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OFFICE OF THE
CITY TREASURER

THOMAS P. FRIERY
TREASURER

DONALD E. SPERLING
ASSISTANT TREASURER

CITY OF SACRAMENTO
CALIFORNIA

800 TENTH STREET
SUITE ONE
SACRAMENTO, CA
95814-2688

916-449-5318
OPERATIONS

916-449-5168
INVESTMENTS &
ADMINISTRATION

916-448-3139
DEX TRANSCEIVER

November 1, 1988

Budget and Finance/Transportation and Community
Development Committees
Sacramento, California

Honorable Members In Session:

SUBJECT: Policy Regarding Use Of 1915 Act Special Assessment
And Mello Roos Bonds

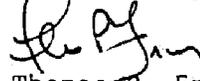
SUMMARY

The attached report recommends approval of an amendment to City policy regarding issuance of 1915 Act bonds to include, in certain instances, the use of 1915 Act and Mello Roos bonds to finance improvements of assessment districts that are less than 60 percent developed.

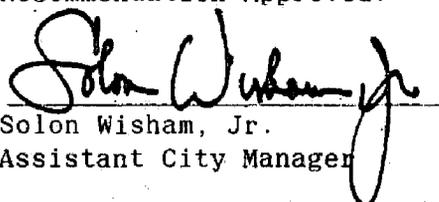
RECOMMENDATION

It is recommended that after hearing the attached report, the joint Committees recommend adoption and forward the report to the full City Council.

Respectfully submitted,


Thomas P. Friery,
City Treasurer

Recommendation Approved:


Solon Wisham, Jr.
Assistant City Manager

November 9, 1988
All Districts

Attachments



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City Council
Sacramento, California

Honorable Members In Session:

SUBJECT: Policy Regarding Use Of 1915 Act Special Assessment
And Mello Roos Bonds

SUMMARY

City Council adopted policy guidelines in 1980 authorizing the issuance of 1915 Act bonds for three types of special assessment districts: 1) districts where the City is paying a substantial part of the cost of improvements, 2) districts where little or no City contributions are involved and the area is from 60% to 100% developed, and 3) districts requiring trunk sanitary and storm sewers and water mains in areas of little or no development.

Since adoption of these policy guidelines, changes have occurred both to California law and the market for special assessment bonds. For example, in 1982 the Mello Roos Community Facilities Act was passed allowing municipalities to form and issue debt for districts that provide public improvements and services of general rather than specific benefit to property owners. Also, issuers were given the ability to issue limited obligation 1915 Act bonds in 1987. Finally, market interest in 1911 Act bonds has diminished because of a lack of investor interest in projects financed with 1911 Act bonds. Greater interest by investors for 1915 Act and Mello Roos bonds surfaced primarily because of their affordability, technical structure and marketability.

Relative to other California cities and counties, Sacramento has taken a less significant role in total assessment district financing than it had in 1980. Primarily, this is a result of the increasing use of 1915 Act and Mello Roos bonds by municipalities to finance local public improvements. For example, as of June 30, 1978 the City had issued approximately 7.4 percent of all assessment bonds outstanding in California. At that time Sacramento was the third largest issuer in the State. As of June 1987, the City's relative position statewide had declined to 1.3 percent. The City's decreasing volume of special assessment bonds in relation to other issuers is further evidenced by the fact that the City issued less than 1.0 percent of all assessment bonds issued in California from 1982 through 1987.

Finally, it was not envisioned in 1980 that Mello Roos and limited obligation 1915 Act improvement bonds would become available to issuers nor that there would occur a greater commitment by cities and counties to permit land development. These changes were predicated primarily upon the lack of available conventional financing due to historically high interest rates, the precarious position of the banking industry in general and the sharply increasing cost of land development.

This current trend toward development of large land areas required financing of substantial public improvements and presented a new challenge. The scope of the City of Sacramento's policy does not provide suitable public improvement financing options for this kind of development. Therefore, it has become necessary to update the City's policy for issuance of 1915 Act and Mello Roos bonds to reflect the changes that have occurred to state law and the market for special assessment bonds.

BACKGROUND

Bonds for special assessment districts have been issued by the City to finance two types of projects. The first type of project provides improvements to an existing neighborhood. The second type of project provides improvements to undeveloped land. Improvements to undeveloped land fall into two subcategories. Improvements may be for a subdivision of a private developer(s) or for sewer and water trunk facilities serving several subdivisions. Policy guidelines approved by City Council March 18, 1980 specified the circumstances and type of district that 1915 bonds could be issued.

In 1980, the City had about \$27 million par value assessment district bonds outstanding, representing 7.4 percent of the total \$363.4 million city and county assessment bonds outstanding in California. At that time, Sacramento was the third largest issuer of assessment bonds in California, behind Stockton and Santa Clara. However, as of June 30, 1987, Sacramento had increased bonds outstanding to only \$33.7 million, while the statewide total increased nearly seven times to \$2.51 billion. (Table 1) Sacramento's share of total city and county assessment bonds outstanding statewide had declined to 1.3 percent. On a statewide basis, Sacramento's relative exposure compared to other issuers has been significantly reduced.

Table 1
 Assessment Bond Outstanding
 June 30, 1987
 (000's Omitted)

	<u>1911</u>	<u>1915</u>	<u>Mello Roos & Other</u>	<u>Total</u>
Cities	\$ 74,961	\$2,151,010	\$159,524	\$2,385,495
Counties	<u>49,291</u>	<u>60,948</u>	<u>14,686</u>	<u>124,925</u>
Statewide	\$124,252	\$2,211,958	\$174,210	\$2,510,420
	=====	=====	=====	=====
Sacramento	\$ 6,426	\$ 27,259	-0-	\$ 33,685
% of State	5.2%	1.2%	0.0%	1.3%

The decline of the City as a major issuer of assessment bonds is further emphasized by issuing trends from 1982 through 1987. As shown in Table 2, Sacramento issued only 1.0% of all assessment bonds during that six year time period. It is also important to note from Table 2 that the majority of assessment bonds now sold are either 1915 Act or Mello Roos bonds. Investor interest in 1911 Act bonds has diminished to the point where only about five percent of assessment bonds issued are 1911 Act bonds.

Table 2
 Assessment Bond Issued
 1982 - 1987
 (000's Omitted)

	<u>1911</u>	<u>1915</u>	<u>Mello Roos</u>	<u>Total</u>
Statewide	\$154,550	\$2,936,450	\$507,100	\$3,598,100
Sacramento	12,761	23,187	-0-	35,948
Percent	8.3%	0.8%	0.0%	1.0%

Tables 1 and 2 are also indicative of market trends of investor preference for 1915 Act and Mello Roos bonds over 1911 Act bonds. From an issuers perspective, changes to California law in 1987 have increased the attractiveness of issuing 1915 Act bonds because of the ability to limit City obligation in the event of default by property owners. Further, the introduction of the Community Facilities Act of 1982 (Mello Roos bonds) has increased the scope of improvements which can be financed directly by property owners.

LEGAL AUTHORITY TO ISSUE BONDS

California has several laws permitting the formation of assessment districts to finance public improvements. Three statutes are commonly used by the City for assessment district financing. Each Act has advantages and disadvantages depending on the type of district being formed and the extent of improvements to be financed.

- The Improvement Act of 1911, ("1911 Act") specifies procedures for district formation and authorizes the issuance of bonds.
- The Municipal Improvement Act of 1913, ("1913 Act") specifies a procedure for establishing assessment districts.
- The Improvement Bond Act of 1915, ("1915 Act") authorizes the issuance of bonds.

1911 ACT

Improvements financed under the 1911 Act procedure must be completed and in place before an assessment is levied or bonds issued. An advantage of the 1911 Act is that all costs are known and improvements are in place at the time the assessment is levied on property owners. The disadvantage of using 1911 Act proceedings is that the contractor/developer must finance the cost of construction before bonds are issued. Where substantial improvements are required, this provision either reduces the number of contractors that can bid on the project or makes development impractical.

Bonds issued under the 1911 Act have as their security specific parcels of property in the district. Assessments are determined based on the benefit the parcel receives from the improvements. Bonds are issued based on the unpaid assessment levied against the parcel of property. Therefore, bonds are likely to be for different amounts depending on the particular parcel of property securing the bond.

1911 Act bonds are subject to the following limitations:

- The stated interest rate may not exceed 12% per year.
- Principal is payable on January 2. Interest is payable on January 2 and July 2.
- Bonds may be sold at a discount.
- Property owners may prepay the outstanding assessment at any time upon payment of interest due and a premium to the bondholder.
- The maximum maturity is 24 years.
- Bonds must be serial bonds. A portion of the principal matures annually.

The Treasurer delivers the bonds to the contractor as payment for the improvements constructed. If the contractor has made arrangements for sale of the bonds, then the bonds are delivered to that buyer. The Treasurer also has the authority to bid on the bonds and take delivery of them into the City treasury. If the City purchases 1911 Act bonds, they must be purchased at par.

Where the contractor does not take delivery of the bonds, the purchase price is paid to the contractor by an underwriter by previous agreement as full payment for the work performed.

1913 ACT

The procedures for creating an assessment district and levying assessments under the 1913 Act are similar to those under the 1911 Act. The major difference between the two Acts is that the 1913 Act provides that improvements may, but need not be completed before bonds are issued. Therefore, assessments levied under the 1913 Act are often based on estimated construction and incidental amounts. Bonds are sold by competitive bid or on a negotiated basis. The contractor is paid out of bond proceeds as the construction progresses.

1915 ACT

The Improvement Bond Act of 1915 authorizes the issuance of bonds. Proceedings of either the 1911 Act or 1913 Act may be used in conjunction with bonds issued under the 1915 Act. Bonds issued under the 1915 Act differ from 1911 bonds in that security for the bonds is the aggregate of the liens on all the parcels within the district. Bonds are not associated with individual parcels of property. Therefore, the City may establish the denomination and the dated date of the bonds issued under the 1915 Act.

1915 Act bonds may mature in equal annual principal amounts unless the City specifies otherwise. Bonds are sold by competitive bid or on a negotiated basis with a maximum interest rate as specified by law. Bonds may also be issued with a reserve fund not exceeding 10% of par bonds issued.

1915 Act bonds are subject to the following limitations:

- The stated interest rate may not exceed 12% per year.
- Principal is payable on September 2. Interest is payable on March 2 and September 2.
- Assessments may be prepaid at any time upon payment of the entire assessment and a premium to the bondholder.
- The maximum permissible maturity is 39 years. However, current market conditions are supporting maturities of from 20 to 25 years.
- One year of Capitalized interest may be funded. After January 1, 1989, it will be possible to fund up to two years of Capitalized interest.
- The issuer may be reimbursed from the district for collection and administration expenses and to replenish the Reserve if delinquencies occur.
- Bonds are issued serially in \$5,000 or multiples thereof.

In the past, the City stood behind 1915 bonds and guaranteed their payment from available funds of the City. However, legislation passed in 1987 has given an issuer the choice of whether to advance available funds or to allow the bonds to go into default should property owners not pay their assessments. Upon adoption of the resolution of intention, the City determines whether it will obligate itself to provide money from legally available funds to pay bondholders in the event sufficient money is not available in the Redemption or Reserve fund.

MELLO ROOS COMMUNITY FACILITIES ACT

In addition to the three Acts, the Mello Roos Community Facilities Act of 1982 was passed to allow a broadened range of public facilities that could be constructed with special assessment financing. In addition to those public improvements which may be financed under the three Acts, schools, libraries, police and fire facilities, ambulance services, maintenance and services may all be financed with proceeds from Mello Roos bonds.

The Mello Roos Act is similar to the improvement bond acts in a number of ways. Both provide a vehicle for generating a source of revenue to pay for public improvements. In both cases the land being assessed or taxed is the ultimate security for the bonds. Both acts provide for fast foreclosure proceedings in the event of delinquency, and both have provisions for a reserve fund.

A major difference is that Mello Roos bonds may be used to finance a broader list of improvements. Where the 1911 and 1915 Act bonds enforce a fixed lien against the property, the Mello Roos Act authorizes the levy of an annual tax, the amount of which is adjustable within certain limits. In many cases, the formula for the special tax is based upon land use, the level of development or a combination of these factors.

CURRENT ASSESSMENT DISTRICT POLICY

The current City policy affecting special assessment bonds was adopted March 18, 1980. Three main district categories were approved by Council for issuance of 1915 bonds.

- Districts where the City is paying a substantial part (75%) of the cost of improvements.
- Districts where little or no City contributions are involved and the property is from 60% to 100% developed with homes or businesses.
- Districts requiring trunk sanitary, storm sewers and/or water mains in areas of very little or no development.

1915 Act bonds are issued with a reserve fund as recommended by the underwriter and City Treasurer but not to exceed 10% of total par bonds. Also, 1915 Act bonds state the call premium and include a fast foreclosure procedure in the event of delinquencies.

A district where the City is subsidizing a substantial (approximately 75%) part of the cost of improvements may use 1915 Bonds and the Municipal Improvement Act of 1913. Often, these bonds are for public improvements in low and moderate income neighborhoods. The overall cost of the district is reduced because the added expense of contractor financing is reduced or eliminated.

Districts where little or no City contributions are involved and the property is from 60% to 100% developed with homes or businesses may use either 1911 or 1915 bonds under the 1913 Act proceeding. Because the 1913 Act allows the City to sell bonds prior to completion of the improvements, contractors are paid from bond proceeds as work progresses. This arrangement reduces the need for contractors to provide their own construction financing that would be required with 1911 Act proceedings. Therefore, competitive bidding is encouraged and small contractors are given an opportunity to compete for large construction projects.

Districts where trunk sanitary and storm sewers and water mains are to be installed in areas owned by several developers with very little or no development may use 1915 Bonds under the Improvement Act of 1911. Installation of trunk sewer and water mains is the first step to develop a large land area owned by several developers. It is not feasible to install trunk facilities to one parcel without providing benefit to surrounding parcels. Generally, no City funds are involved in these districts.

ADVANTAGE OF 1915 BONDS

1915 Act bonds are more attractive to investors for several reasons. First, bonds are normally issued in even denominations that mature in a stated year. Next, the security for the bond is a pro rata share of the whole district rather than a specific parcel of property. The inclusion of a reserve fund further adds to their attractiveness. Finally, in the event of a default, the City enacts foreclosure proceedings on behalf of the bondholders.

From the issuer's perspective, the advantage of 1915 Act bonds is that they are sold at lower prices than equivalent 1911 Act bonds providing a less expensive means of financing public improvements. As pointed out earlier, 1915 Act bonds are less expensive because they are more marketable than 1911 Act bonds. 1915 Act bonds also provide a means to finance large-scale development of bare land that would not otherwise be possible with 1911 Act bonds.

It should also be considered that issuing 1911 Act bonds is not practical when major infrastructure development is required and extensive segregation (subdividing) of the parcels is likely to occur in the future. Investor interest is difficult to generate for a 1911 Act bond secured by a large tract of undeveloped land and issued in a significant denomination.

Prior to 1987, bonds issued under the 1915 Act contained a provision obligating the City to advance available funds to pay bondholders should delinquencies occur and the redemption and reserve funds be depleted. However, the inclusion of Section 8769 to the California Streets and Highways Code in 1987 provided an issuer the option to not obligate itself to advance available funds to cure any deficiency which may occur as a result of delinquencies. Should the issuer stipulate that it will not obligate itself to advance available funds in accord with Section 8769, the 1915 Act bonds issued are termed "limited obligation improvement bonds," signifying the nonrecourse nature of the bonds. The City's decision to not obligate itself is made at the time the resolution of intention is adopted by Council. However, this determination does not prevent the City from advancing funds in the future if it should so choose.

FINANCIAL

Prior to the 1987 Code change, 1915 Act bonds exposed the City to a contingent liability should significant delinquencies occur in the district. In addition, rating agencies analyzed the direct and overlapping debt of the community and evaluated the impact (if any) that large development would have on a City's borrowing ability and the community's local economy. For these reasons, rating agencies take the possible fiscal impact of 1915 Act bonds into consideration when rating new or outstanding City debt. Although the nonrecourse provision of 1987 removed the legal obligation of the issuer to pay 1915 Act bond debt service, it does not prevent the issuer from advancing funds at a later date. Because of this, rating agencies still tend to view 1915 Act bonds as a "moral obligation" of the issuer that would be honored since the issuer's name is associated with the bonds.

However, the City's credit rating could be negatively affected if a major developer defaulted on a loan even if no assessment bonds were issued to finance infrastructure. This might occur because major defaults (as has occurred in Texas and New Orleans) can be viewed as an indication that a major economic weakness exists in the community. Why a major local enterprise failed and the impact its failure will have on the local community is sometimes more significant than the fact that it failed.

Rating agencies examine several factors when assigning a rating to a bond issuer. Although they look at the contingent liability of 1915 Act bonds, they also evaluate the strengths and weaknesses of the local economy. A major default of a significant developer or industry in the City would be viewed very carefully by rating agencies and investment analysts. Default by a substantial private developer would cause concern regardless of whether the developer obtained financing through public or private debt issuance.

Further, rating agencies also examine the impact that major development will have on the City. The need for additional services and capital expenditures that are the result of major development affect the City's rating. The impact on capital and operating budgets and how well this has been planned for are considered carefully by rating agency analysts. However, it should also be pointed out that significant benefits can accrue to a City when large development occurs including an increased tax base, job opportunities and economic growth of the community.

ASSESSMENT DISTRICTS LESS THAN 60% DEVELOPED

Although state law permits the issuance of 1915 Act bonds for districts where little or no development has occurred, the City's policy guidelines do not allow for it. However, where an assessment district is composed of large tracts of undeveloped land, either 1915 Act or Mello Roos bonds provide an efficient vehicle to finance public improvements.

In contrast, 1911 Act bonds do not provide an efficient financing mechanism. Under current market conditions there is lack of broad investor interest in 1911 Act bonds secured by large tracts of undeveloped land. From the investor's perspective, the negative features of 1911 Act bonds are accentuated because the bond denomination may be very large, forcing the investor to concentrate his money in one area, limiting diversification. For this reason, 1911 Act bonds would likely be sold at either a substantial discount (thus raising the property owner's assessment) or a higher interest rate, if the bonds could be sold at all.

However, the use of 1915 Act bonds for a district without regard to its size, would likely prove to be a cumbersome process. Therefore, the use of 1915 Act bonds for districts less than 60 percent developed should be limited to large districts that are perceived to have a unique or wide benefit to the City. A large district would be defined as one where the total build out value of the area would exceed \$25 million if residential and \$50 million if mixed use.

If 1915 Act bonds are selected as the preferred financing vehicle, formation of these districts should be as acquisition assessment districts, using 1913 Act proceedings. Improvements to be financed should be completed at private expense and in place prior to the issuance of bonds. This process assures that all costs are known, will eliminate the time, expense and effort of making cost estimates, and will reduce construction risk to the City. Developers should work closely with City staff from the early stages of the formation of these districts.

RECOMMENDATION

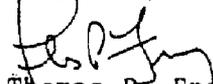
Although California law approves the issuance of both 1915 Act and Mello Roos bonds for largely undeveloped districts, City of Sacramento policy only considers the use of 1915 Act bonds for districts that are at least 60 percent developed. In consideration of the availability of these financing vehicles for undeveloped districts, it is appropriate to amend City policy to include the use of both 1915 Act bonds under 1913 Act proceedings and Mello Roos bonds using the Community Facilities Act of 1982. Recommendation to issue bonds for large undeveloped assessment districts, the development of which is perceived to have a wide benefit to the City, would be made by the Director of Public Works, City Treasurer and Finance Director.

It is recommended that existing City policy regarding the issuance of 1915 Act and Mello Roos bonds be amended to include districts where:

- little or no City contributions are involved, and
- the property is less than 60% developed with homes or businesses, and
- the area is perceived to have a wide benefit to the City, and
- if primarily residential development, the project will be completed within two years, and the total value of the land and improvements will exceed \$25 million, or
- if for mixed use development, the project will be completed within five years, and the total value of the land and improvements will exceed \$50 million.

It is further recommended that bonds be issued as limited obligation improvement bonds of the City. As such, the City does not obligate itself to advance available funds to cure any deficiency which may occur as a result of delinquencies. Also, the bonds will be issued with the maximum reserve requirement allowed by law and contain a provision for fast foreclosure of delinquent assessments.

Respectfully submitted


Thomas P. Friery
City Treasurer

Recommendation Approved:

Walter J. Slipe, City Manager

November 9, 1988
All Districts