RECOMMENDED CHANGES TO THE MELLO-ROOS ACT OF 1982

Report to the Legislature and Governor

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California State Treasurer
and Chair

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TABLE OF CONTENTS

Summary and Findings

Introduction 1

Background 1

Summary of the Mello-Roos Hearing 3

Findings of the Commission Staff 5

Finding #1
Public Policy Should Recognize the Importance of Mello-Roos Financing in Post-Proposition 13 Local Government Finance 5

Finding #2
Improved Information Flows Should Lower Yields on Mello-Roos Bonds 6

Finding #3
Improved Disclosure to Homebuyers Should Permit the Housing Market to Function in a More Competitive Manner 7

Finding #4
The "Landowner Vote" is a Necessary but Imperfect Form of Democratic Expression; Additional Taxpayer Protections May be Warranted 7

Recommended Changes to the Mello-Roos Act

Recommendation #1
Amend the Notice of Special Tax Requirement to Improve Disclosure to Homebuyers 9

Recommendation #2
Establish an Annual Reporting Requirement for Mello-Roos CFDs 10

Recommendation #3
Limit the Annual Increase in the Maximum Special Tax on Residential Properties to Two Percent (2%) for Landowner-approved Financings 12

Recommendation #4
Require Timely Joint Financing Agreements Which Ensure Greater Involvement of Responsible Agencies 13

Recommendation #5
Require that Substantial Redirection of Funds be Subject to Majority Protest Provisions 14

Recommendation #6
Require that School District Attendance Policies Give Priority Consideration to CFD Residents 16

Other Issues for Legislative Consideration

Issue #1
The Subsidization of Developers by Homeowners in Mello-Roos CFDs 18

A. Tax Differentials on Developed and Undeveloped Land 18
B. The Cross-Collateralization of Property in CFDs 21
C. The Capitalization of Interest 22

Issue #2
Limiting the Maximum Special Tax Rate 22

Issue #3
The Need for Uniform and Independent Land Appraisals 24

Summary and Findings

SUMMARY AND FINDINGS

INTRODUCTION

On January 15, 1992, the California Debt Advisory Commission (CDAC) conducted a public hearing on the topic of Mello-Roos financing at the Orange County Civic Center in Santa Ana, California. CDAC's Chairperson, State Treasurer Kathleen Brown, presided over the hearing. Other CDAC members attending the hearing included Sonoma County Treasurer-Tax Collector Don Merz, Anaheim Treasurer Mary Turner, and Deputy Director of Finance Susanne Burton (representing the Governor and the State Department of Finance). In addition, State Senator Marian Bergeson accepted an invitation to sit with the commissioners and listen to testimony.

The purpose of the hearing was to solicit testimony on how the Mello-Roos Act has been implemented in communities throughout California. Specifically, the Commissioners were interested in evaluating the creditworthiness of Mello-Roos bonds, given the persistent slump in real estate activity. In addition, the commissioners wanted to provide taxpayers with a public forum to voice their concerns about the fairness of Mello-Roos taxes implemented in their communities. Finally, the commissioners wanted to determine what, if any, future role the state and local governments should play in ensuring the proper use of Mello-Roos financing. The commissioners heard from a diverse group of 25 witnesses, including taxpayer groups, local government officials, developers, and municipal finance professionals.

The first part of this report provides background on CDAC's involvement with the issue of Mello-Roos financing, reviews the testimony presented at the hearing, and presents findings based on the testimony. The second part of this report offers recommendations to the Legislature and Governor on improving the Mello-Roos Act. Appendix A provides a complete transcript of the hearing. Appendix B consists of written testimony presented to CDAC.

BACKGROUND

The California Debt Advisory Commission (CDAC) is the state agency responsible for the collection and dissemination of data on municipal bond issuance. In this capacity, CDAC staff was in a good position to note the fairly dramatic increase in Mello-Roos bond issuance by California local governments during the late 1980s. As recently as 1987, the annual volume of Mello-Roos bond issuance statewide was less than $250 million annually. The statewide volume of issuance grew annually to nearly $1 billion by 1990, before falling off slightly to $821 million in 1991.

The growth in Mello-Roos bond issuance during the late 1980s helped fuel the real estate development boom experienced in the state at that time. Local governments found it advantageous to raise a large sum of capital early in the development process through Mello-Roos financing, rather than delaying construction until developer fees accumulated in a sufficient amount. From the perspective of the development community, Mello-Roos financing provided access to a source of tax-

exempt financing, which facilitated the installation of the infrastructure needed to serve development projects.

Given that Mello-Roos bonds had become an important financing vehicle for addressing the infrastructure costs of growth, it was a logical research topic for CDAC staff. This interest in the topic was heightened by the downturn in the economy which began in 1990. Because Mello-Roos bonds are secured by real estate, the decline in real estate values caused by the recession has weakened the security of outstanding Mello-Roos bonds. CDAC staff began research on the topic in the spring of 1991 and released the report, *"Mello-Roos Financing in California"* (hereafter referred to as "the CDAC report") in September 1991.

The CDAC Report

Background. The first part of the CDAC report reviews the reasons why the Mello-Roos Act was enacted by the Legislature in 1982. The Act was largely a response to the restrictions on property taxation imposed by Proposition 13 in 1978, which had the effect of reducing the amount of property tax revenues available to subsidize the infrastructure costs of growth. At the same time that local governments faced dramatically reduced levels of property tax revenues, the federal government began to cut back its grants to state and local governments for infrastructure--shifting more responsibility for these programs to lower levels of government. Consequently, local governments were forced to cope simultaneously with new spending demands and reduced revenue sources. In response, local governments began to rely more on their legal authority to require developers to pay exactions and fees as conditions of development approval.

In order to provide a more flexible funding source to local governments, the Legislature enacted the Mello-Roos Act in 1982. The Mello-Roos Act permits landowners, upon receiving approval from a local government agency, to form a community facilities district (CFD), to levy a special tax, and to authorize bonds secured by the special tax. As the properties in the CFD (or Mello-Roos district) are developed and sold, new homebuyers assume the responsibility for paying the Mello-Roos special tax, which is included on their property tax bills. The Mello-Roos Act has proven to be very popular with local governments and has been used to finance over $3.5 billion worth of infrastructure in California communities to date. It has become one of the primary funding sources for constructing the schools, roads, sewer and water systems, and other public facilities which are needed to serve development projects throughout the state.

Public Policy Issues. In addition to providing a historical context and technical treatment of Mello-Roos financing, the report covers the public policy issues associated with using this form of financing. The report found that the "landowner vote" permits local officials to make decisions, early in the development process, about the mix of taxes and service levels to be provided to developing areas of their communities. In essence, landowner-approved Mello-Roos financing permits landowners to borrow against the value and tax capacity of their land through the tax-exempt market to pay for the infrastructure needed to serve development.

The CDAC report found that the structuring of Mello-Roos bond issues involves a tension between the goals of *credit quality* and *tax equity.* The Act permits the use of security features that tend to increase the credit quality of Mello-Roos bonds by

shifting more of the tax burden to developed properties. To the extent that the adoption of these security features results in a lower cost of capital, however, all taxpayers in the CFD may benefit.

Credit Analysis of Mello-Roos Bonds. In analyzing the creditworthiness of Mello-Roos bonds, the CDAC report drew a distinction between Mello-Roos bonds issued in undeveloped and developed areas. The debt service supporting Mello-Roos bonds issued in undeveloped areas is dependent upon the successful development of real estate; consequently, these bonds are vulnerable to several development-related risks. In the event of slow market absorption, for instance, developers have to hold newly developed properties for longer than anticipated. To the extent that developers become financially overextended, the payment of debt service on outstanding Mello-Roos bonds may be threatened.

CDAC Guidelines. The CDAC report concludes by identifying guidelines to assist local governments in taking advantage of the benefits offered by Mello-Roos financing, while minimizing the associated credit risks and keeping tax burdens reasonable and equitable. These guidelines focus on proper planning, greater project evaluation, and adherence to prudent debt management practices.

SUMMARY OF THE MELLO-ROOS HEARING

At the January 15, 1992 hearing, State Treasurer Kathleen Brown stated in her opening remarks that the purpose of the public hearing was to *"separate fact from fiction"* regarding the use of Mello-Roos financing by local governments throughout the state.

Specifically, Treasurer Brown stated, *"The lion's share of all Mello-Roos bonds issued over the last decade remain success stories for taxpayers, for investors, and local governments alike. Without them, dozens of California communities, complete with schools, roads, sewers and water systems would not be in existence today."*

Nonetheless, Treasurer Brown pointed out that some of the publicized problems might serve as an *"early warning system"* indicating that some reforms are needed to protect the credit quality of the bonds and taxpayers from possible abuses.

Tax Equity Concerns. The initial testimony was provided by three Mello-Roos taxpayers: Walter Hueck from Palmia, John Beckley from Aliso Viejo, and Robert Beaulieu from Tracy. The primary complaint of these taxpayers was that their Mello-Roos taxes are being used to finance public facilities of broad regional benefit. Mr. Hueck succinctly articulated the concerns of these taxpayers, stating *"Our concerns are more with the fairness of the burden to the ultimate property owner than with the financial security of the bonds."* Because their Mello-Roos tax payments are financing the construction of public facilities that will confer broad regional benefits, such as the San Joaquin Tollway Project in Orange County, these taxpayers feel that they are being required to pay more than their fair share of public improvements.

Ironically, the legitimacy of requiring taxpayers in Mello-Roos CFDs to finance regional facilities was also questioned by the development community, as represented by David Booher speaking on behalf of the California Council for Environmental and Economic Balance. Commenting on the relative merits of Mello-Roos versus developer fee financing, Mr Booher said *"The major thing here is*

not the cost of financing, it is the extent to which the local government requires the proponents of a development to finance broader-based community facilities for the entire community." By requiring development to finance regional facilities, new homebuyers pay more because they are required to bear the financial responsibility for public facilities which are not directly related to the burden imposed by development.

Disclosure of the Special Tax Lien to Homebuyers. In addition to the question of tax equity, many speakers commented on the inadequacy of the provisions of the Act requiring notification of the special tax lien to prospective homebuyers. Several speakers related the common complaint that in cases where the notification requirement is buried in the Department of Real Estate "White Report," homebuyers may not be fully aware of the financial consequences of the special tax. David Doomey of the Capistrano Unified School District reported that his district has developed a form which must be signed by the initial homebuyer in the CFD. But he expressed concern that disclosure to secondary homebuyers may be inadequate. *"I think it would be helpful if secondary buyers also had some vehicle in which the special tax was specifically identified for them,"* he said.

Ongoing Disclosure for Investors. Perhaps the issue which attracted the greatest amount of attention was the need for ongoing information on the status of Mello-Roos districts. Because of the dynamics of real estate development, the credit worthiness of individual CFDs can change rather dramatically over the course of a year. Yet it is very difficult for potential investors in Mello-Roos bonds to obtain the information needed to make informed decisions on a case-by-case basis. Greg Harrington of the Franklin Fund told of some of the information-gathering difficulties faced by Franklin, the largest single purchaser of Mello-Roos bonds, *"We call and we can't even find out what the fund balances are in most cases."* He expressed support for an annual reporting requirement covering current assessed valuations, delinquency reporting and foreclosure actions, as well as fund balances.

Steve Zimmerman of Standard & Poor's Corp. echoed Mr. Harrington's concerns, *"If we at S&P have difficulty getting information on the issues we rate, you can imagine the difficulty [faced by] the individual investor."* Mr. Zimmerman pointed out that an ongoing stream of disclosure would counteract the negative effects of groundless rumors. *"Rumors in this industry are to no one's benefit. And I think to the extent that there is more information available, it limits the amount of damage done by idle rumor."*

Mello-Roos Shopping. David Ambler of Moody's Investors Service brought the problem of *Mello-Roos shopping* to the attention of Commission members. This term is used to describe the practice of developers approaching different governmental entities to secure the most favorable terms for a Mello-Roos transaction. *"Through my discussions with school districts and overlapping entities, it is not uncommon to find that they were not the first approached entity."*

Zane Mann, editor of the *California Municipal Bond Advisor* expressed the opinion that "Mello-Roos shopping" should be outlawed. *"It has always been our impression that school bonds are the safest, most secure of all bonds. But this cannot be said if the school district is in the real estate development business,"* Mann concluded.

Possible Legislative Action. Dean Mysczinski of the California Research Bureau reported that Senator Henry Mello has asked him to draft a clean-up bill for the current legislative session. The legislation is likely to reflect the concerns

expressed at the CDAC hearing, focusing on disclosure to homebuyers and ongoing disclosure for investors. The legislation might also include statutory caps on Mello-Roos tax rates and annual escalators as well as a minimum value-to-lien requirement.

FINDINGS OF THE COMMISSION STAFF

Generally, the Commission staff found the mood of the people who testified to be quite supportive of what has been accomplished under the Mello-Roos Act, even from critics who feel that major changes are needed. The predominant sentiment was that the Mello-Roos Act is an integral tool of local government finance, and a tremendous void would be created if this tool was either eliminated or severely curtailed. Nevertheless, the Commission staff found that some areas of the Act do require some attention and possible correction by the Legislature.

This section discusses the findings of the Commission staff, which are based on upon the testimony received at the hearing as well as the staff's own research on the topic. These findings serves as the basis for the recommended changes to the Mello-Roos Act included in the second part of this report.

FINDING #1

Public Policy Should Recognize the Importance of Mello-Roos Financing in Post-Proposition 13 Local Government Finance.

In the aftermath of Proposition 13, fewer public subsidies were available to address the infrastructure costs of growth. Increasingly, the infrastructure costs of development projects had to be isolated on the development itself. For that reason, California experienced a dramatic increase in special assessment bond issuance (primarily under the authority of the 1915 Act) in the initial years following Proposition 13 (before the enactment of the Mello-Roos legislation). Assessment bonds had long been used for development purposes, but on a more limited scale. The growth in Mello-Roos bond issuance which occurred during the late 1980s can be considered a continuation of this trend.

Land-backed securities serve a vital role in post-Proposition 13 local finance because they provide the means to address infrastructure costs without subsidy from the broader community. Moreover, land-backed securities are advantageous from a land-use planning perspective, because they facilitate the early installation of infrastructure, which helps to mitigate the congestion problems traditionally associated with growth. Finally, land-backed securities serve economic development goals, insofar as many development projects could not occur without the public financing provided through land-backed securities.

The Mello-Roos Act has emerged as California's most important type of land-backed financing mechanism because it offers greater flexibility than the assessment acts. The State and its local governments should recognize the importance of the Mello-Roos Act in modern local government finance, and their policies should work toward eliminating the real or perceived shortcomings associated with this form of financing.

FINDING #2

Improved Information Flows Should Lower Yields on Mello-Roos Bonds.

Notwithstanding the importance of Mello-Roos financing in supporting local infrastructure, California local governments can only rely on Mello-Roos financing to the extent that investors are willing to buy Mello-Roos bonds. Evidence presented at the hearing suggests that yields on Mello-Roos bonds today overcompensate investors for the degree of credit risk associated with these bonds. Certainly some risk premium is justified, insofar as land-backed securities are linked to the real estate development process and carry more risk than most types of municipal securities. Yet most Mello-Roos bonds contain important security provisions designed to ensure uninterrupted debt service through a prolonged real estate downturn, such as California is presently experiencing.

Nonetheless, recent press reports questioning the creditworthiness of Mello-Roos bonds have caused repercussions throughout the bond market, causing yields in the primary and secondary markets to rise. Given that there are presently 228 Mello-Roos districts in the state, it is not inconceivable that some individual districts will experience problems during the current recession. Yet the bond market does not have ready access to the information that would allow it to distinguish between strong and weak Mello-Roos districts. In fact, one of the major reasons why the market overreacts to press reports is that there is a limited amount of relevant financial information available on individual districts.

In the absence of the information needed to discern weak and strong credits, the negative publicity focusing on the problems of individual districts may continue to tarnish the overall market for Mello-Roos bonds, thus raising the cost of capital for Mello-Roos issuers. There are two basic policy options available to address this problem. One option is to upgrade the credit quality of the entire market by establishing stricter issuance standards, such as minimum value-to-lien ratios, letter-of-credit requirements, or other measures. Eliminating the weaker issues would reduce the likelihood of defaults and restore investor confidence in the market. Yet this policy option requires greater state regulation and would result in diminished local flexibility. The other policy option is to facilitate the ability of the market to distinguish between weak and strong credits by improving the flow of information pertaining to individual Mello-Roos districts. To the extent that an improved flow of information would (1) permit investors to discern credit quality variations between Mello-Roos bond issues, and (2) reduce the impact of unsubstantiated rumors, all Mello-Roos issuers would likely benefit (in the form of lower capital costs).

In our view, the latter option offers the best course of action for California at this time. Because the problems experienced in individual districts to date are not representative of the entire market, we do not see the advantage of taking actions that would curtail issuance volume. The policy objective should be to make the primary and secondary market for Mello-Roos bonds operate more efficiently and to accurately reflect the degree of risk associated with these securities. This objective may be served best by establishing a reporting requirement for Mello-Roos districts. Though such a requirement would undoubtedly impose costs on

issuers, these costs may be infinitesimal when compared to the savings resulting from the improved functioning of the bond market.

Of course, information is only useful if it is accurate and reflects some standardization between districts. In this regard, there appears to be a problem with land value appraisals conducted for Mello-Roos bond issues according to different standards. Given the importance of land values in determining the creditworthiness of Mello-Roos bonds, there may be a statewide interest in establishing uniform appraisal standards for Mello-Roos bond issues. It is not enough to collect information; the information must be accurate.

FINDING #3

Improved Disclosure to Homebuyers Should Permit the Housing Market to Function in a More Competitive Manner.

Proposition 13 has effectively reduced the property tax burden in established areas of the state, but it also has necessitated the use of Mello-Roos financing and other financing tools in developing areas of the state. As a consequence, the modern California real estate market is characterized by disparities in tax rates between communities--and even between neighborhoods within communities. In a competitive real estate market, tax differentials not matched by equally valuable service differentials should be capitalized into lower and higher housing values. Homebuyers need to be aware of these tax disparities in order to make informed purchasing decisions.

A consensus is emerging that the current law requiring disclosure of the special tax lien to prospective homebuyers is inadequate. First, the disclosure occurs after the homebuyer has already decided to purchase the home at a specified price. Second, the buyer might not appreciate the financial implications of disclosure, given the volume of paperwork which must be processed at the close of escrow. Consequently, there would appear to be a public interest in amending the disclosure requirement to make it more effective. In order for the housing market to operate in a competitive manner, homebuyers need to be fully aware of the financial consequences of purchasing a home in a Mello-Roos district.

FINDING #4

The "Landowner Vote" Is a Necessary But Imperfect Form of Democratic Expression; Additional Taxpayer Protections May Be Warranted.

The vast majority of Mello-Roos bond issues are authorized through a vote of landowners, who receive one vote per acre or portion thereof. The necessity of the landowner vote stems from the simple fact that real estate development requires significant infrastructure investments before improved properties can be marketed and sold. The purchasers of the improved properties essentially "vote with their

feet" by making the decision to move into the Mello-Roos district and assume the responsibility for the tax payments.

While the landowner vote may be necessary for the early installation of infrastructure, it is often used to authorize bond issues extending decades into the future. It is true that prospective homebuyers are not forced to acquiesce to the terms and conditions established through the landowner vote; they are free to move elsewhere. Yet it is also true that even improved disclosure to homebuyers may not effectively convey all of the pertinent information that the homebuyer should know, such as how the tax formulas will operate, or that the projects scheduled for funding may be subject to change. Consequently, it may make sense to restrict the scope of agreements which may be reached between local governments and developers through the landowner vote. There may be opportunities to give CFD resident a greater voice in the tax and spending decisions of their communities.

Recommended Changes to the Mello-Roos Act

RECOMMENDED CHANGES TO THE MELLO-ROOS ACT

The following recommendations are intended to provide the Legislature and Governor with advice and counsel on ways to improve (1) the fairness of the special tax, (2) the administration of community facilities districts, and (3) marketability of Mello-Roos bonds. This report is not intended to imply support or opposition for any particular bill which may come under consideration by the Legislature.

RECOMMENDATION #1

Amend the Notice of Special Tax Requirement to Improve Disclosure to Homebuyers.

Several of the witnesses at the hearing commented on the inadequacy of current law regarding the disclosure of the special tax lien to the homebuyer. Under current law, the disclosure of the special tax lien is included in the Department of Real Estate Preliminary Title Report, or "White Report," which is required for most subdivisions and is given to the homebuyer at the close of escrow (Business & Professions Code Section 11010). If a White Report is not required, the purchaser must sign a "Notice of Special Tax" at the close of escrow which discloses: (1) that the property being purchased is, or will be, subject to a special tax; (2) the maximum annual amount of the special tax and the number of years for which it will be levied; and (3) the types of facilities or services to be paid for with the proceeds of the special tax (Government Code Section 53341.5).

Two main criticisms of the current disclosure requirement are that (1) the disclosure occurs after the buyer has made the decision to purchase the property, and (2) the buyer may not appreciate the financial implications of the disclosure, given the volume of paperwork that must be completed at the close of escrow. The Department of Real Estate White Report is a lengthy document that includes legal documentation concerning the title of the property, soils conditions and other information. Few people actually read the entire document; therefore, its usefulness as a disclosure mechanism is questionable.

These criticisms are important because the efficient operation of the housing market, like other markets, depends upon the timely flow of information. Ordinarily, the imposition of the special tax on a property should cause a buyer to reduce his or her bid for the property, unless the property will receive higher service levels than comparable properties outside the CFD (see CDAC Report, pages 37-38). In a competitive housing market, the buyer should discount his or her bid price for the property by the present value of the future stream of special tax payments associated with the property. In that manner, the higher annual special tax payments are offset by lower annual mortgage payments, due to the lower purchase price. However, a buyer unaware of the existence of the special tax, or a buyer who has negotiated the purchase price prior to being notified of the existence of the special tax, will not be in a position to discount his or her bid for the property.

Consequently, we recommend that the Notice of Special Tax provisions be amended to (1) advance the disclosure requirement to the time that the buyer bids on the property by signing the contract of purchase, and (2) disclose more information about the special

tax and the projects that it will fund. The same disclosure requirement would apply to both the initial sale of homes in new CFDs and subsequent sale of homes in CFDs. It is envisioned that the Notice of Special Tax would remain unchanged for subsequent purchases of homes within a CFD.

Specifically, we recommend that the Notice of Special Tax form include the following information:

(1) A statement that the property is subject to the special tax, which is in addition to the regular property taxes and any other charges, fees, and special assessments on the parcel.

(2) The amount of the maximum special tax which may be levied on the property, the duration of the special tax, and where applicable, information as to how the special tax may be prepaid.

(3) Where applicable, a statement that developed and undeveloped property will be taxed at different rates and that more information on the special tax formulas may be obtained from the issuing agency.

(4) A description of the facilities and services which will be paid for by the special tax, along with the cost estimate prepared for each facility and service.

(5) In cases where the CFD will finance school facilities, a statement indicating whether school attendance policies may limit students within the CFD from attending schools constructed with special tax proceeds.

(6) A statement indicating that the information in the Notice of Special Tax dates from the original sale of property and that current information may be obtained from the issuing agency.

(7) A requirement that the prospective buyer sign and date the Notice of Special Tax form prior to entering into the contract of purchase.

This notification requirement would apply prospectively to all home sales in CFDs occurring after the effective date of the authorizing legislation.

RECOMMENDATION #2

Establish an Annual Reporting Requirement for Mello-Roos CFDs.

Another cause for concern cited by many witnesses at the hearing is the lack of ongoing information on the status of individual CFDs. While information concerning the status of development and the amount of indebtedness is provided in the Official Statement for each bond sale, this information becomes dated rather quickly, due primarily to the dynamics of the real estate development process. Investors considering the purchase of Mello-Roos bonds on the secondary market face the time-consuming task of gathering current information on the

status of these districts. In turn, these information barriers inhibit the liquidity of the secondary market for Mello-Roos bonds.

An illiquid secondary market may actually drive up yields in the primary market--to the extent that investors are wary of buying bonds that will be difficult to unload later on. In the absence of timely information, the bond market is more likely to react to press reports which may or may not be accurate. Moreover, concerned taxpayers have no source of information on the status of the CFDs where they presently live or where they may choose to relocate. For these reasons, we believe that investors, taxpayers, homebuyers, and local governments would benefit from a better flow of information concerning the status of Mello-Roos CFDs. (In fact, the California Public Securities Association has already begun a data collection effort aimed at evaluating the financial condition of Mello-Roos CFDs.)

Of course, the establishment of an annual reporting requirement for Mello-Roos CFDs would undoubtedly impose costs on local governments. The policy question for legislative consideration is whether the benefits of such a requirement would outweigh the costs. In our view, issuers would benefit from a reporting requirement, to the extent that an improved flow of information would permit investors to make more accurate evaluations of the risks associated with individual Mello-Roos bond issues--resulting in lower yields. It is true that individual investors and bonds funds can independently seek the information needed to make such evaluations. But it seems justifiable to ask the issuer to collect this information and place it in the public domain, instead of requiring this effort to be duplicated countless times by different investors.

In addition, the stream of data generated by a reporting requirement would permit state policymakers to evaluate the financial condition of CFDs on an ongoing basis. Such information would provide an objective basis for determining whether additional changes to the Mello-Roos Act are warranted in the future.

Consequently, we recommend that an annual reporting requirement be established for Mello-Roos CFDs. Specifically, we recommend that the governing board of each CFD be required to report the following information to CDAC at the conclusion of each calendar year:

<u>Development Status</u>

1. *Number of residential properties developed in the prior year.*

2. *Square footage of commercial and industrial properties developed in the prior year.*

3. *Current assessed valuation of developed and undeveloped properties.*

4. *Number and sales prices of properties sold in the prior year.*

<u>Capital Projects Status</u>

1. *A progress report on construction activity (status of individual projects included in the Notice of Special Tax)*

2. Fund balances in CFD construction accounts

CFD Financial Status

1. Reserve fund balance.

2. Capitalized interest fund balance.

3. Tax delinquency rates.

4. Foreclosure actions initiated by the CFD to remedy special tax delinquencies (number of actions and dollar amount of delinquencies).

5. Outstanding principal and interest amounts.

6. Debt authorization levels.

In addition to the annual reporting requirement, we recommend that the governing board of CFDs be required to submit an addendum to the annual report if, at any time during the year, one of the following events takes place: (1) a scheduled debt service payment is missed; (2) funds are withdrawn from the reserve fund to meet a scheduled debt service payment; or (3) an owner of 10% or more of the property within the CFD declares bankruptcy.

This reporting requirement would apply to all existing CFDs. Local agencies would be permitted to charge a fee to offset the administrative costs of collecting this information. Local agencies would no longer be required to comply with the reporting requirement once the value-to-debt ratio of the CFD can be demonstrated to be at least 10:1 (in accordance with the appraisal standards expected to be promulgated pursuant to SB 1464).

Unless inaccurate information has knowingly been reported, neither the reporting local agency or CDAC shall be liable for reporting inaccuracies. CDAC would be required annually to publish and make available all annual reports submitted by CFDs.

RECOMMENDATION #3

Limit the Annual Increase in the Maximum Special Tax on Residential Properties to Two Percent (2%) for Landowner-approved Financings.

Many of the witnesses testified that the Mello-Roos special tax is more acceptable to the community if it is not subject to large fluctuations. A common method employed by the development industry to safeguard against large fluctuations is to limit the annual increase in the maximum special tax to two percent (2%). Although there does not appear to be a problem with local agencies exceeding this

threshold, the enactment of this standard into law would provide added protection to taxpayers.

Consequently, we recommend that the annual increase in the maximum special tax on residential properties be limited to two percent (2%) for landowner-approved financings. This limit would apply to all special taxes authorized after the effective date of the bill and would apply only to developed properties after occupancy.

In cases where special tax payments support the provision of services, rather than capital facilities, ongoing costs will be affected by the rate of inflation. Consequently, the appropriate inflator in these cases is the state and local deflator for goods and services, which typically is higher than 2 percent.

These limits would apply to maximum tax rates, not the tax rates actually levied by CFDs. Consequently, it is possible that special tax bills could increase by more than 2 percent annually.

These limits would not apply to *registered voter-approved financings.* CDAC believes that the electorate within a voter-approved CFD should be allowed to determine the level of annual special tax increases that best suits local situations and preferences.

RECOMMENDATION #4

Require Timely Joint Financing Agreements Which Ensure Greater Involvement of Responsible Agencies.

Several witnesses commented on the practice of developers approaching different government agencies in the same area for the purpose of securing the most favorable terms for a Mello-Roos transaction. This practice, known as "Mello-Roos shopping," can result in one agency issuing a large share of bonds for purposes outside the general responsibilities of that agency.

While it might seem advisable merely to outlaw this practice, substantial written testimony received by CDAC advocated the need for this type of flexibility. For instance, in some cases larger agencies with experience in Mello-Roos formation can assist smaller entities by issuing on their behalf. Moreover, there may be a need for coordinating multijurisdictional facilities construction which is best handled through the creation of one CFD. Finally, several agencies may choose to come together in order to realize economies of scale with regard to bond issuance costs.

Nevertheless, there can be potential fallout from the practice of Mello-Roos shopping. For example, it can undermine the efforts of responsible local agencies to dictate to developers the permissible terms and conditions of Mello-Roos financings. It can also result in developers and their consultants overwhelming less sophisticated agencies which do not have experience with the Mello-Roos Act and lack the staff resources to thoroughly review developer proposals. Finally, it can lead to situations where the legislative body of a CFD has little expertise or

interest over the improvements being financed, thereby reducing the level of scrutiny and proper management which might be applied to these transactions.

In order to maintain the benefits provided through cooperative CFD financial arrangements, yet curb some of the problems associated with Mello-Roos shopping, CDAC believes that greater attention must be paid to the joint exercise of power agreements and joint community facilities agreements which govern these cooperative efforts. These agreements can be strengthened in at least three ways.

Currently, the Mello-Roos Act *permits* agencies to enter into these agreements in cases where benefits can be demonstrated. While such agreements are routinely entered into in cases where a number of jurisdictions will be responsible for CFD improvements, there is no statutory provision to require it. Enacting such a requirement would ensure that all responsible public agencies have been properly noticed and involved in the creation of the CFD.

Second, agreements can be entered into any time prior to the formation of the district. Consequently, agreements may come after a public hearing has been conducted on formation of the district, thereby reducing potential scrutiny and attention which might help strengthen such agreements. Due to the nature of the landowner vote, the public hearing process is one of few safeguards which ensures that all relevant financial matters have been addressed. To the extent that the public hearing results in changes which affect financing agreements between agencies, there would be sufficient time to amend such agreements prior to the formation of the district.

Finally, the current provisions of the Mello-Roos Act provide no guarantee that agencies which will benefit significantly from the improvements being financed will play a significant role in monitoring or administering the construction of such improvements. As a result, a school district might end up overseeing sewer improvements, even though the school district has no specific expertise over such affairs. This problem can be exacerbated when an agency other than the one which issued the bonds ultimately becomes responsible for maintaining such improvements.

Accordingly, we recommend that the Mello-Roos Act be amended to require that (1) joint exercise of power agreements or joint community facilities agreements be entered into when the CFD improvements being financed extend to more than one agency, (2) such agreements be subject to the public hearing process which occurs prior to the adoption of the resolution of formation, and (3) joint financing agreements spell out the terms and conditions governing the construction, inspection, and acceptance of improvements subject to the agreement, including which agencies shall be responsible for overseeing and inspecting such improvements.

RECOMMENDATION #5

Require that Substantial Redirection of Funds be Subject to Majority Protest Provisions.

Under current law, the types of facilities and services to be funded through the CFD must be specified in the resolution of intention to establish the CFD

(Government Code Section 53321). The governing board may subsequently eliminate facilities or services from this list at its discretion, but it may not fund facilities or services which were not identified in the resolution of formation (Government Code Section 53330.7). The governing board is required to develop cost estimates for the facilities and services to be funded through the CFD (Government Code Section 53321.5), but the governing board retains complete discretion to change the amount of funds devoted to the projects identified in the resolution of intention.

The flexibility retained by local officials to re-allocate funds between different projects was a source of contention for certain Mello-Roos taxpayers who testified at the hearing (see testimony of John Beckley and Donald Swift). These taxpayers were particularly concerned by decisions made by their local officials to divert funds away from projects which would confer direct benefits to residents of the CFD towards projects that provide a more regional benefit to be enjoyed equally by residents outside of the CFD.

Many local officials and industry professionals maintain that CFDs should not be bound to the cost estimates prepared at the time of the resolution of intention. They argue that the long time horizons involved with multiphased CFDs make it difficult not only to estimate project costs, but even to identify which projects will need to be funded through the CFD. Because of this uncertainty, the projects identified in the resolution of intention often reflect a "laundry list" of projects which may ultimately be financed through the CFD. The size of the bond authorization is determined by underlying land values and tax capacity, rather than by a meaningful capital expenditure plan. These local officials and industry professionals argue that requiring voter consent for fund redirections could inhibit their ability to fulfill the various mitigation measures imposed as a condition of development approval.

At a minimum, the flexibility granted to local officials to make substantial re-allocations of funds presents a disclosure problem. Homebuyers in CFDs have no assurance that their special tax payments will be used to fund the projects disclosed at the time they purchased their homes. To the extent that funds subsequently are diverted away from neighborhood projects toward more regional projects, for example, taxpayers justifiably may feel that they have been subjected to a game of "bait and switch." If local governments are not required to (1) identify precisely the projects that will be funded through the CFD or (2) adhere to specific cost estimates, the value of including this information in the initial resolution is severely undermined. If the public interest is served by granting public officials such broad latitude, it would make more sense merely to authorize a blanket tax levy to be used at the discretion of the local agency, without maintaining the veil of capital budgeting and planning. We do not believe that such latitude is either necessary or reasonable.

In our view, the taxpayer protections in the Mello-Roos Act could be strengthened by granting CFD residents the right to review any substantial re-allocations of CFD funds between projects. There is no reason to believe that voters would object to perfectly legitimate fund redirections, necessitated by the preliminary nature of the original cost estimates or the subsequent availability of unanticipated revenue sources for certain projects. However, voters might object to any proposed redirection of funds which fundamentally alters the arrangements disclosed at the time they purchased their homes. In such instances, we believe that there should be a mechanism to provide voters with a voice in these matters.

Consequently, we recommend that a noticed public hearing be required if a proposed re-allocation of CFD funds would result in a deviation of more than 20 percent from the original cost estimate prepared for any project identified in the resolution of intention. The public hearing shall provide for a majority protest (i.e., at least 50 percent of the electorate objecting) terminating the redirection of funds.

This requirement would apply prospectively to all CFD fund redirections occurring after the effective date of the authorizing legislation.

RECOMMENDATION #6

Require that School District Attendance Policies Give Priority Consideration to CFD Residents.

One great advantage of the Mello-Roos Act is that it can be used to finance public facilities which provide a general benefit to the community. Schools, police stations, and other public facilities which confer "general" benefits may be financed through Mello-Roos special taxes. By contrast, special assessments may be used only to finance improvements which confer "special" benefits to the assessed property.

However, testimony offered at the Mello-Roos hearing in Orange County indicated that this flexibility was being abused by local officials in at least one instance (see testimony of Robert Beaulieu). In the City of Tracy, Mello-Roos CFD taxpayers are financing the construction of new schools, yet not all of these taxpayers are permitted to send their children to these schools. Instead, their children are transported to other schools within the school district, while children residing outside the CFD are assigned to schools financed through Mello-Roos special taxes.

City and school district officials contend that Mello-Roos CFD taxpayers are "buying capacity in the system," not necessarily acquiring the right to send their children a specific school--even if that school is within close proximity and funded through their Mello-Roos tax dollars (see written testimony of Dan Bort and Deborah Bailey). Commenting on the policy of guaranteeing Mello-Roos taxpayers access to Mello-Roos schools, Mr. Bort asserts "the [Tracy] School Board believes this would create a divisive *first* and *second class student* distinction which it prefers to avoid".

Defenders of this policy have noted that homeowners within CFDs understood "the deal" when they purchased their homes. Yet the taxpayers who testified at the hearing contend that they were not informed of the controversial school attendance policy when they purchased their homes. In fact, these Mello-Roos taxpayers indicate that they would not have purchased their homes had they been informed that they would wind up paying for schools which their own children would not be permitted to attend. Thus, at a minimum, it appears that greater disclosure is needed regarding policies which limit the access of Mello-Roos taxpayers to facilities financed through their tax payments. (This issue is addressed under Recommendation #1.)

While the use of Mello-Roos financing should not dictate school attendance policies, it must be recognized that Mello-Roos financing might not be the appropriate financing vehicle in cases where the pursuit of broader societal goals severs the link between taxes paid and benefits-received. Taxpayers within Mello-Roos CFDs are already burdened with significantly higher tax payments than residents of other areas of the state; it is questionable public policy to require them to pay for facilities from which they will not derive a direct benefit.

Nonetheless, several school officials have pointed out to the Commission many of the complexities involved in the annual process of establishing school attendance policies. Because annual enrollment growth cannot be accurately predicted, it may not be possible to guarantee all CFD residents space in CFD-funded schools. Moreover, school attendance decisions often must be subordinated to broader desegregation and diversity policy goals. Consequently, the goal of providing a direct benefit to CFD taxpayers may come into conflict with other concerns which must be balanced by school officials.

While Mello-Roos financing may not be the ideal financing option in cases where school districts cannot ensure a direct benefit to CFD taxpayers, it realistically may be the only option available. Thus, it is likely that school districts will continue to find themselves faced with the conflict between taxpayer considerations and other educational goals. In order to resolve this conflict in a manner that is fair to CFD taxpayers, school officials should make every attempt to place students residing within a CFD in those schools paid exclusively or primarily with Mello-Roos special taxes.

Accordingly, we recommend that school officials be required to adopt school attendance policies which give priority consideration to Mello-Roos students who wish to attend Mello-Roos schools. Unless school officials can cite and document overriding reasons for denying such access, any student living within a CFD would be allowed the option of attending a school constructed with Mello-Roos special taxes.

Other Issues for Legislative Consideration

OTHER ISSUES FOR LEGISLATIVE CONSIDERATION

Although the January 15th hearing was extremely productive, it did not reach a consensus on all of the important issues surrounding the Mello-Roos Act. One issue that deserves the attention of the Legislature concerns the level of subsidy provided to developers by the Mello-Roos Act. Another issue involves establishing maximum Mello-Roos special tax rates. A third issue concerns the need for uniform appraisal standards for determining land value in Mello-Roos CFDs. While the Commission believes that it would be premature to offer specific recommendations on these topics at this time, it does seem reasonable to forward these issues to the Legislature for further deliberation and discussion. These issues are discussed below.

ISSUE #1

The Subsidization of Developers by Homebuyers in Mello-Roos CFDs

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The Commission heard conflicting testimony on the whether the implementation of the Mello-Roos Act results in homebuyers subsidizing developers. Specifically, three provisions of the Act give rise to this concern: (A) the taxation of developed properties at higher rates than undeveloped properties within CFDs; (B) the *cross-collateralization* of properties in CFDs, which refers to the practice of raising taxes on nondelinquent properties (up to the maximum rate) to cover tax delinquencies on other properties; and (C) the capitalization of up to two years of debt service payments into Mello-Roos bond issuances.

The public policy of subsidizing development is not something unique to the Mello-Roos Act; as discussed in the CDAC report, public subsidies have traditionally played a major role in the development of California (see CDAC report, Chapter I). What distinguishes the Mello-Roos Act from more traditional public subsidies is that Mello-Roos subsidies are paid from a very narrow tax base (developed property within a CFD), as opposed to the broad-based subsidies which existed prior to the passage of Proposition 13.

While the issue of subsidies to developers warrants close legislative attention, it must be noted that the three aforementioned security features of the Mello-Roos Act clearly strengthen the credit quality of Mello-Roos bonds. Therefore, any reforms intended to diminish these subsidies could affect how investors perceive the creditworthiness of Mello-Roos bonds in the future. In addition, the subsidies may help to ensure that certain development proposals are financially viable. The elimination of these subsidies could result in a lower level of development activity, thereby restricting the new supply of homes and leading to higher average housing prices.

A. Tax Differentials on Developed and Undeveloped Land

The Mello-Roos Act contains perhaps the most permissive set of tax provisions in California law, insofar as the tax rate and method of apportionment is left to the discretion of the local agency imposing the tax. In practice, most Mello-Roos special tax formulas tax undeveloped properties at lower rates than developed

properties. The point in the development process where property is reclassified as "developed" is also left to the discretion of the local agency, but generally the reclassification occurs when the building permit is drawn.

At the CDAC hearing, Carla Stalling, speaking on behalf of Harry Clark of Muni Financial Services, suggested that the tax differential between developed and undeveloped properties results in a subsidy to developers. Ms. Stalling noted that developers favor Mello-Roos districts over assessment districts because the Mello-Roos Act permits the tax burden to be shifted to developed land. Conversely, developed and undeveloped properties are taxed at the same rate under the special assessment acts. She reported that her firm has experience with CFDs where the undeveloped land never carries a tax burden because the initial year's debt service is covered through capitalized interest, and in subsequent years the tax formulas shift the entire tax burden to developed property.

A similar argument was advanced by Donald Swift, a taxpayer from the Aliso Viejo CFD 88-1. Mr. Swift stated that in Orange County it is not uncommon for developers to put 30 homes on an acre of land, each with an average Mello-Roos tax rate of $1,000 per year. Consequently, the developed land generates about $30,000 per acre, while the undeveloped tax burden typically ranges between $600 to $1,000 per acre; although the maximum tax rate might be as high as $12,000 per undeveloped acre. He reported that one bond consultant estimates that the landowner/developer will pay less than 3% of the total debt service of CFD 88-1. This example illustrates the magnitude of the subsidy by comparing the relative tax burdens according to *a common unit of measurement*--the amount of tax revenue generated per acre.

In the CDAC report, we recommended that the Mello-Roos special tax be apportioned to individual properties on the basis of *benefit-received* from the expenditures financed through the CFD (see pages 28-31 of the report). In other words, Mello-Roos special tax formulas should attempt to treat similar properties as equally as possible. Because the concept of *benefit-received* is not directly measurable, we noted that special tax formulas typically use the physical dimensions of the property, such as square footage and acreage, as a proxy for benefit-received; similar to the manner in which special assessments are apportioned to individual properties.

To promote the goal of tax equity, we recommend in the CDAC report that developed and undeveloped land be taxed at the same rates, as a general policy (see CDAC report, pages 62-63). We recognize, however, that there may be a justification for taxing developed land at higher rates to pay for the early installation of certain large infrastructure items, such as water supply systems and sewage treatment plants, which must be installed with significant excess capacity because of economies of scale in construction. Nevertheless, the evidence presented at the hearing suggests that the disparities in developed and undeveloped tax rates serve more often to subsidize undeveloped properties, rather than to reflect differences in benefits-received by different properties in the CFD.

Conflict Between Equal Tax Rates and Residential Rate Tax Stability in Multi-phased CFDs. One argument presented against taxing developed and undeveloped land at the same rates concerns the impact of such a policy on residential tax rates for multi-phased CFDs. The problem, simply stated, is that if developed and undeveloped land is taxed at the same rate, subsequent bond issuances would require sharp increases in residential tax rates above the maximum acceptable rate

increase of 2 percent annually. Conversely, if undeveloped land is taxed at a lower rate, the undeveloped land "absorbs" the additional debt service requirements of subsequent bond issuances when it is reclassified as "developed" land (and is subject to higher tax rates).

In our view, while this argument is correct mathematically, it does not present a persuasive case for maintaining the status quo. The broader question that needs to be asked is whether the design of special tax formulas should be subordinated to the goal of accommodating serial bond issuances extending many years into the future. Many CFDs are formed with enough bonding capacity to address service levels for decades into the future, conceivably because of the difficulties faced by issuers in obtaining taxing authority through conventional means. Don Swift reported that the Aliso Viejo CFD 88-1 is authorized to issue bonds exceeding *a quarter of a billion dollars*, to be supported by special tax payments of CFD residents extending well into the next century (see written testimony of Donald Swift).

In such cases, local officials appear to be relying on the landowner vote to lock-in long-term public financing for CFDs. While the landowner vote is necessary for the early installation of public facilities in developing areas, it is not clear that it should be used to authorize serial bond issuances extending decades into the future. For the areas *outside* of CFDs, local officials traditionally go to the voters to address long-term public financing needs. Despite the difficulties presented by current two-thirds voter-approval requirements, it might not be unreasonable to give CFD residents the same voice on tax and service level decisions as residents outside of CFDs, once development proceeds beyond its initial stages.

However, the desire to avoid two-thirds voters approval requirements is not the only reason that many Mello-Roos CFDs lock-in long term public financing for decades into the future. The other reason for doing so is that development projects typically are approved subject to various service level mitigation measures (i.e., adequate school, freeway, and sewage treatment capacity). The inevitable service level impacts of development cannot be deemed as mitigated if the financing needed to construct additional facilities is subject to voter approval at some point in the future. By locking-in long term public financing through a large initial bond authorization, local officials gain some assurance that needed public facilities will ultimately be constructed.

Accommodating Multi-phased CFDs. Consequently, we recognize that some developments may require multi-phased CFDs and that Mello-Roos tax policy should be flexible enough to accommodate these instances. As mentioned above, we recommend that "benefit-received" serve as the guiding principle of tax equity. To avoid sharp increases in residential tax rates while applying the benefit principle to multi-phased CFDs, we recommend that the CFD be divided into improvement areas whenever possible (see CDAC report, page 30). By forming improvement areas, each phase of the development pays for its own infrastructure, which permits the debt service costs of serial bond issues to be isolated on the benefitting areas. In cases where serial bond issues are needed for facilities that will benefit the *entire* CFD, it is possible to accelerate special tax collections during the earlier stages of the debt service schedule to maintain level tax rates over time. The surplus revenue can be used to downsize future bond issues.

Even with the institution of improvement areas, we recognize that requiring a minimum tax on undeveloped property, coupled with the 2% annual cap on

residential tax rate increases (Recommendation #3), could inhibit the implementation of some multi-phased CFDs. In such cases, the CFD governing board would have to seek voter approval for future bond issues, thereby promoting the goal of giving CFD taxpayers a voice in future tax and spending decisions. In cases where public agencies want to retain the flexibility to implement a multi-phased CFD through the landowner vote while ensuring that undeveloped land carry some of the tax burden, a reasonable compromise might be to set the minimum undeveloped land tax at one-half the rate levied on developed land. Setting the minimum tax at that level, coupled with the 2 percent annual cap on residential tax rate increases, would leave room for serial bond issues, while simultaneously restricting the authorization of decades worth of bonds through the landowner vote.

B. The Cross-Collateralization of Property in CFDs

Most Mello-Roos tax structures provide greater than 1.0 debt service coverage; that is to say the maximum tax rates typically generate 110% or more of the revenue needed to meet debt service requirements. In the event of higher-than-expected tax delinquencies, the tax rates on nondelinquent properties can be raised to cover tax delinquencies on other properties. This "cross-collateralization" of properties in CFDs provides added assurance to investors that debt service will not be interrupted by low to moderate tax delinquency rates.

But the cross-collateralization of property can also cause equity problems if the nondelinquent taxpayers are not eventually compensated for their subsidization of delinquent taxpayers. Anecdotal evidence suggests that local debt management practices vary in this regard: in some cases, delinquent tax payments and penalties are used to lower residential tax rates in subsequent years; in other cases, delinquent tax payments and penalties are used to replenish the bond reserve fund and the nondelinquent taxpayers are never compensated for the subsidies that they paid to cover tax delinquencies. As noted in the CDAC report, developer cash-flow difficulties often lead to a higher rate of tax delinquencies on undeveloped properties. In such cases, the buyers of homes in a new development may be forced to subsidize the developer by paying higher taxes.

One proposal that has been suggested to simplify the tax structure and eliminate this source of subsidy is to require that residential properties be taxed at fixed dollar amounts, similar to assessment districts, rather than through complicated tax formulas. By taxing residential properties at fixed dollar amounts, residential tax rates could not be increased to offset the tax delinquencies of developers and other taxpayers.

In evaluating this proposal, we would remind the Legislature that the bulk of the subsidy to developers stems from the tax differential between developed and undeveloped properties, *not from the cross-collateralization of property.* The cross-collateralization of property provides a limited source of subsidy to developers. Requiring that residential properties be taxed at a fixed rate would eliminate this source of subsidy, but it would not prohibit issuers from setting the fixed residential tax rate at levels much higher than the tax rates levied on undeveloped property. In addition, issuers may respond to the elimination of cross-collateralization by requiring higher debt service coverage ratios--in excess of 110 percent. High debt service coverage ratios might be the only way to safeguard against higher-than-expected delinquency rates.

While the establishment of fixed residential tax rates would achieve the goal of simplifying Mello-Roos tax formulas, it could weaken the credit quality of Mello-Roos bonds, by eliminating the ability to cross-collateralize properties. The establishment of fixed residential tax rates would not itself result in a major reduction in the level of subsidies flowing from homebuyers to developers, unless the fixed residential tax rate was coupled with a minimum tax rate on undeveloped property, as discussed above.

C. The Capitalization of Interest

Finally, the Mello-Roos Act permits up to two years of interest payments to be "capitalized" into the bond issuance. In other words, the bond issuance can be sized to include the first two years of debt service payments, to reduce the tax liability of the landowner/developer during the construction period. While capitalized interest clearly can improve the credit quality of Mello-Roos bonds, the extra funds borrowed will eventually have to be paid back, with interest, over the remaining maturity schedule of the bonds. Consequently, capitalized interest can amount to a significant subsidy from homebuyers within a CFD to the developer.

Some of the testimony questioned whether two years of capitalized interest provides an excessive subsidy to developers. Some amount of capitalized interest is needed to cover debt service during the time that the county assessor is adding the special tax to the tax rolls on a parcel-by-parcel basis. However, a period of one year should be adequate for this purpose. Beyond that point, the public policy question becomes whether the added security to investors afforded by the capitalized interest results in a lower price for the bonds, offsetting the subsidy from CFD homebuyers to developers.

ISSUE #2

Limiting the Maximum Special Tax Rate.

The Mello-Roos Act does not limit the maximum tax rate that may be levied on individual parcels. Given that overlapping government entities can each form Mello-Roos CFDs over the same area, there is a danger that overlapping tax rates could become onerous. Many residents of developing areas of the state, in fact, live in multiple CFDs. In the CDAC report, we recommended that local governments adopt guidelines to limit the total Mello-Roos tax on each parcel to one percent of assessed value and to limit the total property tax burden on each parcel to two percent of assessed value. These limits are commonly accepted as industry standards, though there may be individual cases where the tax burdens exceed these levels.

Although there does not appear to be a problem with Mello-Roos special taxes exceeding the thresholds above, there are two reasons why the Legislature may want to consider enacting these limits into law for *landowner-approved financings*. First, the "landowner vote," through which most Mello-Roos bonds are authorized, is at best an imperfect tool of democratic expression. Even if the Legislature were

to enact legislation to improve the disclosure of the special tax to homebuyers, there may continue to be reports of homebuyers who were unaware of the financial consequences of their decision to purchase a home in a Mello-Roos CFD. For that reason alone, it may make sense to limit the level of taxation which may be imposed on a parcel through the landowner vote.

Second, the tax burden in Mello-Roos CFDs could become a detriment to the marketing and sale of the improved properties if the maximum tax rates are permitted to exceed the levels specified above. If developers are unable to unload these properties, the security of the bonds may be threatened. Again, the enactment of statutory tax rate limitations on landowner-approved financing could avoid this problem.

Undesirable Consequences of Tax Rate Limitations. In considering statutory tax rate limitations on landowner-approved financings, the Legislature needs to be aware that such limitations can produce an unhealthy competition between overlapping governmental entities for available debt capacity. Each local government serving the developing areas might be tempted to approve the formation of a CFD and issue bonds before the available taxing or bonding authority is fully utilized. The danger is that available debt capacity will be squandered on lower priority facilities that could be phased-in later, leaving the developing area without the resources to address immediate needs.

For this reason, we continue to recommend that local governments adopt the *Planning Guidelines* outlined in the CDAC Report (see pages 57-59). Essentially, these guidelines require cities and counties to view the available tax capacity of developing areas as a shared resource to be used to mitigate the negative service level impacts of growth. In our view, the incentive for overlapping local agencies to compete for available debt capacity is diminished if each agency can be assured that either their service level needs will be addressed or the development will not be permitted to proceed. The *Planning Guidelines* provide a rational framework for overlapping agencies to coordinate their planning activities and allocate the available debt capacity on a priority basis. .

In conclusion, the Legislature may want to consider the issue of Mello-Roos tax rate limitations within the broader framework of growth management policy. It may make more sense to first define the financial responsibilities of local agencies for mitigating the service level impacts of growth before considering the issue of Mello-Roos tax rate limits. Otherwise, the unhealthy competition for tax capacity described above might result. Given that presently there does not appear to be a problem with local agencies exceeding the 1 percent tax rate threshold, it might not be necessary to codify this limit at this time.

ISSUE #3

The Need for Uniform and Independent Land Appraisals

Much of the discussion at the hearing focused on the credit quality of Mello-Roos bonds. Several witnesses pointed out that Mello-Roos bonds are ultimately secured by the value of the land in the CFD. The Mello-Roos Act provides for rapid foreclosure proceedings to remedy tax delinquencies. Under such action, delinquent parcels are sold to pay off the tax delinquencies. Consequently, credit analysts typically focus their attention on the *value-to-debt ratio*, or *value-to-lien* ratio. A rule of thumb among investors is that the value of land plus improvements should be at least three times as high as the value of all outstanding indebtedness on the property. The 3:1 value-to-debt ratio provides some assurance that foreclosure proceedings would generate sufficient revenues to pay investors, even if land values decline. The CDAC guidelines recommend that local issuers adopt the 3:1 value-to-debt ratio as a minimum issuance standard, and at least one witness suggested that the Legislature may want to enact this requirement into law (see testimony of Dean Mysczinski).

Uniform Appraisals. However, one problem with relying on the value-to-debt ratio as a measure of credit quality is that no industry standard exists for appraising the value of land. Among professional real estate investors, property values typically are estimated by developing a discounted cash flow analysis of the property. The rental value of the property over time is discounted by the rate of return available on alternative investments. To develop a discounted cash flow analysis, the appraiser needs to make assumptions about (1) the buildout of the development, and (2) the value of the properties at buildout. The problem is that these assumptions are essentially subjective, despite the technical nature of appraisals.

Until some consensus can be reached as to how property values should be determined, enacting a minimum value-to-debt requirement into law might not translate into a meaningful standard of creditworthiness. A more meaningful measure might be to establish standards for the appraisal of property within CFDs, thereby assuring the bond market that a reliable and somewhat objective standard exists. The Uniform Standards of Professional Appraisal Practice could serve as one model for this purpose. Otherwise, value-to-debt ratio comparisons between bond issues may continue to be a questionable exercise.

Independent Appraisals. A related issue raised at CDAC's hearing on the Mello-Roos Act concerns the use of appraisers hired by the developer to determine the value of property within the CFDs. Testimony offered at the hearing focused on the ethical dilemma that is created when an appraiser, paid directly by the developer, must render a judgement which will have a direct impact on the size of the bond issue. Thus, the concern centers on whether an appraisal might be inflated in order to permit a larger bond sale which benefits the developer.

While CDAC does not possess any documented evidence which indicates that this has occurred, the Legislature may nevertheless want to review whether it makes sense to require that all appraisers involved in Mello-Roos transactions be the agent of the sponsoring public agency, rather than the agent of the developer. This policy might also be extended to the hiring of other professionals involved in the transaction (e.g. financial advisors, absorption study specialists, and tax consultants).