



102

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Budget and Finance/Transportation &
Community Development Committee
Sacramento, California

Honorable Members in Session:

SUBJECT: Partial Defeasance of 1989 Certificates of Participation

SUMMARY

This informational report responds to the question raised by City Council regarding the possibility of defeasing unexpended proceeds from the 1989 Certificates of Participation financing ("1989 COP") previously identified with acquisition of a NFL franchise fee. No action is required by the Committee. The City covenanted to complete the projects named in the Project Lease or fund alternate projects with certificate proceeds in the event any of the named projects proved impossible to complete. The City also covenanted not to take any action or fail to take any action that would adversely affect the tax exempt status of the certificates.

Failure by the City to name alternate use of proceeds and place the balance in an escrow account to pay future debt service could place the City in jeopardy of causing all of the certificates to be considered "hedge bonds" under federal tax law. If it were determined that federal tax law had been violated, interest on the 1989 COP could become taxable to investors retroactive to the day of issuance, thereby exposing the City to significant investor liability. Further, any action of the City that would potentially jeopardize the tax exempt status of the issue would have significant negative repercussions upon future financing plans of the City. Unless otherwise directed, the Treasurer will eliminate defeasance of a portion of the 1989 COP as an option.

BACKGROUND

The certificates are dated as of November 1, 1989 and were sold with a nine year call protection. Eleven serial maturities from 1990 through 2000 and a term certificate maturing in 2009 were sold. Each maturity has a specific interest rate associated with it. Partial retirement of the 2009 term certificates will begin in 2001 and continue through the year 2009. This provision, known as mandatory prepayment, requires the trustee to call a predetermined amount of the 2009 certificates through a random selection process.

The certificates maturing from 1990 through 1998 may not be prepaid prior to their respective maturity dates. This protection prevents the City from prepaying ("calling") the certificates until the year 1998, at which time the city may call all or part of the outstanding certificates at predetermined premiums as shown in Table 1.

Table 1
 1989 COP Prepayment Provisions

<u>MATURITY</u>	<u>PRINCIPAL AMOUNT</u>	<u>1998 CALL PREMIUM</u>	<u>1999 CALL PREMIUM</u>
1999	\$4,365,000	2%	-0-
2000	\$4,660,000	2%	1%
2009	\$58,405,000 (1)	-0-	-0-

1) Term certificates due in 2009 have a mandatory prepayment schedule beginning in 2001. A portion of the certificates are prepaid each year at par beginning in 2001.

All of the certificates maturing in the years 1999, 2000 and 2009 may be called on November 1, 1998 at the premiums shown in Table 1 and at the total costs shown in Table 2.

Table 2
 Cost to Call Certificates

<u>PREPAYMENT DATE</u>	<u>PRINCIPAL OUTSTANDING</u>	<u>CALL PREMIUM</u>	<u>TOTAL COST TO CALL</u>
November 1, 1998	\$67,430,000	\$180,500	\$67,610,500
November 1, 1999	\$63,065,000	\$ 46,600	\$63,111,600
November 1, 2000	\$58,405,000	\$ -0-	\$58,405,000

The 1989 Certificates of Participation were issued to finance specific capital projects of the City including the Civic Center Plaza Garage, the Downtown Plaza Garage, various smaller projects supported by the General Fund and a NFL franchise fee. The City made covenants to the certificate holders and the U.S. Department of the Treasury regarding its intent to complete these projects or substitute alternate projects if it became impossible to "acquire" or construct one or more of the named projects. The list of alternate projects and the estimated amount required to complete each have been taken from the Official Statement and are shown as Attachment A.

The Official Statement of the City issued in connection with sale of the certificates listed nine alternative projects in excess of \$157 million which could be funded in the event any of the named projects became delayed or abandoned. Further, the City was permitted the flexibility to name projects not included on the alternate list. Use of proceeds for alternate projects must comply with federal tax law tests pertaining to "hedge bonds," "arbitrage bonds" and "private activity bonds." These regulations are discussed in the "Policy Considerations" section.

FINANCIAL

Defeasance of a portion of the certificates could be accomplished by depositing sufficient money in an escrow account for the purpose of purchasing obligations that will mature at appropriate times and in sufficient amounts to pay future debt service on outstanding certificates until the first call date. Defeasance is the termination of the rights of the certificate holders to receive rental payments from the General Fund of the City because the terms of the Project Lease have been fulfilled. In some cases, new obligations are issued to provide the monies required to either call or advance refund outstanding bonds. Funding an escrow account rather than calling bonds is preferred in those instances when bonds are not callable or a clear economic benefit to do so exists.

Four reasons an issuer might repay (call) or defease (escrow) bonds include: 1) taking advantage of lower interest rates, 2) releasing an asset pledged as collateral, 3) freeing a revenue source dedicated for repayment, or 4) eliminating restrictive debt coverage covenants. It would be rare for an issuer to defease all or part of an outstanding obligation with unexpended proceeds if projects have not been completed, particularly within only six months of issuance. However, it would be perfectly acceptable to defease a portion of bonds with unexpended proceeds after all projects intended for financing had been completed. A partial defeasance of the 1989 COP with proceeds intended for the NFL franchise fee would contradict the reasons most issuers defease bonds.

Defeasance occurs by making a deposit into an escrow account sufficient to pay, together with interest earnings thereon, future principal and interest payments on the outstanding obligations. A deposit of approximately \$45,705,000 invested at the arbitrage permitted yield of 7.06% would be required to repay a proportional share of the 1989 COP attributable to financing the NFL franchise fee.

Funds currently available for deposit include \$40,000,000 from the Improvement Fund and \$4,431,000 from the Reserve Fund, or \$44,431,000 in total. Available funds are approximately \$1,274,000 less than what would be required to completely fund an escrow and repay the NFL portion of the 1989 COP. The additional \$1,274,000 deposit requirement has occurred for two reasons. First, there are less monies on deposit than certificates issued because \$708,000 of the proceeds have been expended on costs of issuance and underwriter's discount. Second, investment earnings would be restricted to a maximum of 7.06 percent. Therefore, either a \$1,274,000 deposit would have to occur or the proceeds available for authorized projects would have to be reduced by the same amount in order to fully defease the portion of the 1989 COP attributable to a NFL Franchise fee. These analysis is presented for illustrative purposes and is not recommended.

POLICY CONSIDERATIONS

The City made certain representations to certificate purchasers, underwriters, bond counsel, rating agencies and the U.S. Treasury Department as part of the issuance of the 1989 COP. The City covenanted to complete the projects named in the Project Lease or fund alternate projects with certificate proceeds in the event any of the named projects proved impossible to complete. The City also covenanted not to take any action or fail to take any action that would adversely affect the tax exempt status of the certificates. Bond counsel has advised that failure by the City to name alternate use of the proceeds and place the balance in an escrow account to pay future debt service could place the City in jeopardy of causing all of the certificates to be considered "hedge bonds" under federal tax law, and therefore taxable. Further, naming alternate projects other than those listed in the Official Statement will require their compliance with "arbitrage bond" and "private activity bond" tests.

"Hedge Bonds"

Hedge bond tests are based on issuer expectations at the time of issuance. Bonds are considered hedge bonds when an issuer does not reasonably expect to spend 85% of the "spendable proceeds" within three years of issuance or 50% or more of the proceeds are invested in securities with a guaranteed yield for a period of four years or longer. There are exceptions to these rules where an issuer, under certain circumstances, may reasonably expect to spend 85% of the proceeds within five years.

The City stated at the time of issuance that it reasonably expected to spend all of the "spendable proceeds" within three years. The City further represented that 95% of the proceeds would be spent within five years. This representation was based on estimated project completion dates and the anticipation of spending proceeds on a NFL franchise fee. Further, the City listed \$157.4 million of alternate projects which could be funded in the event a NFL team were not secured.

"Arbitrage Bonds"

Arbitrage bonds are obligations that would not otherwise have been sold or have been sold in excess of the project requirement in order to take advantage of the lower interest rates of tax exempt financing over taxable bond financing. Issuers of tax exempt financing are also prevented from borrowing at tax exempt rates and lending to private business at higher rates or to governmental persons at levels greater than 0.125% above the arbitrage yield on the bonds. Failure to adhere to these rules could cause the bonds to become arbitrage bonds and thereby lose their tax exempt status. Use of proceeds for an alternate use not previously anticipated must include an examination of the intended use with respect to compliance with arbitrage bond tests.

"Private Activity Bonds"

Private activity bonds are obligations sold as tax exempt bonds, the proceeds of which are used in the trade or business of private individuals in excess of limits prescribed by tax law. Rules regarding permissible use of proceeds by private business are complex and over-simplification of them should be avoided. However, there are two tests used in determining whether private use has occurred. A general guideline to follow with respect to total projects financed is that 1) no more than 10% of the spendable proceeds may be used by private persons in their trades or businesses and 2) on a present value basis, no more than 10% of the spendable proceeds of the bonds are repaid from private persons.

MBE/WBE

MBE/WBE goals are non-applicable.

RECOMMENDATION

This report is an informational item. No action is required by the Committee. Unless otherwise directed, the Treasurer will eliminate defeasance of the portion of the 1989 COP attributable to the NFL franchise fee as an option.

Respectfully Submitted,

David M. Affleck
for Thomas P. Friery,
City Treasurer

RECOMMENDATION APPROVED:

April 10, 1990

Solon Wisham Jr.

Solon Wisham Jr., Assistant City Manager

All Districts

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Alternate Improvements

Other capital improvements would be financed with proceeds of the Certificates in the event that any of the aforementioned Improvements became delayed or abandoned, and the following table sets forth those alternate improvements which the City has identified to date:

Alternate Capital Improvement Projects	Estimated Improvement Cost
Memorial Auditorium Remodel	\$40,000,000
Community Center Expansion(1)	75,000,000
Animal Control Facility	2,916,000
Belle Coolegge Library	3,140,000
Meadowview Community Center	4,497,000
Clunie Community Center	2,055,000
South Natomas Park	
Acquisition - Phase II	3,400,000
SHRA Projects(2)	20,000,000
Capitalized Interest	<u>6,400,000</u>
Total	<u>\$157,408,000</u>

- (1) The expected completion date of the Community Center Expansion project is 1993-94. Proceeds, if any, allocated for this improvement would be used for land assemblage, site clearing and the first phase of construction.
- (2) Allocation of proceeds to additional SHRA projects would require amendment to the existing Repayment Contract between SHRA and the City. See THE SACRAMENTO HOUSING AND REDEVELOPMENT AGENCY -- The Repayment Contract.