Financing Alternatives for Wastewater Treatment Plant, Levee Improvements and Recreation Center Master Plan

Introduction

The City of Foster City ("City") is considering a potential capital project for approximately $30 million to construct a new Recreation Center for the City. At the same time, the City is undertaking two other capital projects: $119.6 million in improvements to the wastewater treatment plant ("WWTP") jointly owned with the City of San Mateo and approximately $75 million for City-wide levee improvements. This is an unprecedented time for the City to be dealing with so many significant capital projects with such a large aggregate total dollar cost. This report will suggest how to best finance a new Recreation Center in the context of the other two major capital projects.

Background

The City has considerable cash reserves that can be contributed to these projects. In addition, the City has available to it a variety of borrowing alternatives that will allow it to achieve its objectives. From a public policy and public financing perspective, it would be best to consider all three capital projects at once and in the context of the various forms of financing available to the City.

Besides paying cash for a project, the City has access to at least four forms of debt financing for capital projects. The main distinction between the forms of financing is the basis for debt repayment, meaning the source of funds budgeted annually to pay debt service for the full term of the financing (which is usually for 30 years for a major capital project), whether a vote of the electorate is required, and whether the funds used to pay debt service are generated by new resources or from existing monies. Each tool is discussed below.

Cash: The City has accumulated cash balances in its Wastewater Enterprise Fund, in its General Fund and in its Capital Preservation Fund. While cash in the Wastewater Enterprise Fund is restricted for application to wastewater projects, cash in the General Fund and Capital Preservation Fund can be used for any capital project. The question is how much of the cash in each fund should be expended on these projects, and to which projects should the cash in each fund be applied, if at all. Rationales for the use of cash to fund large public projects are varied and often come down to availability more than anything else. Some reasons include:

- Reserves are available and there are no major competing capital uses;
- The demand on future budgetary resources for services and salaries/benefits is expected to consume all available revenues, leaving no room for future debt service payments;
- The stability of future revenues is uncertain, making the assumption of debt that is not supported by dedicated taxes or revenues too risky to the financial health of the public agency; and

- The project is not of uniform benefit to residents, or could be controversial, making the success of a voter-approved bond issue unlikely or highly uncertain.

Debt: There are various types of debt that a California city can issue for projects like these. Debt is frequently used when the cost of a project exceeds available current resources, and although it includes the extra cost of interest, it allows a public agency to theoretically avoid over-collecting revenues (such as taxes where jurisdictions can set their own tax rates) from residents who are not yet enjoying the benefit of the asset in order collect sufficient reserves to build an asset that will also benefit future residents. Using debt allows a public agency to better align financial responsibility with benefit.

The City has at its disposal both voter-approved and non-voter-approved debt alternatives. In general, any debt that is secured directly by new taxes to pay debt service requires 2/3rds voter approval. Enterprise debt that is secured by rates or fees does not require voter approval, but any increase in fees or rates that is necessary to secure the debt generally requires a majority protest approval process, and debt secured by assessments against property requires majority protest approval. Debt that requires neither a new tax, assessment, nor rate increase do not require voter approval. The various types of debt available to the City that can be used to finance these projects is discussed in brief below. Also see Exhibit A at the end of this analysis for a table that compares the four types of debt financing alternatives using different characteristics.

a. **Enterprise Revenue Bonds:** An enterprise fund is self-sustaining from revenues generated by that enterprise and is not supported by the City's General Fund. The Estero Municipal Improvement District ("District") is essentially an enterprise of the City that can issue wastewater revenue bonds secured solely by ratepayer fees and not by other, non-enterprise resources. These revenue bonds are independent of the General Fund, are secured solely by the enterprise's revenues and do not require voter approval. Any increase in wastewater rates (which would be necessary to secure bonds) would require majority protest approval.

b. **Assessment District Bonds:** These bonds are secured by assessments on real property and can be used to finance public improvements such as roads, parks and levees where specific benefit can be demonstrated to those within the district boundaries. The amount assessed against each property is based on benefit received, and the City must pay for all benefits determined to be of a general nature. No voter approval is needed, but bonds for the project to be financed are subject to a landowner majority protest procedure. Votes are weighted by the amount of the assessment ascribed to each property.

c. **Mello-Roos Community Facility District/General Obligation Bonds:** Both types of bonds are also secured by real property tax payments to finance a broad variety of public infrastructure projects. Mello-Roos bonds are a more flexible form of assessment district financing, with special taxes that must be approved by 2/3rds of voters within the district if there are more than 12 registered voters. Unlike assessment districts, where the cost must be allocated based on special benefit received, the special taxes

can be levied on any reasonable basis, except *ad valorem*. G.O. bonds must also be approved by 2/3rds of voters within the City and are the most highly-rated form of bond financing because voters approve an unlimited *ad valorem* property tax on all real property within the City to secure the bonds. The tax rate is initially set at a level that pays for debt service, but adjusts downward as the City's assessed valuation ("AV") base grows (or could go up if AV drops in a severe recession). The tax rate is the same for all properties, so a property owner's tax bill is entirely dependent on the total assessed valuation of the property. The owner of a commercial property usually pays more in total dollars than a homeowner, but voter approval is based on registered voters and not landowners.

d. **General Fund Lease Revenue Bonds:** Whereas the other types of bonds described have debt service paid by enterprise revenues or new tax or assessment payments, General Fund lease revenue bonds are paid through a lease agreement with the City's General Fund where payments must be budgeted annually from available City financial resources. A public agency should not take on future lease payment obligations unless it has room in future budgets to appropriate payments out of current revenues. Absent the provision of new revenues, the issuance of General Fund lease revenue bonds means a reduction of General Fund financial resources available for other City purposes in the amount of debt service on the lease revenue bonds for the term of the financing.

While lease revenue bonds do not require voter approval, if they are combined with a general tax increase, the general tax increase requires majority voter approval. A general tax increase (such as a transient occupancy tax, a sales tax, a utility user's tax, or a parcel tax) is one that raises new revenue for any General Fund purpose. Lease revenue bonds can also be combined with a special tax increase; however, special taxes require a two-thirds voter approval. The same types of taxes, e.g., transient occupancy tax, , sales, utility user's, or parcel, can be imposed for restricted uses, in which case they would qualify as special taxes. Some cities restrict the use of such taxes to make them more palatable to voters, who might otherwise be reluctant to extend "blank check" spending to a city council.

Analysis

City staff and the City's municipal advisors have been working for some time on how the City will pay for its share of the WWTP capital improvement program and for the City-wide levee improvements, as separate capital projects. The current plan of finance for those two projects is described below, followed by options for the Recreation Center.

WWTP: The City is planning to issue wastewater revenue bonds to finance its share of WWTP capital costs and has already established a joint powers financing authority with the City of San Mateo to potentially issue such debt. These bonds would be secured solely by revenues collected from the City's wastewater ratepayers, based on predominately fixed charges and multi-year rate increases, and the two cities' respective debt burdens would be separate and distinct. Using General Fund and Capital Preservation Fund reserves to pay for WWTP costs would not be recommended in this case, given that there is a ratepayer structure in place to

have users pay for WWTP improvements over time. Wastewater enterprise reserves, in conjunction with wastewater enterprise debt, would be used to finance WWTP capital costs. Wastewater rate increases necessary to pay for bond debt service will be subject to majority protest procedures.

Public utility projects are well suited to debt financing with repayment from direct users of the project because use and benefit can be directly tied. Using the City's General Fund to finance or cash-fund the WWTP would be technically possible, but the competing demands of the levee improvements and the recreation project, neither of which has a ready source of revenues to pay debt service, on the General Fund and the Capital Preservation Fund, make it compelling to use only wastewater enterprise cash balances and wastewater enterprise revenue bonds for WWTP capital projects. To the greatest extent possible, the City will use low-cost loans issued by the State Water Resources Control Board via its Clean Water State Revolving Fund ("SRF") program in place of wastewater revenue bonds to finance WWTP costs. Like wastewater revenue bonds, SRF loans would be secured solely by ratepayer fees. However, access to the SRF program is not guaranteed and it is recommended that wastewater rates be established high enough to allow the financing of WWTP costs solely through more expensive wastewater revenue bonds.

Levee Improvements: City staff and consultants are currently evaluating the use of either assessment bonds or G.O. bonds to finance levee improvements. General Fund lease revenue bonds could technically be used for levee improvements, but the other forms of financing are property-related and levee improvements can be directly beneficial to the property being assessed or taxed to pay the related debt service. So General Fund lease revenue bonds are not under consideration for levee improvements because of there are financing alternatives available that would not burden the General Fund.

G.O. bonds would the most cost-efficient form of financing for a City-wide capital improvement of this type because they are the most secure and highly-rated form of municipal bond financing, based on an unlimited authority to levy an ad valorem property tax on all AV in the City. The higher the bond rating, the lower the interest rate, and therefore the lower the cost of debt service. Absent construction of the levee improvements, the entire City will be placed in a FEMA high risk flood zone, which will require any lender that is federally regulated or insured to require flood insurance on mortgages that it issues. The cost of such insurance in a high risk area could run into the thousands of dollars. Because the levee improvements will remove the City from the FEMA high risk flood zone, it will provide homeowners considerable savings if they are not required to pay high risk zone rates on flood insurance premiums and this should help to garner the 2/3rds voter approval needed to issue G.O. bonds. To enhance the argument in favor of issuing bonds for this project, it may be prudent for the City to apply some cash reserves to pay for public properties that will benefit by these improvements, but the levee project is an ideal candidate for G.O. bond financing because of the project's essentiality and high potential for voter approval. This is a situation where the application of City reserves would lower the burden to the individual taxpayer, but the impact would be relatively marginal in dollar terms.

For example, assume the City issues $75 million of G.O. bonds with a final maturity of 30 years at current

interest rates plus a cushion to be conservative[1], with annual debt service sloping upwards at a rate of 2% to match the same assumed growth rate for the City's total AV to keep the projected tax levy as level as possible (the City's actual annual growth rate for the last 10 years through FY15-16 is 4.6%). The annual tax levy for this bond issue given these assumptions would be about $40 per $100,000 AV, while a homeowner's tax bill would be based on that owner's actual taxable AV (for example, a home with a taxable assessed value of $500,000 would see a total tax bill of $200 for that year, given all these assumptions). This projected tax levy is a good-faith estimate that the City has to provide to voters at the election authorizing the G.O. bonds, but the ballot measure would authorize a maximum par amount of bonds to be sold and would not set a tax rate. If the bonds are issued, the City Council would be authorized to set the annual tax rate at the amount required to pay annual debt service for the next year. The tax rate could go up or down, depending upon the City's total AV.

Now assume the City Council decided to allocate $10 million in City reserves to this project, reducing the debt need by 13.3%. The tax rate reduction would also be by 13.3%, meaning $5.32 per $100,000 or a reduction of $26.60 to $173.40 from the prior annual tax bill for $200 if the homeowner's taxable AV was $500,000. Halving or doubling the City reserves allocated for this project would proportionately affect the tax levy in the same way, meaning reducing the City contribution to $5 million would reduce the tax rate by $2.66 per $100,000 and doubling the contribution to $20 million would double the tax rate reduction to $10.64 per $100,000. The actual tax levies would not be set until the pricing of the G.O. bonds, so the $40 per $100,000 tax rate is approximate and subject to market risk. But the formulas just described would remain the same. The impact of allocating City reserves to a Mello-Roos or special assessment bond financing would work the same way, but the parcel tax or assessment would be calculated differently than a G.O. ad valorem tax levy.

G.O. bonds are recommended for the levee improvements rather than Mello-Roos bonds because while both require two-thirds voter approval, G.O. bonds are usually more highly-rated than Mello-Roos and therefore would be priced at a lower interest rate and have lower debt service than Mello-Roos bonds for the same purpose. Assessment district bonds don't require voter approval, but are subject to majority protest and would also be rated lower than G.O. bonds. A full rating category difference (say between "AA" and "A") could mean a difference of 38 basis points (.38%) in today's market[2]. For the $75 million G.O. bond scenario

[1] Current interest rates means an assumed AA-rated scale as of 2/17/17 plus a spread of 50 basis points (.50%) per maturity to account for future higher interest rates, resulting in a true interest cost of 4.22% (including the 50 basis point cushion). Costs of issuance would have to come out of bond proceeds, but for simplicity the bond sizing here is just assumed to be $75 million.

[2] The Municipal Market Data ("MMD") index is a national measure of G.O. yields from 1-30 years, updated every business day. MMD is used to estimate interest rate levels in the municipal market, but the City's actual interest rates in any pricing will depend on the details of that issuance's rating and characteristics. The MMD 30-year "AA" yield on 2/17/17 was 3.37%, compared to 3.75% for the "A" yield. This is a spread (difference) of 38 basis points, or .38%. The 30-year yield is assumed to be a proxy for the entire scale, although spreads tend to be a bit narrower in the early part of the scale (first 10 years, from 2018-27. This example assumes a difference of a full rating category, between the mid-level "AA" and mid-level "A", but there are two rating "notches"

discussed earlier in this section, 38 basis points more in interest cost across the scale increases debt service by 5%, resulting in a tax levy of $42 per $100,000 instead of $40.

Recreation Center: This project may generate some user fee revenues, but not enough to pay for any significant portion of debt service and would more appropriately be used for operating expenses. The project could be financed through the issuance of City-wide Mello-Roos Community Facility Special Tax bonds or G.O. bonds, but both financing vehicles would require 2/3rds voter approval for a project that does not have the public safety benefits or the essentiality of levee improvements project. This would indicate a lower likelihood of getting 2/3rds voter approval for either G.O. or Mello-Roos bonds. An assessment district could be drawn to support construction of a recreation center and would be subject to a majority-protest procedure rather than direct voter approval, but this would require a special benefit finding and assessments based on this special benefit – assessments cannot support a general enhancement. General benefits must be paid by the City, not by assessees, which could be done through either cash reserves upfront or General Fund lease revenue bond debt over time.

Recreation centers are typically financed by cities through the issuance of General Fund lease revenue bonds rather than the other forms of financing described earlier, because of the difficulties with getting voter approval or finding special benefit. General Fund lease revenue bonds do not require voter approval, just majority approval of the City Council, but the downside is that the City's General Fund must pay for annual debt service without any dedicated new source of revenue to pay for debt service, unlike the other forms of financing just described. Nevertheless, the City could pay cash for a portion of this project using some of the balance in its Capital Asset Preservation Fund or unassigned General Fund reserve, and use a General Fund lease for the balance. If the financing is combined with a general use tax increase to provide a new source of revenue to pay debt service, the voter approval hurdle would be lowered to only 50 percent.

Using City reserves to cash-fund all or a portion of this project would not directly impact the City's taxpayers in the form of lower taxes if new taxes or assessments are not imposed to support a debt financing (taxes would be unaffected by using cash resources), but using reserves for this purpose would deplete cash resources that might be applied to other or more essential projects.

If the City were to issue $30 million of General Fund lease revenue bonds for the Recreation for a final maturity of 30 years[3], the annual debt service would be about $1,760,000. This means the City Council would have to annually budget $1.76 million in the General Fund for 30 years, paying over $52.7 million over 30 years to pay off a $30 million Recreation Center. The debt service costs are roughly proportional if City

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between these levels ("AA-" and "A+" on S&P's scale, "Aa3" and "A1" on Moody's scale). Each rating notch would mean a proportionate pricing change and therefore difference in debt service.

[3] This scenario is a simplified version that assumes no issuance costs or debt service reserve fund and an average coupon of 4.11%, which is 100 basis points over the 30-year MMD yield of 3.11% as of 2/17/17. Taking into account the positive yield curve, this means a cushion of about 50 basis points over the current market.

reserves were used in place of debt: for example, using $10 million of City reserves would mean issuing $20 million in General Fund lease revenue bonds, reducing the annual debt service by one-third.[4]

Conclusion

WTTP improvements are most appropriately financed with user charges through wastewater revenue bonds or SRF loans. The levee project is an ideal candidate for a property-based financing like G.O. bonds because of the type and scale of direct benefit to both private and public properties. While public funds may be appropriate (and even necessary) to pay for the public benefits of the levee project, a property-based bond financing technique assigns the cost of the assets directly to those who benefit in the future. G.O. bonds should have a high probability of success at the ballot, and are the most highly-rated and cost-efficient form of such financing.

The Recreation Center project is not a candidate for financing based on user charges or property, but could be funded with the proceeds of General Fund lease revenue bonds. Because this would burden the General Fund with annual debt service for the life of the bond issue, using cash reserves in place of debt would directly benefit the General Fund and therefore, indirectly, the City's taxpayers. If the City is considering using City cash reserves for any capital project, the Recreation Center should be the primary candidate.

[4] Technically there are economies of scale in debt issuance and costs of issuance are relatively fixed, so downsizing the issue doesn't save exactly on a perfectly proportionate basis.

Exhibit A: Debt Financing Alternatives

Type of Bond Financing: Most-Likely Project Application	Enterprise Revenue: WWTP	Assessment District: Levee Improvements	Mello-Roos and General Obligation: Levee Improvements	General Fund Lease Revenue: Recreation Center
What Can Be Financed	Enterprise capital projects wastewater related to that enterprise	Public improvements such as roads, parks, levees, but not O&M and equipment.	Public infrastructure and capital projects. G.O. bonds can't pay O&M.	Public infrastructure and capital projects.
Voter Approval	No voter approval needed. Any increase in enterprise rates subject to majority protest approval.	No voter approval needed. Subject to majority landowner protest procedure.	Mello-Roos (M-R) with >12 voters and all G.O. bonds require 2/3rds voter approval.	No voter approval needed.
Rate, Assessment, Special Tax or G.O. Levy Used to Pay Debt Service	Enterprise rate increases usually required for new debt, rates paid by utility users (water, wastewater, power).	Static lien, fixed at time of issuance, assessments collected by County on tax bill, must be proportional to "special benefit"	Dynamic lien, can change, special tax just needs to be "reasonable". G.O. levy can change over time, based % of total City AV.	Can be issued with no new source of tax revenue, but then General Fund must pay debt service out of existing resources
District Boundaries	Enterprise service area can be larger than City, may involve outside parties.	AD must demonstrate special benefit, cannot be general enhancement.	CFD can be flexible in borders/benefits/taxes. G.O. tax is on entire City.	City General Fund is the borrower, although project can benefit subset of City.
Credit Rating	For essential utility can be rated just below G.O. and more attractive to buyers.	Often unrated, depends on district size and rating characteristics.	City-wide M-R can be rated almost as high as G.O., which is highest.	Usually rated one or two notches below City's G.O. bonds.
Issuance Process	3-4 months to complete financing, assuming rate increases already set and CIP established.	Engineering study required first, then 6-7 months for Council resolution, public hearing, 30-day challenge period, bond documents, pricing and closing.	M-R needs engineering and special tax reports, then about 9 months for same process as AD. G.O. requires same time, but after election survey work.	3-4 months to complete financing, assuming any pledged revenues already set and CIP established.
Pros	No voter approval required. Enterprise is self-supporting and does not rely on City General Fund for support.	No voter approval, but can be majority protest. Property owners who benefit directly pay costs. District borders can be drawn specifically. New revenue to pay bonds.	M-R special tax can be tailored, as can district boundaries. G.O. bonds are lowest-cost form of bond financing. Both provide new revenue.	No voter approval needed and not subject to Prop 218 process. Fastest issuing process compared to other options.
Cons	Utility rate increases usually required on multi-year basis. If variable rate (based on usage), then rate increases may not result in projected revenue increases if usage decreases.	Costs must be allocated based on special benefit received. One tax rate that applies to all. Subject to Prop 218 weighted majority protest ballot process. General benefits must be paid by City, not assessees.	City-wide M-R and G.O. bonds both need 2/3rds voter approval. One G.O. ad valorem tax rate applies City-wide, can't be tailored.	Requires City to budget annual debt service from General Fund. Unless dedicated new revenues can be used, General Fund must pay from existing resources.