities Company in Los Angeles.

Reprinted with the permission of *The Fiscal Report*.